

**FILING YOUR TAXES: AN OUNCE OF PREVENTION  
IS WORTH A POUND OF CURE**

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**HEARING**  
BEFORE THE  
**COMMITTEE ON FINANCE**  
**UNITED STATES SENATE**  
ONE HUNDRED TENTH CONGRESS  
FIRST SESSION

APRIL 12, 2007



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## **FILING YOUR TAXES: AN OUNCE OF PREVENTION IS WORTH A POUND OF CURE**

**THURSDAY, APRIL 12, 2007**

U.S. SENATE,  
COMMITTEE ON FINANCE  
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:02 a.m., in room SD-G50, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Lincoln, Wyden, Stabenow, and Grassley.

### **OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE**

The CHAIRMAN. The hearing will come to order. Benjamin Franklin once said that an ounce of prevention is worth a pound of cure. It is an old expression, but no less true today than when old Ben said it over 200 years ago.

We keep fire extinguishers in our homes in case a fire breaks out. We take vitamins every day with the hope they keep us healthy. We believe that these are good up-front actions we can take to prevent bad things from happening later.

Today's hearing will demonstrate that up-front measures are necessary to prevent inaccurate or false tax returns from being filed. The quality of tax return preparation has a direct effect on tax compliance as it applies to the tax gap.

The IRS says the tax gap—the difference between taxes legally owed and taxes timely paid—is, in gross sense, about \$345 billion every year; that is, legally owed but not collected—\$345 billion a year.

The IRS says we have a voluntary compliance rate of 84 percent. Raising that voluntary compliance rate by 1 percentage point will yield an additional \$25 billion each year to pay for priorities like children's health care, energy independence and other issues, and other matters, without raising taxes on anyone.

Allowing tax non-compliance to continue is unfair to the majority of our Nation's taxpayers who pay the taxes they owe. Not forgetting that we are very quickly coming upon a deadline date for filing our returns, it is a very appropriate time to be addressing this issue.

Last year paid preparers filled out 60 percent of the individual tax returns that were filed—paid preparers, 60 percent. That means that the accuracy of 80 million tax returns depends on the education, skill, and integrity of tax professionals.

Given the enormous effect of compliance on the tax gap, it is reasonable to expect that tax preparers will meet high standards of competency and trustworthiness. I know many fine tax preparers in my own State of Montana. The vast majority are honest, they are professional, they make every effort to stay up to date so the returns they prepare are accurate.

Unfortunately, that is not always the case. Anyone can hang out a shingle. Anybody can charge fees to prepare a tax return without passing a single test or establishing that he or she can be trusted with the Social Security number and other personal and financial information.

The problem is much broader than that. Every year millions of taxpayers flock to national preparation chains confident that their tax returns will be prepared accurately and their personal information will be protected. Yet, last year, the Government Accountability Office conducted an undercover investigation for the Committee and found that 19 out of 19 preparers at national chains filled out very simple tax returns incorrectly. That is, all of the 19 examined improperly filled out their returns—all 19 of the firms that were examined by the GAO.

These preparers took dependents and exemptions they should not have, failed to report cash income they should have. Some failed to follow due diligence procedures with the earned income tax credit. The GAO referred these cases to the IRS for appropriate action—all of them—referred to the IRS.

Tax preparation firms have an obligation to ensure that the quality of the returns prepared under their purview is topnotch. To do this, they must provide training, establish basic competency standards, and monitor the quality of client interviews as the tax returns are being prepared. They need to hire professionals. They need to hire persons with integrity. IRS must also step up to the plate with effective oversight for tax preparers.

Last week, the IRS—and the Department of Justice, I might also add—issued civil injunctions on franchises of a major national tax preparation firm for using phony W-2s, creating false businesses, and claiming exorbitant credits. I commend the IRS and the Department of Justice for strong enforcement of these egregious cases.

However, although injunctions are impressive and effective, few preparer oversight issues rise to the level of an injunction. That is why the IRS must not shortchange the day-to-day routine of preparer oversight.

It has been a full year since the GAO conducted its undercover investigation, and, to our knowledge, the IRS has not contacted preparers, has failed to initiate any audits in connection with the undercover operation, and so far the IRS follow-up has been delayed by more studies, more red tape, more bureaucracy, and I think it rises to the level of an outrage.

The IRS's failure to take decisive action on these high-profile cases that may not rise to the standard of an injunction sends a message to other preparers that it is okay to be incompetent, it is okay to cheat the government just a little bit.

Obviously, the IRS cannot visit each paid preparer. That is why it is important for the IRS to have robust up-front processes so it knows the caliber of those who are authorized to file returns, both

on paper and electronically. That is why the IRS must clamp down on the use of stolen identities to file fraudulent tax returns.

That, too, is becoming a much greater issue. It is so easy these days, electronically, to engage in identity theft, so easy to steal one's identity, Social Security number, and other forms of identification. It is so easy to end up filing a return, ask for a refund—it is so easy to do these days. All done without the aid or assistance of a preparer—just done by individuals who, on their own, figure out how to game the system very effectively.

So, I urge us to do all we can today to get to the heart of this, that we give some confidence to Americans who are filing their returns. Clearly, our voluntary system is further shaken by more revelations, by more problems, by a feeling that, heck, the IRS is not doing its job. Then voluntary compliance becomes a bit shaky. That is clearly something we cannot let happen.

Today's witnesses will bear out Mr. Franklin's wisdom. Their testimony will demonstrate that our Nation's tax system is only as good as the quality and ethics of our nation's tax preparers. And also the competence of the IRS to assure that bad people do not do bad things on their own, with or without preparers.

The Commissioner will describe the IRS's efforts they say they are conducting to oversee preparers and also with respect to the filing season processes. I am very interested in hearing what he has to say.

Eileen O'Connor will relate how identity theft increasingly is being used in connection with fraudulent claims. She will tell the committee about recent injunctions in connection with scams and schemes perpetrated by unethical preparers and promoters.

Michael Phillips and James White will talk about the IRS filing season processes and whether they are effective, in their judgment, at deterring and detecting filing abuses.

And, Mr. Evangelos Soukas, currently serving a sentence for crimes including identity fraud and submitting fraudulent claims to the IRS will explain to us, to the world, how he received thousands of dollars in fraudulent refunds from the IRS by using stolen identities before he was apprehended. And, I might say, he was discovered not by IRS, but by the FBI in relation to other crimes, other investigations with respect to Mr. Soukas; it was not by IRS, not directly.

Together these witnesses will demonstrate that paid preparers substantially affect the level of tax compliance. Filing season processes are vulnerable to abuse today. Their testimony will lay the foundation for legislation that Senator Grassley and I will introduce again to strengthen the regulation of paid preparers and to protect the security and privacy of our country's taxpayers and to secure the privacy of Americans' private financial information.

I thank the witnesses for appearing before the committee today. We very much look forward to their testimony.

Senator Grassley?

**OPENING STATEMENT OF HON. CHUCK GRASSLEY,  
A U.S. SENATOR FROM IOWA**

Senator GRASSLEY. Thank you very much for holding this hearing on the rules and responsibilities of the tax community. I think

everybody on my side of the aisle would associate myself with your remarks and for sure, I do. The only thing that I would ever change about this hearing is just the title of it. I think I would call it "Sharks in the water—let the taxpayers beware," because of the increasing amount of danger that is involved with either honest inaccuracy or even fraudulent taxpayer preparation of returns. You probably know the statistic that 62 percent of taxpayers use paid tax preparers.

So naturally, these preparers have a direct and substantial impact on tax compliance. And while I believe that most tax return preparers are honest, knowledgeable individuals who serve the community well, there are clearly some sharks in the water, preying on innocent taxpayers either through bad advice, incompetence and the most disgusting of all, downright fraud. Just look at the recent allegations against Jackson Hewitt as an example. These franchisees took taxpayers, in many cases, for a washing. These allegations are very disturbing considering that this firm is the nation's second-largest tax preparation firm.

Examples of fraud involving this firm—and these were alleged as recently as April 3—filing false returns, claiming refunds based on phony W-2 forms, using fabricated businesses and business expenses on returns to claim bogus deductions. Claiming fuel tax credits in absurd amounts for people not entitled. Massive fraud relating to claiming of Federal Earned Income Tax Credit. While it is great news that the IRS and the Department of Justice were working to close down these fraudulent tax preparations, it is too bad it was not done early in the year, because we just have 2 weeks, well now, just almost 2 days left, in the filing season.

Last year's undercover investigation of paid preparers has already been spoken to by Senator Baucus. I was going to speak about that at length as he did. There is no point in my doing that. But, I think it surely indicates that the lifeguard is asleep at the chair, particularly since the Government Accountability Office had pointed out just how dangerous the tax preparation waters can be.

I will talk at length of that in a statement I will put in the record.

The IRS and the Justice Department need to pick up the pace on the cases that Senator Baucus has referred to. There is too much of a snail's pace approach to this work that the Government Accountability Office has pointed out very well. In fact, that was the subject of a hearing we had last year—you may have mentioned that in your statement.

Consequently, we are not sending the right message to the paid preparer community that we, as an agency, take this problem as seriously as we should. Because paid preparers need to know that they are going to be held accountable. The IRS and the Department of Justice need to be proactive in getting that message out.

But another area that needs some proactive attention by the agency is that of stolen identity. This is one of the fastest-growing crimes in the United States. And, filing false returns is one way that that is enhanced. Yet, the IRS seems to have no systematic way of identifying cases involving claims of identity theft or what the impact of these cases is in terms of aggregate dollar value of the refunds issued.

Resolution of cases involving identity theft, obviously, can be time-consuming, frustrating, and difficult for the victims, especially when the IRS is not reaching out to help the taxpayers who fall victim, but seems to be interrogating the honest taxpayer as if that taxpayer were a crook.

We here in Congress need to do more to ensure that those who are preparing returns are competent and ethical, and our legislation deals with that. In looking at the bill we are introducing, we need to consider whether the law, as it stands today, provides adequate protection to victims of identity theft whose information is used in the filing of false returns and what can be done better to assist these taxpayers in resolving their cases with the IRS.

When it seems like the IRS is on the honest taxpayer who, in one instance I know about, there was not even a return filed, and it was quite obvious that the identity had been stolen, but the honest taxpayer was being asked questions about what the thief had done, these are things that we need to resolve to the benefit of the honest taxpayer.

I am going to put my entire statement in the record. Thank you.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. Thank you Senator very, very much. You have been a real leader in this effort.

Our first witness this morning is Mr. Evangelos Dimitrios Soukas, who was convicted of crimes including identity theft and filing false tax returns and is currently serving a prison sentence in the Federal prison in California.

He is here today by writ of habeas corpus issued by Judge Thomas Hogan, April 10. Judge Hogan is the Chief Judge of the U.S. District Court for the District of Columbia.

Mr. Soukas, thank you for appearing today. After you complete your testimony, each member of the committee will then ask you questions and, when we finish with the questions, you will then be excused. Thank you very much for attending. You may begin your testimony.

**STATEMENT OF EVANGELOS DIMITRIOS SOUKAS,  
INMATE, CALIFORNIA FEDERAL PRISON**

Mr. SOUKAS. My name is Evangelos Dimitrios Soukas. I am currently serving time for wire fraud, mail fraud, fraudulent use of another person's means of identification, and identity theft resulting in false claims to the IRS.

To hijack the personal information of someone is not hard at all. Social Security numbers are available in many places for a common thief to obtain. For example, telephone company, insurance card, workplace, school records, and the list goes on. The system, in my eyes, is inviting criminals like myself to steal from the IRS, banks, and etc.

In March, 2000, I came across an advertisement on the Internet that states "receive your tax refund within days of filing."

For a criminal already on the run from the FBI, this was an easy way to make money quickly if I was able to be successful. I clicked on the advertisement and was directed to the H&R Block website.

After looking around on the website, I started to file a tax return for myself by entering all of my personal information, then making up a W-2 entry on the website which I copied from my mother's tax return.

It took me a couple of hours to work it out to make the tax return look legitimate.

Then I came across a problem. The site requested a 9-digit tax code for employer filed. I did not want to use my mother's employer code, so I contacted one of my past employer's Human Resources and requested the 9-digit code. I got the code instantly and continued the process on the website.

When I finished the preparation, I had a refund of \$3,614, then sent the filing to the IRS via the H&R Block website.

Then I got an offer to apply for an anticipation loan and to receive my refund within a few days of approval of the IRS. So I applied for the simple loan, and a few days later I received the money in my checking account.

On a few filings, I was not offered the anticipation loan, so I had to wait for the refund to be deposited into my checking account by the IRS. The ironic thing is that the IRS system never detected that I was using the same checking account number for all the fraudulent filings.

I did not know if the scheme was going to work, but it was worth a try to see if it was going to happen. In only a few hours I had made \$3,614. My first thoughts were—

The CHAIRMAN. How much was that—how much did you make?

Mr. SOUKAS. \$3,614. My first thoughts were, this is a really easy way to get money, and, if I wanted to, I would be able to hijack other people's identities and never get caught if I were to take the necessary precautions.

The following year, after January 1, I went into overdrive and quickly started filing false claims to the IRS through numerous websites, with other people's personal information that I had used in past crimes of identity theft.

I was successful on many attempts that netted me \$43,600 in 2001, by simply doing the same thing as the year before, but using hijacked identities. But that year, I was doing it at an average of 2 hours to file for each return. I was a little careless about depositing the money into my own checking account.

I could have easily opened up false checking accounts online and have the money fed into a fraudulent account and never been traced back to me. But, I had this mentality that I was in Greece and the FBI was not able to capture me, so I really did not care if I was using my personal information.

On a few occasions, I called the IRS call center. I was checking on the status of the false returns I had placed. Most of the time the automated service would answer my request by entering in the Social Security number and the exact amount of the refund and then they would tell me the status of the refund.

On a few filings I was denied and I wanted to see what happened. So, I requested to speak to the IRS representative to request what happened to my tax return. I would give information that was wanted to grant access to that IRS file by stating that I

was the Joe Doe and gave the Social Security number and exact amount of the refund.

Then the IRS representative would state the problem and tell me I would have to file the return by paper, which I never did.

I would have continued this scheme in the following years, but I moved on to bigger and better things to make more money in different areas of fraud.

In 2003, an IRS agent had made contact with my sister to find out where I could be found. My sister informed the agent I was on the run from the FBI and to contact the FBI agent in charge of my case.

My sister gave me the contact information of the IRS agent, and I had given him a call for the reason of finding out what he had on me pertaining to the IRS. I spoke to him briefly, and I was honest to him, and the one question that stuck in my head was that he asked if I had any professional training in tax preparation.

I simply responded by saying, no. I just have a high school diploma and never took any training in tax preparation.

The agent found it hard to believe I was able to do well with what I was doing with no education in taxes and simply called me a genius. I simply responded by telling him that it does not take a rocket scientist to do what I have done. After that, I ended the call and never heard from him again.

After my arrest 2 years later, I had seen my discovery from the prosecutor's office that showed in the report that IRS has spent countless hours investigating me, with many field agents taking statements from the victims of my crimes. If my memory serves me correctly, the IRS spent around 250 hours on my case in total, from what it said in the IRS report.

In my eyes, it does not take an Einstein to file false tax claims; it is actually pretty easy. If I really wanted to continue in this field I could have safeguarded my true identity and never been caught.

What I do not understand is why doesn't the IRS have some type of security measures by issuing out a PIN number or even using a mother's maiden name when filing electronically, or even calling in to the call center. There should be some type of extra measure to safeguard the people's tax records, in my opinion.

The CHAIRMAN. Thank you, Mr. Soukas, very much.

[The prepared statement of Mr. Soukas appears in the appendix.]

The CHAIRMAN. Basically said, it is easy to do.

Mr. SOUKAS. True.

The CHAIRMAN. And it is easy because it is pretty easy to steal identification?

Mr. SOUKAS. Yes.

The CHAIRMAN. That is number one? And it is pretty easy, to just electronically, to file a false return and steal somebody's W-2, find somebody's employer identification number, and even if you use your own checking account—and it is an hour's work—and jiggling things around a little bit—you are able to do pretty much what you want to do. Is that basically it, or is that not?

Mr. SOUKAS. True. You can safeguard yourself by opening up a checking account in somebody else's name with that stolen identity and have that debit card sent to you to wherever you are at. How

will the IRS ever catch you if you are using somebody else's—their identity and their ATM card? There is no—

The CHAIRMAN. Could you describe a little more for us, I find it humorous and sad, and a little bit disgusting, that you were able to call the IRS to get help to perpetrate your fraud, basically. Could you describe that in a little more detail, please?

Mr. SOUKAS. When I called the call center, the automated service would let me know it was declined. So I called the call center. I asked for a representative and I gave them my information—the person's information—I was acting as a person—and they were friendly to me on the telephone—they didn't know, you know—I assume they didn't know it was fraudulent. They were telling me what I had done wrong and how I should—I need to file the return in paper form to fix the problem.

But on one occasion, I was playing with the numbers one year and I wanted to find out if I could really see if I could get a tax refund for \$36,000 for myself. The year after I practiced on myself, on the second time I tried to put \$36,000, and when I called in, she is like, well this does not look good because you put a refund for \$36,000, you know. She was talking to me normal, you know, and I said, oh, I must have made mistake—played it stupid, you know. Oh, I must have added an extra zero somewhere, you know. They were pretty friendly to me.

The CHAIRMAN. But still, the IRS asked you to file a paper return?

Mr. SOUKAS. Yeah. They told me to do, I do not remember in detail what they told me because I did not care—I just didn't want to hang up the phone. I just had to listen to, you know, play out the conversation to the end.

The CHAIRMAN. Why did they want a paper return?

Mr. SOUKAS. I do not remember—I cannot remember.

The CHAIRMAN. Why do you think? Is it because, maybe, they detected something?

Mr. SOUKAS. I think they found it—there was a couple of errors and they wanted me to do it in paper form. Send in the W-2 forms and all that. I think I was being audited.

The CHAIRMAN. Do you know of others doing the same thing?

Mr. SOUKAS. I do not know any, myself, others, but I am sure there are other people doing it. If I stumbled across this on accident, you know—I didn't think about, you know, oh, okay, let me see if this would work, you know.

The CHAIRMAN. And, again, how were you finally discovered? What led to the investigation and the conviction? How were you discovered? How did IRS come upon you—that is my question.

Mr. SOUKAS. I don't know. I did not read in to that report.

The CHAIRMAN. But you were a fugitive.

Mr. SOUKAS. Yeah, I was a fugitive already.

The CHAIRMAN. And were those related crimes?

Mr. SOUKAS. Yeah. Yes. I was using those names with other identities—I was applying for other—like other credit, you know, trying to hack into their credit reports, and all that stuff.

The CHAIRMAN. What do you think the IRS could do? To prevent—apply it to your case, personally. What could or should, perhaps, it have done to—



Mr. SOUKAS. They should have a code—like banks use a mother's maiden name, you know. Like the year before's tax refund amount, you know. Give that exact number or use it, I would say, mother's name, you know. Those two together would be pretty foolproof to add. It can eliminate the fraud in an electronic way. I do not believe there are people doing it the old fashion way, sending it in. That just takes too long.

The CHAIRMAN. And so in your experience, they did not do anything to check on PIN number, mother's maiden name? There is no way to confirm that your data is accurate or not accurate?

Mr. SOUKAS. No.

The CHAIRMAN. They just accepted it?

Mr. SOUKAS. Yes. It is easier to get money from the IRS than from a bank, or even calling the department store, you know, call center for a credit card.

The CHAIRMAN. And you used your same checking account for all of your activities?

Mr. SOUKAS. Every single one.

The CHAIRMAN. And the total amount that you were able to fraudulently obtain was how much?

Mr. SOUKAS. I believe it was, what I gathered was—

The CHAIRMAN. I heard you say \$43,000.

Mr. SOUKAS. \$43,600.

The CHAIRMAN. Well, thank you very much. This has been distressing, but hopefully your testimony is going help prevent this from reoccurring. Thank you very much. Senator Grassley?

Senator GRASSLEY. Very interesting. I hope it doesn't give people ideas they can get away with what you are doing.

The CHAIRMAN. It gives me a lot of ideas. [Laughter.]

Senator GRASSLEY. But, I would also hope that you are evidence of the consequences of doing that.

I think I am headed down for the first question—or it is not really a question—just an affirmation on your part where Senator Baucus took you.

I think it is fair to say that when you claimed these fraudulent returns and you were able to come up with identifying information that you used, both for the taxpayer you claimed to be and for any potential employer you listed, that this was very easy. I think you made that point in your statement. I think you made this point here, but you want to leave the bottom line in here that this was very, very easy for you to do. Is that fair to say?

Mr. SOUKAS. Yes.

Senator GRASSLEY. I want to emphasize it. Very, very easy to do. At the same time, that I think you are trying to tell us that there are things that are very easy for the government agency to do to make it harder for people like you to do what you are doing.

Mr. SOUKAS. True. Yes.

Senator GRASSLEY. True. Okay. My next question, during your interview with members of my staff, you indicated that, while you were living in Greece, you electronically filed numerous fraudulent returns with the IRS using stolen and, as you stated, hijacked identities. As a result the IRS deposited fraudulent refunds into your personal back account although the names on the refunds were of your identity theft victims. While you were filing these

fraudulent returns, did anyone from the IRS contact you to question the validity of the refunds, in other words, somebody else's name on the check, but being deposited in your checking account? Did they ever raise that question with you?

Mr. SOUKAS. No.

Senator GRASSLEY. Never?

Mr. SOUKAS. Never.

Senator GRASSLEY. How long did it take the IRS to eventually contact you and question you about the fraudulent refunds that you received?

Mr. SOUKAS. Two years.

Senator GRASSLEY. How many?

Mr. SOUKAS. Two years.

Senator GRASSLEY. Three years?

Mr. SOUKAS. Two.

Senator GRASSLEY. Oh, 2 years. Thank you. Based on your testimony you were able to defraud innocent taxpayers and the Federal Government out of thousands of dollars. As part of your plea agreement with the government, you were ordered to pay restitution. Three questions all at once.

Was the IRS able to recover any of the fraudulent refunds that you received? What did you do with the funds you received as a result of your fraudulent activities? And, do you currently have any assets available to you to repay the IRS?

Mr. SOUKAS. The first one was, no, they didn't recover any of the funds. The money that I used at the time was, I traveled to different countries. And, the third one, I have no assets to pay back the restitution.

Senator GRASSLEY. So you basically used the money to have a life of recreation?

Right?

Mr. SOUKAS. True, yes.

Senator GRASSLEY. I have no further questions.

The CHAIRMAN. Thank you very much, Senator. Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. I just have one. What strikes me is you seemed to have had a system to guarantee you these refunds. I want to hear a little bit more about what went into the system. So, when you did the identity theft, you went to a website and you filled out various forms. Tell me, if you would, a little bit, about what you plugged into these forms. What kind of numbers did you use? I would assume it would be things like salary or expenses, that sort of thing. But, tell me a little bit more about how the system worked.

Mr. SOUKAS. I had a copy of my mother's W-2 form. But that is not—I did not get in to using the child's credits or anything like that. I just made it really basic. And, from her numbers, I just multiplied it a little bit, maybe two or three times and entered it in.

It would guide you in through to the end of, you know, the questionnaire. And then sometimes it would say, you owe money. Then I would go back and change the numbers again to make it look like—for me to get a refund. And go through the process again. And then at the end, you know, I will come up with, you know, something that was under \$5,000.

Senator WYDEN. And manipulating these numbers probably took, what, an hour or so?

Mr. SOUKAS. I would, the income and the taxes—excuse me.

Senator WYDEN. How long would it take to manipulate the numbers.

Mr. SOUKAS. Not more than 2 hours.

Senator WYDEN. Mr. Chairman, what I think is really striking about this is that if you are corrupt it is pretty easy to beat the system. And what we are going to learn today is if you are honest it is pretty hard to make the system work for you. I am very pleased that you started with this witness.

The CHAIRMAN. Thank you, Senator. Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman. Could you speak a little bit more about how you were able to get Social Security numbers? We know in general how it works. But, in your case, how did you get the different Social Security numbers?

Mr. SOUKAS. In my case, I had somebody working in a cellular company, and they were just writing down the Social Security numbers and name and date of birth—what I needed, too.

Senator STABENOW. Of the customers—

Mr. SOUKAS. Of the customers.

Senator STABENOW [continuing]. Who were going in.

Mr. SOUKAS. Actually, it was an entry level job. You know—it has all that information right there, at a, you know, wireless company.

Senator STABENOW. And you are suggesting some pretty basic things. I know if somebody does banking online—a PIN number—we know those kinds of things are pretty basic. So the basics are not even there for the IRS.

Mr. SOUKAS. No. Not even my mother's maiden name. Everybody has a mother's maiden name, or a password, you know. They don't even issue that.

Senator STABENOW. Right. I am wondering just one other thing. Do you know anything about the victims—who they were—what happened—hardships caused by what you did?

Mr. SOUKAS. No, I did not read reports from them. I didn't get victim impact statements from that area—for tax fraud. I just know that one of them—I knew of an acquaintance I had—and they went to go try to file for a return and they were shocked—because they went to H&R Block, too—and they said, you already filed, you already got your return.

And so, this person was in shock. And, what is this person supposed to do? I don't know, I didn't read into it. I can only imagine.

Senator STABENOW. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator. Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman. I don't have any questions, but I just think that the witness has certainly shown us that, as we work to modernize our tax filing system, it is going to be really, really important for us to keep in mind some of the challenges we are going to face regarding security and taxpayer identification. We appreciate, certainly, you sharing that information with us and more than that, appreciate the Chairman bringing us together on this hearing.

So, thanks, Mr. Chairman.

The CHAIRMAN. Thank you, Senator. One more question, Mr. Soukas. To what extent did solicitations, or refund anticipation loans by the online tax preparers, influence your decision. Is that—enticement—is that come on—did that encourage you to go farther, or not?

Mr. SOUKAS. Yeah. That is what encouraged me the most, I believe. When I saw the pop-up on, you know, the taxes, you know, you get the pop-up saying, get your refund within days. Apply for the anticipation loans. That is what caught my eye—the anticipation loans.

The CHAIRMAN. So that is what caught your eye in the first place?

Mr. SOUKAS. That is what caught my eye.

The CHAIRMAN. In the first place?

Mr. SOUKAS. Get your money—

The CHAIRMAN. Even today, and it caught your eye—and I say okay, I have to file a false return and get a loan.

Mr. SOUKAS. Yeah. That is what—the only thing—that is what grabbed it, you know. Even though there were a few of them that I did not apply for anticipation loans, I got the money directly from the IRS a couple of weeks later. But, you know, I was not expecting that. I was more expecting the money from the loans, more.

The CHAIRMAN. Well, thank you very much, Mr. Soukas, for your very illuminating testimony here. It is riveting, it is distressing, frankly. And, we have a lot of work ahead of us, certainly the IRS does, to prevent similar crimes from recurring. I mean, frankly, the story you tell is not one to be proud of, but there is not much for the IRS to be proud of, either.

And frankly, as I see it, your tale is not just one of your own criminal ingenuity, but it also a tale that the tax system is riddled. It is riddled with technological holes, it is even broken and it is certainly behind the times.

I think the ease with which you broke the law is partially a mark of your accomplishment. I think it is more a mark of the government's failure to protect taxpayers. The government's job is to prevent people like you, frankly, from getting away with what you got away with.

So that is the real failure here. It is the government's IRS. I compliment you for suggesting ways, as tentative as they are, and as simple as they are, for the government to do a better job in preventing you in the future, and people like you from getting away with what you got away with. I thank you very, very much.

Mr. SOUKAS. You are welcome.

The CHAIRMAN. Mr. Soukas, as you are escorted from the room, I ask that members of the audience remain seated, the press stay where they are. The committee is finished interrogating the witness. Mr. Soukas, you are now excused.

Mr. SOUKAS. Thank you.

The CHAIRMAN. All right, I will call the next panel to the witness table. They include: the Honorable Mark Everson, Commissioner, IRS; Mr. James White, Director of Tax Issues with the Government Accountability Office; Mr. Michael Phillips, Deputy Inspector General for Audit, Treasury Inspector General for Tax Administration;

and the honorable Eileen O'Connor, Assistant Attorney General for the Tax Division with the U.S. Department of Justice.

Commissioner Everson, you are first. We are interested in hearing what you have to say about this.

**STATEMENT OF HON. MARK EVERSON, COMMISSIONER,  
INTERNAL REVENUE SERVICE, WASHINGTON, DC**

Commissioner EVERSON. Good morning, Chairman Baucus, Ranking Member Grassley, and members of the committee. Thank you for the opportunity to testify today. Before taking your questions on these subjects, I would like to cover a couple of points just on the filing season currently underway. I know that is always an important issue at this time.

At the IRS, we recognized some time ago that this would be a challenging filing season. As the committee knows, two of the reasons were Congress's late action on the extender legislation, which you spoke about quite a bit. And, also, the fact that we did not have an operating budget until well into February. The one-time refund of the telephone excise tax and the initiation of the split refund were also of concern.

Taken together, we anticipated the most difficult filing season in a number of years. Sitting before you today, with less than a week to go, we are keeping up with the work, and the system is functioning well. The extenders were successfully implemented, our software updates were taken care of by early February. Electronic return filing continues to grow, and our service indicators are healthy.

On the other hand, we have seen a lower than expected claim rate for the telephone excise tax and, thus far, what I would characterize as minimal interest in our new split refund program.

Along with the increase in the e-file rate, we are seeing healthy gains in our volunteer preparer returns. They are up, actually, 13 percent so far this year. And, that is a cornerstone of our outreach program. As you know, this effort helps eligible participants claim the Earned Income Tax Credit (EITC)—a very important program for us.

Probably our most significant disappointment is the fact that, while we successfully made our planned upgrade to the Customer Account Data Engine (CADE)—that is the new master file for individuals—we completed our work a number of weeks late. So, our CADE buy-ins, while still expected to more than double compared to last years, are short from what we thought they would be. But it is now running where it should be.

Let me turn to enforcement. We again enjoyed significant increases in our enforcement results in 2006. And, I am pleased to tell you that we are making continued strides in 2007. One of the things that I am proudest of is that, as Senator Grassley noted in your visit when you both came to the IRS several weeks ago, the service has restored the credibility of the enforcement programs without generating a significant amount of noise or increased allegations of infringement of taxpayer rights.

In addition, we have successfully launched the Private Debt Collection Initiative passed into law by the Congress in 2004. I understand this is a sensitive initiative; we are doing our level best to

do it correctly. And, TIGTA indicated that what we have done so far has been responsible in this program.

Concerning the '08 budget, I just want to share with the committee that I think that this is the best budget that I have seen in my 4 years at the agency. It is particularly important that it provides additional monies for IRS infrastructure and systems, which gets to some of the issues we are talking about today.

I ask the members of the committee to support the President's budget, and also, to make sure that we enact an Appropriation, or that you enact an Appropriation, before the year starts. That is really essential for a large operating agency.

Before concluding, I would like to mention next week's filing deadline. Senator Grassley, our records indicate that for the last several years, you have been a timely filer. [Laughter.]

Chairman Baucus, regrettably, our records indicate that you have been a non-filer. I am referring, of course, to Monday's filing deadline for the ACLI Capitol Challenge, a 3-mile race that will be run on May 2, to benefit the Special Olympics.

Mr. Chairman, I hope that you will join Senator Grassley and me this year, and others, for this race. I am thinking that it would be in the spirit of bipartisanship, and even, all-too-rare cooperation between the Legislative and Executive Branches, maybe the three of us could run together. Thank you.

Senator GRASSLEY. He still has until Friday at 3 o'clock—right?

Commissioner EVERSON. I think he has till Monday—I am told Monday.

Senator GRASSLEY. Okay. Well, then, he doesn't have any excuse.

Commissioner EVERSON. There is no excuse. The last 2 years he has sort of given me some excuses. [Laughter.]

The CHAIRMAN. Well, I'll have to prepare.

Commissioner EVERSON. It is only 3 miles. It is not one of your 100-milers.

The CHAIRMAN. Well, okay.

[The prepared statement of Commissioner Everson appears in the appendix.]

The CHAIRMAN. Mr. White?

**STATEMENT OF JAMES WHITE, DIRECTOR, TAX ISSUES,  
GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC**

Mr. WHITE. Mr. Chairman and members of the committee, my statement is joint with David Powner, Director of IT at GAO.

We appreciate this opportunity to support your oversight of IRS and the broader tax administration system. I will cover several topics.

First, IRS's filing season performance, so far this year, has improved in some areas, but there have also been challenges. Improvements are evident in electronic filing, which is up again—and now saves IRS about 1,700 full-time equivalent staff per year—and, use of IRS's website, which is also up.

Tax returns and refunds are being processed at about the same rate as last year. And, IRS's answers to taxpayers' questions remain accurate about 90 percent of the time.

As I said, there have been challenges. The latest release of the new returns processing system, called CADE, was delayed 2

months as the Commissioner indicated. As a result, this year, CADE should process about 17 to 19 million returns—still a big increase over last year—but not nearly as many as expected.

Use of the Free File program, an alliance of companies offering free online tax preparation and filing, is down again this year.

The telephone excise tax refund, which the Commissioner called high risk, has not affected the processing of returns or telephone service. In part, because fewer taxpayers than expected are claiming it. Those who do are claiming the standard amount. And, IRS devoted significant management attention to plan for it.

Now I want to cover some other topics.

One is how to increase electronic filing. For several years we have noted that State mandates requiring certain taxpayers to file State returns electronically have had the byproduct of significantly increasing Federal electronic filing. Thirteen States now have such mandates.

Last year we suggested that Congress consider mandating electronic filing by large preparers. Recently, we examined the impact of States' Internet return preparation and filing systems—an option that IRS does not provide. In the 8 States we looked at, however, usage was low. Perhaps because the systems only prepared State returns rather than State and Federal.

Another topic is IRS's systems modernization, critical to improving both taxpayer service and enforcement. Over the past year, IRS made further progress implementing modernization projects on time and at cost, but there were two programs that had cost overruns—CADE and modernized e-file.

IRS has also made significant progress implementing our prior recommendations to improve its systems modernization management controls. However, the needed controls are not yet fully implemented.

Future project releases continue to face significant risks which IRS is taking steps to address. For example, the delay in employing the latest release of the CADE system will likely impact the design and development of the next two CADE releases planned for later this year. We are continuing to monitor that situation.

Another topic of longstanding concern for us is the adequacy of the IRS's research into understanding the impact of service and enforcement on taxpayer compliance and the tax gap. Briefly, IRS's 2008 budget request includes a proposal for annual updates of IRS's most recent compliance study—a request that we support. A better understanding of noncompliance should help IRS better target its resources and reduce audits of compliant taxpayers.

My final topic does not cover IRS. Rather, it looks at the role of paid tax preparers, it looks at the role that paid tax preparers play in the broader tax administration system. Last year, as you noted, Mr. Chairman, we reported to this committee on errors made by paid preparers.

In visits to 19 outlets of chain preparers, we found that preparers made mistakes in every case with tax consequences that were sometimes significant. To update you on the results of that work, IRS and the paid preparer community have taken some actions. In four of our cases IRS is looking for a larger pattern of compliance

problems. The audits have not begun—they are supposed to begin this month.

IRS also told us that 10 other preparers in our sample will be visited. They have not been visited yet, but will be visited to check on compliance with particular program requirements.

We also presented our findings at IRS's six tax forums last year—large educational conferences for paid preparers. Because they help the majority of taxpayers prepare their returns, paid preparers are a critical quality controlled checkpoint for the tax system.

Mr. Chairman, this concludes my statement, and Mr. Powner and I would be happy to answer any questions.

The CHAIRMAN. Thank you, Mr. White, very much.

[The prepared statement of Mr. White appears in the appendix.]

The CHAIRMAN. Mr. Phillips?

**STATEMENT OF MICHAEL PHILLIPS, DEPUTY INSPECTOR GENERAL FOR AUDIT, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, WASHINGTON, DC**

Mr. PHILLIPS. Chairman Baucus, Ranking Member Grassley, and members of the committee, I thank you for the opportunity to testify.

My comments today focus on the 2007 filing season, identity theft, and fraud—all challenges for the Internal Revenue Service. Overall, the 2007 filing season appears to be progressing without major problems. Use of *IRS.gov* is up, while visits to the taxpayer assistance centers are about the same as this time last year. Electronic filing is also up.

TIGTA is concerned, however, that changes in the Free File agreement and elimination of the TeleFile program in 2005 may be slowing the growth in electronic filing. This slower growth makes it unlikely that the IRS will meet Congress's goal of 80 percent electronic filing by 2007.

Unlike last year, the electronic fraud detection system is up and running. Also, the customer account data engine, CADE, the foundation of the IRS's modernization program, is successfully processing tax returns. However, due to delays in implementing the most recent release of CADE, the IRS will not meet its goal of processing 33 million tax returns on the system for the year.

The greatest concern so far this season is the IRS's telephone excise tax refund program. The IRS estimated that hundreds of millions of people, including those who are not required to file a Federal tax return, would seek this one-time refund. Taxpayers may claim either a standard refund amount or an itemized refund for the actual excise tax they paid on their telephone bills.

However, to date, about 30 percent of the approximately 74 million individual tax returns processed failed to claim the rebate. Most troubling is that some paid tax preparers filed thousands of highly suspicious claims, well over the standard amounts, yet too low to trigger IRS scrutiny.

Identity theft is a growing national problem. But, identity theft cases affecting tax administration are still relatively infrequent. Of the 246,000 identity theft complaints referred to the Federal Trade



Commission in 2006, approximately 20 percent impact tax administration.

There are two primary types of identity theft that relate to tax administration. The first is an individual using another's name and Social Security number to file a fraudulent tax return in order to steal a tax refund. The second is using another person's Social Security number to obtain employment.

Although the IRS has acted to protect the personally identifiable information it collects, it needs to improve its protection of this sensitive information. In July, 2005, TIGTA reported that the IRS lacked a corporate strategy to adequately address identity theft issues.

In response, the IRS established its Identity Theft Program Office. However, most of its efforts are still reactive—assisting victims after they come forth in response to an IRS notice or enforcement action.

The IRS processes over 130 million individual tax returns annually and holds personal information on approximately 240 computer systems. Protecting the data is a significant challenge. Its sensitivity makes IRS computer systems an attractive target for hackers and others who could use the information for identity theft.

TIGTA's reviews over the past 4 fiscal years have identified persistent weaknesses, which jeopardize the security of personally identifiable information. TIGTA's most recent evaluation found that employees were not encrypting personal information on their laptop computers and other electronic media. Nor were they properly reporting incidents of lost or stolen computers.

Fraudulent claims remain a significant concern to both the IRS and TIGTA. The IRS estimates that fraudulent refund claims exceed \$500 million a year. In 2005, the IRS's criminal investigation function identified almost 133,000 fraudulent refund returns claiming approximately \$516 million in refunds. In 2006, by contrast, it identified only 45,000 fraudulent returns—claiming \$232 million in refunds.

This dramatic decrease occurred largely because the IRS's electronic fraud detection was not functioning last year.

In April, 2005, TIGTA examined refund fraud by Federal and State prisoners. TIGTA found that fraudulent prisoner returns identified by the IRS had increased by 318 percent, from about 4,300 during 2002 to more than 18,000 during 2004.

In 2005, fraudulent prisoner returns increased again to nearly 20,000 returns claiming over \$834 million in refunds. In 2006, due to the failure of the EFDS, the IRS was only able to identify about 4,200 fraudulent prisoner returns and stopped \$12 million in improper refunds. TIGTA remains concerned about the IRS's capability to identify fraudulent prisoner returns.

Identity theft is a growing problem associated with refund fraud. Of the almost 45,000 fraudulent refunds in 2006, nearly 18 percent involved identity theft. Yet, in response to the Taxpayer Advocate who took exception to the IRS's policy of automatically freezing current and future refunds of the identity theft victims, the IRS no longer freezes these accounts in subsequent years.

TIGTA recently reported that the IRS is unable to determine whether an account has been frozen because the taxpayer had been a victim of identity theft or to timely determine if that taxpayer is again a victim of identity theft.

Contrary to the position of others, TIGTA believes that allowing potentially fraudulent refunds to be paid in subsequent years will not significantly reduce taxpayer inquiries and could result in additional lost revenue and significant taxpayer burden.

The IRS could improve service to taxpayers and better protect Federal revenue if it could identify freezes associated with identity theft, notify the taxpayers, and timely resolve the freezes.

I hope my discussion of the 2007 filing season, identity theft, and fraud issues will assist you with the oversight of the IRS. Mr. Chairman and members of the committee, thank you for the opportunity to share my views. I will be pleased to answer any questions you may have.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Phillips appears in the appendix.]

The CHAIRMAN. And now, I'll turn to Ms. O'Connor. Thank you very much.

**STATEMENT OF HON. EILEEN O'CONNOR, ASSISTANT ATTORNEY GENERAL, TAX DIVISION, U.S. DEPARTMENT OF JUSTICE, WASHINGTON, DC**

Ms. O'CONNOR. Good morning, Chairman Baucus, Ranking Member Grassley, and members of the committee.

Greetings from the Tax Division of the Department of Justice for whom this is not filing season, but rather statute season. Thank you for the opportunity to appear before you this morning to discuss our enforcement work. I understand that you wish my focus today to be on the enforcement actions the Tax Division has aimed at fraudulent tax return preparation and the promotion of tax fraud schemes and scams. We have much to report in that area, and I am happy to talk about it.

By way of background, let me mention that the attorneys in the Tax Division—there are over 300 of them—represent the United States in virtually all civil and criminal trial and appellate litigation that arises under the internal revenue laws in all State and Federal courts except the United States Tax Court.

Tax Division attorneys are essential to IRS enforcement activity at all levels. When the IRS is examining an income tax return, for example, it often relies on the Justice Department's Tax Division attorneys to defend or enforce summonses during the examination. When the examination is complete and the IRS has determined that additional tax is owed, the Tax Division will represent the United States to defend its determination of that tax and to take action, if necessary, to collect the assessments. At any given time, we have nearly 7,000 civil cases in litigation and in any given year we handle approximately 700 civil appeals, including those from the decisions of the Tax Court.

The Tax Division's criminal prosecutors authorize all grand jury investigations and all prosecutions involving violations of the internal revenue laws and, alone or in conjunction with Assistant

United States Attorneys, prosecute all tax crimes. In the last few years, we have authorized between 1,100 and 1,800 criminal tax prosecutions per year.

During the nearly 6 years since my confirmation to head the Tax Division, its workload has increased and has changed in character. The cases we have now are much more labor-intensive and have much more at stake than those we faced just 8 or 10 years ago. Not only are the dollars at stake much higher, but the cases' potential impact on the ultimate enforceability of the tax laws has grown significantly.

The President's budget request for the Tax Division for the fiscal year 2008, as did the one for fiscal year 2007, requested additional resources for the Tax Division to enable us to meet the additional challenges created by the Internal Revenue Service's increased enforcement. The members of the Senate Finance Committee can appreciate more than most the importance of the Tax Division's work. I request your strong support for ensuring that tax law enforcement is appropriately funded, both at the Internal Revenue Service and at the Department of Justice, and, as Commissioner Everson emphasized, in time for it to do some good during the year. A budget that we know about halfway through the fiscal year damages our ability to accomplish our mission.

During the past year we have achieved substantial and meaningful victories in the tax shelter arena. Among other things, the Supreme Court recently let stand two important decisions of the United States Court of Appeals which validated the government's position on tax shelter cases where the economic substance doctrine was implicated.

We have also won three challenges to the government's disallowance of benefits from the so-called Son-of-BOSS tax shelter and have dozens and dozens more of those cases pending litigation.

On March 29, the law firm Jenkens & Gilchrist entered into a non-prosecution agreement with the United States Attorney for the Southern District of New York, admitting wrongdoing in connection with developing and marketing fraudulent tax shelters and providing fraudulent tax opinions that wrongly deprived the U.S. Treasury of significant tax revenues and billions and billions of dollars.

In the past several months, two defendants have pleaded guilty to felony tax charges in connection with a criminal probe of tax shelters undertaken in the United States Attorneys Office for the Southern District of New York.

Since 2001, when I came to the Justice Department, the Tax Division has enjoined more than 230 promoters of abusive tax scams and preparers of false and fraudulent returns. We have helped the IRS identify and pursue people who are responsible for promoting these scams. Last fall, Susan O'Brien and two of her colleagues were sentenced to terms in prison ranging up to 10½ years for preparing fraudulent returns. Just last month a Broward County tax return preparer was sentenced to 5 years in prison for preparing and presenting false and fraudulent Federal income tax returns.

Also last month, in Seattle, a defendant pleaded guilty to various crimes involving tax fraud and identity theft. As you noted in your opening statements, last week the Justice Department filed four

lawsuits against five corporations and 24 individuals who are operating Jackson Hewitt franchises in a number of locations.

We have, as I mentioned, over the past several years enjoined hundreds of tax scam promoters and fraudulent tax return preparers.

Thank you again for inviting me to participate in this hearing. I see that my time is up. I will be pleased to answer any questions you may have.

The CHAIRMAN. Thank you, Madam Secretary, very much for all that you are doing.

[The prepared statement of Ms. O'Connor appears in the appendix.]

The CHAIRMAN. First, turning to Commissioner Everson. You heard Mr. Soukas—so what do you have to say about all that?

Commissioner EVERSON. Let me make a couple of points. One, I commend you for getting after this issue—both—at the fraud issue. I think this is a good development that we are having this conversation after last year's conversation where the Congress basically stepped in and told us to really go slow on the questionable refund, and did, as was indicated, pressure us very directly to go along with the Advocate's position. This is a balancing question. Fraud is not a good thing. It undermines the system as you have all indicated.

But, the truth of the matter is that what we were doing was, we were screening out a lot of questionable refunds, and in some instances poor people who were actually entitled the refund—because when you are working through the systems you are analyzing the data and if it seems to be out of whack—it is different from last year or the numbers do not quite add up—then you hold that refund. That is the way the system worked—the EFDS system that Mike talked about and others, you will recall.

The CHAIRMAN. Well, I beg to differ—there is no balancing with respect to what Mr. Soukas said.

Commissioner EVERSON. Can I, can I go through this? This is a big issue and I—

The CHAIRMAN. We do not have a lot a time here.

Commissioner EVERSON. But—

The CHAIRMAN. I do not want you to filibuster here.

Commissioner EVERSON. I'm not filibustering. But, this is enough—part of the problem is—if you stop everything that you think is questionable, then you will be damaging the interest of some legitimate taxpayers. That is the first point.

I accept the fact that not all of these cases do get prosecuted. The amount of money at issue here—\$40,000—\$41,000—that case, frankly, would not be accepted by many U.S. attorneys.

The CHAIRMAN. I am sorry. You are not answering my question. I did not ask you how many issues are prosecuted or not—that is not the question I asked.

Commissioner EVERSON. I am sorry.

The CHAIRMAN. I asked you to respond to what he has been doing. This witness over here.

Commissioner EVERSON. I think it is criminally—he is doing time for it.

The CHAIRMAN. How did the IRS let him get away with that? Why isn't the IRS doing more to prevent more of those occurring? He gave a lot of ideas that the IRS can pursue—like PIN numbers, maiden names, all kinds of things.

Commissioner EVERSON. Well, Senator—

The CHAIRMAN. Why doesn't the IRS do something about that?

Commissioner EVERSON. We have active programs and if you want to ask—my answer to that question is, the first and best thing we can do is get fully funded. The Congress, in my 4 years here, the Congress has not funded \$360 million of—

The CHAIRMAN. Are you telling me that currently you cannot prevent that from reoccurring because you do not have the funds? Is that what you are telling me?

Commissioner EVERSON. I am telling you at the margin we do not go after everything we can. That is correct, sir.

The CHAIRMAN. Not the question I asked you. Why can't you do some simple things like he suggested?

Commissioner EVERSON. You mean the passwords? And, the—

The CHAIRMAN. Yeah—he said, so simple anybody can do it.

Commissioner EVERSON. We can certainly look at that. I will look at that. But, that will be costly and also I would suggest to you—

The CHAIRMAN. Costly to ask somebody to provide—

Commissioner EVERSON. Yes sir. If you ask the tens of millions—we get tens of millions of calls, as you know, and we have made every effort to make it easier to interact with the IRS—so if you call in and say, I am Max Baucus, here's my Social Security number, and this is what my return says, and you say what is the status, then you will get an answer.

You will not get any different treatment. Your return will not get there sooner or later, but if you want to get into a more detailed conversation, that is a different issue. You cannot get—

The CHAIRMAN. If I hear you, you are basically telling this committee that it is a little more difficult to screen out the Mr. Soukases of the world.

Commissioner EVERSON. At that level, at \$40,000, sir, I am suggesting to you that if we have this conversation, think about lowering thresholds, but it is a very much a tradeoff compared to audits and other issues.

Can I make one point on the resources? The combination of the money that we didn't get and the extra pay increase that was given, our estimate over my 4 years is that almost 7,000 enforcement personnel were not hired who could have been hired at the IRS to work on—and this includes a lot of criminal investigators—to work on areas like this. So, if I had to give you responses to how do you do better on this, the first thing you would do is give us our enforcement funding.

The CHAIRMAN. Well, wait a minute. You just said in your opening statement that this is the best budget ever. You are happy with your budget.

Commissioner EVERSON. Yes, but we do not get the budgets that we send up.

The CHAIRMAN. What is the difference?

Commissioner EVERSON. The difference?

The CHAIRMAN. How much did you send up? How much did you ask for?

Commissioner EVERSON. Over the last 4 years—

The CHAIRMAN. I am talking about the last budget—the last budget—the one you are happy about.

Commissioner EVERSON. The one I am happy about, we have over, we have about \$500 million of an increase, and over \$200 million is in the enforcement.

The CHAIRMAN. Well, you can decide where some of that goes. Why can't you stop some of the Mr. Soukases of the world from—you are basically saying that, if it is \$40,000, let it go.

Commissioner EVERSON. I am saying, I am not saying if it is \$40,000, let it go. What I am—

The CHAIRMAN. That is what I heard you say.

Commissioner EVERSON. No. What I said was, you will not get—in most districts across the country—you will not get prosecuted for \$40,000 of a refund crime. This is an unusual instance, I would suggest to you.

The CHAIRMAN. What are you saying to the American people—you can commit fraud for \$40,000 and you are not going to get prosecuted? Go ahead, defraud the government?

Commissioner EVERSON. I am not saying that at all, sir. I am saying that we are—we need to look at the refund program and this balancing of how we work. What we hold and then what we do not work on the audit stream, because the guide we got from this committee and others was to—if you cannot work it, then send it on—

The CHAIRMAN. My time is expired. With all due respect, that is not a satisfactory response. Senator Grassley?

Senator GRASSLEY. Commissioner Everson, to comment on the fact that, when he received these refunds, only one in four of the refunds in which Mr. Soukas requested refund anticipation loans was actually refunded. Yet, that is versus two out of three refunds paid out of the returns that did not request a refund anticipation loan. This would seem to indicate, at least anecdotally, that the banks have a better system of up-front fraud detection than the IRS does. Could you please comment on that? And then I have three other things I want comments on.

Commissioner EVERSON. Yes, yes. First of all, regarding refund anticipation loans, I consider these predatory. I have said consistently that they are a bad thing. However, we get about, there are about 10 million a year—people request the money—they want to get the money sooner. There is a debt indicator, this is very controversial, a number of Senators and others want to get rid of the debt indicator. What the debt indicator does is, it is shared with the return processor so that the refund anticipation loan is not given because there is an existing debt to the government that is there. And, therefore, you will not process that \$3,000 or \$4,000 refund request.

I think that gets at what you are talking about. People are telling us they want to get rid of the debt indicator. We had a group of people within the Service look at this, and they said you should not do that because you will get a bigger problem with more of these loans being issued.

Senator GRASSLEY. So one of the tools that banks use, you can use, but you are getting pressure not to use it. Is that right?

Commissioner EVERSON. We use it now; we've been asked to get rid of it. We think it protects people.

Senator GRASSLEY. Okay.

The CHAIRMAN. Who is asking to get rid of it?

Commissioner EVERSON. A number of Senators. Senator Akaka is very big on this, and I think there is actually some—isn't there some legislation that is moving on this? Ways and Means—I think Ways and Means—actually Ways and Means has marked something up already to get rid of the debt indicator, sir, on the other side of the Congress.

Senator GRASSLEY. Since it looks like it is easier to defraud the IRS than it is the banks, if the IRS has a tool—I am not sure that I am aware of this argument that you are making, but it is something I need to be on top of so that we watch that legislation if it is going to move.

Commissioner EVERSON. Senator, they get the information from us, is what the banks do.

Senator GRASSLEY. Senator Baucus asked you this, but I thought I would concentrate on a couple of suggestions that Mr. Soukas had about the PIN number and about the maiden name. Are you making adequate use of the maiden name, or what about the suggestion of a PIN number?

Commissioner EVERSON. I am sorry. I think we can absolutely look at this. I do want to emphasize that, as you both know from the hearings a decade ago, we wanted to make the Service more customer-friendly, taxpayer-friendly, the ability to interact—the only nice thing I thought about his story was that he was treated politely by our people—but, there is an important element of an ability to talk to the IRS. If you add those things in, for the very occasional person who calls to the IRS with a question, it is just an extra step. But I will look at it. I will see what we can do on it.

Senator GRASSLEY. You are looking at whether or not you can do it, or is there some doubt in your mind about whether or not it would help to prevent fraud?

Commissioner EVERSON. I am not sure it would get after this problem.

The CHAIRMAN. You are not? I am astounded. Utterly astounded.

Commissioner EVERSON. I am not sure—people are pretty clever about getting information right now. You have had instances where 46 million credit card numbers, and others where all the data was just stolen, just a few weeks ago. That was all revealed. So, obviously you have an infinite number of protections, sir. And, we will look at them, but they are costly.

Senator GRASSLEY. Then, also he testified that on his fraudulent schemes he filed the returns using stolen names, Social Security numbers, yet consistently deposited or attempted to deposit the refunds into one back account—and that was in his own name. Isn't this a flaw in the system?

Commissioner EVERSON. I do not know whether we would detect that or not. I do not think we are routinely—I do not know the answer to that. I will have to look at that.

Senator GRASSLEY. Well, if Chuck Grassley got a refund—  
Commissioner EVERSON. Right.

Senator GRASSLEY [continuing]. And it was going to be deposited in Jim Smith's account, wouldn't that raise a red flag? I mean, shouldn't I be getting it back?

Commissioner EVERSON. People have joint accounts they—I am not sure what the protocol is now—I will take a look at it and get back to you for the record.

Senator GRASSLEY. Okay. Mr. Phillips, in your testimony you indicated that the IRS lacks comprehensive data needed to determine the impact that identity theft has on tax administration, and that the IRS is unable to identify theft trends, or take proactive steps to identify these cases in order to reduce the burden on the taxpayers.

As the IRS Identity Theft Program Office currently operates, is it prepared to efficiently meet the needs of the identity theft victims and handle the continuing increase in identity theft being reported each filing system?

Then the last question on the same subject: What proactive measures should the IRS undertake to address the identity theft issues it currently faces or will face in the future?

Mr. PHILLIPS. As I mentioned in my testimony, the IRS established, as a result of the report that we issued several years ago, an Identity Theft Project Office, which was a positive step. Most of their efforts have been geared towards outreach and education for taxpayers and practitioners. The Commissioner and the Inspector General have just recently participated in the development of a video that approaches the issues around identity theft.

Unfortunately, the effort that has been devoted so far still does not move all the way to where the IRS needs to go in terms of helping victims of identity theft when they contact the IRS.

For example, there is not a consistent process in place throughout the IRS, so that if you as an individual contacted the IRS and said, I feel like someone has stolen my identity and used it to file a fraudulent tax return, the procedures are not consistent. And, that is one of the things that they need to continue to do. But, progress has been made.

The CHAIRMAN. Thank you very much. Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. Mr. Everson, I have been told that the written instructions that your office put out on the 1040 form inaccurately state that the tuition deduction and education expenses deduction have expired. Are those written instructions inaccurate on those two key education issues?

Commissioner EVERSON. This gets, I think sir, to the question of—that I mentioned in my statement.

Senator WYDEN. Just answer the question. Are the written instructions inaccurate? Yes or no.

Commissioner EVERSON. The Congress acted after the written instructions were written. Yes, sir.

Senator WYDEN. So the written instructions are inaccurate. Now here is what troubles me. Mr. Soukas just told us that ripping off the system is a piece of cake.

Now for thousands of teachers across this country, who are honest and are trying to comply with the system, they are going to



have to figure out how to reconcile the difference between these various instruction forms and sort out, for example, how to get a fair shake when they are trying to buy some supplies for poor kids. I think that is just a disgrace. That the honest teachers who are trying to comply and do the right thing have to go through all kinds of contortions to figure out what is right. And yet, this gentleman who ripped off the system told us it was a piece of cake. Your reaction.

Commissioner EVERSON. I agree with you, Senator. And, I think the Chairman worked his tail off to try to not have this happen. And we warned about it and screamed about it, and so did the previous Chairman, but the Congress did not act. And, we issue our instructions based on the law as it stands—not what we think you may or may not do. It is unfortunate, as you indicate.

The CHAIRMAN. Let the record show that it was the last Congress. [Laughter.]

Commissioner EVERSON. I will not go there, sir. [Laughter.]

Senator WYDEN. One step that can be taken in the right direction—this is the 1-page 1040 form that I proposed in my Fair Flat Tax Legislation. I am going to be proposing it again on Monday. Congressman Rahm Emanuel on the Ways and Means Committee in the House will be introducing it over there. Isn't something like this—it is not the entire answer—isn't something like this a step in the right direction, Mr. Everson?

Commissioner EVERSON. Senator, you and I have had this conversation before. You know I do not take particular policy position, but I absolutely am a champion of simplification. Simplification is necessary because complexity obscures understanding. It is more difficult for the taxpayer who wants to comply, to comply. And, it also presents opportunities for those who seek to be noncompliant to get around the code.

Senator WYDEN. Isn't it also correct that this would be one of the best ways to get at this problem of unscrupulous and incompetent tax preparers? Because if you could do your form yourself—the people of *Money* magazine, for example, did my form in under half an hour. If people could go out and do their own with something like this, wouldn't this be one of the ways to get at this problem of unscrupulous tax preparers?

Commissioner EVERSON. I think that that is true because our system depends on the integrity of the practitioner. But, if you go beyond the 60 percent figure that the Chairman cited, actually right now all but 13 or 14 percent of people are using computer software, either through a practitioner or themselves to prepare a return.

Most Americans could not do their return without their software. It is just so complex—but the software at least asks you a yes or no question, and then you fill in the amount.

Senator WYDEN. People at *Money* magazine did our form in under half an hour.

At the Federal level, it seems to me there are also some questions about compliance costs. Our understanding is that at the Federal level Americans now spend between 22 and 24 cents on compliance for every dollar collected. And the Tax Foundation has done some analysis indicating these compliance costs will continue for

the rest of the decade. What is the IRS doing to help bring down the cost for American taxpayers so they do not have to pay this kind of overhead cost when they do their forms?

Commissioner EVERSON. I think, sir, a lot of the burden is associated with the complexity of the code and the filing requirements. We have an Office of Burden Reduction. Wherever we can we try to simplify within our administrative capabilities—that is an ongoing process, but the real answer here—the reduction of burden—is in simplification, as you indicate.

Senator WYDEN. Mr. Chairman, I know my time has expired, but with you, Mr. Chairman, and Senator Grassley both here, I would just once again proselytize for this cause of tax simplification. I think also in the House, Chairman Rangel is very interested in this as well. So, both Chairman Baucus and Senator Grassley have talked to me about this on many occasions before. I think we have a chance to get it done now in a bipartisan way. I look forward to working with both of you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator, very much. Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman, for this important hearing and to all of our witnesses. First, just a quick follow-up to what Senator Wyden had said about the changes. We understand that, unfortunately, many of us pushed for those changes and continuations on some important tax policy to happen at a different time. But, once it did, as it related to the education tax credits, did you make any changes on your website?

Commissioner EVERSON. Oh yes. Absolutely. And, in fact, as I indicated in my statement, we had to—not only just us—this is how complex the system is—we had to work with all the software vendors so they would change their own materials. That was all done and then people were able to file by, I think it was February 3, they could file electronically under the new provisions. We updated the website and tried to publicize it, Senator, as much as we possibly could.

Senator STABENOW. Secondly, regarding again the gentleman who spoke before, I just have to say, again, as a person who does a lot of business online where there is a PIN number—

Commissioner EVERSON. Right.

Senator STABENOW [continuing]. I do not feel that that stops me one little bit—that 30 seconds worth of extra effort—that allows me to have some protection and security.

Commissioner EVERSON. Right.

Senator STABENOW. It seems to make sense. And, so I would hope—I do not want to get into a lot discussion about that—

Commissioner EVERSON. We will take a look at it.

Senator STABENOW [continuing]. But I think I would agree with the Chairman that your answer on that really is not satisfactory to people who are out there worried about what is going to happen to them. So, I hope it will not be just looking at it, but that you are going to make the change. Because this is not acceptable. I do not care, I mean, because it is simple things. It is simple things—we are not asking—we know about the budget. We are actually doing, as a member of the Budget Committee, a budget that is much better overall to meet the priorities of the country and to ad-

dress your concerns this year. But, the reality is that we are talking about pretty simple things. I am concerned that they not be dismissed.

Commissioner EVERSON. No. I do not mean to convey, I do not mean to be dismissive. I apologize if that is the impression I conveyed to you or the Chairman. It is not—I am a little frustrated—I was just frustrated. It is difficult for me to see a criminal sitting here making allegations and—

Senator STABENOW. It is difficult for all of us. And, I imagine the folks that were ripped off, in particular, the victims find the most difficulty.

Commissioner EVERSON. I will certainly follow up as you indicated.

Senator STABENOW. The question I would ask Mr. Phillips, when you were talking about it—I actually wanted to ask a question regarding the phone excise tax refund program. You spoke about individuals in that program. But, I am concerned about whether or not the IRS is inadvertently leaving out a very important group of folks which are the small businesses who also have to reply to be able to receive that refund.

We know the IRS has announced a refund of about \$15 billion in excise taxes, in long distance and bundling services, to both individuals and businesses—the largest refund ever. We also know that there is a system for individuals to receive an automatic standard deduction or apply, and so on.

But my concern is that the Padgett Foundation did a survey of small businesses regarding the current tax filing system. Of the businesses that have filed their returns, less than a third, about 26 percent, actually were able to take the credit. The reason that was cited is because the IRS is requiring them to access 41 months of records in order to receive the refund owed to them.

Now, I am introducing legislation that would require the IRS to keep the refund period open through the year and provide small businesses a safe harbor similar to what individuals have been provided, so that they get some time to be able to do the extra effort—to be able to put together the records and so on.

I wondered if you might have any thoughts about that or any suggestions. We might hear both from Mr. Phillips and Mr. Everson about what the IRS is doing, if anything, to try to facilitate small businesses.

Mr. PHILLIPS. Sure, thank you, Senator. Actually, from a personal standpoint, I did fill out the form for the excise tax refund this year. It took me about 5 hours to complete the form and, fortunately, I am a pretty organized person and had the records, so I was able to do it.

But, about 99.6 percent of the returns that have been received this year that have claimed the credit have claimed the standard amounts—the \$30 to \$60 for the individuals. There is that 30-percent range that I mentioned in my testimony that have not claimed it for unknown reasons.

I know that, as part of the work that TIGTA is currently doing, we are trying to look to see why taxpayers chose not to file either the simple form that was prepared by the IRS this year or claim it on their 1040 return. The numbers that the IRS recognizes have

been certainly lower than what was projected. They, too, are looking to see why that has occurred.

Senator STABENOW. How many of those are small businesses versus individuals?

Mr. PHILLIPS. I do not have that information right now. I do know that as of the end of March there were about 79 million returns that had already been processed, and that is where the—30 percent of those had not claimed the rebate.

Senator STABENOW. Okay. Mr. Everson, I don't know—I know my time is up, Mr. Chairman but if this—

Commissioner EVERSON. Sure. You are talking about what is the most difficult issue with the rebate or the refund. Just because the individual can claim the standard amount, but if they are a Schedule C filer, they have their own business, obviously they would use phones more, presumably, than a family. We tried to craft a methodology that we thought would sort of guide people to an easier answer. But, it can be difficult, and it is not just individuals, I would add, Senator. You have churches or charities, or other, lots of organizations that may not even file a return, but they have obviously had phones—State governments and others. It takes some time to compile the actual records if you are going to claim actuals.

Senator STABENOW. Well, do you have flexibility to be able to help them be able to keep that period open or provide some safe harbor?

Commissioner EVERSON. I do not believe we have the flexibility, because what happens is, the statute tolls, there is an amount of time that you have to refund—that is why it only goes back the 41 months, and I believe that would require a statutory change. My lawyer is around somewhere, but we will get back to you on the record. But, I don't think we can do it administratively.

Senator STABENOW. Mr. Chairman, I would hope that we might provide them with that flexibility. Thank you.

The CHAIRMAN. Thank you, Senator. Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman, and thank you for holding this hearing. It has been very helpful and informative. I just have about four questions, and I am going to throw them out there so you guys can answer them.

First of all, I have heard from several of you that the integrity of the tax preparer is very important. I want to commend the Chairman and the Ranking Member along with Senator Bingaman for the work that we all worked on—but they certainly championed last year in Senator Bingaman's Taxpayer Protection and Assistance Act.

I would like to know, particularly from Ms. O'Connor and Mr. Everson, if that is something you all would support in terms of standards for preparers and other things like that. I am assuming you all are aware of the Protection Act we passed out of the committee last year.

The other thing, on the extender tardiness, certainly we have our own issues in that, and we understand that. What I would like for you to expand on, Mr. Everson, though, is what the cost was to you in the tardiness that we had and where we could have redirected those dollars within the IRS to do more of what we really feel like needs to be done. How timely do we need to be for you to be able

to, instead of using those dollars on catch-up work, redirect those dollars to where they should be.

Mr. Phillips, in terms of identity theft, I guess we talked about—you mention that largely the IRS is just reacting. It is a reactive nature for them. Working on the front end to prevent identity theft seems like the most common-sense thing to do. Maybe you might expand on some of the things that have already been mentioned or what you think would be the most important things we could do that would deal with that. I think you have touched on some of it.

And, then last, Commissioner Everson, I wanted to commend you for the work that you have done over the last several months to improve the Free File program. I hosted a seminar in my State during the break, particularly for low-income filers, as well as community service folks, to take back the information on the Free File program that is out there. We trained several community organizations so they could go back into their neighborhoods and really make sure that everyone was aware of and knew how to use that program—particularly since its improvement. Free File really does help us to that end. Those are my questions, Mr. Chairman.

The CHAIRMAN. And all of you have only 2 minutes to answer those questions. [Laughter.]

Commissioner EVERSON. A couple of things. I think the subject of regulation of return preparers is an important one. I think it's what the Chairman is getting at, and we need to discuss that. I have said that more regulation will not necessarily get at the fraud *per se*. It will educate and help practitioners, I think, with tests, if we went down that road in terms of understanding the code.

But, if somebody wants to be fraudulent and criminal, as this individual was, they will seek a way to do that. And, that just needs to be borne in mind as we look at this question of oversight of the preparers. On the extenders, as the Chairman knows, it did have an impact on our enforcement programs, as well, from that being late and from the late passage of the budget.

The portal. That is an important question. I would suggest to you, Senator, along with the conversation of more regulation of preparers, this is the other issue that really gathered momentum last year. There are sort of two—you can bracket this in two ways. One is, just to get rid of what—a lot of people have to pay a fee after they finish the return to file it electronically. I think a large consensus is to get rid of that fee one way or another. But, at the other extreme there is the idea that the IRS should take this all over. That you would not have tax preparers, or the software providers—you ought to be able to go right to *IRS.gov* and start working on your return.

This is a delicate balance that we have right here, and even with this hearing we rely on the integrity of practitioners, and it is a big industry, of course. I have said to the Chairman when we talked about this subject privately some time ago, I do not want to get into the situation where the private sector is bashing and attacking the IRS because the government is taking away from their business, if you will.

If that happens, then you will see a great undermining of the system, I would suggest to you, because there would be a lot of al-

legations about what we are doing or not doing. So I think we need to look at all of these issues but proceed carefully.

Mr. PHILLIPS. Senator Lincoln, there are three things that I see in terms of identity theft the IRS can do, and we have made recommendations to improve.

The first is their electronic fraud detection system, which is now back up and running after being down last year. That is sort of the cornerstone for their questionable refund program and identifying questionable tax returns.

The second is their Office of Professional Responsibility, which we have reported on in the past, which has responsibility for oversight of tax professionals, the CPAs, that type of thing, to make sure that those people are in good standing, both with their own taxes, but also in how they are working with the tax paying community.

And finally, the electronic return originator program, both the screening process, when someone wants to become an electronic tax practitioner, they apply through the IRS's originator program. There are certain screening checks, including criminal background checks they have to go through. Once someone is accepted into the program they are monitored on occasion. We have made recommendations on both components of that program for improvements.

Ms. O'CONNOR. Thank you for tossing that first question in my direction. As many of the opening statements commented, the integrity and honesty of tax return preparers is very important in our system. Those are not things you can legislate. You can make sure the administrative branch is funded so that the problems can be detected, investigated, and prosecuted, and, as the Commissioner noted, the prisoner here is a prisoner. He is sentenced and he is doing 92 months for his crimes. Tax crimes were at the end of a long list of crimes that he had committed. I also hasten to point out that he was apprehended in Greece. He was a fugitive from the FBI. The Federal Government did what it needed to do to get him, to try him, to prosecute him, to put him behind bars.

Senator LINCOLN. Well, we do not doubt that you are doing your job, and that is a good example. My point is, and we are not trying to put you out of business, but we might lessen your load if, in fact, we were requiring greater standards of tax preparers, initial exams, qualifying those preparers, making sure there is continuing education, that they are aware of changes and certainly other things.

The CHAIRMAN. There is a vote going on, so we are going to have to be pretty efficient here. Thank you very much. Ms. O'Connor, I have a question about tax shelters, disclosure penalties, etc., and this Form 8886, whatever it is.

Ms. O'CONNOR. Right.

The CHAIRMAN. Namely, under the law, if a taxpayer is engaging in a shelter—a listed shelter—that has to be disclosed on the taxpayer's return. And, if it is not, there are penalties. Or, if a return is incomplete, namely it says, more information on shelters, etc.—listed shelters, we are talking about here—will be provided.

My first question is to the Commissioner on that subject. My understanding is that it has been 2½ years since legislation here en-

acted strong penalties, yet it is my information that there is not one case where the IRS asserted its jurisdiction and the agency's efforts here to assess penalties for failure to disclose a listed shelter. Is that correct?

Commissioner EVERSON. I will have to get back to you for the record on that, sir. Again, sometimes the new cases will take a while to proceed. As you know, I have been a champion of reducing that and pressing to get things resolved sooner. So, I will take a look and see what has been done.

The CHAIRMAN. It has been 2½ years according to my information. And if you get back—and I just have a bit of a sense that for some reason the IRS does not want to pursue all—

Commissioner EVERSON. If that is the case, I will make sure that is corrected. I do not think that is the case though.

The CHAIRMAN. Ms. O'Connor, let me ask you, how important is it for you in your work to have at least in your toolbox the IRS's following up on this issue? That is, issuing penalties if the form is incomplete, failure to list?

Ms. O'CONNOR. I am sorry, I do not understand your question.

The CHAIRMAN. How important, if the IRS were to do its job here, how important is that to you in prosecuting taxpayers for failure to comply here, or because they are engaging in sheltered—

Ms. O'CONNOR. Let me just say here, penalties are very, very helpful in tax enforcement. Before Congress got serious about instituting serious penalties for engaging in substantial valuation overstatement or understatement and substantial understatement of a tax liability, every tax practitioner in the world had a very easy calculus to make that just said, you know, are we going to get caught and, if we are, what is it going to cost us?

The tax and the interest, hey, the government is charging a lower interest rate than anybody else these days anyway. Once the penalties were instituted and the IRS started raising them, it is now a very different calculus.

When somebody is trying to advise a client who wants to do something that might be problematical that they are not only going to have the taxes and the interest, but also, perhaps, a 40-percent penalty. That is a very different calculus, and I think the penalties being in the law is very, very helpful.

And if you would like for us to get back to you on—

The CHAIRMAN. A very broad basic question I would like to pursue with all of you is just how well we are doing or not doing with respect to shutting down abusive shelters, you know, scams and schemes generally. What is the progress rate here?

There is a vote going on now, so you are basically all saved by the bell. I have to run right now. I do not have time to stay for the answer to the question. But if you would, the best you can, put something down for the record, because it is a huge issue. Especially as we try to get at the tax gap.

Commissioner EVERSON. Yes.

The CHAIRMAN. There is a lot involved here. It is not just what I mentioned—it is offshore accounts, lots of things going on here. Thank you very much. Senator Grassley does want to come back, so the hearing is recessed until Senator Grassley returns, which I think will be in about 5 or 10 minutes. Thank you.

[The committee recessed at 11:42 a.m., reconvening at 11:48 a.m.]

Senator GRASSLEY. I am done. You are done. That is what Senator Baucus said. I will not be very long. I did have, first of all, it is my understanding, Commissioner Everson, that you wanted to clarify something. So why don't we start out with whatever—

Commissioner EVERSON. I just wanted to come back to this question of identity theft. What I do not like to see is some impression that the system is rife with identity theft—our tax system. It is a very serious issue, and certainly for any individual who gets caught up in it, it is a horrible thing. But I do not want Americans to think that the tax system is rife with identity theft.

We talk about a noncompliance problem, something like 1 in 7—that is the overall tax gap, which you are familiar with. If you look at the number of cases that we have been working on, which involve the identity theft, which is different from refund fraud, it is in the tens or thousands—it is 31,000 or so. That is very limited compared to the 135, 136 million returns we get. I just wanted to place this in a context. We work hard to resolve these matters. I do not want anybody to believe that there is something that is happening in the tax system that is that pervasive, sir.

Senator GRASSLEY. Thank you, and I wanted to bring up, not necessarily for your comment, Mr. Everson, but to carry on a little bit about the question I asked you. This is in regard to the banks not depositing some money that may be—went directly to a taxpayer—in each case, one stopping—seemingly stopping some fraud and the other one not. And, that is, that the banks have their own fraud detector analysis that they use to help alert IRS of potential fraudulent cases. But, given the statistics that we have as a result of just the Soukas case, the banks are doing fraud detecting better, irrespective of the debt indicator. There is nothing showing that Mr. Soukas's refunds were stopped by the banks because of debt owed by the victims of that crime.

For Ms. O'Connor. You are aware of the Walter C. Anderson case. One article that I read said—they had the headline—"Biggest tax cheat in history escapes Federal tax liability." The article discusses a sloppy job that DOJ did in that case. As a result, the Justices, because of the sloppy paperwork, Mr. Anderson will not have to pay the IRS restitution ranging from \$100 million to \$175 million because prosecutors listed the wrong statute in Anderson's plea agreement. The judge said he could have ordered Anderson to repay the money as part of the probation, but prosecutors had also omitted any discussion of probation from Anderson's paperwork.

Now the IRS must bring civil charges to get the money. How does this happen? How did all the attorneys up the line miss this? And, what disciplinary actions are being taken to hold these individuals responsible?

Ms. O'CONNOR. Quite a string of questions. Let me start with commenting that headlines are not always accurate. And, the headline you just read was not accurate. Walter C. Anderson entered into a plea agreement in which he agreed to restitution. The fact that there was a scrivener's error in the plea agreement and the wrong section of the United State Code was cited, it is certainly a regrettable error. It should not, however, have prevented Judge



Friedman from ordering the restitution that the defendant had agreed to.

We requested that Judge Friedman reconsider his finding on that, and he declined to do so. Even so, however, the Internal Revenue Service was never without recourse regarding the money that Walter Anderson owes the United States. The same procedures that would have been available without the plea agreement are still available to the United States to recover any money that might be recoverable from Walter Anderson.

Other of your questions are, how did it happen? One of the prosecutors working on the case made a mistake in drafting the plea agreement. It is unfortunate that nobody noticed it until the defense attorney did at the sentencing hearing.

Again, Walter Anderson agreed to the restitution. He signed the agreement agreeing to the restitution and he will be held accountable to the extent there are funds available to pay the restitution that he agreed to. We will find them, and we will collect them.

Senator GRASSLEY. Disciplinary action?

Ms. O'CONNOR. That is still under consideration.

Senator GRASSLEY. Mr. Everson, are you going to be able to recover the \$100 million to \$175 million?

Commissioner EVERSON. I don't know the answer to that, sir. We will in all cases work to recover as much as we can. But, as you know, this is a very large sum, and Mr. Anderson went to great lengths to have a great number of complex transactions in different jurisdictions around the world.

Senator GRASSLEY. Okay. Ms. O'Connor, I mentioned in my opening statement that it is encouraging to hear that the Tax Division in conjunction with the IRS shut down several unscrupulous preparers, and I mentioned Jackson Hewitt. I questioned the timing of the Tax Division pursuing these injunctions since they happened approximately 2 weeks before the end of filing, which provided additional opportunity for these return preparers to continue with their fraudulent behavior. Why weren't these preparers put out of business before they had an opportunity to defraud the government out of possible millions of dollars this filing season? And, when did the IRS refer these cases to your office?

Ms. O'CONNOR. Senator, we brought the suits as soon as we had the information ready to make the case. No delay occurred. It is an initiative of this administration, during my tenure at the Tax Division, that we bring civil injunction suits at all. And the reason is, as you have noted, as long as these activities are ongoing, harm continues. More and more people are enabled to defraud the Federal Treasury. More and more people are going to be behind the eight ball when the IRS figures out they owe taxes and then they are going to owe penalties and interest too. And, the people who are promoting the scams get richer and richer by doing so.

So, we have undertaken to enjoin people and their activities before a criminal case can be prepared. But, we bring the cases as soon as we can, develop the facts that will support bringing them.

Senator GRASSLEY. What was the date on which you received this information?

Ms. O'CONNOR. I do not have that information ready.

Senator GRASSLEY. Would you get it to me?

Ms. O'CONNOR. If it is appropriate, I will provide that information to you.

Senator GRASSLEY. Why wouldn't it be appropriate?

Ms. O'CONNOR. Well, as you well know, Senator, section 6103 of the Internal Revenue Code provides that anything the Internal Revenue Service does, any tax return information, is information that only the Internal Revenue Service can have. Information about when we receive a referral from the Internal Revenue Service may still be 6103 information. Until we file a matter in court, and it becomes public information, it is still 6103 information which we have under our privilege with the Internal Revenue Service.

Senator GRASSLEY. What is privileged about a transfer of paper from IRS to you?

Ms. O'CONNOR. As I just said Senator, section 6103 of the Internal Revenue Code protects taxpayer information. That means the Internal Revenue Service can provide information to the Department of Justice when it believes that it is ready to ask the Department of Justice to bring suit or to file charges. Until we actually bring the suit or file the charges, no one but we and the IRS know about that referral.

Senator GRASSLEY. What you are saying is that it could have been laying around the Department of Justice for 2 years and it is nobody's business that it has been laying around there for 2 years. I think it is the business of this committee. I think it is the business of the Judiciary Committee to know how efficiently Justice is functioning.

Ms. O'CONNOR. Justice is functioning very, very efficiently, Senator.

Senator GRASSLEY. Well, that is your judgment. Constitutional oversight indicates that I ought to be able to make that judgment too.

Ms. O'CONNOR. And you very well may, sir. As I said, if it is appropriate, I will certainly provide that information to you.

Senator GRASSLEY. Okay. Mr. White, in your statement you note that the IRS is undertaking research on paid preparer compliance but that research does not fully address the Government Accountability Office's recommendations that the IRS conduct research to determine the extent to which paid preparers live up to their responsibilities to file accurate and complete tax returns based on information they obtain from their customers.

What additional research should the IRS be doing, in your opinion, on paid preparers, and how might that improve compliance? And then I would ask Mr. Everson to respond.

Mr. WHITE. Senator, first of all, since paid preparers prepare so many returns, they are, as I think your question implies, a critical checkpoint in the compliance system. There are several steps that I think could be taken. Right now, based on the work we did last year, the 19 visits that we made to large paid preparer chains, we know that there is a widespread problem out there.

But beyond that, there is not any quantitative information about the size of the problem. So last year we recommended that more be done by the Service to measure a paid preparer's compliance with their responsibilities. So, that is one thing that could be done.

Something else that could be done, there is an experiment underway right now, both the State of California and the State of Oregon have imposed various forms of legislation on paid preparers. It ought to be possible—maybe enough time has passed now—to do some research to determine what the effect of that regulation has been on the performance of paid preparers in those States.

Those are two things that could be done to get a better handle on the problem and what might be effective to address the problem.

Senator GRASSLEY. Commissioner Everson?

Commissioner EVERSON. Yes, sir. There are two comments that I would make here as to this—about the budget, I had indicated that one of the best things about the budget was the money for the infrastructure which gets to all the stuff we are talking about today.

The other thing that is great about this budget is, over \$40 million has been requested for research on the enforcement side. It will very much get at this issue. It will also help us look at the individual returns, the update on the National Research Program. So I think it is an important subject. As I have indicated, we have over a million practitioners. They are absolutely essential to the way the system functions. The more we can know about how they are actually doing it, the better off we are.

Senator GRASSLEY. Thank you all very much. The meeting is adjourned.

[Whereupon, at 12:02 p.m., the hearing was concluded.]



## **A P P E N D I X**

### **ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD**

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**Senator Maria Cantwell**  
**Finance Committee Hearing on “Filing Your Taxes:  
An Ounce of Prevention is Worth a Pound of Cure”**  
**April 12, 2007**

Mr. Chairman, thank you for holding this hearing. Tax filing season is always a nerve racking time for our constituents. One of the more important oversight responsibilities of this committee is to ensure that the IRS is doing all it can to help honest taxpayers manage their obligation to pay taxes.

As we experienced last year, Congress does not always make this an easy task for the IRS. By waiting until the 11<sup>th</sup> hour to extend important tax benefits we compounded the challenges that face both the IRS and taxpayers.

While it is good news that the filing season has gone smoothly, IRS was forced to expend additional resources because of Congress' slow action to restore and extend important tax benefits like the state sales tax deduction, which is so important to the taxpayers in my state of Washington. This deduction expired at the end of 2005 and Congress left taxpayers hanging throughout all of 2006, uncertain if their tax benefits would be restored by the time they had to file their taxes.

Most taxpayers work in good faith to comply with the law and pay their taxes. Congress should, at the very least, minimize the uncertainty that goes along with this annual obligation.

Commissioner Everson noted that the IRS conducted extensive outreach and media events to publicize the extension of the tax provisions and sent a special mailing of Publication 600, which included the state and local sales tax tables and instructions for claiming the sales tax deduction, to taxpayers who had previously claimed the state and local sales tax deduction.

These efforts were necessary and appreciated, but the additional resources IRS expended here would have been unnecessary had Congress acted before the tax forms and instructions went to print in October.

The title for today's hearing is “Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure.” We should heed that advice. While we will not face the same mad scramble for next year's filing season, the state sales tax deduction does face expiration at the end of 2007. I have introduced a bill to make the state sales tax deduction permanent, so that taxpayers can have some certainty with respect to their finances.

I hope that the Committee will act early this year on legislation addressing this important deduction and the other tax benefits that expire in 2007, so that taxpayers can plan accordingly and the IRS can make the best use of its resources.

The witnesses at this hearing also raise another area of concern—the security of personal information and the rising threat of identity theft if that information is compromised.

As was evidenced here today, once personal account information is obtained, the identity theft begins. The result is usually serious financial damage to the victims and significant losses to legitimate businesses and to the Federal government.

Mr. Soukas used at least 15 victims' names, Social Security Numbers and dates of birth to open bank accounts, to apply for lines of credit and loans on the internet, and to purchase merchandise. Using false identities, he fraudulently applied for home equity lines of credit in his victims' names and also filed false income tax returns in his victims' names in an attempt to obtain tax refunds to which he was not entitled and applied for refund anticipation loans in his victims' names.

I am troubled, as are the Chairman, Sen. Grassley, and the other members of this committee at the ease with which criminals can access and use Social Security numbers and other personal information to commit fraud.

I hope that the IRS will take a serious look at steps it can take to better identify fraudulent tax refund claims and I look forward to working with my colleagues on what additional legislative steps are needed to better protect the personal information of our constituents.

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**WRITTEN TESTIMONY OF  
COMMISSIONER OF INTERNAL REVENUE SERVICE  
MARK EVERSON  
BEFORE  
SENATE FINANCE COMMITTEE  
ON  
FILING YOUR TAXES: AN OUNCE OF PREVENTION IS WORTH  
A POUND OF CURE  
APRIL 12, 2007**

**Introduction**

Chairman Baucus, Ranking Member Grassley, and members of the Committee, thank you for the opportunity to appear this morning. While I recognize that the prime focus of this hearing is to discuss identity theft, electronic return originators (EROs), and tax preparers, I would also like to take this opportunity to update the Committee on a number of other matters relating to the operations of the IRS.

Specifically, I would like to discuss the results of our efforts in Fiscal Year (FY) 2006 to continue to balance a strong taxpayer service program with an aggressive enforcement strategy that respects taxpayer rights. I would also like to offer some details of our proposed FY 2008 IRS budget. Finally, I would like to update you on the 2007 filing season, which ends in a few days.

**Producing Results**

In FY 2006, we continued making improvements in both our service and enforcement programs. This is not just our assessment, but also that of the IRS Oversight Board in its most recent annual report. According to the Board, the IRS has made steady progress towards “transforming itself into a modern institution that provides efficient and effective tax administration services to America’s taxpayers.”

***Improving Taxpayer Service***

According to a survey commissioned by the Board in 2006, taxpayers increasingly recognize that the IRS provides quality service through a variety of channels, such as its Web site, toll-free telephone lines, and Taxpayer Assistance Centers (TACs). This is supported by the metrics that we use to determine the effectiveness of our taxpayer service efforts. In category after category, we continue to see improvement in the numbers in our telephone services, electronic filing, and IRS.gov access. This is demonstrated by the following FY 2006 business results:

- Electronic filing by individuals continued to increase. It rose three percentage points from FY 2005, to 54 percent of all individual returns.

- The level of service for toll-free assistance was 82 percent, about the same level as FY 2005 and up substantially from FY 2001. The level of customer satisfaction with the toll-free line remains 94 percent.
- The tax-law accuracy of toll-free responses improved to 91 percent and account accuracy increased to over 93 percent.
- Visits to the IRS Web site jumped nearly 10 percent in FY 2006 to more than 197 million visits.
- More taxpayers used the online refund status tool “Where's My Refund.” In FY 2006, there were 24.7 million status checks, up nearly 12 percent from FY 2005.

At the IRS, we continue to work to improve services. Clearly, we are making progress, and these numbers underscore that point.

Another development in our taxpayer service program is the Taxpayer Assistance Blueprint (TAB). This collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate began in July, 2005 in response to a Congressional mandate to develop a five-year plan for taxpayer service delivery. We sent Phase 1 of the Blueprint to Congress in April, 2006. Phase 1 identified and reported the following five strategic service improvement themes for increasing taxpayer, partner, and government value:

- *Improve and expand education and awareness activities:* This theme addresses the critical need for making taxpayers and practitioners aware of the most effective and efficient IRS service options and delivery channels for meeting their tax obligations and receiving benefits they are due.
- *Optimize the use of partner services:* This theme emphasizes the critical role of third parties in the delivery of taxpayer services, and calls for improving the level of support and direction provided to partners to ensure consistent and accurate administration of the tax law.
- *Enhance self-service options to meet taxpayer expectations:* This theme focuses on providing clear, standard, and easily customized automated content to deliver accurate, consistent, and understandable self-assistance service options—particularly for transactional tasks.
- *Improve and expand training and support tools to enhance assisted services:* This theme highlights the need for ensuring accurate information across all channels by improving and expanding training, technology infrastructure, and support for employees, partners, and taxpayers.
- *Develop short-term performance and long-term outcome goals and metrics:* This theme provides for the development of a comprehensive set of performance goals and metrics to evaluate how effectively the IRS is meeting taxpayer expectations, and how efficiently it is delivering services.

Phase 2 of the Blueprint was delivered to Congress yesterday. Throughout this project, extensive research allowed us to refine our understanding of taxpayer and partner needs, preferences, and behaviors and to identify current planning documents, decision



processes, and existing commitments affecting IRS service delivery. Certain recurring findings emerged from the wealth of data analyzed. These findings, combined with agency-wide considerations and priorities, led to the development of the five-year TAB Strategic Plan for taxpayer service.

The TAB Strategic Plan includes a suite of service improvement initiatives across all delivery channels, a portfolio of performance metrics, and an implementation strategy, which recommends numerous future research studies. The TAB Strategic Plan outlines a decision-making process for prioritizing service improvement initiatives based on taxpayer, partner, and government value and ensuring continued stakeholder engagement. This process is designed to help the IRS to balance quality service with effective enforcement to maximize compliance.

As a first step in incorporating Blueprint results into the IRS budgeting process, the FY 2008 budget request includes the funding necessary to implement some of the telephone service and Web site enhancements recommended by the TAB Strategic Plan. Enhancing telephone service will contribute to the goal of increasing taxpayer, partner, and government value. Improving IRS.gov will help us to make the Web site the first choice of individual taxpayers and their preparers when they need to contact the IRS for help.

The TAB Strategic Plan also recommends a suite of multi-year research studies to continue to refine and improve our understanding of optimal service delivery. In addition to funding for research regarding noncompliance, the FY 2008 budget includes funding for research to understand better the effect of service on compliance.

#### ***Expanding Enforcement Efforts***

Another reason for the Oversight Board's positive assessment of our work in FY 2006 is that IRS enforcement efforts have increased in virtually every area. According to the Board, "As demonstrated by a variety of measures, the IRS' performance on enforcement has improved considerably, and real progress has been achieved over the past six years."

One of the most obvious measures is the increase in enforcement revenue, which has risen from \$34 billion in FY 2002 to almost \$49 billion in FY 2006, an increase of 43 percent.

In FY 2006, both the levels of individual returns examined and coverage rates have risen substantially. We conducted nearly 1.3 million examinations of individual tax returns. This is almost 75 percent more than were conducted in FY 2001, and reflects a steady and sustained increase since that time. Similarly, the individual audit coverage rate has risen from 0.58 percent in FY 2001 to more than 0.97 percent in FY 2006.

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. The number of examinations in this category rose by almost 78 percent compared to FY 2004,

the first year the IRS began tracking audits of individuals with income over \$1 million. The coverage rate has risen from 5 percent in FY 2004 to 6.3 percent in FY 2006.

Growth in audit totals and coverage rates extend to other taxpayer categories. IRS examined over 52,000 business returns in FY 2006, an increase of nearly 12,000 over FY 2001. The coverage rate over the same period rose from 0.55 percent to 0.60 percent. For corporations with assets over \$10 million, examinations rose from 8,718 in FY 2001 to 10,578 in FY 2006, an increase in the coverage rate from 15.1 percent to 18.6 percent. For the largest corporations, those with assets over \$250 million, examinations have increased by over 29 percent growing from 3,305 in FY 2001 to 4,276 in FY 2006.

We have also been active in the tax exempt community. Overall, examination closures for tax exempt organizations have risen from 5,342 in FY 2001 to 7,079 in FY 2006. In addition, we have an innovative program utilizing correspondence contacts to leverage our activities in the compliance area. We have used it successfully in the hospital and executive compensation areas and will be using it elsewhere.

While examinations in the tax exempt community generally do not provide the tax collection "return on investment" that audits in other areas might, it is important that we keep a "cop on the beat" in order to prevent abuses in the exempt sector and an erosion of the tax base. Maintaining a strong enforcement presence in the tax-exempt sector is particularly important given the role that a small number of these entities have played in the past in accommodating abusive transactions entered into by taxable parties. In appropriate cases, this results in the collection of income or excise taxes--and in the most egregious cases, revocation of exempt status.

One area we have paid particular attention to is the credit counseling industry. Through a compliance initiative in this area, as of March 23rd, we had revoked or proposed revocation of the tax-exempt status of 45 credit counseling agencies, with another 16 examinations still in process. Proposed or final revocations to date represent 41 percent of the revenues of the credit counseling industry.

Using our correspondence contact techniques, we have also sent more than 700 questionnaires to all tax-exempt credit counseling organizations we know of that were not already under examination. Based on responses to the questionnaires and our independent research, we expect to examine at least 82 additional credit counseling organizations from this group.

We also have been actively reviewing seller-funded down payment assistance programs that provide cash assistance to homebuyers who cannot afford to make the minimum down payment or pay the closing costs involved in obtaining a mortgage. When properly structured and operated, down payment assistance programs can qualify as tax-exempt charitable and educational organizations. In May 2006, we issued Revenue Ruling 2006-27, which provides examples of organizations that may qualify for tax exempt status, but also makes it clear that organizations providing seller-funded down payment assistance do not qualify for tax exemption.

Seller-funded down payment assistance programs improperly benefit the home seller through circular funding arrangements that result in the home buyer paying for all or much of the down payment “gift” he or she receives from the organization. It also results in buyers becoming overextended as the cost of the down payment is added to the purchase price of the home. A Housing and Urban Development (HUD) commissioned study and a Government Accountability Office (GAO) report found that seller-funded programs led to underwriting problems and resulted in an increase in the cost of homeownership.

In the audits we have conducted in this area, not only have we found improper private benefit and activities, but also that the down payment assistance organizations often provide excessive compensation to their officials. Revocation of exempt status will shut down abusive seller funded programs without harming the innocent low income home buyers who participated in these arrangements.

We will continue to look at other areas within the exempt sector that have the potential for abuse.

#### **President’s FY 2008 Budget Maintains the Balance between Taxpayer Service and Enforcement**

The IRS and its employees represent the face of the Federal Government to more American citizens than any other government agency. The IRS administers America’s tax laws and collects 95 percent of the revenues that fund government operations and public services. We spent just 42 cents to collect each \$100 of tax revenue in FY 2006, the third lowest figure in the last 25 years and down from 46 cents in FY 2005.

Our taxpayer service programs provide assistance to help millions of taxpayers understand and meet their tax obligations. Our enforcement programs are aimed at deterring taxpayers inclined to evade their responsibilities, while vigorously pursuing those who violate tax laws. Delivering these programs demands a secure and modernized infrastructure able to fairly, effectively, and efficiently collect taxes while minimizing taxpayer burden.

The IRS FY 2008 President’s Budget request supports our agency-wide strategic plan as well as Treasury’s compliance improvement strategy. These documents underscore the IRS’ commitment to provide quality service to taxpayers while enforcing America’s tax laws in a balanced manner. The IRS’ strategic plan goals are:

- *Improve Taxpayer Service.* Help people understand their tax obligations, making it easier for them to participate in the tax system;
- *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 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 effectively and efficiently meet service and enforcement strategic goals.

### ***Budget Request***

Our total budget request for FY 2008 is for \$11.1 billion in appropriated resources and represents a 4.7 percent increase over the recently enacted FY 2007 Joint Resolution (JR) level of \$10.6 billion.

The IRS' taxpayer service and enforcement activities are funded from three appropriations: Taxpayer Services (TS); Enforcement (ENF); and Operations Support (OS). The total FY 2008 Budget request for these three operating accounts is \$10.8 billion, supplemented by the \$180 million from user fee revenue, for a total operating level of \$10.9 billion--a 5.5 percent increase over the FY 2007 JR level. As in FY 2006 and FY 2007, the Administration proposes to include IRS enforcement increases as a Budget Enforcement Act program integrity cap adjustment. I am pleased that both the House and Senate passed Budget resolutions for 2008 include the full cap adjustment for this activity, recognizing the return on investment from these enforcement investments.

The Budget also includes \$282.1 million for Business Systems Modernization (BSM) and \$15.2 million to administer the Health Insurance Tax Credit program--a 32.6 percent and 2.6 percent increase, respectively, over the FY 2007 JR level.

Our FY 2008 Budget request provides \$409.5 million for new initiatives and \$340 million for the pay raise and other cost adjustments needed to sustain base operations. The IRS' initiatives focus on the most significant needs for FY 2008:

- *\$20.0 million to enhance taxpayer service* through expanded volunteer tax assistance, increased funding for research to determine the most effective means to help taxpayers, and implementing new technology to improve taxpayer service;
- *\$246.4 million to expand enforcement* activities targeted at improving compliance; and
- *\$143.1 million to improve the IRS' information technology (IT) infrastructure*, including \$62.1 million for the BSM program and \$81.0 million for security and infrastructure enhancements.

This request also includes several program savings and efficiencies that reflect the IRS' aggressive efforts to identify and deploy work process and technology improvements that will benefit both taxpayer service and enforcement programs. Collectively, these cost savings total \$120.0 million:

- *Taxpayer Service Efficiencies -\$23.4 million / -527 FTE:* These savings will result from operational efficiencies achieved through ongoing efforts to automate and

enhance IRS taxpayer service programs' workload distribution, such as the implementation of automated issuance of Employer Identification Numbers and Correspondence Imaging System. Additional efficiencies and savings are expected to be achieved through the implementation of optimal service delivery initiatives identified by the Taxpayer Assistance Blueprint.

*Enforcement Program Efficiencies - \$60.2 million / -620 FTE:* These savings will result from productivity and efficiency improvements realized through the implementation of enhanced technology and business processes, such as improved case selection tools and techniques. In addition, the completion of initial training and transition of the FY 2006 new hires back to their front-line enforcement activities will result in additional efficiencies for the examination and collection programs.

- *Shared Service Support Efficiencies - \$36.4 million / -37 FTE:* These savings will result from several efforts, including the optimization and consolidation of space projects, implementation of cost-efficient government-wide contract support, and postage savings achieved through the consolidation, automation, and renegotiation of contract services for correspondence delivery.

#### **2007 Filing Season**

This filing season presented the potential to be one of the most challenging in recent memory. The Tax Relief and Health Care Act of 2006 (TRHCA), which was enacted late last year, included the extension of several significant tax benefits. Since forms and publications for Tax Year 2006 were printed and distributed prior to enactment, we were required to notify taxpayers on IRS.gov and through other channels as to how to modify those forms to claim the allowable benefits. We are also faced with implementing the Telephone Excise Tax Refund Program (TETR). In addition, this was the first filing season that we allowed taxpayer refunds to be split and deposited into separate accounts. And, because the normal April 15<sup>th</sup> filing date falls on a Sunday and the following Monday is a legal holiday in the District of Columbia, we had to adjust our programs to provide taxpayers an extra two days to file and pay this year.

Despite these challenges, I am proud to report that thus far the filing season has gone very well. By early February, we were able to begin processing tax returns claiming the tax benefits authorized by the enactment of TRHCA in December. We have also taken a number of steps to make sure that taxpayers understand how to claim the benefits. For example, we provided instructions on IRS.gov and conducted extensive outreach and media events to publicize these provisions. In addition, we sent a special mailing of Publication 600, which included the state and local sales tax tables and instructions for claiming the sales tax deduction on Schedule A (Form 1040), to 6 million taxpayers who had previously claimed the state and local sales tax deduction.

I will discuss the TETR Program later in my testimony, but let me first give an update on some of the numbers we are looking at approximately one week from the return due date.

*Numbers Thus Far*

We expect to process over 136 million individual tax returns in 2007, and we anticipate a continued growth in the number of those that are e-filed. In the 2006 filing season, 54 percent of all income tax returns were e-filed. We fully expect to exceed that number this year. As of April 7, we have received almost 61.3 million tax returns electronically, an increase of 6.11 percent compared to the same period last year.

This increase in e-filing is being driven in large part by people preparing their own returns using their personal computers. The total number of self-prepared returns that are e-filed is up by over 8.4 percent compared to this time a year ago. Over 17 million returns have been e-filed by people from their personal computers, up from over 15.8 million for the same period a year ago.

Overall, 69.6 percent of the 88.1 million returns filed through April 7<sup>th</sup> 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. The error reject rate for returns e-filed with the IRS is significantly lower than that for paper returns.

More people are choosing to have their tax refunds directly deposited into their bank account than ever before. So far this year, we have directly deposited almost 49.9 million refunds, or 68 percent of all refunds issued this tax filing season. This is up from 65 percent for the same period in 2006.

People are also visiting our Web site, IRS.gov, in record numbers. Through April 7<sup>th</sup>, we have recorded over 111.2 million visits to our site this year, up almost 8 percent from 103.1 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 Web site. We have made it easier for taxpayers to get answers to many of their tax questions online. The Web site:

- Assists the taxpayer in determining whether he or she qualifies for the Earned Income Tax Credit (EITC);
- Assists the taxpayer in determining whether he or she is subject to the Alternative Minimum Tax (AMT);
- Allows more than 70 percent of taxpayers the option to file their tax returns at no cost through the Free File program;
- Allows taxpayers who are expecting refunds to track the status via the “Where’s My Refund?” feature; and
- Allows a taxpayer to calculate the amount of their Sales Tax Deduction

As of April 7, we have received almost 88.1 million returns. We have issued 73.6 million refunds so far this year, for a total of \$174.2 billion. The average refund thus far is

\$2,366, which is \$76 more than last year. In addition, as of April 7, 23.3 million taxpayers have tracked their refund on IRS.gov, up more than 23 percent over last year.

As of March 31st, our Taxpayer Assistance Centers (TACs) are reporting a very slight increase in face- to-face contacts this filing season as compared to last year. We have seen a slight decline in the number of calls answered (-1.82 percent) as well as automated calls (-5.79 percent). The decline in the number of calls answered can be attributed to a few weather-related temporary call site closures earlier this winter and a slight decrease in overall caller demand.

#### *Free File*

Free File started slowly this filing season but has been steadily increasing. We remain cautiously optimistic that the program will reach 2006 totals by the end of the filing season. As of April 5<sup>th</sup>, almost 3.1 million people have utilized Free File, down 4.65 percent from last year. This year, anyone with adjusted gross income of \$52,000 or less is eligible for Free File. This would include 95 million taxpayers. The number of Free File returns compared to the prior year has been steadily increasing.

A key difference in this year's program is that Free File Alliance members are no longer offering ancillary products, such as refund anticipation loans (RALs), through the Free File program. IRS data from the last filing season shows that only 0.5 percent of Free File users chose to utilize a RAL. The Free File Alliance may still offer customers the option of having their state tax return prepared for a fee, though some Alliance members are offering to do the state return at no cost along with the Federal.

In the 2006 filing season, an indicator was included for the first time on Free File returns allowing the IRS to identify those taxpayers using Free File. As a result, the Service was able to obtain important information such as customer satisfaction and demographic data that had never before been available. This information allowed us to verify that there was a high level of customer satisfaction with Free File. According to a survey conducted for the IRS, 94 percent said they intend to use Free File again next year; the same number said they found Free File very easy or somewhat easy to use; and 97 percent said they would recommend Free File to others. Convenience, not the free cost, was the most appealing factor of Free File.

#### *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. In FY 2006, over 2.2 million returns were prepared by volunteers. As of March 31st, volunteer return preparation is up over 13 percent above last year's level. Volunteer e-filing is also up slightly, by 1 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 attempt to improve outreach to taxpayers, particularly those taxpayers who may be eligible for the EITC. For example, we sponsored EITC Awareness Day on February 1, 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.

#### *Telephone Excise Tax Refunds*

In the middle of 2006, the IRS announced plans to refund approximately \$13 billion in telephone excise taxes to more than 160 million taxpayers. To do this, the IRS modified every individual and business tax return form, retooled our systems to handle the forecast demand, and launched an extensive communications campaign to increase awareness and encourage people without a filing requirement to request a refund.

One difficulty in administering this refund was that taxpayers could have experienced significant burden if they had been required to find 41 months of old phone bills in order to obtain the information they needed to compute their refunds. For this reason, the IRS created a set of standard amounts that individuals can claim in lieu of actual amounts. For businesses and non-profits faced with potentially more paperwork than individuals, the IRS developed an estimation method that could require significantly less paperwork than requesting an actual amount.

A review of returns filed so far this year turned up a surprising fact: over 31 percent of returns we have received did not include a telephone excise tax refund request. Though one of our communications goals was to encourage taxpayers not to overlook the telephone tax refund, it appears many taxpayers are missing out. In response to these early numbers, we consulted with tax professionals, citizens groups, and tax software companies to determine potential causes for the low take-up rate. The only logical reason we were given was that despite our best efforts, some taxpayers were still not aware of the credit and how to claim it. We then conducted additional media outreach to increase awareness of the refund and were able to generate broad national media coverage, including CNN, the Associated Press, and USA Today.

As we monitored the initial returns, we also noticed some problems. Even though 99.5 percent of all taxpayers who are requesting the refund are claiming the appropriate standard amount, some tax-return preparers were requesting thousands of dollars of refunds for their clients in instances where clients are entitled to only a tiny fraction of that amount. This may indicate criminal intent on the part of the return preparer. In some cases, taxpayers requested a refund in the thousands of dollars, suggesting that the taxpayer paid more for telephone service than they received in income. While some of the large claims may be the result of misunderstandings – a number of refund requests appear to be for the entire amount of the taxpayer's phone bill, rather than just the three-percent long-distance tax – others may be deliberate attempts to scam the system.

To address this problem, in late February, IRS special agents executed search warrants seeking evidence from a small number of tax-preparation businesses suspected of



preparing returns on behalf of clients requesting large, improper amounts in telephone excise tax refunds. Special agents temporarily closed these businesses, seizing computers and documents to use in their investigations. In addition, IRS revenue agents (auditors) and special agents also visited other tax preparers who were suspected of preparing questionable telephone tax refund requests.

On a positive note, the number of returns with seemingly high telephone excise tax refunds dropped significantly this month. This suggests our enforcement actions, along with increased communications, may be having the desired effect.

#### *Tax Scams*

Each year, we alert taxpayers about the “Dirty Dozen”, 12 of the most blatant tax scams affecting American taxpayers. This is in part an effort to alert taxpayers so that they may be wary if approached and encouraged to participate in any of the listed schemes. It also alerts promoters that we are aware of the scam and will be taking steps to prevent them from getting away with it.

This year the “Dirty Dozen” highlights five new scams that IRS auditors and criminal investigators have uncovered. Topping the list this filing season are fraudulent refunds being claimed in connection with TETR, which I have already discussed. Other scams making the list include:

- **Abusive Roth IRAs:** Taxpayers should be wary of advisers who encourage them to shift under-valued property to Roth Individual Retirement Arrangements (IRAs). In one variation, a promoter has the taxpayer move under-valued common stock into a Roth IRA, circumventing the annual maximum contribution limit and allowing otherwise taxable income to go untaxed.
- **Phishing:** This is a technique used by identity thieves to acquire personal financial data in order to gain access to the financial accounts of unsuspecting consumers, run up charges on their credit cards, or apply for loans in their names. These Internet-based criminals pose as representatives of a financial institution — or sometimes the IRS itself — and send out fictitious e-mail correspondence in an attempt to trick consumers into disclosing private information. A typical e-mail notifies a taxpayer of an outstanding refund and urges the taxpayer to click on a hyperlink and visit an official-looking Web site. The Web site then solicits a social security and credit card number. It is important to note the IRS does not use e-mail to initiate contact with taxpayers about issues related to their accounts. If a taxpayer has any doubt whether a contact from the IRS is authentic, the taxpayer should call 1-800-829-1040 to confirm it.
- **Disguised Corporate Ownership:** Domestic shell corporations and other entities are being formed and operated in certain states for the purpose of disguising the ownership of the business or financial activity. Once formed, these anonymous entities can be, and are being, used to facilitate underreporting of income, non-

filing of tax returns, listed transactions, money laundering, financial crimes, and possibly terrorist financing. The IRS is working with state authorities to identify these entities and to bring their owners into compliance.

- **Zero Wages:** In this scam, which first appeared in the Dirty Dozen in 2006, a Form 4852 (Substitute Form W-2) or a “corrected” Form 1099 showing zero or little income is submitted with a federal tax return. The taxpayer may include a statement rebutting wages and taxes reported by the payer to the IRS. An explanation on the Form 4852 may cite statutory language behind Internal Revenue Code sections 3401 and 3121, or may include some reference to the paying company refusing to issue a corrected Form W-2 for fear of IRS retaliation.
- **Return Preparer Fraud:** Dishonest return preparers can cause many headaches for taxpayers who fall victim to their schemes. Such preparers make their money by skimming a portion of their clients’ refunds and charging inflated fees for return preparation services. They attract new clients by promising large refunds. Some preparers promote filing fraudulent claims for refunds on items such as fuel tax credits to recover taxes paid in prior years. Taxpayers should choose carefully when hiring a tax preparer. As the old saying goes, “If it sounds too good to be true, it probably is.” Remember that no matter who prepares the return, the taxpayer is ultimately responsible for its accuracy. In recent years, the courts have issued injunctions ordering dozens of individuals to cease preparing returns, and the Department of Justice has filed complaints against dozens of others. During fiscal year 2006, 109 tax return preparers were sentenced to prison for committing tax crimes with an average prison sentence of 18 months.
- **American Indian Employment Credit:** Taxpayers submit returns and claims reducing taxable income by substantial amounts, citing an American Indian employment or treaty credit. Although there is an Indian Employment Credit available for businesses that employ Native Americans or their spouses, there is no provision for its use by employees. In a somewhat similar scam, unscrupulous promoters have informed Native Americans that they are not subject to federal income taxation. The promoters solicit individual Indians to file Form W-8 BEN seeking relief from all withholding of federal taxation. A recent “phishing” variation has promoters using false IRS letterheads to solicit personal financial information that they claim the IRS needs in order to process their “non-tax” status.
- **Trust Misuse:** For years, unscrupulous promoters have urged taxpayers to transfer assets into trusts. They promise reduction of income subject to tax, deductions for personal expenses, and reduced estate or gift taxes. However, these trusts do not deliver the promised tax benefits. There are currently more than 150 active abusive trust investigations underway, and 49 injunctions have been obtained against promoters since 2001. As with other arrangements,

taxpayers should seek the advice of a trusted professional before entering into a trust.

- **Structured Entity Credits:** Promoters of this newly identified scheme are setting up partnerships to own and sell state conservation easement credits, federal rehabilitation credits, and other credits. The purported credits are the only assets owned by the partnership and once the credits are fully used, an investor receives a K-1 indicating the initial investment is a total loss, which is then deducted on the investor's individual tax return.
- **Abuse of Charitable Organizations and Deductions:** The IRS continues to observe the use of tax-exempt organizations to improperly shield income or assets from taxation. This can occur when a taxpayer moves assets or income to a tax-exempt supporting organization or donor-advised fund, but maintains control over the assets or income. Contributions of non-cash assets continue to be an area of abuse, especially with regard to overvaluation of contributed property. In addition, the IRS is noticing the return of private tuition payments being disguised as charitable contributions to religious organizations.
- **Form 843 Tax Abatement:** This scam rests on faulty interpretation of the Internal Revenue Code. It involves the filer requesting abatement of previously assessed tax using Form 843. Many using this scam have not previously filed tax returns, and the tax they are trying to have abated has been assessed by the IRS through the Substitute for Return Program. The filer uses the Form 843 to list reasons for the request. Often, one of the reasons is: "Failed to properly compute and/or calculate IRC Sec 83-Property Transferred in Connection with Performance of Service."
- **Frivolous Arguments:** Promoters have been known to make the following outlandish claims: the Sixteenth Amendment concerning congressional power to lay and collect income taxes was never ratified; wages are not income; filing a return and paying taxes are merely voluntary; and being required to file Form 1040 violates the Fifth Amendment right against self-incrimination or the Fourth Amendment right to privacy. Taxpayers should not believe these or other similar claims. These arguments are false and have been thrown out of court. While taxpayers have the right to contest their tax liabilities in court, no one has the right to disobey the law or else they may subject themselves to increased penalties. As part of the Tax Relief and Health Care Act of 2006 [Public Law No. 109-432], Congress amended the Code to increase the amount of the penalty for frivolous tax returns from \$500 to \$5,000 and to impose a penalty of \$5,000 on any person who submits a "specified frivolous position." We recently released guidance identifying these and other frivolous claims that--when asserted by a taxpayer on a tax return filed with the Service or submitted in a collection due process request, offer-in-compromise, application for an installment agreement, or application for a Taxpayer Assistance Order--expose the taxpayer to the \$5,000 penalty.

Now, Mr. Chairman, I would like to discuss some of the specific issues raised by both you and Senator Grassley in preparation for this hearing. I will first discuss identity theft, followed by laptop security, electronic return originators, and paid tax preparers.

### **Identity Theft**

Taxpayer and employee privacy is a foremost concern of the IRS. We are charged with protecting the most critical information about virtually every American. In recognition of this responsibility, we continue to update our systems and our training so that employees who have access to sensitive information are aware of the steps they must take to prevent that information from being compromised.

This job has never been tougher. According to the FBI, identity theft is one of the fastest growing white collar crimes. There has been a 4,600 percent increase in computer crime since 1997. Nearly 10 million Americans each year are affected by identity theft, according to the Federal Trade Commission (FTC). Deloitte-Touche has reported that financial institutions and U.S. banks have also experienced a significant increase in the number of computer based attacks and attempted intrusions into financial systems.

The FTC also reports, "About 90% of business record thefts involve payroll or employment records, while only about 10% are generated from customer lists." These business record thefts also include job applications, personnel records, health insurance and benefits records, and payroll related tax documents that provide personal information that identity thieves use to steal employees' identities. While most identity theft is use of consumer's personal information to make purchases, almost 1.5 millions victims indicated that their personal information was misused in non-financial ways to obtain government documents or tax forms.

Through our Automated Underreporter Program (AUR), we see first hand potential instances of identity theft. The AUR matches W-2s for the same SSN to ensure that the taxpayer has reported all sources of income. If identity theft has occurred the SSN may have been used with multiple employers who have issued multiple W-2s for the SSN. In Tax Year (TY) 2004, the latest year for which we have data, there were 16,152 identity theft claims made through the AUR program. This is far less than the 30,639 cases in TY 2002, but a few more than the 12,618 claimed in TY 2003. In these cases, if the impacted taxpayer provides the necessary documentation on an identity theft claim, the income in question will not result in an additional assessment.

We have tried to take the initiative in proactively analyzing processes to identify areas of vulnerability, and in educating taxpayers and employees about identity theft. We have teamed with other federal agencies, such as the Federal Trade Commission (FTC), the Department of Justice and the Social Security Administration (SSA) to address identity theft crime.

In 2005 we began an aggressive strategy to research and address this growing problem. We established an Identity Theft Program Office charged with implementing the IRS'

policy on identity theft. This policy requires the IRS to take the necessary steps to provide assistance to victims of identity theft within the scope of their official duties. Our Identity Theft Program Office works with offices throughout the IRS to implement the agencies' Identity Theft Enterprise Strategy comprised of three components—Outreach, Prevention and Victim Assistance.

#### *Outreach*

The IRS has undertaken several outreach initiatives to provide taxpayers, employees, and other stakeholders with the information they need to proactively prevent and resolve identity theft issues. 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 Department of 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.
- Lead 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.
- Partnered with the Treasury Inspector General for Tax Administration (TIGTA) to develop and promote 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.”
- Jointly with TIGTA published 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.

#### *Victim Assistance*

We recognize that outreach alone is not enough and that we also must be prepared to assist victims when identity theft occurs. With respect to the victim assistance prong of the Enterprise Strategy:

- The IRS established a new identity theft policy that provides for 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, address, and the fact of the identity theft. These documentation standards are consistent with those required by FTC and SSA.
- The IRS has worked closely with SSA to reduce the time required to resolve cases where more than one taxpayer uses the same SSN on a tax return (called the Scrambled SSN process). The average timeframe to resolve the case is now approximately 10 months compared to 18 months previously. As of March 24, 2007, the current scrambled SSN inventory count is approximately 5,000 cases. Approximately 38,000 cases have been referred to SSA in 2003-2006.
- The IRS updated its processes and notices to help taxpayers whose name and SSN were used by an identity thief for employment purposes. When the IRS matches an identity thief's W-2 information with a legitimate taxpayer's income tax return, the IRS sends the taxpayer a notice regarding the under-reported income. This is often the first time the victim is aware of the identity theft. To aid these victims of identity theft, the under-reporter notices were updated with specific instructions on the type of documents and information needed to validate the identity theft cases.
- The IRS is taking additional steps to reduce taxpayer burden associated with identity theft. By January 2008, the IRS will implement a new service-wide identity theft indicator that will be placed on a taxpayer's account upon the authentication of identity theft. Once the new process is fully deployed, taxpayers should only have to provide identity theft authentication one time, and the IRS will be able to reject returns which do not appear to be from the legitimate owner of the SSN.

#### *Prevention*

There are three types of identity theft crimes in tax administration: refund crimes, employment and income diversion.

- Refund crimes are perpetrated by criminals who use another person's tax information to fake a return and steal a refund. The Refund Crimes Unit of the IRS' Criminal Investigation Division identifies those returns through the Questionable Refund program.

- The IRS is developing several initiatives to reduce the incidence of theft related to employment, such as working with SSA to explore initiatives to improve the accuracy of SSN reporting.
- Individuals who make false identity claims to underreport income will face additional tax and penalties, as will preparers who promote such schemes.

To augment the IRS Identity Theft Enterprise Strategy composed of outreach, assistance, and prevention, the IRS initiated a Service-wide Identity Theft Risk Assessment to qualify and quantify existing threats and vulnerabilities related to IRS processes that could directly or indirectly facilitate identity theft and/or taxpayer burden. As an output of this risk assessment, the IRS developed (and has begun the implementation of) targeted remediation strategies designed to address the identified threats and vulnerabilities.

Where justified, we have referred cases of identity theft to our Criminal Investigation (CI) unit. In the past two years, CI has successfully investigated a number of cases that were successfully prosecuted in which identity theft has led to tax fraud. Just last month, two women from Ohio were sentenced to 63 and 188 months, respectively, and ordered to pay \$300,000 in restitution for perpetuating an identity theft scheme. As part of this scheme, the women claimed nearly \$114,000 in tax refunds to which they were not entitled.

Last November, a Florida man was sentenced to 63 months in prison to be followed by three years of supervised release for making false claims against the IRS and for identity theft. He was also ordered to pay a personal money judgment of \$152,171, and to pay \$152,171 in restitution to the IRS. To carry out this scheme, the man used the Internet to obtain personal information, including names and dates of birth, for at least 150 Florida inmates.

We are also reviewing ways we can protect our employees from identity theft. The IRS Office of Privacy is studying the existing usage of employee SSNs and identifying ways to reduce or eliminate the agency's use of employee SSNs in certain applications to minimize the risk of improper use. We are closely coupling privacy and identity theft protections with the agency security program, so that when we do need to collect SSNs – either employee or citizen, we can ensure that they are adequately protected within our systems.

The main focus for the annual IRS' Security Awareness Week, last November, was "Identity Theft/Fraud." Activities were focused on raising awareness and making employees aware of their responsibilities.

While research shows that the IRS has one of the lowest rates of identity theft in all the Federal government, we still take this situation very seriously. We have made significant progress, but additional work remains--including implementing additional mediation strategies and conducting in-depth analyses of the remaining high-priority processes.

### **Laptop Security**

Every year, the IRS processes over \$2 trillion in revenues to fund the U.S. operating budget. Although the majority of this is collected in an automated banking system throughout the year, about \$300 billion is collected through 8 IRS campuses where taxpayers send their tax returns for processing. We house computing systems that hold data on all taxpayers, and also process enormous volumes of paper data in our more than 500 offices across the country. We have more than 82,000 full time and 12,000 part-time employees across the U.S. Our workforce is highly mobile, as revenue agents and officers are often in the field working directly with taxpayers. As a result, the IRS has assigned 52,000 laptops to its employees.

IRS computers, networks, and databases are protected by multiple layers of security, including modern security technology devices such as firewalls, encrypted communication links, and automatic intrusion detection devices.

The IRS is one of the few government agencies operating its own 24/7 computer security incident response center (CSIRC) to monitor IRS computer and network security, and to collect and follow up on any security incidents. The IRS' CSIRC works in close coordination with the Treasury Department and the Department of Homeland Security's CSIRCs and the US-CERT incident reporting center.

The FY 2008 Budget for IRS proposes \$21 million to be used to enhance CSIRC and the network infrastructure security. This infrastructure initiative will provide \$13.1 million to fund enhancements to the CSIRC necessary to keep pace with the ever-changing security threat environment through enhanced detection and analysis capability, improved forensics, and the capacity to identify and respond to potential intrusions before they occur. The remaining \$7.9 million will fund enhancements to the IRS' network infrastructure security. It will provide the capability to perform continuous monitoring of the security of operational systems using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

The IRS has always had policy guidance in place requiring employees to protect taxpayer information and other personal and private data. Protection of taxpayer information is emphasized and stressed in all employee orientation and refresher training as one of the Service's highest priorities.

Prior to January 2007, all IRS laptops included encryption tools that IRS employees were required to use to encrypt all sensitive information. We recognize that this previous generation of encryption tools may have been technically complex and challenging for many employees and as a result some may have not have done the proper encryption. Therefore, we have recently completed installation of an automatic full disk encryption product on all IRS laptops that automatically encrypts all data on the laptop, without requiring any employee action. This encryption system has been tested and certified to



meet mandatory standards. Physical security locks have also been provided with all IRS laptops.

IRS employees have reported the loss or theft of over 500 laptop computers over the last five years. Prior to May 2006, these reports primarily focused on reporting the theft or loss of IT equipment. Given the heightened awareness across the Federal Government in 2006 to the protection of sensitive personally identifiable information (PII), all government agencies now are focused more on the reporting of any sensitive information that may have been lost when a laptop is lost or stolen.

The IRS laptop losses were reported to TIGTA, which investigated these incidents and provided reports back to IRS management. Very few devices were recovered, as these devices are quickly re-sold. We have not received any reports indicating that any of the IRS lost or stolen laptops resulted in a case of identity theft for any citizen. Many of these laptops are used by revenue agents or officers in the field, and typically include a working case load involving a small number of cases (an average of 10 to 25 cases with there being one individual per case).

We are also working with our Federal and State partners with whom we share information to implement encryption solutions on data tapes. The encryption solutions are planned to be completed by October 1, 2007. In the interim, the IRS is using special security shipping containers and courier services to ensure that tapes shipped from IRS are protected. Recipients of the data are subject to implementing specific safeguards and complying with published standards for the protection of the data. Appropriate documentation is required for the transport of the tapes.

As the President's Taskforce on Identity Theft recommended, the Office of Management and Budget (OMB) is working closely with all agencies, including the IRS, to develop policy guidance for notification in instances where an individual's personally identifiable information has been compromised. The IRS has everything in place to comply with this new policy. We have reviewed all incidents, and there are a few that likely will require follow up (notification).

#### **Electronic Return Originators**

One of the IRS' top priorities is to encourage e-filing. In fact, in the IRS Restructuring and Reform Act of 1998, Congress set a goal that by 2007, 80 percent of all returns would be e-filed. Although we have not yet reached that target, e-filing has shown a steady growth each year. In the 2006 filing season, 54 percent of all returns were e-filed. As of the end of March, we are running almost 6 percent ahead of last year's pace. Nearly 57 million people have filed their returns electronically thus far in the 2007 filing season. People are rapidly coming to the realization that electronic filing is the most efficient way to file their Federal tax return.

In order for all of these taxpayers to file electronically, the IRS has created a process by which returns can be batched and provided to an electronic return originator (ERO) for

submission to the IRS. An ERO is a firm or business entity and not an individual. There are currently 264,303 EROs registered with the IRS.

It is important to note that the ERO may or may not have prepared the return that is being submitted. For example, a small accounting firm may forward all of the returns they prepare to an ERO for electronic filing. Or, someone who does their own return online may forward the return to the ERO who in turn submits it to the IRS. In these cases, the ERO has no responsibility for the content of the return—it simply ensures that the return gets to the IRS properly.

The critical point is to distinguish between the preparation of the return and its electronic submission to the IRS. E-file supplements return preparation, but is not part of it.

In order to become an ERO, the applicant must complete an application and submit it to the IRS. The IRS processes all new applications by checking the firm and the identified Principals and Responsible Officials against IRS records for prior IRS *e-file* sanctions and any tax compliance issues and also by checking criminal backgrounds of some of the individuals.

If applicants answer “yes” to any of the compliance questions on the application, the IRS completes additional appropriate checks. If an applicant answers “yes” to the criminal background question, the fingerprint card of the individual is forwarded to the FBI for a complete report.

The IRS Criminal Investigation Division (CI) reviews the FBI criminal activity reports and recommends if the related application should be accepted or denied. This process can take up to 45 days to complete and applicants are advised by mail as to whether they have been approved.

Once a provider has been approved, it is issued credentials each year in the form of an acceptance letter that allows continued participation in IRS e-file. The letter includes an assigned Electronic Filing Identification Number (EFIN). The letter is sent prior to December to the mailing address of each provider. All providers must include their identification numbers with the electronic return data on all returns that are transmitted to the IRS.

If more than one authorized IRS e-file provider is involved in the origination and transmission of the return data, applicable electronic filing identification numbers for each provider must be included in the electronic record. Providers are required to have the appropriate identification numbers and the annual acceptance letter to participate in IRS e-file. When IRS becomes aware of an EFIN that has been compromised, the IRS deactivates the EFIN.

We also have a program in place to monitor the work of EROs. Monitoring is accomplished through visits to e-file providers’ establishments, including its collection points (satellite offices) and seasonal offices, by the Electronic Monitoring Coordinator

(EMC) and/or e-file Monitors. The e-file Monitors are Tax Compliance Officers and Revenue Agents trained by the EMC to perform visits and monitoring functions.

There are four types of visits:

- **Referral Visits** – mandatory if the referral clearly suggests noncompliance and warrants immediate attention. Referrals are received from other authorized IRS e-file providers, other tax preparers, taxpayers, IRS Campuses, and other IRS functions.
- **Follow-up Visits** – conducted from the previous year’s referrals that involved any identified violations to verify that corrective action was taken.
- **Random Visits** – A random visit is based upon a non-discriminatory sampling of active providers selected from a central database in the monitor’s geographic area.
- **Targeted Visits** – A targeted visit is based on selection criteria indicating that e-file compliance issues may be present in a particular EROs e-file practice.

Referrals and follow-up visits are made unannounced and used to investigate allegations and complaints submitted against authorized IRS e-file providers. Random and targeted visits are made by appointment and used to determine general compliance within IRS e-file. Our headquarters office determines the number of total visits to be performed from a central database of active providers in the monitor’s geographic area.

Monitoring includes, but is not limited to:

- Investigating complaints;
- Scrutinizing advertising material;
- Checking Form 8453 submissions, which are used to provide the taxpayer’s signature on a paper declaration for the electronic return;
- Observing office procedures;
- Inspecting the acknowledgement files, from which they pull a sample of tax returns to review;
- Verifying compliance with the provision of Internal Revenue Code Section 6659(g), which relates to the due diligence requirements for returns claiming the Earned Income Tax Credit (EITC) if the provider is an income tax return preparer;
- Reviewing Form 8879, the signature requirements for transmitting e-file returns; and
- Questioning the provider to verify the taxpayers received a copy of the electronic tax return.

Violations, depending on the seriousness of the infraction, may result in a warning, written reprimand, suspension, or expulsion of the authorized IRS e-file provider. These visits are also a means of detecting potential fraudulent activities. Non-compliance issues

outside of the IRS e-file are not addressed during a visit, but a referral is made later to the appropriate function.

In calendar year 2006, we made 1129 monitoring visits to EROs. We issued warnings in 190 instances. We gave a written reprimand in 146 cases. In 43 cases, we proposed suspensions and in 12 other cases we issued immediate suspensions. In addition, we referred six cases for criminal investigation.

In addition, our CI division's Electronic Fraud Detection System (EFDS) has components that can identify ERO's filing suspicious tax returns. IRS-CI uses EFDS to primarily identify false claims for refunds, but the computer system is also able to use complex algorithms to identify EROs that are preparing suspicious tax returns that appear to follow particular patterns, such as abusing various tax credits, claiming false EITC, or claiming false expenses. The IRS-CI Fraud Detection Centers develop leads from EFDS on potentially bad ERO return preparers. These leads then are disseminated to IRS special agents throughout the country to initiate criminal investigations.

IRS-CI also coordinates outreach efforts with the EITC Program Office and our Small Business/Self Employed (SBSE) division by providing leads from EFDS for EITC due diligence audits of EROs. CI provided the names of over 200 EROs for FY 2006.

#### **Paid Tax Preparers**

As contrasted with an ERO, a paid tax preparer is someone who prepares tax returns for individuals or businesses for a fee. A tax preparer's basic responsibilities are to:

- Review financial records;
- Calculate form preparation fee according to the complexity of the return;
- Compute taxes owed, following tax form instructions and tables;
- Consult tax law handbook or bulletins;
- Verify totals;
- Interview clients for allowable credits and deductions; and
- Identify themselves on the return as the paid preparer.

A tax return preparer may or may *not*:

- Have credentials as an Enrolled Agent, Certified Public Accountant (CPA), or tax attorney. Only attorneys, CPAs and enrolled agents can represent taxpayers before the IRS in all matters including audits, collection actions and appeals. Other return preparers may represent taxpayers only in audits regarding a return that they signed as a preparer.
- Be affiliated with a professional organization that provides or requires its members to pursue a continuing education and holds them accountable for a code of ethics.

While most preparers provide excellent service to their clients, we have consistently urged taxpayers to be very careful when choosing a tax preparer. Taxpayers should be as careful in choosing the person who prepares their taxes as they would be in choosing a doctor or a lawyer. It is important to know that even if someone else prepares a tax return, the taxpayer is ultimately responsible for all the information on the tax return.

Specifically, we have urged taxpayers to:

- Be careful with tax preparers who claim they can obtain larger refunds than other preparers.
- Avoid preparers who base their fee on a percentage of the amount of the refund.
- Use a reputable tax professional who signs your tax return and provides you with a copy for your records.
- Consider whether the individual or firm will be around to answer questions about the preparation of your tax return months, or even years, after the return has been filed.
- Review your return before you sign it and ask questions on entries you don't understand.
- Never sign a blank tax form.
- Find out the person's credentials.
- Find out if the preparer is affiliated with a professional organization that provides its members with continuing education and resources and holds them to a code of ethics.
- Ask questions. For example does the taxpayer know anyone who has used the tax professional? Were they satisfied with the service they received?

In addition to alerting the taxpayer to be careful when choosing a tax preparer, we also routinely reach out to tax professionals to ensure that they adhere to professional standards and follow the law. This comprehensive outreach includes educational campaigns, ethics workshops, phone forums, e-news for Tax Professionals, and Tax Talk Today.

However, one only has to look to recent press reports to understand that despite our best efforts, a number of paid tax preparers have not adhered to professional standards and some have even resorted to tax fraud. Last week, we and the Department of Justice (DoJ) requested an injunction that would prevent 5 Jackson Hewitt franchisees, operating 125 retail outlets, from continuing to prepare Federal tax returns. This was the largest enforcement action of its kind and is particularly disturbing in that it involves franchisees of the country's second largest tax preparation firm.

A year ago, this Committee held a hearing at which the GAO reported that they had visited 19 different tax preparation firms and all had made substantive errors in the preparation of the return. I can report that we have followed up on all 19 cases.

Four of the cases have been identified as "Program Action Cases" or PACs. These are the preparers that we have deemed from case building analysis to be the most non-compliant based on a detailed analysis of client return information.

The PAC process involves a sample of 30 client returns. These thirty clients are audited in the field to determine whether or not the suspected non-compliance issues are corroborated. If the client audits determine that a pattern of non-compliance exists, the remainder of client returns is sent to an IRS Campus for a correspondence exam. Meanwhile, the 30 field audits are used to support penalties against the preparer. If, during the audit of the client returns, the non-compliance appears particularly egregious and/or it appears the behavior is likely to continue, the Service may consider transferring the cases to the Abusive Tax Avoidance Transaction (ATAT) program for an investigation.

During the case building evaluation of the GAO cases, 10 other case issues were identified that indicated there may be abuses in the EITC arena. Thus, these cases were referred for possible EITC due diligence visits. This is part of our return preparer strategy aimed at reducing abuses with the EITC and putting bad preparers out of business. If EITC violations are further developed, these cases may then be turned into PACs, as described above, and the same process is followed.

I would also note that during the case building process, it was apparently determined that some of these preparers are also EROs and thus should be subject to a monitoring visit. Those visits are currently being planned.

The review of the final five cases indicated that there does not appear to be a pattern of noncompliance among the client returns that were examined. Therefore, these cases did not warrant the initiation of a Program Action Case or preparer penalties. These will be closed without further action.

I should also note that our CI division conducted a detailed analysis of the information provided by GAO and concluded that in none of the cases did the conduct identified meet the criteria for initiating a criminal investigation. This analysis included a review of the volume of returns prepared by each preparer during previous filing seasons. It also consisted of reviewing these returns to determine potential fraudulent filing patterns based on common characteristics that could be indicative of fraud.

Based on the characteristics of the cases that IRS-CI has successfully recommended for prosecution and in reviewing the results from the scenarios in the GAO cases, it was determined that although these preparers made errors, there was no pattern of fraud or intent by the return preparer to knowingly file a fraudulent return. These cases were more an indicator as to the complexities of the tax law and the knowledge or competence levels of the return preparer providing these services.

In order to become a criminal case, IRS-CI is required to prove that the return preparer had the *prerequisite knowledge* of the tax law and *intended* to defraud the government.

In the case of prerequisite knowledge, the IRS needs to prove that the return preparer had the knowledge and that they were committing an illegal act, which means that the return preparer has the education and skill set to have known that the information they are putting on the return is in fact not accurate.

The second part of the Criminal Investigation equation, *intent*, means that the return preparer showed their intent to defraud the government by committing a pattern of certain overt acts in order to perpetrate the fraud.

In Return Preparer investigations that the IRS-CI pursues, the return preparer has likely committed numerous acts of fraud on each return. These acts include but are not limited to, completely fabricating Schedule A itemized deductions to reduce the Taxable Income, or completely fabricating Schedule C loss to lower the taxable income, which results in claiming a higher Earned Income Tax Credit (EITC). Conversely, Schedule C's may be prepared with a gain to fabricate income, when the client had no income in order to qualify the client for EITC as well as to falsify qualifying children to make the client appear eligible for EITC, and other child-related tax benefits. More sophisticated return preparers will form complex business entities on behalf of the client, such as partnerships and Sub S Corporations. They will fabricate a business return with significant losses that will flow through to the clients' personal tax return, which will significantly reduce or eliminate any tax.

The most egregious return preparers victimize their clients. These egregious return preparers file a different return than the one provided to the client, wherein they claim a significantly higher refund, have the refund deposited to a bank account that they control and provide the lower amount to the client. The client has no knowledge the return preparer received the higher refund until they are contacted by the IRS.

In the last several months, we have had several successful prosecutions of return preparer cases. In one case in Texas, a man was sentenced to 18 years for preparing fraudulent returns. In Florida, another man was sentenced to 37 months after pleading guilty to filing false tax returns and preparing false tax returns. A North Carolina woman was sentenced to 18 months for preparing fraudulent federal tax returns in order to generate large refunds for herself and for some of her clients. She also prepared nine tax returns without the knowledge of the taxpayers for her own personal gain.

In total in FY 2006, IRS-CI initiated 197 return preparer fraud investigations and recommended 153 prosecutions. There were 135 indictments and 109 tax preparers were sentenced to prison. The average sentence was 18 months.

Tax practitioners can also become subject to disciplinary action by the IRS Office of Professional Responsibility (OPR). OPR monitors CPAs, tax attorneys and enrolled agents. Once a complaint is received, it is assigned to an OPR attorney who will develop it by investigating the allegations. If the evidence indicates the allegations, taken as true, would constitute a violation of Circular 230, a letter will be sent to the practitioner

informing him or her of the charges and affording the individual the right to respond in writing or by requesting a conference with OPR.

If OPR finds that violations have occurred, it has a range of sanctions that it can impose. These include disbarment, suspension, censure and reprimand. Disbarment is the permanent revocation of a practitioner's privilege to represent taxpayers before the IRS. While a practitioner may petition the OPR for reinstatement after a period of five years, the decision to reinstate a practitioner rests within the discretion of the OPR Director.

A suspension is the revocation of a practitioner's privilege to practice before the IRS for a certain period. A censure is a public reprimand. A reprimand is a private admonishment from the OPR Director to the practitioner.

In FY 2006, OPR issued suspensions or disbarment to 87 practitioners. Reprimands were issued to 8, and 205 were given expedited suspensions.

Regulating the tax preparer community beyond what OPR does would be a monumental task beyond the reach of existing IRS resources. Traditionally, regulation of these types of services occurs at the state level.

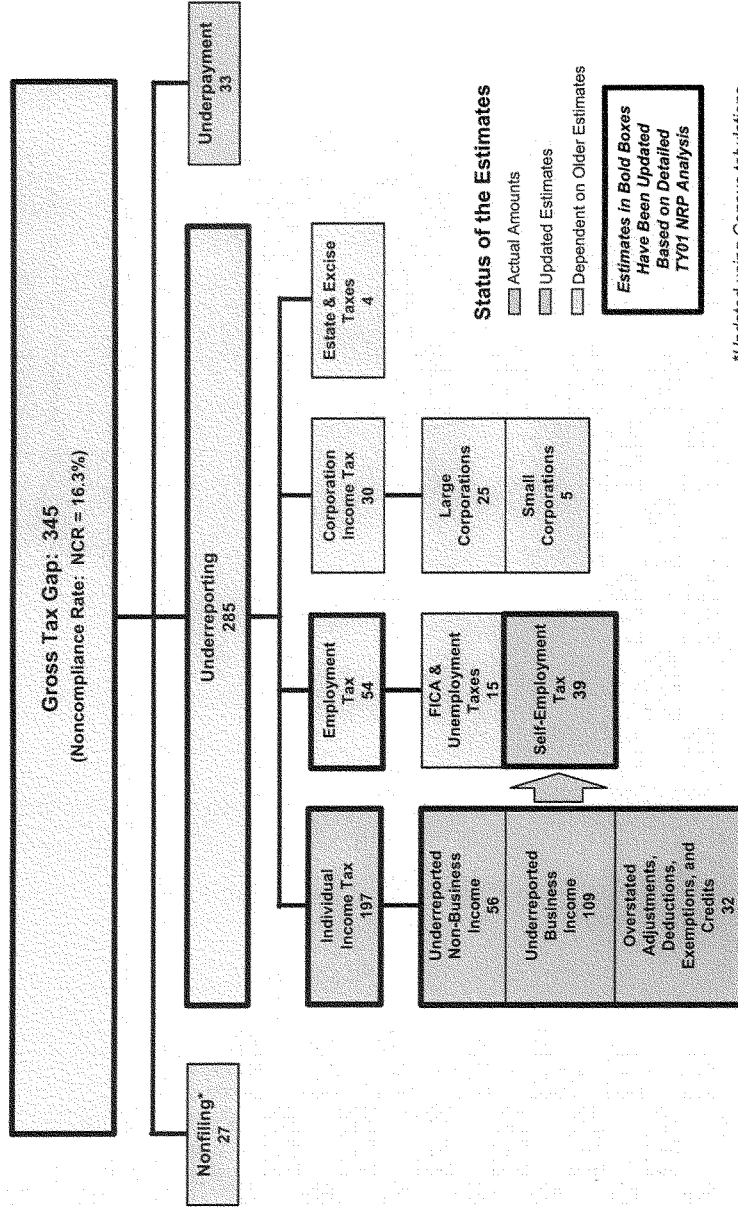
#### **Summary**

Mr. Chairman I have attempted this morning to detail our efforts in a number of areas in which you and your staff have expressed interest. These are all areas which we take very seriously and in which we have ongoing programs. We will continue to work these areas as we move forward consistent with my desire to provide a balanced program that recognizes the need for both strong taxpayer service programs and aggressive enforcement that respects taxpayer rights.

I appreciate the opportunity to be here and I will be happy to respond to any questions.



# Tax Year 2001 FEDERAL TAX GAP (in Billions of Dollars)



\*Updated using Census tabulations

## Individual Income Tax Underreporting Gap Estimates, Tax Year 2001

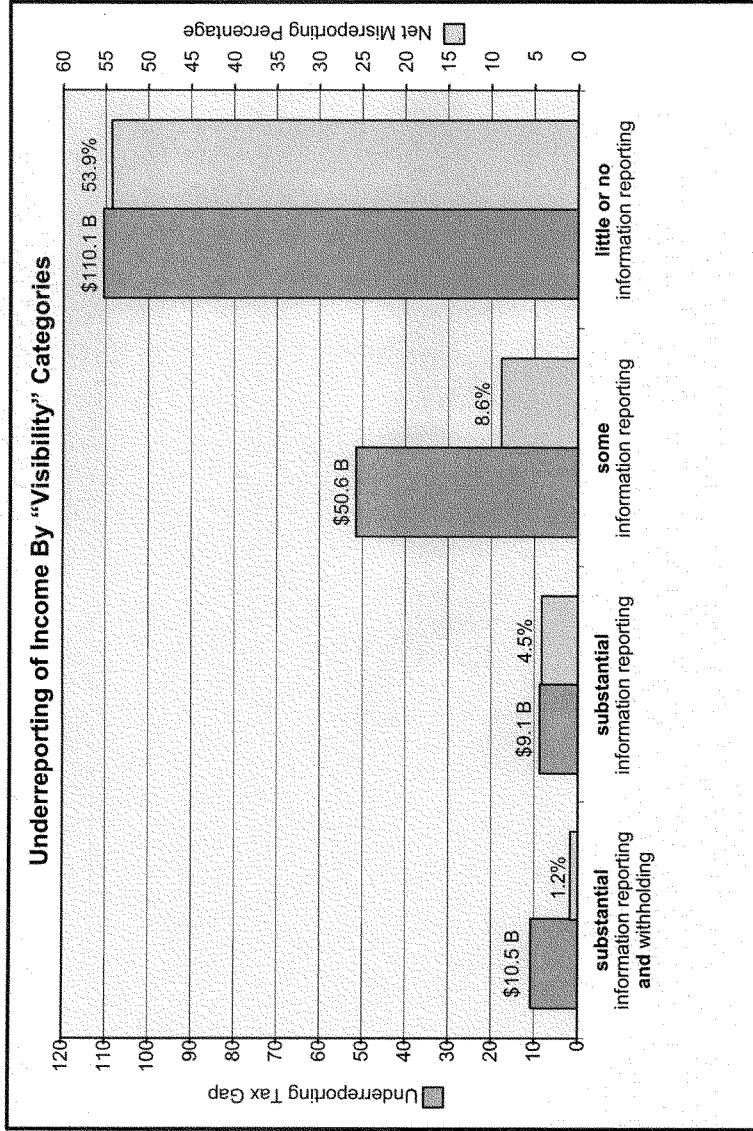
Tax Return Line Item	Tax Gap (\$B)	NMP †
<b>Total Underreporting Gap</b>	<b>197.4</b>	<b>18.0%</b>
<b>Items Subject to Substantial Information Reporting &amp; Withholding</b>	<b>10.5</b>	<b>1.2%</b>
Wages, salaries, tips	10.5	1.2%
<b>Items Subject to Substantial Information Reporting</b>	<b>9.1</b>	<b>4.5%</b>
Interest income	1.6	3.6%
Dividend income	1.1	3.7%
State income tax refunds	0.6	11.6%
Pensions & annuities	4.2	4.1%
Unemployment Compensation	0.5	11.1%
Social Security benefits	1.1	5.8%
<b>Items Subject to Some Information Reporting</b>	<b>50.6</b>	<b>8.6%</b>
Partnership, S-Corp, Estate & Trust, etc.	22.0	17.8%
Alimony income	*	7.2%
Capital gains	11.0	11.8%
Deductions	13.5	5.4%
Exemptions	4.2	5.4%
<b>Items Subject to Little or No Information Reporting</b>	<b>110.1</b>	<b>53.9%</b>
Form 4797 income	3.3	64.4%
Other income	22.6	63.5%
Nonfarm proprietor income	68.0	57.1%
Farm income	5.8	72.0%
Rents & royalties	13.4	51.3%
Total Statutory Adjustments	-3.0	-21.1%
SE Tax deduction	-3.6	-50.8%
All other adjustments	0.6	6.2%
<b>Not Shown on Visibility Chart (Tax Credits)</b>	<b>17.1</b>	<b>26.3%</b>

† NMP = Net Misreporting Percentage

\* Less than \$0.5 billion.

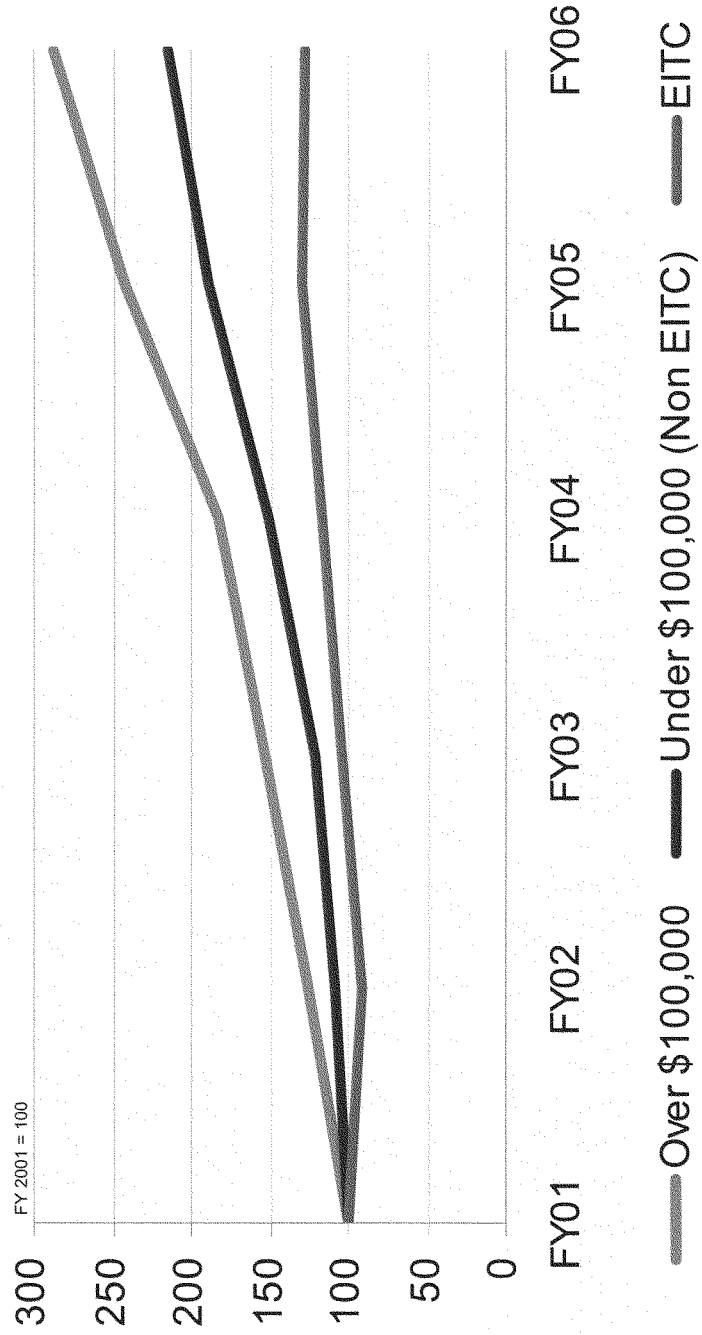
Derived from the TY2001 National Research Program (NRP) individual income tax underreporting study.

### Tax Year 2001 Individual Income Tax Underreporting Gap



Based on updated estimates derived from the National Research Program underreporting compliance study.

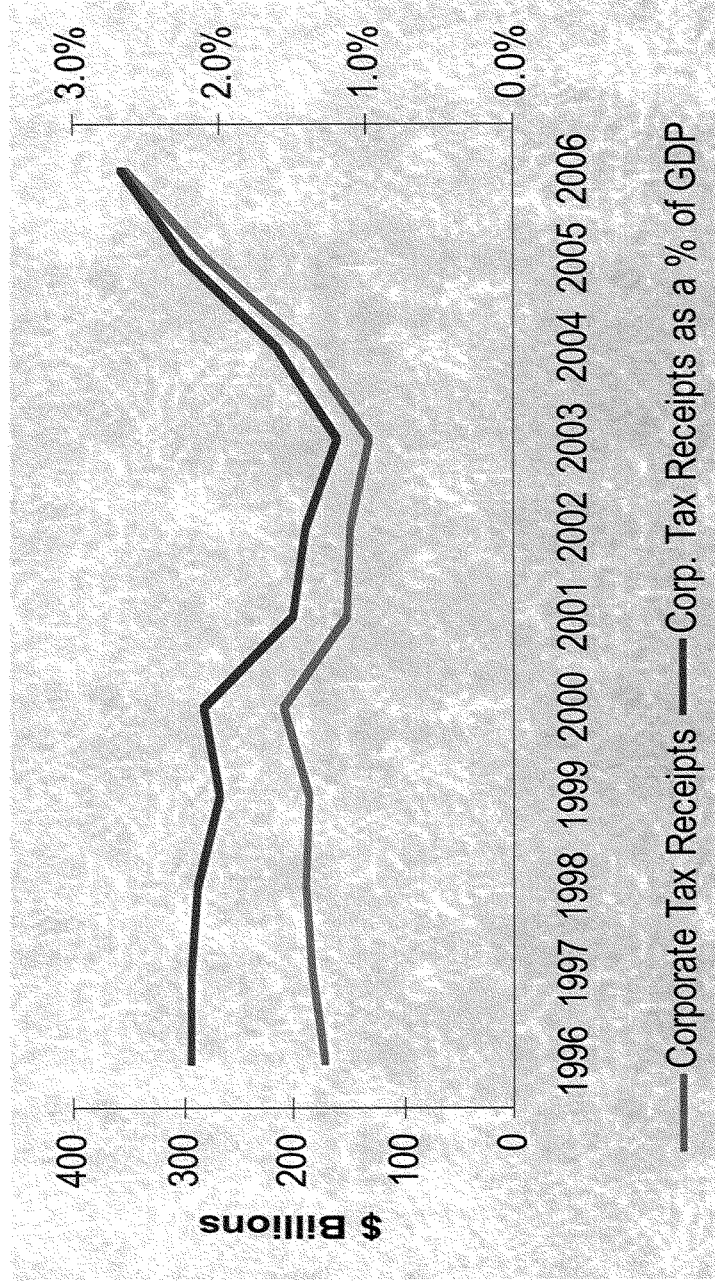
# Growth In Individual Audits Since FY 2001



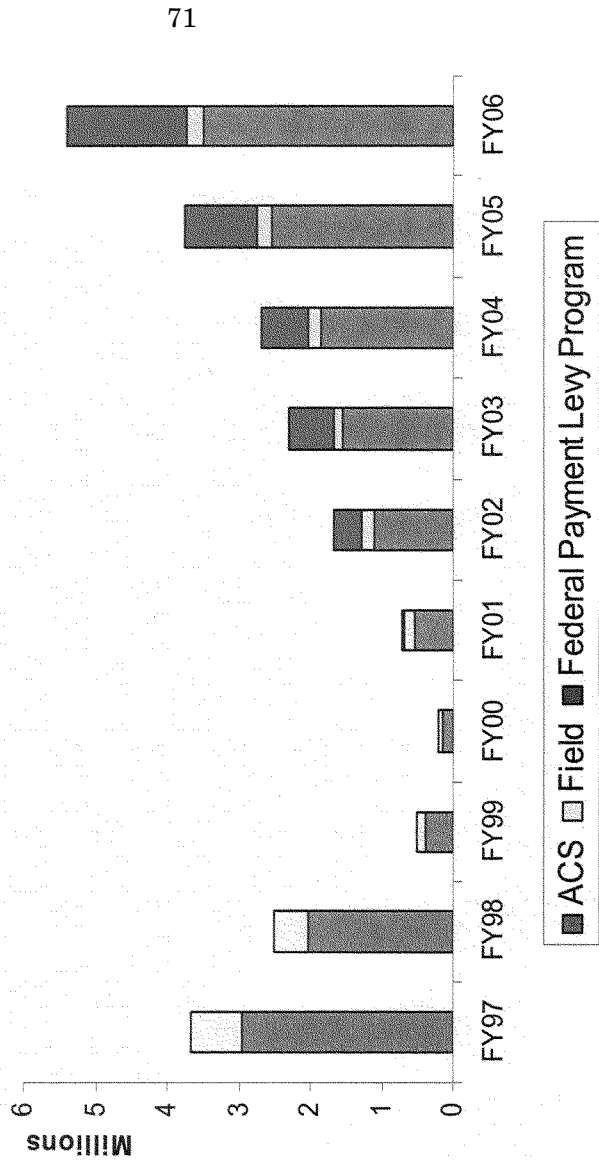
**IRS Corporate Audit Data  
2001-2006**

	2001	2002	2003	2004	2005	2006
<b>Assets \$10 m-\$250 m</b>						
Returns Audited	5,413	4,694	3,795	5,137	5,970	6,302
Dollars Recommended (\$B)	\$0.54	\$0.63	\$0.80	\$0.76	\$1.42	\$1.31
Audit Cycle Time (months)	17.0	17.1	18.3	13.6	12.0	10.0
<b>Assets &gt; \$250 m</b>						
Returns Audited	3,305	3,749	3,330	4,386	4,859	4,276
Dollars Recommended (\$B)	\$12.77	\$13.67	\$12.29	\$15.23	\$30.14	\$25.53
Audit Cycle Time (months)	31.9	33.2	32.8	29.4	31.2	29.0
<b>Total Assets &gt; \$10 m</b>						
Total Returns Audited	8,718	8,443	7,125	9,523	10,829	10,578
Total Dollars Recommended (\$B)	\$13.31	\$14.30	\$13.10	\$15.99	\$31.56	\$26.84
Audit Cycle Time (months)	23.0	24.4	25.4	21.1	20.9	17.8

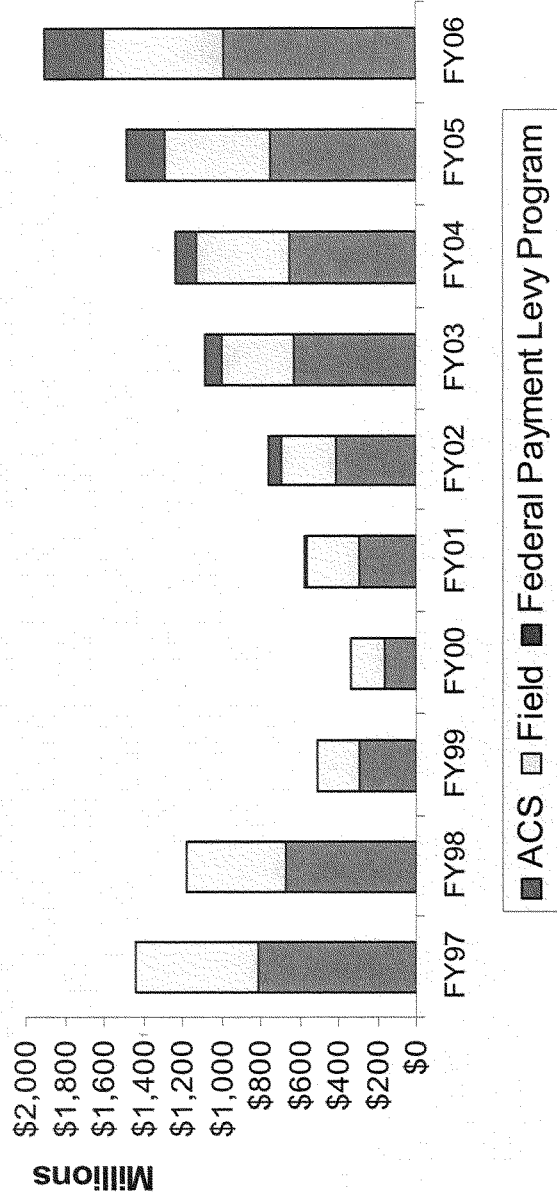
# Growth of Corporate Tax Receipts



# Levies Issued (in Millions)

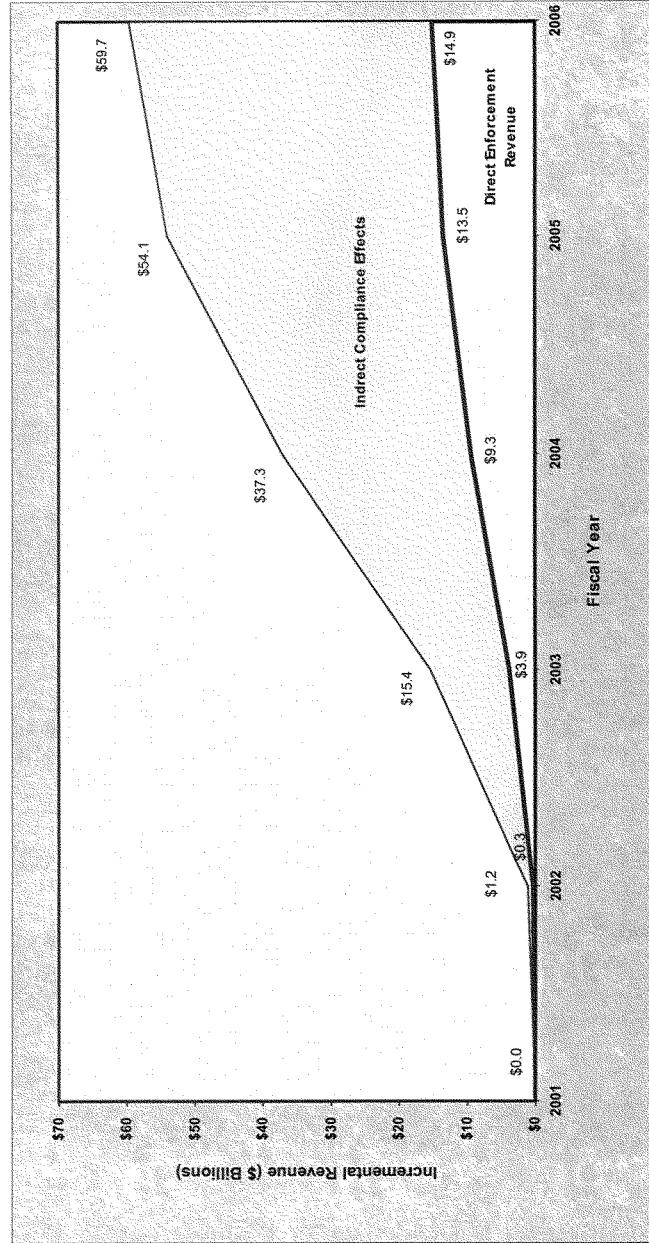


# Levy Dollars Collected (in Millions)

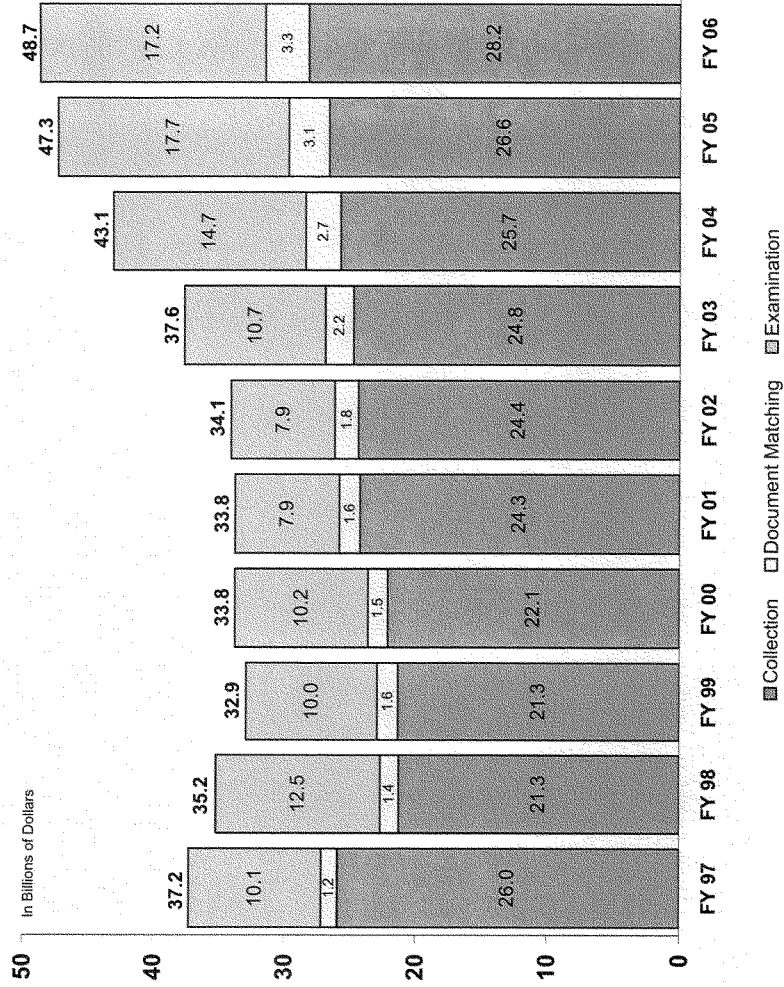




# Even Using Conservative Assumptions For Indirect Compliance Effects, IRS Activities Have Generated Tens Of Billions In Additional Revenue



### IRS Enforcement Revenue



## FY 08 Tax Gap Legislative Proposals

### **Expand Information Reporting**

#### Information reporting on payments to corporations

- Expand filing of Forms 1099 to include payments made to corporations, including S corporations
- Basis reporting on security sales
- Require financial institutions (brokerage houses and mutual funds) to report customers' basis in securities sold on Form 1099
- Broker reporting
- Require filing of Forms 1099 to report sales through an auction, consignment broker or exchange

#### Reporting of merchant payment card reimbursement

- Require payment card processors to report gross annual reimbursement to merchants - no back-up withholding requirement

#### Increase information return penalties

- Increase amounts of penalties for failure to file information returns

#### TIN Verification

- Require non-employee service providers to certify accuracy of their TINs on Form W-9; as well as require TIN verification by IRS

#### Information reporting on certain government payments

- Establish information reporting requirements on payments for procurement of goods by the federal government

### **Improve Compliance by Businesses**

#### Require e-filing by certain large businesses and exempt organizations

- Mandate e-filing for all corporations and partnerships filing an M-3
- Applies primarily to:
  - Corporations with significant assets, but few employees
  - Large partnerships owned by corporations

#### Employee leasing standards

- Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes
- Collection due process
- Amend collection due process procedures applicable to employment taxes to permit post-collection review.

### **Strengthen Tax Administration**

#### Provide IRS with access to NDNH database

- Allow use of National Directory of New Hires data for tax administration purposes

#### Disclosure of prison scams

- Permit IRS to disclose to prison officials return information about tax offenses committed by inmates

#### Felony Failure to File

- Create a criminal felony provision for aggravated failure to file

### **Penalties**

#### Expand preparer penalties

- Expand (and increase) signature requirement and related penalty provisions beyond income tax returns

#### Failure to file electronically

- Establish a specific assessable penalty for failure to file electronically, when required

#### Erroneous refund claim

- Create a penalty for negligent or frivolous claims for refund

**SENATE COMMITTEE ON FINANCE  
HEARING ON  
“Filing Your Taxes: An Ounce of Prevention Is Worth A  
Pound Of Cure”**

**April 12, 2007**

**Questions for Commissioner Mark Everson**

**Questions from Chairman Baucus:**

- 1. What is the IRS's policy on a free, direct filing portal for individual income tax returns?**

Private industry, given its established expertise and experience in the field of electronic tax preparation, has a proven track record. We have collaborated with the private sector in developing a Free On-Line Electronic Tax Filing Agreement. The Free File Program has four main objectives: to increase e-file penetration; provide more free online options to taxpayers; ease tax preparation and filing; and, provide greater access to taxpayers. By focusing on these objectives, this program is mutually beneficial to the IRS and taxpayers. The e-file option offers the advantages of reduced burden on filers and quicker refunds, and the Free File Program makes these benefits available to taxpayers who may have previously prepared and filed paper returns. The percent of potential tax filing public eligible to use Free File is 70 percent of all taxpayers (95 million taxpayers). In 2006, the IRS received almost 4 million Free File returns and, as of April 21<sup>st</sup>, 2007, we have received 3.74 million returns through this program.

The Department of the Treasury has no current intention of engaging in the business of providing taxpayers with electronic filing or tax preparation services directly to taxpayers.

- 2. What are the primary impediments to increasing the use of electronic filing? How can they be mitigated?**

The 2007 Electronic Tax Administration Advisory Committee's Annual Report to Congress identified three major barriers to increasing electronic filing:

*Though a majority of Americans have access to a computer and the Internet, the IRS faces significant challenges in convincing these taxpayers to adopt e-filing and eServices. The reasons vary but generally include concerns about privacy, security, the reliability of transactions, risk of audit and comfort with traditional paper filing.*

*ETAAC recommends that the IRS develop education and public relations initiatives with messages targeted to overcome these barriers.*

- *Privacy, security and reliability of electronic transactions. Transmitting sensitive, personal financial data increases the concerns of taxpayers who already do not trust IRS technology or government in general. The integrity of both the IRS and its systems is critical to changing the behavior of these taxpayers and creating loyalty to eServices solutions.*
- *Risk of audit. There is a strong perception among many paper filers that e-filing increases the chances of an audit. While we know that e-filed returns are twenty times more accurate than paper ones, the IRS needs to address the audit concerns for this taxpayer segment.*
- *Comfort with status quo. Comfort with traditional paper filing overrides perceived benefits to e-filing for many individual taxpayers who are computer savvy or who have balances due. They need a reason to change. In some situations the tax preparer is not encouraging e-filing. In others, a once a year event does not provide the momentum for an eServices mindset. Again targeted messages and enhanced eServices that deliver real benefits are critical to change the behaviors of this group.*

The IRS does concur with the ETAAC findings. Some taxpayers will always be reluctant to use the Internet or pay any fee for electronic filing. However, the IRS' e-Strategy for Growth outlines plans to reduce taxpayer burden and continuously grow the e-file program. Key strategies include:

- Make electronic filing, payment and communication so simple, inexpensive, and trusted that taxpayers will prefer them to calling and mailing
- Substantially increase taxpayer access to electronic filing, payment, and communication products and services
- Aggressively protect transaction integrity and internal processing accuracy
- Deliver the highest quality products and services as promised
- Partner with states and other governmental entities to maximize opportunities to reduce burden for our common customer base
- Encourage private sector innovation and competition.

### 3. **What are the potential benefits from a federal I-file system for individual income tax returns?**

The GAO recently enumerated a number of these benefits in its report to the Senate Committee on Finance – *State Experiences Indicate IRS Would Face Challenges Developing an Internet Filing System with Net Benefits*, Audit #: GAO-07-570 :

The benefits to state tax agencies included reducing the costs of processing paper returns plus related costs due to correcting math and transcription errors and contacting taxpayers about such errors. The magnitude of the benefits to tax agencies depends on the savings per return and the number of taxpayers converted from paper to electronic filing. Returns prepared and filed through I-file that would have otherwise been electronically filed do not generate significant benefits in the form of reduced costs for the tax agencies. Only returns converted from paper to

electronic filing generate benefits in terms of cost savings for the tax agency.

In addition to the benefits to the tax agencies, state I-file systems also generated benefits for users. Taxpayers who convert from paper to electronic filing because of the availability of I-file received the benefits of electronic filing, such as faster refunds. Compared to paper filing, Utah's TaxExpress I-file system reduced return processing time to 4-5 days from 8-10 days and generated faster refunds. South Carolina's SCnetFile! users received direct deposit of refunds within 9-10 days, paper checks were processed within about 3 weeks, according to agency officials. Some taxpayers who convert from paper may benefit by not having to respond to notices for math errors, by having lower compliance burdens, and by preferring electronic confirmation that the tax agency received their return. A benefit to some taxpayers using I-file is saving on electronic filing fees. Taxpayers who were charged electronic filing fees and convert to I-file would save. Taxpayers, who electronically file for free, such as users of the Free File program, would not save on fees. Another benefit to some taxpayers using state I-file systems is the security of not having to file through a third party such as an ERO.

**4. What lessons from states' experiences with I-file systems should be kept in mind when considering developing such a system?**

The GAO discusses technology, features and eligibility. Also discussed were benefits and costs. A number of lessons that can be drawn from the states' experiences as highlighted in its report to the Senate Committee on Finance entitled -- *State Experiences Indicate IRS Would Face Challenges Developing an Internet Filing System with Net Benefits*, Audit number GAO-07-570 as outlined below:

The options available to IRS for implementing I-file system vary in technology, features, and eligibility. The states profiled all employed an interactive format on their Web sites for tax return preparation. The systems varied in whether they included features such as the ability to save and return. Systems also varied in eligibility, i.e. limiting income or residency.

For the system profiled, both reported benefits and costs were relatively modest and it is unclear whether benefits were greater than costs. I-file system may generate benefits by increasing electronic filing and reducing filing fees for taxpayers.

IRS's potential to realize net cost savings from an I-file system depends on the costs of developing the system and the number of taxpayers converted from paper to electronic filing. IRS's costs could be higher than the states'. First, the federal tax system is more complex. Second, unlike states which already had Web sites with Internet transaction capabilities, IRS would have to significantly upgrade its Web site and incur new

security costs. Finally, developing an I-file system would further stretch IRS's capability to manage systems development.

**5. How long would it take for the IRS or an outside contractor to design, install and implement a direct portal?**

The federal tax system and federal tax returns are more complex than the states and the IRS' fixed and variable costs would be substantially higher than those incurred by the states that have a direct portal. The scale of any such systems that might be implemented by the IRS would inevitably require investments in hardware, software, and business process redesign, and would have to be prioritized in the context of all the other modernization projects the IRS is in the process of delivering. Other critical issues to take into account include taxpayer security and privacy, ongoing maintenance and continuous upgrades to keep pace with changes in the tax laws, and the impact of such an effort on IRS operations and IRS' portfolio of enterprise improvement projects. In addition to the costs, the IRS would probably not be able to have a system available until at least 2011.

**6. What is the estimated cost of a direct portal with a) fillable .pdf files, b) .html with simple calculators?**

The amount of planning and development that would have to go into this effort is substantial and the IRS would need to look at a variety of scenarios to determine how to accomplish this most effectively. Depending on the scenarios, costs could vary considerably – and could run into in the hundreds of millions of dollars once support expenses are factored in.

**7. Are there lessons that could be learned for how IRS handled TETR claims that could be applied to other issues?**

Yes, the Telephone Excise Tax Refund initiative has resulted in lessons learned that can be applied to other issues or similar refunds that may arise in the future. In particular, we believe the following best practices are applicable to other areas:

A multi-faceted compliance approach, which included Commissioner statements, press releases, and "knock and talk" visits, positively affected tax preparer behavior. Monitoring tax preparer behavior after "knock and talks" confirmed the effectiveness of our efforts. Additionally, cross-enterprise collaboration resulted in criminal investigations for a number of questionable preparers.

Managing the audit process real-time and performing ad-hoc reporting during the filing season also contributed greatly to the success of the compliance effort.

IRS disseminated a large volume of TETR information to both internal and external stakeholders created an overall awareness of the TETR initiative. By actively soliciting questions and comments from stakeholders and continuously updating the web-based Q&As, the IRS was able to respond quickly to inquiries and emerging issues and ensure that up-to-date information was readily available. Targeting large preparers early in the season through education and

outreach was also effective in increasing awareness and reducing filing errors as the season progressed.

Establishing a single point of contact for communications also ensured that a consistent message was disseminated throughout the IRS and communicated to external stakeholders. And, establishing a single point of contact for TIGTA and GAO audits minimized disruption to the day-to-day activities of IRS staff.

#### 8. **What specific concerns has TIGTA identified in the Telephone Excise Tax Refund Program?**

TIGTA is currently conducting an audit of IRS' TETR compliance efforts, and most of their concerns stem from this study. They've noted no other problems and, in fact, appear to concur with GAO's assessment of IRS' TETR approach as a management best practice. Below are concerns TIGTA has raised regarding the TETR Program.

- The number of claims received for the one-time TETR has been lower than expected, especially the number expected from taxpayers who were not otherwise required to file tax returns. Because there are far fewer Forms 1040EZ-T being filed than expected, the IRS has revised its projections for the remainder of the filing season. The IRS is now projecting the number of Forms 1040EZ-T receipts to be about 676,000 through June 9, 2007<sup>1</sup> versus the previous estimate of 22 million.
- As of April 22, approximately 28.5 percent of the 96 million individual returns processed have not requested TETR.
- TIGTA felt the criteria IRS used when taxpayers claimed refunds for more than the standard amounts but did not provide the required Form 8913 to substantiate their claims were not stringent enough. (*Note: When TIGTA reported this issue, the IRS took steps to address the problem.*)
- Criteria used for screening TETR refund requests were not set to identify when taxpayers claimed one amount on their tax return and a different amount on their Form 8913.
- TIGTA is concerned that the criteria used to identify questionable claims for audit were not stringent enough. However, each year, top IRS management makes carefully thought out decisions about how to deploy scarce audit resources to achieve a balanced compliance program. In doing this, IRS is forced to deal with the difficult reality that we cannot address every compliance problem completely. The TETR was one of many competing priorities this year. TIGTA recommended that the IRS re-examine all options at its disposal to address significantly more inappropriate telephone excise tax refund claims, including offering taxpayers the opportunity to self-correct their returns, postponing some examination work, and having non-examination employees work (or partially work) some of the simpler cases. The IRS responded to TIGTA's concerns, stating that we did consider

<sup>1</sup> The "Lower" projection has the IRS receiving only 315,208 Forms 1040EZ-T; the "Most Likely" projection is 637,030, and the "Higher" projection is 7,347,546.



different ways of addressing TETR compliance, including creating a completely new compliance model and selection engine, establishing a weekly review of questionable refund requests and adjusting the audit selection mix based on that review, and identifying potential abuse by preparers and initiating both criminal and civil actions to address them.

- TIGTA also shared concerns about paid preparers requesting the telephone excise tax refund on their client's behalf. In mid-February, IRS issued search warrants for tax preparers in seven cities and teams of revenue agents (auditors) and special agents (criminal investigators) began visiting tax preparers across the country that were filing questionable refund requests.

**9. Are IRS filters to detect fraudulent Telephone Excise Tax Refunds adequate to stop false refunds from being issued? Will special processes be required to recoup incorrect refunds that have been issued, and, if so, please describe what they are?**

If all or a portion of a Telephone Excise Tax Refund has erroneously been issued, the government can only recoup the erroneous refunds through voluntary repayment by the taxpayer or by filing an erroneous refund suit. For this reason, the IRS is screening and examining returns prior to a refund being issued.

The screening includes filters to detect questionable refund requests. Filters for business entities were developed using actual telecommunications industry expenditures gathered by a telecommunications analytics company. The filters were derived from analyses of business phone expenses and limit, but do not completely eliminate, the possibility of erroneous refunds being issued.

The filters used for non-business refund requests were set above the median dollar amount the IRS believed that taxpayers were owed, but at a level that limits exposure of the government by ensuring that the cost of recovery is not greater than the overstated amount requested by the taxpayer. Again, this limits but does not eliminate the possibility of an erroneous refund being issued. As of April 22, 2007, more than 99.5 percent of individual taxpayers opted to request a safe harbor amount, which we believe has effectively limited fraudulent requests.

**10. To what extent is the existing IRS refund fraud detection system (EFDS) effective? What is the status and timeline of IRS plans to develop and implement a new EFDS system?**

The Fraud Detection Centers (FDCs) have used EFDS this filing season to identify more than 91,000 potentially fraudulent tax returns claiming more than \$628 million. This is more than double the number identified in the 2005 Filing Season during the same timeframe. Several factors are contributing to this growth. Changes were implemented to the data mining model which improved the performance of the models. Additionally, with the public awareness of EFDS not being operational last year, it is possible that more fraud is being attempted.

The current version of EFDS has been fully operational the entire filing season with few problems. Enhancements will be made this calendar year to incorporate

data from Health and Human Services (HHS) to improve the employment verification process for returns claiming the Earned Income Tax Credit (EITC). Additionally, detailed requirements for the 2008 Filing Season are being developed on high priority items such as codes to track identity theft cases and further improvements to the data mining models.

The current version of EFDS will be in place at least through the 2008 Filing Season. A study to evaluate future alternatives for EFDS was conducted which assessed the viability of completing work on Web Portal and evaluated its ability to support future business model and process requirements defined in the Pre-Refund effort. IRS Executives, as members of the EFDS Advisory Council, have approved the recommended strategy to return to the Web Portal Development while in the interim keeping the current EFDS client server healthy until Web Portal development is completed and successfully placed into production. The EFDS Advisory Council will provide an oversight role throughout the development of the Web Portal system with a first release not likely occurring until Processing Year 2010.

**11. How well has the IRS implemented the requirement for taxpayers to substantiate the value of noncash charitable contributions?**

The IRS continues to emphasize the importance for taxpayers to substantiate the deductions reflected on their tax return. In dealing with noncash charitable contributions, IRS publications and instructions provide that there is no single formula that applies when determining the value of the property. The taxpayer must consider the condition and all other relevant facts and circumstances associated with such property value. If the donation is restricted or limited in any manner, the value must take into consideration all restrictions made to the gift.

The IRS has revised forms and instructions to reflect recent legislation tightening the rules for valuing donations of certain property. For example, for donated vehicles valued at more than \$500, the deduction is limited to the lesser of the gross proceeds received by the charity from the sale of the vehicle or the fair market value unless certain exceptions apply. A new form 1098-C is used by the charity to provide acknowledgement of the gross proceeds received and any exceptions that may apply. Other new requirements apply to donations of clothing and household items, taxidermy property and easements on buildings in historic districts.

While taxpayers claiming deductions larger than specified amounts on certain types of noncash charitable property are required to have an appraisal and in some cases attach it to their tax return, the value of such property (as with all noncash charitable property) is self-reported by the taxpayer or their appraiser. The only way to ensure the value identified on the return is representative of fair market value (at the time of the gift) is by examining the tax return. In order to review the audit potential of these cases and ensure we properly utilize our compliance resources, we have started Compliance Initiative Projects in addition to our normal audit selection and classification methods.

The Treasury Inspector General for Tax Administration (TIGTA) also reviewed our procedures to identify non-compliance with the reporting requirements for noncash charitable contributions during FY2006, and most recently with the reporting requirements for contributions of motor vehicles. While the latter report is still in draft, we have committed to a number of actions to better identify and address non-compliance in this area. We are expanding our outreach and education efforts, and our Tax Exempt and Government Entities (TEGE) organization is also promoting awareness of the increased reporting requirements to donee organizations, including the requirements for appraisals and appraiser signatures on Form 8283. We are partnering with external professional stakeholder groups such as the Tax Executive Institute, American Institute of Certified Public Accountants, American Bar Association, as well as professional appraisal stakeholders such as American Society of Appraisers and Appraisal Institute to promote awareness of the increased reporting requirements. We are corresponding with taxpayers claiming a noncash contribution over a specific threshold dollar amount and missing Forms 8283, and are also in process of developing a systemic indicator for such returns.

**12. Why does the IRS accept and process tax returns when taxpayers have failed to attach required forms, including Forms 8282 and 8283, to the tax return? What effect does this have on tax compliance?**

The Form 8282, Donation Information Return, is required to be filed by charitable organizations that dispose of donated property generally within three years from the date of the gift. A Form 8282 that is submitted by the charity to the IRS is separately processed at our Ogden Campus. The only instance where Form 8282 should be attached to a tax return is where a taxpayer is using this document as their written acknowledgement as defined in IRC section 170(f)(12).

The taxpayers (donors) must attach Form 8283, Noncash Charitable Contributions, to their return if the amount of their deduction for all noncash gifts is more than \$500. Specific to Form 8283, the IRS has current procedures in place to contact those taxpayers over a threshold dollar amount where the Form is not attached. In response to a recent TIGTA report, the IRS plans to expand its scrutiny of such returns by applying a specific indicator with a much lower threshold on processed tax returns missing Form 8283.

**13. How does the IRS plan to increase the number of taxpayers who take advantage of the split refund option to increase savings?**

The IRS will continue to promote the split refund program directly to taxpayers, tax professionals, partners, and stakeholders (e.g. financial institutions, software developers). The IRS also will support tax professionals, partners, and stakeholders in promoting split refunds to their customers and clients. The IRS will write and distribute news releases specifically about the split refund as well as incorporate information about split refunds into communications products about other topics such as direct deposit, e-file and e-pay. As we did this year, we will develop or update fact sheets, FAQs, and articles and post them on IRS.gov and distribute them to the news media and more than 100,000

tax professionals and other partners that subscribe to IRS e-news for tax professionals. We will also actively leverage partnerships and stakeholder relationships to encourage them to spread the split refund message at the grassroots level.

- 14. The IRS increasingly is relying on volunteers to prepare tax returns for low income and elderly people. A TIGTA sample found a 100% error rate of volunteer-prepared returns. What is the IRS doing to enhance the quality of volunteer tax preparation?**

IRS has developed a comprehensive Volunteer Return Preparation Program Quality initiative in response to TIGTA and IRS findings of widespread inaccuracies in tax return preparation services. In April 2004, the IRS established a SPEC/Partner Quality Improvement Team to formally address the accuracy of tax returns prepared at Volunteer Income Tax Assistance and Tax Counseling for the Elderly (VITA/TCE) sites. The Quality Team developed a multi-year business plan to identify operational processes, clarify roles and responsibilities, and develop metrics, training and tools for partners and volunteers. These improved operational processes were put into place for the 2005 Filing Season.

The IRS began the second phase of its Volunteer Return Preparation Program-Quality Improvement Process (VRPP-QIP) in FY 2006 and implemented a number of critical improvements. Highlights included enhanced partner training, required volunteer certification, and mandatory use by all volunteers of the Interview & Intake Sheet throughout the preparation and review process. We also conducted Site Reviews to measure the procedural and administrative aspects of volunteer site operation, Return Reviews to measure whether tax law was applied properly for critical items and resulted in a correct return, and Shopping Reviews to measure the taxpayer's qualitative experience at the volunteer site.

While TIGTA has not issued its report for the FY 2007 filing season, TIGTA acknowledged a significant improvement over previous years in the accuracy of returns filed at IRS' VITA/TCE sites, as well as in the accuracy of high impact tax law elements such as Earned Income Tax Credit (EITC), Filing Status, and Dependents.

- 15. Describe IRS support and oversight efforts at volunteer tax preparation sites. How does the IRS test and measure service and accuracy at volunteer sites? What are the most recent accuracy rates for volunteer tax preparers?**

Every partner, both local and national, works with an IRS Stakeholder Partnerships, Education and Communication organization (SPEC) point of contact (called a "Relationship Manager") that is responsible for managing the relationship and supporting the partner. SPEC's Relationship Managers maximize every talent, skill and resource to create partnerships that provide mutually supporting value for taxpayers, partners and the IRS. SPEC provides its partners a number of items such as tax preparation software, loaned computer

hardware, volunteer training materials, tax law and software training for partner designated trainers, participation in volunteer training delivery, quality assurance reviews of return preparation sites, educational outreach products & marketing materials, research data for optimal site placement and effectiveness, supplies and technological support.

To test and measure accuracy at volunteer return sites, SPEC conducts Site Reviews to measure the procedural and administrative aspects of volunteer site operation, Return Reviews to measure whether tax law was applied properly for critical items and resulted in a correct return, and Shopping Reviews to measure the taxpayer's qualitative experience at the volunteer site. SPEC uses the results to identify areas of concern due to process, training, communication or guidance.

It was determined that the accuracy measure would be based on TIGTA's assessment of the overall accuracy rate for tax returns prepared within the VITA/TCE program. For Filing Season 2007, SPEC identified an accuracy goal of 55 percent. While TIGTA has not issued its report, preliminary results show a significant improvement over the overall accuracy rate of 39 percent in FY 2006.

**16. Identify the five up-front actions (before or during return-filing) that the IRS could take to most effectively improve tax compliance?**

While we cannot identify specifically just five up-front actions that the IRS could take to most effectively improve tax compliance, we can point out the various actions either underway or that will be taken to improve tax compliance. For example, the following actions taken in the Taxpayer Assistance Centers (TAC) could improve tax compliance:

- Continue emphasis on using established technical guidance documentation and processes when answering tax law questions for taxpayers.
- During return preparation contacts, thoroughly explain issues such as Earned Income Tax Credit (EITC) and dependents credits to taxpayers.
- Continue implementation of Contact Recording which is the recording of taxpayer contacts including face-to-face contacts for quality purposes as a tool for improving the quality of responses and service to taxpayers.

Contact Recording is an automated system that records the audio portion of an employee- customer contact. Its purpose is to monitor the quality of employee responses and services to taxpayers.

- Begin testing the feasibility of recommendations in the Taxpayer Assistance Blueprint (TAB) Phase 2 Report for self-assisted services in the TACs. The recommendations are based on extensive research on taxpayer service preferences and, if found feasible, could result in a redirection of resources.

As the education and outreach function of the IRS, the Stakeholder Partnerships, Education and Communication organization is taking the following actions:

- Increasing EITC outreach
- Testing and expanding the Life Cycle product line

The Life Cycle product line is a series of informational publications designed to educate taxpayers about the tax impact of significant life events.

- Developing initiatives for targeted taxpayers (the Disability Initiative, the Limited English Proficiency Hispanic Initiative, the Native American Initiative, and the Rural Initiative).
- Expanding web-based training programs
- Developing products and educational outreach tools
- Improving the Quality Process

In addition to the above activities, to improve tax compliance, the following 16-point request for statutory changes was included in the FY 2008 President's Budget Request:

1. Require information reporting on payments to corporations
2. Require basis reporting on security sales
3. Expand broker information reporting
4. Require information reporting on merchant payment card reimbursements
5. Require a certified taxpayer identification number from contractors
6. Require increased information reporting for certain government payments for property and services
7. Increase information return penalties
8. Require e-filing by certain large organizations
9. Implement standards clarifying when employee leasing companies can be held liable for their clients' federal employment taxes
10. Amend collection due process procedures for employment tax liabilities
11. Expand IRS access to information in the national directory of new hires for tax administration purposes
12. Permit disclosure of prison tax scams
13. Make repeated willful failure to file a tax return a felony
14. Expand preparer penalties
15. Impose penalty on failure to comply with electronic filing requirements
16. Create an erroneous refund claim penalty

**Please note any responses to the following questions concerning identity theft that should not be entered into the public record.**

- 17. What is the IRS policy for processing tax returns with stolen or false social security numbers?**

The IRS does not knowingly process tax returns filed for fraudulent purposes including identity theft. Per the Internal Revenue Code, the IRS is mandated to process all tax returns which appear to constitute a valid return. The IRS employs multiple tools to identify suspicious tax returns to combat against processing returns with stolen or false social security numbers.

- 18. To what extent does the IRS policy concerning stolen or false social security numbers comply with all applicable federal laws, including making false statements or misprision of a felony?**

In connection with the IRS' routine processing of tax returns, the use of stolen or false social security numbers may be discovered. When the use of stolen or false social security numbers is uncovered as part of a refund fraud scheme, the Fraud Detection Center refers to CI field offices for further evaluation those schemes meeting criminal prosecution potential for tax, money laundering, or bank secrecy act violations. If the investigation does not reveal enough to warrant a referral for prosecution, the tax matter is turned over to the civil functions which pursue the tax violations civilly. Internal Revenue Code section 6103 generally precludes the IRS from sharing information about related violations with other agencies.

While the use of stolen or false social security numbers can be investigated under a variety of criminal statutes, the IRS generally relies on 18 USC § 1028(a)(7) to prosecute identity theft cases. The IRS' jurisdiction over identity theft violations, however, is limited to cases that have a nexus with tax administration or money laundering. As such, identity theft cases are generally charged along with substantive tax and money laundering violations. The final decision as to how the use of stolen or false social security numbers is ultimately charged rests with the Department of Justice.

**19. Why has the IRS adopted a policy that tolerates, even encourages, the use of stolen identities, without consequences to the identity thief?**

The IRS does not have any policies which tolerate or encourage the use of stolen identities.

Where justified, we have referred cases of identity theft to our Criminal Investigation (CI) unit. In the past two years, CI has investigated a number of cases that were successfully prosecuted in which identity theft has led to tax fraud. In March 2007, two women from Ohio were sentenced to 63 and 188 months, respectively, and ordered to pay \$300,000 in restitution for perpetuating an identity theft scheme. As part of this scheme, the women claimed nearly \$114,000 in tax refunds to which they were not entitled.

Last November, a Florida man was sentenced to 63 months in prison to be followed by three years of supervised release for making false claims against the IRS and for identity theft. He also was ordered to pay a personal money judgment of \$152,171, and to pay \$152,171 in restitution to the IRS. To carry out this scheme, the man used the Internet to obtain personal information, including names and dates of birth, for at least 150 Florida inmates.

**20. How many IRS resources are devoted to combating identify theft?**

IRS resources are devoted to combating identity theft on an integrated basis. There are multiple business units throughout the IRS that are devoted to the integrity of the tax return information, including those instances where identity theft is suspected or may contribute to an adverse tax implication. The

predominant programs that dedicate resources to resolving suspicious tax administration issues are the Scrambled SSN unit, the Automated Underreported Income unit and the Questionable Refund Program. The IRS has established a corporate Identity Theft and Incident Management Program which will focus on identifying proactive strategies to combat identity theft issues related to tax administration as well as IRS employees. This program will be staffed initially by 10 dedicated employees and the number of employees may increase as the program assumes additional responsibilities. In addition, multiple IRS resources across the service are devoted to combating identity theft in the form of security protections against internal breaches of Personally Identifiable Information which can lead to identity theft.

**21. Are there tools that IRS needs to more cost effectively combat identify theft?**

The IRS has initiated a Joint Anti-Phishing Task Force to identify improvements for more robust authentication capabilities for the tax return submission process. It is currently in the exploratory stages of evaluating technologies which electronically "brands" authorized e-file partners as well as more robust technologies that crawl through Internet sites across the World Wide Web to look for indications of fraudulent schemes related to electronic tax transactions.

Additionally, as required by OMB Memorandum M-07-16 ("Safeguarding Against and Responding to the Breach of Personally Identifiable Information"), we are currently reviewing our current holdings of personally identifiable information and reducing them to the minimum necessary for the proper performance of a documented agency function. Additionally, we are implementing Attachment 1 of Memorandum M-07-16 which requires employees (including managers) to receive training on their privacy and security responsibilities before permitting access to agency information and information systems, as well as annual refresher training commensurate with the applicable level of responsibility.



- 22. A tax return filed under an ITIN, with a W-2 attached containing an SSN, should be a signal that something is awry. Explain why the IRS accepts these returns, and made it easier to file them electronically in 2007.**

Under the Internal Revenue Code, resident aliens are generally subject to the same tax and are required to file U.S. tax returns in the same manner as U.S. citizens. Such aliens that do not have and who are not eligible to obtain SSNs from the Social Security Administration may apply for an IRS-issued Individual Taxpayer Identification Number (ITIN) to facilitate the filing of tax returns and payment of taxes required by the Code. An ITIN is not valid for employment. Because resident aliens are legally required to file and pay U.S. tax, the IRS processes returns filed with ITINs regardless of whether the attached W-2s contain SSNs used for illegal employment.

The IRS believes that most ITIN holders whose wages are reflected on valid Forms W-2 are using stolen or fabricated SSNs because employers are prohibited from employing individuals who lack an SSN and employers use the SSN provided by such employees in reporting W-2 information. Although the theft or fabrication of an SSN is illegal, the IRS has no legal authority with respect to the enforcement of immigration and social security administration laws. In addition, the IRS is precluded under Section 6103 from sharing that information with third parties, including other executive agencies, except in very limited circumstances provided under Section 6103.

On December 17, 2003, the IRS instituted changes to the ITIN application procedure to ensure that the ITIN assigned is used for its proper tax administration purpose. In most cases, an ITIN applicant is now required to file the ITIN application, Form W-7, attached to a completed tax return for which he or she needs the ITIN. Associating the issuance of the ITIN with the filing of a tax return ensures that the number is properly used for tax administration. Another enhancement to the application process was a decrease in the number of acceptable types of documents that IRS will accept to establish identity and foreign status.

The enhancements to the ITIN application procedures strengthened controls over issuance to help ensure that the ITIN is used for its intended tax administration purpose while at the same time did not pose an undue burden on those who legitimately require an ITIN in order to comply with their tax obligations under the Internal Revenue Code.

- 23. Would you consider the use of a false or stolen SSN to get a job or to file a tax return to be identity theft?**

Anytime an individual's personal, identifying information is used without his/her consent or knowledge, the Federal Trade Commission (FTC) considers the event an act of identity theft. In implementing the Fair and Accurate Credit Transactions Act (FACTA), the FTC defines "identity theft" as a fraud that is

committed or attempted, using a person's identifying information without authority. The rule also states that "identifying information" should have the same meaning as "means of identification" in the federal criminal statute defining identity theft. See the regulatory reference below for additional clarification.

**16 CFR 603.2 Identity theft.**

(a) The term "identity theft" means a fraud committed or attempted using the identifying information of another person without authority.

(b) The term "identifying information" means any name or number that may be used, alone or in conjunction with any other information, to identify a specific person, including any--

(1) name, social security number, date of birth, official State or government issued driver's license or identification number, alien registration number, government passport number, employer or taxpayer identification number;

(2) unique biometric data, such as fingerprint, voice print, retina or iris image, or other unique physical representation;

(3) unique electronic identification number, address, or routing code; or

(4) telecommunication identifying information or access device (as defined in 18 U.S.C. 1029(e)).

**24. How many cases of identity theft were reported to the IRS last year?**

IRS identity theft cases are identified through three primary avenues: through the underreporting of wages, in the filing of a return, or through the identification of questionable claims for refunds. The following table represents the number of identity theft-related cases by these program types.

**Identity Theft Cases by Program Type**

	FY06	FY07 (thru May)
Scrambled SSN	10,623	6,695
Automated Underreported Income	16,152	7,698
Questionable Refund Program* (CI)	4,545	9,561

**25. To what extent does the IRS notify an individual when someone else is using his or her SSN?**

There are three types of identity theft crimes in tax administration: refund crimes, employment and income diversion.

**Refund crimes** are perpetrated by criminals who use another person's tax information to file a fake return and steal a refund. The Refund Crimes Unit of the IRS' Criminal Investigation Division identifies those returns through the Questionable Refund program. The IRS has made numerous fundamental changes to the Questionable Refund Program to ensure that taxpayers receive

notification when their refunds are held for further review and to make timely and proper determinations of the accuracy of their accounts.

**In cases of identity theft relating to the use of another person's identity to obtain employment**, the identity thief provides the employer, the victim's name and SSN to obtain employment. Or the identity thief may use the SSN of another person but still use his or her own name. The wage information is reported to the SSA by the employer on the Form W-2 using the stolen identification information. When the Form W-2 information is received from the SSA, the IRS performs a match of the SSN and name on the wage documents to the IRS records. The IRS will identify a mismatch or underreporting of income when in fact, the identity theft victim did not underreport his or her income. When the IRS identifies a mismatch or underreporting of income, the IRS will issue a notice to the individual involved.

**In cases of identity theft relating to the use of the use of another person's identity to file a tax return**, the victim's name and SSN are used on a tax return filed by another taxpayer. If both the victim and the identity thief file a tax return for the same tax period, a duplicate filing will result. The IRS conducts internal research in an attempt to secure a valid taxpayer identification number. Taxpayers are contacted for additional information if these cases cannot be resolved based on internal research.

**26. How does the IRS prevent the use of stolen identities to file tax returns? What else can the IRS do to protect taxpayers' identities?**

Due to the nature of identity theft, it is a challenge to prevent tax returns filed with stolen identities at the entry point of our pipeline operations. However, the IRS does utilize various filtering mechanisms which result in the segregation of returns possessing certain characteristics from posting within our return disposition process. In addition, IRS Criminal Investigation utilizes the Electronic Fraud Detection System (EFDS) to screen returns which appear to be "questionable" at the onset of our return processing pipeline operations.

Both the filtering mechanisms and EFDS serve as quality control mechanisms which are consistent with sound tax administration stewardship. These are efforts designed to reduce the potential for erroneous and fraudulent return submissions. However, the IRS does not have the ability to proactively prevent individuals from attempting to file such returns. We can only work to mitigate the harm and potential corrosive effect on tax administration presented by tax returns filed with stolen identities.

The IRS has also undertaken several outreach initiatives to provide taxpayers, employees, and other stakeholders with the information they need to proactively prevent and resolve identity theft issues. 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 Department of 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.
- Lead 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.
- Partnered with the Treasury Inspector General for Tax Administration (TIGTA) to develop and promote 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."
- Jointly with TIGTA published 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.

**What else can the IRS do to protect taxpayers' identities?**

As required by OMB Memorandum M-07-16 ("Safeguarding Against and Responding to the Breach of Personally Identifiable Information"), we are currently reviewing our current holdings of personally identifiable information and reducing them to the minimum necessary for the proper performance of a documented agency function. Additionally, we are implementing Attachment 1 of Memorandum M-07-16 which requires employees (including managers) to receive training on their privacy and security responsibilities before permitting access to agency information and information systems, as well as annual refresher training commensurate with the applicable level of responsibility.

Additionally, IRS is looking into bolstering its existing authentication requirements and screening processes.

**27. What actions could the IRS take to prevent the type of fraud perpetrated by Mr. Evangelos Soukas, who testified before the Committee at today's hearing?**

The IRS will look into bolstering its existing authentication requirements and screening processes. If this is done, it may serve to prevent the type of fraudulent activity perpetrated by Mr. Soukas. However it should be noted that, the IRS would have to carefully analyze this issue, as we would not want to unduly increase taxpayer burden for the overwhelming majority of taxpayers whom are not affected by identity theft. In addition, there would most likely be significant financial costs associated with such an effort.

**28. How could the IRS revise its policies and processes to discourage the use of identity theft in connection with filing a tax return?**

IRS works to strengthen its fraud detection capabilities every year. In addition, IRS and the Department of Justice seek to publicize the arrests, convictions, and incarceration of individuals found guilty of tax crimes as a deterrent to others.

**29. Last year the GAO testified that during an undercover investigation of 19 paid preparers, not one of them accurately prepared a simple tax return. On page 24 of the IRS' written testimony, the complexities of the tax law are cited as an excuse for these inaccuracies. Since the scenarios used were very simple and straightforward, not complex, please explain how the IRS' rationale in reaching this conclusion.**

As GAO reported, the preparers made a variety of errors. In 10 out of 19 cases, the preparer did not report business income. In 8 out of 19 cases, the preparer handled state tax refunds incorrectly. In 10 out of 10 cases, a taxpayer did not receive the child and dependent care tax credit to which she was entitled. In 7 out of 9 applicable cases, itemized deductions were not claimed.

In many of these instances, the preparer's errors appeared to be related to the complexity of the underlying law. In order to properly prepare the income tax return, all of the facts and circumstances surrounding the income or expense need to be developed because of the interrelationships built into the tax system which creates the complexity. The return preparer must have a clear understanding of how one income/expense item relates to other income/expense items on the return. For example, in scenarios regarding the state income tax refund, the preparer did not recognize the refund as income in the subsequent year when it had been deducted as an itemized deduction in a prior year. In other cases, preparers did not appear to understand that all income from casual self-employment arrangements had to be reported. In addition, many of the visits

conducted by GAO involved a scenario requiring the preparer to compute Earned Income Tax Credit (EITC). The rules pertaining to EITC are inherently complex, including the rules defining a qualifying child. Mistakes made in the EITC area contributed to the overall inaccuracies attributable to the preparers visited.

Preparers also had difficulty understanding the law as it applied to tax provisions that would have benefited their clients. In two cases, the preparers did not do the necessary (if cumbersome) computations to determine that the taxpayer would benefit by itemizing his or her deductions, rather than claiming the standard deduction. None of the preparers observed that the taxpayer was eligible for the child and dependent care tax credit, even though she was unable to obtain the taxpayer identification number for her caregiver. (Under current law, she was eligible if she had tried to obtain the social security number.)

**30. How many of the CEOs of the tax preparation firms has the IRS contacted?**

Following the preliminary analysis of the GAO investigation by SB/SE, we held briefing sessions with the CEOs of two major firms. The preliminary analysis did not reveal indications of major noncompliance with respect to these particular firms. Because the analysis indicated potential problems with other firms, and subsequent information could potentially result in a referral back to Criminal Investigation (CI), the four other firms were not contacted.

**31. It's been a full year since the GAO investigation – why hasn't more been done?**

See the Answer to Question 32.

**32. What message do you think it sends to other preparers when the IRS fails to take prompt action even on such high-profile cases? Isn't this a missed opportunity for the IRS?**

We take the referral of these cases very seriously and understand that if we had taken more prompt action we could have addressed the issues raised and possibly stopped further noncompliance.

Delays were encountered because the information was provided to us in the form of a "law enforcement referral." Criminal Investigation (CI) reviewed each of the 19 preparer cases first, incorporating information already identified by their fraud detection centers. Our normal process generally involves CI reviewing cases at the end of the review and case building process. Generally, in cases of this type, criminal referrals are made after a civil investigation determines indications or elements of fraud. In this situation, the criminal analysis was completed on the front end. When CI concluded that not one of the 19 referrals met the criteria for a criminal investigation, the cases went into our usual pipeline. The cases were no more egregious than the cases already in the pipeline and were not identified for "special" treatment. In several of these 19 cases, the preparer's error was in favor of the government. In several others, the overstated refund was

approximately \$200 and in approximately four instances, the refund amount was substantially correct. The IRS is pursuing preparer penalty cases against the remaining four preparers and conducting due diligence visits of the remaining 15.

If the IRS receives similar referrals in the future, we will strive to work the cases in an expeditious manner.

**33. Given the importance of paid preparers in our tax administration system, would it be useful for IRS to devote more resources to oversight of the paid preparer industry?**

We need to understand clearly what additional oversight would be intended to accomplish this. Ensuring that taxpayers are dealing with well-educated, competent tax preparers is a worthy goal. While testing and licensing of the estimated 850,000 preparers who might apply for licensure, as well as educating consumers about the benefits of using a licensed tax preparer might help to avoid mistakes on returns, it is not clear that the benefits of a large regulatory regime outweigh the significant costs. Ensuring that taxpayers are using honest preparers, (i.e. the issues surrounding enforcement), is a much more difficult goal to achieve. Developing the appropriate penalties for unethical return preparers, providing disincentives to taxpayers who use unlicensed return preparers who may or may not choose to sign the return, monitoring return preparers and creating the infrastructure to ensure fair treatment of those tax preparers accused of unethical and/or noncompliant behavior would be a resource intensive, time consuming and costly undertaking. At this point, we lack the metrics to determine ROI and whether using scarce resources here would be the best use of those resources. OPR will be doing more work on the metrics to enable all interested parties to make better informed decisions.

**34. To what extent do you believe up-front taxpayer services affect the rate of tax compliance, and the need for enforcement action down the road?**

The IRS does not have strong empirical evidence of the extent to which service programs improve compliance. There are, however, widely accepted theoretical reasons to believe that better information and high value customer service programs can mitigate non-compliance that is inadvertent and unintentional.

For example, we believe our forms, instructions, taxpayer education, outreach, and IRS and volunteer taxpayer services have an effect on filing, reporting and payment compliance. The Taxpayer Assistance Blueprint Strategic Plan has recommended an expanded research effort to understand the causes of inadvertent errors and to analyze which service treatments are cost-effective options for reducing problems of non-compliance. The FY08 Budget Submission includes a request for \$5,000,000 to fund new research on the service needs of taxpayers and the effect of service on taxpayer compliance.

**35. To what extent do current IRS policies, priorities and staffing recognize the value of up-front services and oversight?**

The value of up-front services and oversight are reflected in the Commissioner's efforts to instill this equation into the policies, priorities and culture of the IRS: Service + Enforcement = Compliance and to rebalance the organization. As such, over the last several years, the IRS has seen improvement in both its taxpayer service and enforcement programs.

The Taxpayer Assistance Blueprint Strategic Plan (TAB), recently delivered to Congress, made recommendations to maintain and enhance all IRS service delivery channels. The TAB offers recommendations to expand, simplify, standardize and automate services, and to improve and expand technology infrastructure. The FY08 Budget Submission includes a request for \$10,000,000 to fund TAB recommended initiatives to implement telephone service and electronic interaction enhancements. The TAB also includes recommendations for increasing education and outreach to taxpayers, partners and IRS employees, and incorporating feedback from these stakeholders into future service decisions. In addition, the TAB recommends expanded research to better understand both the causes of inadvertent errors and to analyze which service treatments are cost-effective options for reducing problems of non-compliance.

**36. Two years ago, the IRS abandoned plans to shut down 70 Taxpayer Assistance Centers. What are the IRS's current and future plans for Taxpayer Assistance Centers?**

IRS decisions on Taxpayer Assistance Centers (TACs) will be based on application of the processes recommended in the Taxpayer Assistance Blueprint (TAB). IRS delivery of the TAB Phase 2 Report to Congress in early April 2007 represents its completion of a Congressional mandate to develop a five-year plan for taxpayer service.

The Phase 2 Report includes a step-by-step process for future decisions about the TAC geographic footprint (locations). Data used for the Report revealed that a number of TACs are currently not well situated for the most effective service delivery. Specifically, these TACs show either a low number of contacts per full-time equivalent or they show low or redundant population coverage. To achieve the delivery of quality taxpayer service in a cost effective manner to the government, we will analyze the current locations of TACs by using the 26 taxpayer and government value criteria outlined in the Phase 2 Report. By August 2007 the project team will validate applicable data and present to IRS stakeholders a recommended process for identifying TACs around which a variety of business decisions might be appropriate. We expect that we will receive stakeholder feedback, and that modifications will be made to the process to satisfy or address that feedback.

While there are no plans to close any TACs in 2007, we recognize that a list of recommended closures could result from our using the 26 taxpayer and government value criteria. Any recommendations would be subject to a rigorous decision-making process.



**37. The IRS released Phase 2 of its Taxpayer Assistance Blueprint, a study taking into account taxpayer preferences and needs for IRS services.**

- a. What are the key findings and recommendations for the TAB?**  
**b. Will the IRS implement all of the recommendations of the TAB?**

RESPONSE (a): Thirty-nine separate research studies were conducted with much of the increased understanding of taxpayer needs, preferences, and behaviors coming directly from taxpayers through four major studies. The key findings, which led to over 50 specific recommendations, are far too numerous to detail here, but include:

- A majority of taxpayers surveyed who currently use IRS assistance indicated a willingness to use electronic services for various tasks in the future.
- Few customers visit Taxpayer Assistance Centers (TAC) relative to other channels (e.g., IRS.gov, telephone), but some segments of the population would prefer to continue using TACs rather than migrating to other service channels.
- Taxpayers who use IRS services are most concerned with first contact resolution.
- Overall, nine in ten taxpayers who used the IRS Web site, telephone line, or TACs for service in 2005 reported that they would use the same channel again in the future.

Based on the key findings, TAB made recommendations to maintain and enhance all IRS channels. The Blueprint offers recommendations to expand, simplify, standardize and automate services, and to improve and expand technology infrastructure. It includes recommendations for increasing education and outreach to taxpayers, partners and IRS employees, and incorporating feedback from these stakeholders into future service decisions.

RESPONSE (b): The IRS will continue to integrate TAB Strategic Plan recommendations into the annual planning and budgeting process. Four of the Strategic Plan initiatives and part of the Multi-year Research Portfolio were included in the President's FY08 Budget Request. The TAB-recommended Multi-year Research Portfolio will allow the IRS to continue making service-related decisions grounded in data concerning taxpayer needs, preferences, and behaviors. The plan provides specific actions to improve taxpayer service near-term and strategic direction thereafter. Implementation of specific recommendations is dependent on a number of variables that may contribute to the constant evolution of the five-year plan—including the results of future research, tax legislation, the IRS budget, technology, and the public marketplace.

**38. How can a taxpayer really know whether his tax preparer is competent?**

While no program of professional oversight can make a 100 percent guarantee of competency as to its members, Enrolled Agents, Attorneys, and CPAs have significant professional requirements that should give taxpayers a level of comfort. Enrolled Agents take a rigorous test, administered in three parts: individual, business, and representation/practice and procedures. Thereafter, enrolled agents must re-enroll every three years and prove that they have completed a significant amount of CPE. Attorneys and CPAs are subject to rigorous examinations, and most must complete significant continuing legal education requirements. Additionally, they are subject to disciplinary processes in their licensing state, over and above OPR's regulation of practitioners.

Although taxpayers are ultimately responsible for the preparation of their tax returns the IRS does provide guidance to taxpayers on the IRS web site per the example below.

#### **IRS TAX TIP 2007-06**

Taxpayers who pay someone to do their taxes should choose a preparer wisely. If you choose to use a paid tax preparer, it is important that you find a qualified tax professional. Taxpayers are ultimately responsible for everything on their return even when it's prepared by someone else.

Most reputable preparers will request to see your records and receipts and will ask you multiple questions to determine your total income and your qualifications for expenses, deductions, and other items. By doing so, they have your best interest in mind and are trying to help you avoid penalties, interest, or additional taxes that could result from later IRS contacts.

While most tax return preparers are professional and honest, taxpayers can use the following tips to choose a preparer who will offer the best service for their tax preparation needs.

**Ask about service fees.** Avoid preparers who claim they can obtain larger refunds than other preparers, or those who guarantee results or base fees on a percentage of the amount of the refund.

**Plan Ahead.** Choose a preparer you will be able to contact after the return is filed and one that will be responsive to your needs.

**Get References.** Ask questions and get references from clients who have used the tax professional before. Were they satisfied with the service received?

**Research.** Check to see if the preparer has any questionable history with the Better Business Bureau, the state's board of accountancy for CPAs or the state's bar association for attorneys. Find out if the preparer belongs to a

professional organization that requires its members to pursue continuing education and also holds them accountable to a code of ethics.

**Determine if the preparer's credentials meet your needs.** Are they an Enrolled Agent, Certified Public Accountant or Tax Attorney? Only attorneys, CPAs and enrolled agents can represent taxpayers before the IRS in all matters including audits, collection actions and appeals. Other return preparers may represent taxpayers only in audits regarding a return they signed as a preparer.

**39. What are the three primary actions the IRS is taking to ensure that tax preparers are generating accurate tax returns?**

1. During every field and office examination, examiners determine if return preparer violations exist. If evidence exists that a preparer is filing erroneous returns or there are indications of misconduct, consideration is given to asserting penalties under IRC §6694 (Understatement of Taxpayer's Liability by Income Tax Return Preparer) and/or IRC §6695 (Other Assessable Penalties With Respect to the Preparation of Income Tax Returns for Other Persons). If the preparer's misconduct appears to be pervasive and not isolated to a single taxpayer, then consideration is given to initiating a Program Action Case (PAC). A PAC is the examination of returns prepared by one preparer when information indicates a pattern of noncompliance with the preparer provisions of the Internal Revenue Code.

When the misconduct is extreme and appears likely to continue, the IRS seeks injunctions through the Department of Justice effectively placing the preparer out of business.

2. Criminal Investigation commits specialized resources to identification, investigation and prosecution of cases involving preparer fraud.
3. Earned Income Tax Credit (EITC) Due Diligence and Electronic Return Originator (ERO) Monitoring Visits test preparer compliance with the rules applicable to those programs.

**40. Are IRS preparer oversight efforts sufficient to protect taxpayers from unscrupulous or incompetent preparers?**

It would be impossible to protect taxpayers from all unscrupulous or incompetent preparers. However, the IRS has committed available compliance resources to identify and correct both the returns and the noncompliant behavior of egregious return preparers who prepare noncompliant returns. Once identified, the IRS then takes the necessary steps to ensure that the preparer is either brought into compliance or no longer prepares returns.

**41. What is the number of paid tax preparers?**

Based on research conducted in 2005 by Research Division (Brooklyn Office) the estimate is 1.1 million (1,073,995). The study took into consideration the entire universe of preparers, both Circular 230 and non-Circular 230 covered. The number represents each unique preparer identification number identified from individual and business returns. Preparer identification numbers for purposes of this analysis included Employer Identification Numbers (EINs), Social Security Numbers (SSNs), and/or Preparer Tax Identification Numbers (PTINs). Included in this count are Electronic Return Originator (EROs) and Non-EROs.

Brooklyn Research conducted this research at the request of the Wage & Investment Operating Division to identify preparers for outreach efforts. The analysis was done on "paid preparers" – someone who identifies himself or herself by inserting a preparer ID on the return. However, not all form types include a field for a preparer ID and not all returns require completion of the preparer ID field, even if it is on the return.

In order to perfect and update this information, we have recently initiated a study with the assistance of the IRS Office of Research, Analysis and Statistics to further analyze and research this population. National Public Liaison, with input from the Operating Divisions and Functional Units, will define the scope of the project. The primary use for the information will be for exploring new and improved communication channels.

**42. How many preparers did the IRS investigate last year? Given that there may be as many as 1 million preparers, do you think this level of investigation by the IRS is sufficient to detect and deter bad behavior or incompetence?**

IRS dedicates resources to address the most egregious preparer issues as well as to increase up-front efforts such as visits to EROs and EITC preparers and outreach and assistance to the preparer community, but the ultimate responsibility for choosing to use a preparer is up to the taxpayer.

Taxpayers are ultimately responsible for preparing and filing a correct return. The IRS publishes guidelines on its web site on what to look for in selecting a paid preparer and the responsibility always remains upon the taxpayer to follow that guidance in their selection of a paid preparer.

CI initiated 197 criminal investigations. SBSE had 568 open PAC investigations and conducted 1,129 ERO visits and 104 EITC Due Diligence visits.

**43. Recent information from the IRS does not reflect the number of preparer penalties asserted in tax years prior to 2006. How can the IRS say it takes the quality of tax preparation seriously if it doesn't track the penalties it asserts?**

The IRS does track preparer penalties asserted and publishes certain data regarding these penalties annually in the IRS data book.

The following table presents a brief summary of civil penalties asserted by the IRS for fiscal years 2003 through 2006. Criminal penalties are not included because they are not asserted by the IRS (they are court-ordered penalties).

IRS Civil Penalty Assessments and Collections  
FY 2003 – FY 2006

(All values in millions)

	FY 2003	FY 2004	FY 2005	FY 2006
Penalties Assessed	29.0	27.9	32.8	36.3
Penalties Abated	4.0	4.0	4.3	4.6
Penalty Collections	\$5,480	\$6,086	\$6,675	\$7,152

- 44. TIGTA estimates that as many as 22,500 attorneys, CPAs and enrolled agents have their own, personal tax problems, but the IRS has done nothing to sanction them. Why is that? What is the IRS doing to improve the Office of Professional Responsibility's oversight?**

While TIGTA's estimates may be correct, TIGTA's estimates do not take into account the underlying facts and circumstances. The number of practitioners in "willful" violation of Circular 230 is far fewer. Moreover, it is not correct that the IRS has done nothing to sanction non-compliant practitioners. In early 2006, OPR and the IRS Office of Performance Evaluation and Risk Analysis began a project to identify attorneys, CPAs, and Enrolled Agents who have represented clients before the IRS and have personal tax problems. Based upon specific criteria such as failing to file multiple returns and incurring specific penalties, we prioritized this list down to the roughly 1,200 attorneys, CPAs, and Enrolled Agents who appear to be in violation of Circular 230. To date, OPR has initiated over 500 of these cases. Of these 500, 218 have been closed. More than 70 percent of these closed cases resulted either in a sanction or are currently pending a hearing before an Administrative Law Judge.

The IRS has increased the enforcement staffing of the OPR significantly over the past three years. This resulted in an increased level of enforcement, a stronger outreach program to the tax practitioner community, and increased cooperation with state disciplinary agencies.

- 45. IRS statistics show that 230,000 electronic filing numbers (EFINs) have been issued to authorized Electronic Return Originators. 101,000 of those EFINs belong to only 17 EROs. That works out to almost 6000 EFINs per ERO. These 17 businesses generated 44% of the individual returns filed.**

**a. How can the IRS effectively monitor this many EFINs when it doesn't know who has been delegated the authority to use them?**

The IRS statistics show that 186,587 actively filing Electronic Filer Identification Numbers (EFINs) issued to authorized Electronic Return Originators (EROs) have filed nearly 62 million accepted returns. Because an ERO can only file 100,000 returns per EFIN, large companies have multiple EFINs. Our records reflect that 101,643 unique EFINs filed 1,000,000 or more returns that were transmitted by 17 unique Electronic Transmitter Identification Numbers (ETINs) assigned to 5 transmitter companies. There are a total of 1,709 actively filing unique ETINs, and large transmitters have multiples. Most EROs do not directly transmit to the IRS; they file through a third party transmitter. Since the majority of returns are transmitted by a few large volume transmitters directly to IRS, the number of EFINs does not affect our ability to monitor the e-file program.

**46. Does the IRS have any plans to tighten up its ERO process so that all ERO applicants and delegated users are subject to background checks?**

The IRS is continually monitoring the suitability process for EROs in order to assess for further improvements.

Electronic Return Originator (ERO) is merely one category of IRS e-file Providers who file IRS e-file applications in order to e-file their clients' returns. The other Providers are Intermediate Service Provider, Transmitter, Software Developer, and Reporting Agent. We process all applications by checking the firm and the Principals and Responsible Officials against our records for prior IRS e-file sanctions, any tax compliance issues, and by performing criminal background checks on some of the individuals, as well as those that check 'yes' to any of the compliance questions on the application. Once entered into IRS e-file, the applicants are subjected to continual tax compliance checks and monitoring visits, when appropriate. Referrals from other departments within IRS are also reviewed for sanctioning action within IRS e-file.

Delegated Users of e-services are individuals other than those in authority over the e-file operation and, therefore, are not subject to suitability. Delegated Users perform administrative tasks associated with the e-file application. Delegated Users are input on the e-file application by either a Principal or Responsible Official of the firm.

**47. Why aren't 100% of the fingerprints submitted with ERO applications submitted to the FBI as part of the background check? Doesn't this open the door for unscrupulous persons to e-file fraudulent returns?**

The IRS has performed Fingerprint check analysis several times in past years and has concluded the additional checks are not necessary. While approximately 16 percent of the fingerprint cards submitted to the FBI result in criminal data being found, only a portion of those were found to be unsuitable for IRS e-file. After review by our Criminal Investigation Division, 96.3 percent of

applicants whose fingerprint cards reflect criminal backgrounds are allowed into IRS e-file because the nature of the crimes does not affect their suitability.

The IRS reviews the criminal background reports for the following:

- a. History of conviction of financial crimes such as tax crimes, money laundering, or fraud.
- b. Dishonesty, e.g., bank fraud, mail fraud, securities fraud, etc;
- c. Breach of trust such as embezzlement, violations of fiduciary trust, and theft by misrepresentation, etc. (U.S. Title 18, 26, and 31).

**48. Why did the IRS design an ERO system that has no way of knowing how many delegated users are filing tax returns under the ERO's identification number? Why don't the delegated users have to go through background checks?**

Delegated Users are individuals who are given authority by Principals and Responsible Officials of firms to perform administrative duties involving the e-file applications. Providers are responsible for following the IRS guidelines set forth in Publication 3112, which clearly states that the EFIN is not transferable. We issue credentials to all Providers each year in the form of an acceptance letter. The assigned EFIN is in the letter that is sent each December to the mailing address of each Provider. All Providers must include their identification numbers with the electronic return data of all returns they transmit to us.

If more than one Provider is involved in the transmission and origination of the return data, each Provider must include an applicable EFIN in the electronic record. Providers must have the appropriate identification numbers and annual acceptance letter to participate in IRS e-file.

Providers who are transmitters also play a role in determining if the ERO is a valid customer with whom they have contracted. Unauthorized users could not use an EFIN without infrastructure such as a place of business or website, purchase of return preparation software, purchase of origination software, purchasing transmission capability via software or through contract with a third party transmitter. If IRS detects that an EFIN has been sold or lent to an ERO that has all the assets but does not have a valid EFIN of their own, IRS will investigate and can impose sanctions.

**49. Does the IRS have any plans to revise its ERO process so all fingerprints are checked, and the names of the delegated users are provided to the IRS?**

The IRS is continually reviewing its policy on suitability for additional improvement. As stated in a prior answer, our analysis has not found that fingerprinting 100 percent of applicants required to submit fingerprint cards would be beneficial. Applicants who are CPAs, Enrolled Agents, banking official, or officers of a publicly held corporation are not requested to provide fingerprint cards. The names of Delegate Users of e-services are listed on applicable e-file applications and are available to the IRS.

**50. Are current civil and criminal penalties sufficient to deter unscrupulous or incompetent preparers?**

We believe more can be done in the penalty area. In fact, the Administration's FY 2008 budget includes a proposal to expand preparer penalties.

Under existing law, an income tax preparer is generally subject to monetary penalties for certain failures, unless the failure was due to reasonable cause and not willful neglect. The proposal would expand the existing preparer penalties from income tax returns to include employment, excise, and exempt organization, estate, and gift tax returns. The per failure penalty for certain failures, including failure to furnish a copy of a return to the taxpayer, failure to sign a return, failure to furnish a preparer TIN, failure to retain a copy of a return, and failure to file a correct information return, would be increased from \$50 to \$150. The \$250 penalty imposed on a return preparer who knew, or reasonably should have known, of an understatement of liability on a return or refund claim, due to a position that did not have a realistic possibility of being sustained on its merits and that was frivolous or not disclosed (unless there was reasonable cause and the preparer acted in good faith), would be increased to the greater of \$1,000 or 50 percent of the preparer's fee. The \$1,000 penalty imposed on a return preparer for an understatement of liability on a return or refund claim that is due to the return preparer's willful, reckless, or intentional disregard of rules, would be increased to the greater of \$5,000 or 50 percent of the preparer's fee. The proposal would be effective for returns filed after 2007.

**51. How would increased regulation of paid preparers, including competency standards and continuing education, improve the quality of tax preparation?**

There are no studies of which we are aware that compare the quality of tax preparation of licensed enrolled agents, attorneys and CPAs to that of paid preparers. It is our understanding that California and Oregon, the two states that license return preparers, do not have studies that compare the quality of paid preparer's work products before and after the licensing requirement was put into effect. Nonetheless, we believe most would agree that testing and requiring continuing tax education would, prima facie, have to improve the quality of tax preparers' work products. What we cannot say with any certainty is that the ROI clearly demonstrates the increased costs to the IRS, paid preparers and consumers is justified by the level of improvement.

**52. What percentage of IRS's resources is devoted to oversight of the paid preparer industry including education, monitoring, and compliance enforcement?**

**Preparer Oversight:**

During the course of all IRS examination, both field and correspondence, examiners look for issues attributable to return preparer negligence or misconduct. We do not require our examiners to allocate their time to the search for preparer negligence or misconduct.



In addition in the SBSE compliance program, 5 percent of Tax Auditor time and 0.75 percent of Revenue Agent time is spent conducting compliance enforcement related to tax preparers.

The Office of Professional Responsibility has planned for 58 FTEs for FY 2007 to enforce standards of professional conduct involving tax practitioners. This represents approximately twice the 27 FTEs for FY 2003 and is up from a total of 15 in FY 2002.

**Education:**

Communications and Liaison, through its Office of National Public Liaison, conducts multiple "Nationwide Tax Forums" each year as part of the IRS' education and outreach efforts. These forums usually occur between June and September, are spread among several locations, and annual attendance is historically about 14,000 total tax practitioners. Approximately Three FTEs (two fulltime, two half-time) are dedicated to planning, implementing, and measuring the effectiveness of the Forums.

In addition, Stakeholder Liaison (SL), the external outreach function within SB/SE, considers practitioners one of their primary stakeholders, especially since approximately 80 percent of small businesses engage a paid preparer. They have approximately 265 FTEs engaged in outreach, education and communication. SL has an aggressive outreach strategy geared toward practitioners to provide key tax law messages, as well as current policy and procedural information, through an established network of practitioner organizations, such as the AICPA, National Association of Enrolled Agents (NAEA), and National Association of Tax Practitioners (NATP) at both the national level and locally. Pertinent educational information is shared with practitioners at regularly scheduled national and local practitioner liaison meetings, phone forums, and through electronic communication. SL has also partnered with the Office of Professional Responsibility and local practitioner groups to host Ethics Seminars. These seminars provide detailed instruction to practitioners on their conduct and responsibilities regarding return preparation and representation of clients before the IRS. In addition to these seminars, SL also includes discussion of Circular 230, Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries and Appraisers before the IRS, as an agenda item in their meetings with practitioners, in order to ensure practitioners are aware of the contents of the Circular 230, including any current revisions. In addition to these ongoing strategies, SL is also expanding their strategic approaches to educate practitioners. SL is currently developing an educational outreach targeting unaffiliated practitioners - those return preparers who do not hold a membership with a practitioner association. There is also an outreach under development to provide the same educational information to tax preparers employed by the larger chain tax preparation organizations.

- 53. Given the importance of paid preparers to tax administration in the United States, how does IRS measure and track the performance of the paid preparer industry?**

The IRS tracks and publicizes on its website the top twenty errors made by paid tax return preparers. However, the IRS does not track errors or performance by individual preparers.

**54. The GAO characterized access to IRS's telephone assistors as being stuck in the low 80 percent range for 5 years now. Does this mean that IRS thinks an 80 percent level of service is acceptable?**

In our view, the IRS has effectively delivered a high level of telephone service in the 80 percent range for over 5 years. Ideally, we would like to be able to answer 100 percent of callers on their first attempt. However, given the sheer volume of calls the IRS receives during a very short filing period window it is not feasible or fiscally prudent to do so. If we hired more staff to increase the level of service appreciably beyond current levels, the amount of time these assistors would be idle awaiting a call would increase significantly. By hiring, training, and equipping the number of assistors necessary to deliver the 83 percent level of service provided this filing season, we believe that we are striking the appropriate balance between service and the effective use of public funds.

**55. What was the impact of the delay in the implementation of CADE on 2007 filing season processing?**

The delay in implementation of CADE did not increase processing time and the taxpayer received the same service this year that they have received in past years under the legacy master file cycle. During the time CADE was not deployed into production and CADE-eligible taxpayers were submitting tax returns, we executed what is known as our "Technical Backout Plan" in which tax returns for CADE-eligible accounts were automatically routed to and timely processed in the legacy master file cycle. Since CADE is not a customer facing system, this recovery maneuver was not evident to the taxpayer and did not increase processing time. That said, unfortunately, there were approximately 20 million CADE-eligible taxpayers this year who could have received their refunds a few days earlier based on CADE reduced cycle times had CADE been in production at the time they submitted their returns. There are no other impacts to the taxpayer.

**56. How does this year's delay, and possible delays in future releases of CADE, affect other systems, including the Accounts Management System?**

Current strategy for CADE includes a fail safe approach that eliminates any impact to our systems should a release for CADE be delayed. Recognizing CADE 2.2 would be delayed, we invoked our technical back out and return to Current Processing Environment (RTCPE) protocol which allowed us to proceed with processing with no adverse impact to the taxpayers or our operating systems. While this approach could be evoked for any Releases, it relies on the utilization of our legacy systems. For the upcoming releases (R3.1 and 3.2) we are taking a different approach. In July, we launched an in-depth independent review by MITRE to assess the on-time delivery risk of CADE Release 3.2 for the

FY2008 filing season. If the results of the report indicate the project is at risk for timely delivery, we will mitigate this risk by updating the CADE Release 3.1 baseline in production with required tax law changes. This will ensure that CADE will be available for the filing season and eliminate the need to RTCPE. The additional functionality will be delivered later when the build is complete and risk for its introduction to production is acceptable. Date for decision to be made is mid-August.

s your question notes, possible delays in future releases of CADE can affect other systems, most notably Account Management Services (AMS). We view maintaining alignment between the CADE and AMS programs will be a central challenge and source of risk for the Business Systems Modernization (BSM) program going forward. Development of these two major modernization initiatives requires a level of coordination and cooperative execution that is higher than has been required so far in our modernization efforts. We recognized this challenge in our initial planning for the AMS program and have taken a number of steps to put in place the organizational structure, resources and approaches needed to assure that CADE and AMS are successfully delivered as a coherent set of capabilities. These steps include:

- 1) Establishing the Integrated Review Team (IRT) where CADE, AMS and Enterprise Services parties at the Director-and-below levels meet to identify, discuss and resolve issues that cut across both programs.
- 2) Establishing a joint Release Content Master Plan that shows related content on a release-by-release level.
- 3) Establishing the Business Modernization Organization in Wage and Investment (W&I) with both lead Executives for CADE and AMS reporting through a single executive.
- 4) Building the close relationships between the MITS and W&I Executives with responsibility for both programs.
- 5) Governing CADE and AMS through the Customer Service Executive Steering Committee.
- 6) Establishing a joint engineering team to address cross-cutting architectural issues

For the Release 3 sub-releases of CADE (those that will be released in calendar year 2007), we have taken steps to ensure that functionality in CADE required for proper functioning of AMS is high priority and will be delivered in those sub-releases. CADE is slated to deliver functionality that will support online address change in Releases 3.1 and functionality to support basic notices generation in Release 3.2. To ensure delivery of functionality, CADE made the address change functionality a 'non-negotiable' item of release content for 3.1 and as a result, it has been delivered to testing. In particular, we do not anticipate any significant issues in delivering this functionality as part of these releases.

**57. What, if any, the impact has the delay had on the planned functionality of future releases of CADE?**

The delay in delivering CADE Release 2.2 is having an impact on Release 3. While we have not completely finalized the changes in scope for the two sub-releases in Release 3, we are scaling back some of the functionality.

The priorities for Release 3 will be to maintain the functionality to enable the capabilities to be delivered in conjunction with Account Management Services (AMS), update CADE with any necessary filing season changes, address some technical upgrades and design issues that have been uncovered as we have run CADE in operation, and add functionality that will enable CADE to process additional tax returns (in particular, we will be adding capabilities for CADE to process returns with Math Errors and Disaster Area Designations).

Some of the functionality originally planned that will not be part of Release 3 is as follows:

- Revenue Receipt Transactions: processing of revenue receipt transactions; performing unpostable analysis to match IMF processing;
- Surviving Spouse: accepting the surviving spouse filing status;
- 1040 Decedent Returns: accepting tax returns for decedent taxpayers;
- Process Extension Requests;
- Last Name Changes: process taxpayer last name changes;
- Identification of Penalty and Debit Interest;
- 1040 with Credit Elect: taking all or a portion of overpayment from a tax return and applying it as a prepayment credit for the following year;
- CI Refund Hold: Creation of a re-sequencing situation for a six day hold.

While there will be less functionality in CADE Release 3 than originally planned, we believe the steps we are taking to address the issues in CADE performance will enable us to "catch up" over the next few years, so we do not anticipate changing our planned retirement date of the individual master file in 2012.

**58. What assurances can you give us that the causes of the CADE problems are being addressed and will not surface again?**

While we cannot guarantee that CADE will not have problems in the future, we have taken a serious look at lessons learned from CADE 2.2 and have made many changes in the CADE program to ensure that the problems we experienced in CADE 2.2 do not resurface. One of the areas we have addressed is changes in our relationship with our contractor, CSC. We've mitigated the risk to the government by entering into a firm fixed price contract with CSC. Their commitment is to deliver all of the required functionality for a negotiated fixed price. Furthermore, as a result of the difficulties encountered in CADE Release 2.2, IRS and CSC have committed to form a new partnership which provides for more open communication and elevation of issues as soon as they become known. In addition, a joint focus and emphasis are being placed on requirements management, project management, development procedures, integration testing, and quality review. In the spirit of this new partnership, we conducted a two-day CADE offsite lessons-learned session with key IRS executives and contractor staff to more fully understand and address together the causes of the Release 2.2 delay and to discuss improvement initiatives.

One of the key issues that has become very clear based on our Release 2.2 experience is the complexity of CADE requiring it to interface with numerous legacy IRS systems. As we add more complex form types to CADE and as we

begin to deal with taxpayers with balance due accounts or taxpayers to whom we need to issue notices, this complexity factor grows. To that end, we have committed to increase the number of IRS-employee technical and business subject matter experts that are committed to and a part of the CADE Integrated Project Team. There simply are no contractors that have the broad knowledge of our legacy systems or the deep understanding of the underlying data necessary to address these interface issues effectively. Only IRS personnel that have worked with these systems and data for years can bring the insight necessary to both design those interfaces and to help address problems as they arise in testing. This interfaces issue was the single biggest factor contributing to the delay in delivering Release 2.2.

We also recognize that the IRS needs to have more insight and management control of the CADE program in order to effectively assess progress and make key decisions in the context of the totality of IRS systems that support tax processing. We do not believe one can outsource the program management of the development of mission critical systems, whether it be in the government or private sector. Key trade-offs must be made that involve much more than just CADE, but have major impact on the legacy systems that form the nucleus of the tax administration processing environment. Again, no contractor could possibly bring that understanding. Hence we have collaborated with CSC and we now jointly agree on how the IRS will expand its role in integration and management over the program. To begin such a change, we recently reassigned a senior executive to CADE who has not only a strong IT background, but has also had experience running an IRS submission processing center. Such an executive is ideally suited with the experience and perspective to make key CADE programmatic decisions and trade-offs in context with the overall needs of the organization in processing tax returns. With the addition of this new executive, we believe we now have outstanding leadership over the CADE Integrated Project Team with the depth and breadth of knowledge needed to take on the next generation of challenges facing CADE – the leadership over this CADE team is a three-way partnership with the new executive representing the IT organization, an executive from the business side (Wage & Investment organization) and a contractor executive.

We are also taking aggressive steps to operate the CADE program more effectively. Based on lessons learned and continued maturity in our management process areas, we are seeing improvements in gathering and developing clear and comprehensive functional and system requirements. Good requirements management is foundational for IT development success, and frankly, this has been an area of weakness in the BSM program in the past. We have in the last two years revamped our whole requirements management approach, and have brought in industry-leading tools to aid our business analysts in developing sound requirements. We are also assessing additional tools and changes to existing operating processes to improve software development and testing cycles. In Release 2.2 we realized that we were taking too long to run a test cycle for a new build, so we are exploring ways in which we can both shorten the test cycle and do more testing in parallel in order to shorten the overall time to exercise a full set of test cases (which can number over a 1,000 for an individual CADE release).

And finally, we believe these steps, along with expanding the competition for development work to other vendors for future CADE releases, are the proper, yet measured, approaches to improve the CADE program that reflect the project model we have established and are successfully operating on other modernization programs such as Modernized e-File, Account Management Services, and Filing & Payment Compliance.

**59. What effect might tax preparer registration have on tax fraud prevention initiatives, and do you favor this approach?**

We discussed many of the considerations in our answer to Question 33. Ultimately, licensing return preparers to prevent fraud can only be achieved if each taxpayer is educated as to the licensing process and has an affirmative obligation to ensure that their preparer is licensed and has signed the return. Penalties for non-compliant taxpayers and paid preparers have to be meaningful and the penalty process must be timely and transparent.

**60. Has the recent investigation revealed any significant new quality control elements that could be implemented by the tax preparer community at a local level before such returns are transmitted to the Internal Revenue Service?**

The IRS is still awaiting a response from one of the firms involved. A response from one firm briefed by IRS is as follows:

- Improvements.** While we were pleased with the relative strength of our performance, we recognize there is always room for improvement. We appreciate the time the IRS spent with us to help pinpoint areas for additional attention. To address these specific areas, as well as improve our overall quality of outcome, has taken several steps:
- a. Leaders of our Tax Research area met with IRS officials to understand specific areas of opportunity. Those areas were incorporated into the 50 hours of annual training and continuing education our tax professionals receive.
  - b. We redesigned certain aspects of our software to further clarify how to ask certain questions, particularly around our already industry-leading approach to Uniform Definition of a Child.
  - c. We are rolling out a completely new approach to new Tax Professional training that incorporates appropriate use of computer software much earlier in the training to increase readiness of new tax professionals. We introduced this new approach in 10 percent of the country for tax season 2007 and anticipate expanding it in the next few years.
  - d. We have enhanced our Quality Assurance Program to systematically verify the quality of returns and identify opportunity areas based on annual mystery shopping of return preparation by an independent third party. A multi-department analysis of results determines changes in training or procedures.
  - e. We have increased field compliance audits and upgraded our ability to detect deviations from acceptable standards through centralized monitoring.

- f. We initiated a daylong meeting on quality issues with three tax experts each of whom had been chair of the American Bar Association Tax Section Low-Income Taxpayer Committees (Elizabeth Atkinson and Professors Leslie Book and Diana Leyden).

**61. Is there a matching system that looks for taxpayers having the same addresses where dependents appear to be shuffled between taxpayers to optimize refunds? If so how is that working? What improvements are planned?**

The IRS is currently using several different databases to select cases for audit and one of the selection rules will identify birth parents living together filing as head of household. This will assist our efforts to determine if dependants are moved about to optimize refunds. In addition, we have developed methods of scheme identification for multiple returns filing from the same address. The IRS has created a pre-refund group that will be baselining these systems to determine what improvements can be made.

**Questions from Senator Kerry:**

- 1. Last year, we exchanged correspondences about the Questionable Refund Program (QRP). I was concerned that this program places a freeze on hundreds of thousands of refund claims each year. In 2005, the Taxpayer Advocate Service (TAS) received more than 28,000 additional requests for assistance from taxpayers who had their refunds frozen. TAS studied a randomly selected sample of cases and looked at the ultimate disposition. The results showed that in 80 percent of these cases, the taxpayer was eligible for a full or partial refund, and in 66 percent of these cases there was no evidence of fraud. The median refund was \$3,519. Mr. Evangelos Dimitros Soukas testified that he was able obtain fraudulent refunds totaling over \$43,000. Was the QRP aware of Mr. Soukas' activities and if so, what action was taken?**

Under IRC 6103 disclosure laws we cannot disclose the source of information that lead to Mr. Soukas' conviction. As the Committee is aware Mr. Soukas is currently serving 97 months in prison as a result of his criminal convictions which included 10 counts of submitting fraudulent claims to the IRS, six of which were filed using the identity of other individuals, as well as wire fraud, mail fraud and identity theft charges.

- 2. I am concerned that QRP resulted in many taxpayers having their earned income tax credit (EITC) frozen. Was the QRP more focused on low income taxpayers filing the EITC than uncovering fraudulent returns?**

The Questionable Refund Program (QRP) is designed to detect "bogus" returns

being filed by individuals to thwart the tax system. The program does not focus on any particular category of taxpayer but rather the opportunists who create income that does not exist as well as associated credits, i.e. withholding or earned income tax credit (EITC) to obtain fictitious refunds. QRP focuses on verifying the validity of reported income. If the income is not valid, any associated credits based upon that false income are also invalid.

QRP data models are based upon previously identified fraud. These models evaluate both EITC and non-EITC returns and flag those that are the most suspicious for review by Criminal Investigation (CI). CI contacts the employers to verify the "suspicious" income. If the income is verified, the return continues through IRS return processing. If the income is not verified, the refund is stopped and the taxpayer is notified. If the taxpayer does not substantiate the items in question, statutory notices of deficiency or claims disallowance letters are issued informing the taxpayer of his/her appeal rights.

3. **Last year, the IRS announced changes to the QRP, including notifying the taxpayer when a tax refund has been frozen. It appears that the Service has made substantive progress in the QRP by informing taxpayers that their refunds are being frozen and by trying to speed-up resolution of refund freeze cases. What steps had the IRS been taking to ensure that low-income families receiving the earned income tax credit (EITC) are not unfairly targeted by QRP? Is there a backlog of frozen refunds? What is the timeframe for evaluating a questionable refund?**

As stated, no one group of taxpayers is unfairly targeted by the Questionable Refund Program (QRP). Beginning March 2006, the Service began sending automated notices to taxpayers whose refunds were being held for further review. When CI has determined that the income is potentially false and there are also refundable credits (e.g. EITC) the return is immediately referred to the Examination function. Taxpayers who inquire on these accounts are issued an IRS letter which explains that their return has been sent to Exam and that they will be contacted within 60 days. Exam will issue an initial contact letter and subsequently a statutory notice of deficiency where the taxpayer is advised of appeal rights.

**Is there a backlog of frozen refunds?**

No. There is no backlog of frozen refunds this filing season since refunds are released systemically within a certain period of time. In Processing Year 2007 frozen refunds have either been referred for civil disposition or are related to an ongoing criminal investigation.

**What is the timeframe for evaluating a questionable refund?**

The IRS works within an established number of days for evaluating a questionable refund. The timeframe is based on prior year processes and is closely monitored so that adjustments can be made if warranted.



4. **Is the Service coordinating audits across divisions? For example, Wage and Investment Examinations audit EITC taxpayers and Criminal Investigation (CI) has frozen EITC refunds. Would it make sense for Wage and Investment Examinations to refer to CI cases in which they suspect fraud?**

In 2006, a Questionable Refund Program Executive Steering Committee (QRP-ESC) was formed to provide guidance and oversight to the questionable refund process. This steering group includes representatives of all IRS functions including Criminal Investigation and Wage and Investment. The QRP-ESC met weekly from January through March to discuss and make decisions requiring cross functional coordination. Since April of 2007, the group has been meeting monthly. The workload process and distribution, including potentially fraudulent returns involving questionable EITC claims, is among the topics coordinated. For Processing Year 2007, data matching programs and IRS controls placed on returns help ensure coordinated fraud detection efforts by CI and W&I.

5. **What steps to do you plan to take address fraudulent returns such as those described by Mr. Soukas?**

As detailed above, QRP Data models are derived based upon previously identified fraud. These models evaluate both EITC and non-EITC returns and flag those that are the most suspicious for review by CI. CI contacts the employers to verify the "suspicious" income. If the income is not verified, the refund is stopped and the taxpayer is notified. If the taxpayer does not substantiate the items in question, statutory notices of deficiency or claims disallowance letters are issued informing the taxpayer of his/her appeal rights.

#### **Questions from Senator Schumer:**

1. **Given today's technology, we should be encouraging everyone who can to file electronically. I understand some of the things that led to the Free File alliance, and the fact that the software companies don't want the IRS competing directly with them. But what I don't understand is, if e-filing is saving the government money and increasing the accuracy of returns, and we have put guidelines in place about how many taxpayers should be e-filing every year, why should taxpayers have to pay for the privilege?**

The IRS Restructuring and Reform Act of 1998 (RRA 98) encourages us to work with the private sector to improve electronic filing services, but not to provide taxpayers with tax preparation software or a direct method of electronic filing.

In working towards the 80 percent goal, the IRS continues to actively promote free filing opportunities for all taxpayers. Since 2003, IRS has maintained an active marketing program to promote e-filing and e-payment programs. IRS's efforts to market and increase e-filing have been highly successful. To date, taxpayers have prepared and e-filed 76 million returns this year. This is a nine

percent increase over the same time last year and a 15 percent increase from 2005. Online electronic tax preparation, which includes website and “packaged software” prepared and filed from home computers, has increased more than 31 percent over the last two years. Since 2003, IRS has received more than 19 million returns through the Free File program and so far, in 2007 the IRS has received over 3.7 million returns.

The IRS believes that private industry, given its established expertise and experience in the field of electronic tax preparation, has a proven track record in providing the best technology and services available. Rather than entering the tax software business, IRS’s partnership with private industry:

- Provides taxpayers with high quality services by using the existing private sector expertise,
- Maximizes consumer choice,
- Promotes competition within the marketplace and,
- Meets these objectives at the least cost to taxpayers.

In October 2005, when the IRS and the Free File Alliance extended its partnership to provide free federal online tax preparation and e-file services to American taxpayers, the IRS and the Alliance agreed that to ensure the long-term stability of the Alliance, the scope of this program would focus on providing tax preparation and e-filing services to those taxpayers least able to afford them.

2. **I know that there is an exemption for families with incomes below \$52,000. But I think everyone should be allowed to file for free. Why hasn’t the IRS made it easy for all taxpayers to e-file without paying a fee, instead of relying on a maze of limitations and rules determined by the Free Filing Alliance? This doesn’t mean the online forms have to actually do the math – I understand the concerns of some that this would put the government in the tax software business. But shouldn’t everyone have access to a form they can fill out and submit online, after they have made their own calculations at home? If you can send a form in the mail for free, why can’t you do it online for free – especially if it saves the government money?**

The goal of the IRS and the Free File Alliance is to offer the Free File program primarily to those taxpayers with low adjusted gross incomes (AGI’s) who are most underserved by the tax system. The goal and limitations of the Free File program have been identified in several congressional notices and appropriations bills.

The intent of the Free File program was clarified in the preamble of the Supplemental Memorandum of Understanding signed in January 2004 by describing the program as being principally designed to advance electronic filing and assist lower income, disadvantaged, and underserved taxpayer populations.

House Report 108-243 – Departments of Transportation and Treasury and

Independent Agencies Appropriations Bill 2004, addresses the purpose of the Free File Program in the section entitled "Electronic Tax Filing and the Free File Alliance." The Report identifies the need to suggest specific program improvements that identifies the scope of the program as being limited to a specific population. The Report states:

"Accordingly, the IRS shall ensure that the mission and execution of the initiative is first and foremost to provide electronic federal tax return preparation and e-filing services at no cost to the working poor, and other disadvantaged and underserved taxpayers. The IRS Electronic Tax Administration's related marketing and promotional activities shall be consistently carried out in a manner to advance this key mission objective."

House Report 108-671 - Departments of Transportation and Treasury and Independent Agencies Appropriations Bill 2005, reaffirms the target audience in the 2004 Report stating:

"The Committee reaffirms its position that the Free File Alliance initiative is first and foremost to provide electronic federal tax return preparation and e-filing services at no cost to the working poor and other disadvantaged and underserved taxpayers."

In the FY 2006 Appropriations Bill, the conferees acknowledged their awareness that the IRS and the Free File Alliance signed a new, four-year agreement. The conferees further directed the IRS to abide by the terms and condition of the new agreement. The new agreement stipulates that the Free File program will provide for coverage to 70 percent of the individual taxpayer population. Additionally, the amended agreement states, "The IRS and the Alliance agree that to serve the greater good and to ensure the long-term stability of the Alliance, the scope of this program is focused on covering the taxpayers least able to afford e-filing their returns on their own."

The private-sector already has created a sophisticated market for tax preparation software. These software products cover a wide range of software options for taxpayers rather than a single one-size-fits-all single product. Working together, the IRS, the Free File Alliance, and the IRS Partners program, offer a wide variety of products and services at various levels of complexity, prices and options.

Various Free File Alliance tax software companies may also offer unrestricted free services on their own web sites, and some Alliance members offer free filing services to all taxpayers. In addition, some software companies that are not Alliance members also offer free filing services to all taxpayers.

If the taxpayer's AGI exceeds \$52,000, they can visit the IRS.gov e-file "Partners" page for individual taxpayers to view additional low-cost e-file opportunities.

3. **I noticed recently that some of the bigger banks are getting out of the business of so-called payday or pay-stub loans. I think this is a**

**positive development. But many taxpayers still fall victim to a related product called the Refund Anticipation Loan, or RAL. What are the IRS and the Treasury Department doing to reduce the number of pernicious refund anticipation loans marketed towards low-income taxpayers, and in particular, recipients of the Earned Income Tax Credit (EITC)?**

Commissioner Everson has noted in past testimony to Congress that he finds RALs to be predatory, but he has no authority to regulate RALs. In addition, RALs are both legal and popular. Therefore, the IRS strategy toward RALs is two-fold: 1) reduce demand; and 2) do whatever we can to make RALs as safe and inexpensive as possible.

To reduce demand, IRS is working to process returns as quickly as possible and add features that will make RALs less popular. We encourage taxpayers to e-file so their refunds can be direct deposited in 8-15 days. We continue to develop the Customer Account Data Engine (CADE), a replacement of the Master File system. CADE allows the IRS to process returns on a daily rather than weekly cycle. Refunds can be direct deposited in 5-7 days. This year the IRS also added split refund capability enabling taxpayers the flexibility to have parts of their refunds deposited in up to three different accounts, e.g., savings or retirement accounts, as well as their checking accounts. Many IRS-supported community coalitions and volunteer partners counsel low income taxpayers on the benefits of IRS e-file and direct deposit as an alternative to RALs. In addition, the National Taxpayer Advocate and many consumer advocates are vocal in making this case to low income and EITC taxpayers. Despite these efforts, approximately 10 million taxpayers, many of whom receive the EITC, still choose RALs.

Our second strategy is to require lenders to properly inform taxpayers about their loans and to influence lenders to reduce costs and not lend to taxpayers who cannot repay the loans. E-file rules require EROs and lenders to clearly tell taxpayers that RALs are loans and not faster ways of receiving refunds. The Commissioner and the National Taxpayer Advocate have also questioned industry costs and loan practices in the media and congressional testimony. As a result, most preparers that offer RALs no longer charge document preparation fees. Loan fees have also been falling. This year H&R Block set a 30 percent APR limit on the RALs it offers, meeting the challenge set by consumer advocates. This brings these RALs into the same APR range as credit cards.

### **Questions from Senator Cantwell:**

1. **Commissioner Everson, given the late extension last year of important tax benefits—like the state sales tax deduction—that affected individuals' tax filing responsibilities for 2006, the printed forms and instructions that went out to taxpayers were incorrect. How much did it cost the IRS in additional resources to engage in the needed outreach and special mailing of Publication 600 to inform**

**taxpayers that these benefits had been restored and help them correctly file to claim their benefits?**

At the time the forms and instructions were approved for printing in early November 2006, they accurately reflected current law. That is, there was no reference to the deduction for state and local sales tax since it had expired after December 31, 2005. The instructions that needed to be released for printing to ensure timely availability to taxpayers included cautions advising taxpayers about the status of expired tax benefits. The caution read: *“At the time these instructions went to print, Congress was considering legislation that would reinstate these expired tax benefits. To find out if this legislation was enacted, and for more details, go to [www.irs.gov](http://www.irs.gov), click on More Forms and Publications, and then on What’s Hot in forms and publications, or see Pub. 553”*.

The special mailing of Publication 600, State and Local General Sales Taxes, cost \$575,000 for printing and \$1,169,000 for postage, a total of \$1,744,000. In addition to the special mailing, the cost to provide Publication 600 to libraries and post offices, to the Taxpayer Assistance Centers, and to taxpayers from the IRS National Distribution Center was \$153,000. The IRS also used \$200,000 for outreach.

**2. Has the IRS seen an increase in taxpayer questions or confusion due to these last minute legislative changes?**

We do not have data on the effect of specific legislative changes on taxpayer behavior this year. However, in addition to the costs outlined above, last minute legislative changes affect our ability to schedule and provide training for the employees who must accurately respond to taxpayer questions about these provisions.

**3. Commissioner, you mentioned IRS implementation of the next phase of the initiative to outsource the collection of certain unpaid accounts to private debt collection agencies. As you know, I have serious concerns about this initiative and am among the cosponsors of legislation (S. 335) that would prohibit the Internal Revenue Service from using private debt collection companies. The National Taxpayer Advocate’s report to Congress noted that by design, the first cases assigned to private collectors were the least complicated of the inventory eligible for assignment. However, in monitoring the implementation of the program the Taxpayer Advocate Service has observed that cases of increasing complexity are being referred to private debt collection agencies, including cases involving small businesses and unresolved delinquent return investigations) for which PCA employees are not adequately trained. What criteria is the IRS using to decide whether to refer a case to private debt collection agency?**

The IRS has developed collection inventory management strategies designed to prioritize existing receivables in accordance with the availability of the resources

required to perform the work. For a case to then be assigned to a PCA, it must reach one of the qualifying statuses, and satisfy additional criteria. The objective of the inventory assignment process is to place cases with the PCA's that they have the ability and authority to resolve.

Cases are drawn from select inventory types that current IRS resources are not able to work through internal collection streams. Definitions of each current inventory type and their contribution to the September 7, 2006, placements are presented below.

Inventory Type	Definition	% Composition in First Placement
Status 24 (Queue)	Low Priority – Awaiting assignment based on available resources	54%
Transaction Code 530 Closing Code 03	Reported as Currently Not Collectible; Unable to Locate	1%
Transaction Code 530 Closing Code 12	Reported as Currently Not Collectible; Unable to Contact	10%
Transaction Code 530 Closing Code 39	Reported as Currently Not Collectible; Shelved due to lack of resources	35%

Starting with technical release 1.2 in late January 2007, new case types were added to assignable inventory. PCAs have received detailed training to handle these cases. Should PCAs encounter difficulty with an individual case, the IRS Referral Unit is available to assist the PCA. Small business return cases are not planned for several years at the earliest. Delinquent return cases will not be placed without test placements and full training on handling these cases.

Start Date	New Type of Placement
February 2007	Multiple year cases
February 2007	Cases between \$25,000-\$100,000 balance due
March 2007	Cases with Power of Attorney
May-September 2007	Test of cases with delinquent returns (TDI)

**4. Do you have safeguards in place to ensure that cases that are not appropriate for referral are not, in fact, sent to private debt collectors?**

Yes. Detailed case selection and exclusion criteria have been developed and programmed into case assignment. Prior to case assignment, programming systemically excludes cases not meeting selection criteria and exceptions including (but not limited to) bankruptcy, combat zone, criminal investigation, disaster, innocent spouse, foreign addresses, cases that are too close to collection statute expiration to assign, etc. (list not all inclusive). Subsequent to case assignment, should a case be changed to an excluded status such as those mentioned above, the IRS will systemically recall the case from the PCA.

The General Accounting Office (GAO) and Treasury Inspector General for Tax

Administration (TIGTA) also conducted reviews of the program (GAO-06-1065 and TIGTA 2007-30-066) and found that the IRS did have the appropriate safeguards in place to ensure that the appropriate type of case work was being sent to PCAs.

Safeguards on both IRS and PCA systems have been tested during the IRS' Business Acceptability Testing for exclusion criteria prior to Releases 1.1 and 1.2. In addition, manual screening of cases has been ongoing since project inception.

**5. Commissioner Everson, even though we have seen a steady increase in electronically filed returns are there impediments that we can remove in order to expand e-filing?**

Please see response to Senator Baucus number 2.

**6. What effect does the e-filing fee that taxpayers are charged have on their willingness to file electronically?**

Russell Research has reported these historical trends in cost attitudes toward e-file & paper filing:

Year Survey Conducted	2003	2004	2005	2006
Total Respondents in Survey	502	750	751	1500
Total Agree that e-file is...				
An inexpensive way to file	56%	62%	65%	62%

In the most current external project, 2007 Taxpayer Segmentation Study a telephonic survey among 1700 Individual Taxpayers conducted by Russell Research found that of the taxpayers that used a practitioner to e-file in FY '06, 24 percent reported they were charged an extra fee.

**7. This committee has approved a provision that would require the IRS to establish direct electronic filing, without the use of private intermediaries that now participate in the Free File program. Has the IRS done any analysis of what it would cost to build a return-free or online tax filing web portal? And what it would cost to upgrade and maintain such a system over a 10 year budget outlay?**

Please see the responses to Senator Baucus Questions 1 and 3.

**8. Does either IRS or GAO have recommendations for ways to improve the current Free File program?**

Each year the IRS assesses the filing season and feedback from users to determine how to improve our Free File site and the program as a whole. We work with our partner, the Free File Alliance, to implement the improvements that are identified. One tool we use to get taxpayer feedback is to conduct a survey

with Free File users. We also analyze customer questions that come in during the filing season to look for trends and problems.

The 2006 Assessment indicates our successes as the following:

- Collaboration and cooperation between IRS and FFA in program matters much improved.
- Free File Indicator
  - Able to systematically measure the success of the program.
  - Able to validate that the Free File program is not a major segment for RALs.
- Minimum Performance Standard
  - Monitoring the Alliance participants' acceptance rates allowed for early detection of problems and intervention.
  - Will drive the companies to improve quality.

Two issues from our 2006 assessment are still outstanding, but we plan revisit these recommendations again this year as prepare for the 2008 filing season.

- Increase the Minimum Performance Standard from 60% to 65% which will drive the Free File Alliance members to improve quality.
- Allow members to submit an offer providing coverage to the bottom 55% AGI level, without any state or age qualifiers, and unable to revise their free offer until after April 15. The incentive is the additional 5% in coverage. There is a real concern that certain taxpayer segments within the lower AGI levels may not be covered and that the Alliance may fall short in fulfilling the guaranteed 70% coverage.

Overall, the changes that were made to the program had a positive impact on the customer experience with the Free File program. The number of customer service complaints received by the IRS Help Desk dropped 74% from the prior year. This year was the first year that Free File content was offered in Spanish on the IRS.gov web site. This Spanish Free File web site will be one area the IRS will be working on improving for next filing season.

We are evaluating our experiences with the 2007 Filing Season and will use this data to develop additional recommendations for Free File.

### **Questions from Ranking Member Grassley:**

1. **Commissioner Everson, over 60 percent of taxpayers now use a paid tax preparer to prepare their tax returns. As a result, paid preparers have a large impact on tax compliance. IRS needs to devote the proper attention to ensure that the preparer community is**



**held accountable for the returns they prepare and ultimately submit to the IRS. I have two questions for you on return preparer oversight. What percentage of IRS's resources is devoted to oversight of the paid preparer industry including education, monitoring, and compliance enforcement?**

**Preparer Oversight:**

During the course of all IRS examination, both field and correspondence, examiners look for issues attributable to return preparer negligence or misconduct. We do not require our examiners to allocate their time to the search for preparer negligence or misconduct.

In addition in the SBSE compliance program, 5 percent of Tax Auditor time and 0.75 percent of Revenue Agent time is spent conducting compliance enforcement related to tax preparers.

The Office of Professional Responsibility has planned for 58 FTEs for FY 2007 to enforce standards of professional conduct involving tax practitioners. This represents approximately twice the 27 FTEs for FY 2003 and is up from a total of 15 in FY 2002.

**Education:**

Communications and Liaison, through its Office of National Public Liaison, conducts multiple "Nationwide Tax Forums" each year as part of the IRS' education and outreach efforts. These forums usually occur between June and September, are spread among several locations, and annual attendance is historically about 14,000 total tax practitioners. Approximately Three FTEs (two fulltime, two half-time) are dedicated to planning, implementing, and measuring the effectiveness of the Forums.

In addition, Stakeholder Liaison (SL), the external outreach function within SB/SE, considers practitioners one of their primary stakeholders, especially since approximately 80 percent of small businesses engage a paid preparer. They have approximately 265 FTEs engaged in outreach, education and communication. SL has an aggressive outreach strategy geared toward practitioners to provide key tax law messages, as well as current policy and procedural information, through an established network of practitioner organizations, such as the AICPA, National Association of Enrolled Agents (NAEA), and National Association of Tax Practitioners (NATP) at both the national level and locally. Pertinent educational information is shared with practitioners at regularly scheduled national and local practitioner liaison meetings, phone forums, and through electronic communication. SL has also partnered with the Office of Professional Responsibility and local practitioner groups to host Ethics Seminars. These seminars provide detailed instruction to practitioners on their conduct and responsibilities regarding return preparation and representation of clients before the IRS. In addition to these seminars, SL also includes discussion of Circular 230, Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries and Appraisers before the IRS, as an agenda item in their meetings with practitioners, in order to ensure practitioners are aware of the contents of the

Circular 230, including any current revisions. In addition to these ongoing strategies, SL is also expanding their strategic approaches to educate practitioners. SL is currently developing an educational outreach targeting unaffiliated practitioners - those return preparers who do not hold a membership with a practitioner association. There is also an outreach under development to provide the same educational information to tax preparers employed by the larger chain tax preparation organizations.

**2. Given the importance of paid preparers to tax administration in the United States, how does IRS measure and track the performance of the paid preparer industry?**

The IRS tracks and publicizes on its website the top twenty errors made by paid tax return preparers. However, the IRS does not track errors or performance by individual preparers.

**3. Commissioner Everson, the IRS has learned of a new tax scam on the Internet that lures taxpayers into filing tax information on a site masquerading as a member of the Free File Alliance. The scam involves tax preparation web sites that inaccurately claim to be part of the Free File Alliance and allegedly accept tax information from taxpayers, change the taxpayers' bank account numbers to their own and then file the return through a legitimate Free File partner. To your knowledge, how long has this scam been ongoing? How many tax returns are involved? What is the dollar amount of the refunds that were issued to an incorrect bank account as a result of this scam?**

The IRS is working closely with the Treasury Inspector General for Tax Administration (TIGTA) and the IRS Criminal Investigations Division (CID) is currently investigating this scam. The allegations involved web sites that accepted tax information from taxpayers, changed the taxpayers' bank account numbers to their own and then filed the return through a Free File Alliance partner.

The IRS, TIGTA and CID will be working together to develop processes and procedures to identify suspicious transactions and practices, and to prevent these incidents from occurring in the future. The IRS, through direct messaging and marketing, reminds taxpayers the only place to access the Free File program is through the official IRS.gov Web site.

**4. What type of oversight is provided by the IRS on the Free File Alliance members? Does the IRS monitor the websites to ensure that ancillary products are not offered? Does the IRS test the accuracy of the Free File Alliance programs to determine whether the information solicited from the taxpayer is sufficient to determine the correct tax liability?**

Before we list the company for active participation on IRS.gov, the software must

undergo testing and be approved by the Participants Acceptance Testing System (PATS), which is a testing requirement for all Software Developers, Reporting Agents, and Transmitters planning to transmit individual electronic returns to the IRS.

Prior to the launch of the Free File web page, the IRS conducts an analysis of each Free File Alliance Member website. This "pre-season review" assures that the website adheres to every aspect of the Operating Agreement between the IRS and Free File Alliance. Companies must be in complete compliance with the IRS / Free File Alliance LLC Operating Agreement before we allow them to be posted on the IRS.gov Free File site for active participation in the program. Throughout the filing season and the remainder of the year, IRS monitors the member web sites to make sure that they are in compliance with the IRS / Free File Operating Agreement.

The Free File agreement requires that each member shall guarantee the calculations by its federal free file offering. This guarantee states that all members will pay any IRS penalties and/or interest resulting from an error in the member's software calculations. Currently, software accuracy calculation testing for Free File companies is conducted at the same level as that of non participating companies.

- 5. Commissioner Everson, last year GAO posing as typical taxpayers visited 19 outlets of chain preparers. The preparers made mistakes in all 19 cases. This would seem to be symptomatic of more general problems with the quality of paid preparer assistance. What is IRS doing to address the larger problem of the quality of paid preparer assistance?**

As noted in the responses to questions 1 through 4, the IRS has many outreach and enforcement efforts to assist preparers and to identify the most egregious preparers. However, we agree that more can be done to improve the quality of paid preparer assistance, so IRS is establishing a Service-wide Enforcement strategy to create a cross functional/multi divisional approach to address compliance issues associated with the Return Preparer Program. Equal consideration of the issues generated will be given to both internal and external stakeholders.

- 6. Commissioner Everson, we understand that the latest release of CADE, the system that is intended to replace the antiquated Master File processing system, was put into production in March, about 2 months later than planned. What was the impact of the delay on 2007 filing season processing? What, if any, the impact has the delay had on the planned functionality of future releases of CADE? How does this year's delay, and possible delays in future releases of CADE affect other systems, including the Accounts Management System?**

Please see the responses to Chairman Baucus questions 55 through 58.

- 7. Commissioner Everson, last year, the IRS paid hundreds of millions of dollars in improper tax refunds because IRS's new Electronic Fraud Detection System (EFDS) failed and the IRS lacked a contingency plan. In March, a release of the CADE was put into production 2 months behind schedule under the same contractor. TIGTA determined that the EFDS failure was due to lack of adequate oversight and monitoring of the project. What assurances can you give us that the causes of these problems are being addressed and will not surface again?**

Once it was clear that the EFDS would not be implemented for Processing Year (PY) 2006, the IRS took immediate action to identify weaknesses that led to the implementation failure. It was determined that there were three inter-related factors: 1) lack of proper governance over development activities; 2) inadequate project management discipline; and 3) lack of proper contractor oversight. The IRS has taken the following steps to prevent a similar situation from occurring in the future:

- Revamped our governance structure so that not only EFDS but all of IRS's 400+ IT projects report to an appropriate Executive Steering Committee (ESC). Part of the ESC's responsibility is to ensure that significant risks and issues are identified early and elevated to the appropriate executive level for effective mitigation and to approve milestone exits.
- Instituted project control disciplines whereby IT projects must complete monthly status reports using a standard template, and such "health assessment" information is monitored by our Program Management Office and accessible by all levels of management. Projects that do not meet development standards in their monthly "health assessment" are folded into the Monthly IT Project Control Review where they report out to IT and business executives and senior managers on current performance and discuss mitigation strategies for risks that are in red and yellow status.
- Took steps to ensure that the government project team members are better equipped with the requisite skills and training to provide adequate oversight and review of contract performance and deliverables.

In addition to these measures, the IRS has assigned an experienced executive to oversee current efforts on the EFDS restoration and bolstered the qualifications for the position of the direct project manager. The EFDS restoration acquisition was a completion contract that included cost sharing. An EFDS Advisory Council meets weekly with the business where a study is being conducted to evaluate future alternatives for EFDS.

- 8. During fiscal year 2006, IRS developed a new IT Modernization Vision and Strategy for BSM program along with a 5-year plan to guide IT**

**investment decisions through 2011. While a good step, it does not fully address GAO's recommendation to develop a long-term vision and strategy for completing BSM. When does IRS anticipate completing this strategy, including establishing time frames for consolidating and retiring legacy systems?**

Building a credible and comprehensive long-term vision and strategy to modernize the information technology of the largest and most complex tax administration system in the world is an iterative process which is being developed, institutionalized and matured over time in lockstep with our business partners. Our goals as part of our Modernization Vision & Strategy (MV&S) effort are to provide the vision, creativity, and a repeatable process to rationalize our investments in a way that is now being aligned with OMB's recommendations for Segment Architecture (Domain Architecture). In FY 2005, our first year of this effort, we accomplished many foundational activities, and selected an integrated set of IT investments using sound investment processes across the primary tax administration domains (submission processing, manage taxpayers accounts, customer service, reporting compliance, filing & payment compliance, and criminal investigation).

During this past year, FY 2006, the IRS improved and built out additional capabilities to institutionalize the MV&S investment processes. We applied lessons learned to improve our development of technical solution concepts, added additional layers of functional and technical integration and sharpened our cost estimation processes. In addition to covering the domains of tax administration, we added in a domain for IT security as well as a domain to cover our Internal Management Systems (to include our financial, human resource, and asset management applications). In parallel we have been maturing our IT governance structure, and we have brought our governance committees into the MV&S process to oversee and approve the strategies, project proposals and prioritize at the domain level.

This year we are expanding the depth and breadth of our MV&S processes. A new functional area domain is being added to cover the provision of IT infrastructure products and services. In addition, we plan to fully complete a comprehensive architecture and strategy for one of the primary tax administration domains. This process will entail a comprehensive analysis of current processes and systems, target processes and systems over the next five years, transition strategies to achieve the targets and performance measures to be achieved. This initiative will address plans for consolidating and retiring legacy systems within that domain which you asked about in your question above. We then plan to complete the comprehensive architecture work for the remaining domains during FY 2008.

It takes time and is very difficult to develop, communicate, and achieve organizational commitment to a vision and strategy for modernization that (1) addresses consolidation, transformation and retirement of hundreds of interrelated legacy systems, (2) incorporates modernized capabilities from new systems, and (3) allows IRS to continue to provide systems for end to end tax administration that incorporate each years' new tax laws and policy. Previous

IRS IT modernization plans have been focused on dealing with the replacement of just key systems (e.g., CADE replacing the master files, the implementation of modernized e-File to both replace the legacy e-file system and handle additional forms types). The MV&S is about building the proper modernization plan for all of IRS IT, dealing with the more than 450 systems that support tax administration. The long-term goal is not to replace most of these systems, but, through concepts such as service-oriented architecture (SOA), to transform and streamline our IT environment over time while still being able to address new business needs that are identified through the MV&S process. Doing this right entails changes in a management paradigm that requires significant involvement from hundreds of people across the organization, entails embracing new architectural and engineering concepts that have never been introduced in the past, and given the complexities, entails the use of an incremental approach. In addition, we must build and institutionalize capabilities within the IRS to make sound investment choices along the way so we can use our limited resources prudently. The very good news is that the first two years of embarking on this effort have forged a much better working relationship between the business units of the IRS and MITS.

Even as we formalize and drive these plans ever deeper across the domains, one must realize that the plans must also be flexible to support significant change. Business requirements, tax laws and tax administration policy can change radically over time. One example would be in submissions processing and, in particular, e-File. We have a roadmap for implementing Modernized e-File (MeF) that has the IRS implementing MeF for all major form types by 2014. However, if the IRS is directed to implement a direct file option for individual filers, it will significantly change the implementation approach and direction for MeF. Whether direct filing with the IRS should be done is a policy issue, but a decision such as that would have major impacts on our modernization strategy.

It should be noted here that the MV&S work in no way undermines the work we have done in developing our comprehensive Enterprise Architecture (EA), which defines IRS's target vision – that is, target business practices of the agency, the systems that enable the target vision, and how technology will support that change. In tandem with Treasury's Enterprise Architecture, our EA continues to be the cornerstone of the IRS Business Systems Modernization and is used to guide the IRS Modernization Program and inform investment decisions. Our MV&S process simply operationalizes the use of the EA in both the business and IT organizations by integrating the use of the EA in evaluating candidate IT investments (projects) and using the evolving portfolio of projects to update and refine the EA and Enterprise Transition Strategy (ETS). For example, during the scope definition phase of the investment proposal (part of yearly MV&S process), business architects partner with project sponsors to map project business capabilities to those documented in the current version of the EA, leveraging the As-Built Architecture component of the EA to identify and analyze interfaces to existing processes and systems, and to identify new business services and processes to update the EA. Engineers, referencing guidance in the EA, develop project level solution concepts (conceptual to logical architectures) for each candidate project. This is followed by an evaluation of the portfolio of projects to identify common service opportunities (infrastructure, data, security solution, etc.) to drive efficiencies in overall design, cost and operational support,

including retirement opportunities (Service Oriented Architecture approach). This collective analysis is the basis of the yearly updates to the ETS where the analysis is further refined (e.g., inter-project dependencies and sequencing). This cycle repeats annually building greater maturity in the analysis and our modernization strategies.

9. **According to the IRS data, From FY 2005 to FY2006 there was a decrease in the number of abusive return preparer investigations initiated from 248 to 197. That would mean on the average there were 4 criminal investigations per state initiated for FY 2006.**

This answer is included in response 10.

10. **Is this decline due to the failure of having the IRS's new Electronic Fraud Detection System up and running and what steps has the IRS taken to put a new system in place?**

A study to evaluate future alternatives for EFDS was conducted which assessed the viability of completing work on Web Portal and evaluated its ability to support future business model and process requirements defined in the Pre Refund effort. IRS Executives, as members of the EFDS Advisory Council, have approved the recommended strategy to return to the Web Portal Development while in the interim keeping the current EFDS client server healthy until Web Portal development is completed and successfully placed into production. The EFDS Advisory Council will provide an oversight role throughout the development of the Web Portal system with a first release not likely occurring until Processing Year 2010.

Investigations initiated during FY 2006 were identified and developed using FY 2005 information. The fact that EFDS was not operational in FY 2006 did not have a direct impact on the decline of investigations initiated that year. Criminal Investigation increased focus on more complex tax and tax related investigations and increased dedication of direct investigative time to pipeline cases are driving the lower numbers of initiations.

11. **Is the IRS dedicated to using the necessary resource necessary to investigate return preparer fraud? If so, why the decline in the number of investigations initiated?**

IRS is committed to investigating return preparer fraud as outlined in the IRS 2005 – 2009 Strategic Plan. Criminal Investigation, working in concert with the operating divisions, continues to devote necessary resources to investigate the most egregious tax return preparers. Since actions on a specific investigation may cross fiscal years, the data shown in cases initiated may not always represent the same universe of cases shown in other actions within the same fiscal year. For example, despite the decrease in initiations, prosecution recommendations and indictment /information have increased. CI's increased focus on more complex tax and tax related investigations and increased dedication of direct investigative time to pipeline cases are driving the lower numbers of initiations.

Criminal Investigation works closely with the Department of Justice (DOJ) to ensure that the evidence in return preparer cases, like all criminal tax cases, establishes the violations prima facie, carries a reasonable probability of obtaining a conviction, and is an appropriate use of limited prosecutorial and judicial resources.

**12. It is obvious that the IRS doesn't have enough employees to investigate every alleged fraudulent return preparer, so what other steps are being taken to stem the flow of fraudulent refunds being issued?**

As the administrator of the laws and regulations governing the practice of tax professionals, this IRS takes several steps against those return preparers who choose not to comply with the IRS established standards of conduct. Return preparers under the scrutiny of the IRS where fraud is alleged are subject to a broad range of coordinated actions. These actions include assessment of preparer penalties, disciplinary sanctions imposed under the authority of Treasury Circular 230, suspension of electronic filing privileges, the pursuit of injunctive activity and, when warranted, criminal prosecution.

Systemically the IRS continues to enhance existing systems used to detect fraudulent returns as they enter the processing stream. Criminal Investigation's Fraud Detection Centers (FDCs) have used EFDS this filing season to identify more than 91,000 potentially fraudulent tax returns claiming more than \$628 million. This is more than double the amount identified in the 2005 Filing Season during the same timeframe. Enhancements will be made this calendar year to incorporate data from Health and Human Services (HHS) to improve the employment verification process for returns claiming the Earned Income Tax Credit (EITC). Additionally, detailed requirements for the 2008 Filing Season are being developed on high priority items such as codes to track identity theft cases and further improvements to the data mining models.

**13. In the Treasury Inspector General for Tax Administration report entitled "The Internal Revenue Service is not adequately protecting taxpayer data on laptop computers and other portable electronic media services" dated March 23, 2007, it was noted that IRS employees reported the loss or theft of at least 490 computers and other sensitive data between January 2, 2003 and June 13, 2006. Of these 490 incidents, only 91 (24 percent) were reported to the IRS security organization. The reported stated that the personal information of approximately 2,359 individuals was comprised. Are IRS employees required to take mandatory computer security awareness training? If so, why the lapse in the number of lost computers reported to the IRS security organization? Were the taxpayers who possibly had their personal identification information compromised notified? What measurable steps has the IRS taken to ensure the American public that their personal information is being properly safeguarded?**



Annually, the IRS requires all employees and contractors to complete mandatory Information Protection training, which details employee accountability and responsibility to comply with all IRS policies and procedures in security, privacy, disclosure and unauthorized access. We have long-standing policy guidance requiring employees to protect taxpayer information and other personal and private data. Although we had a program in place to educate and train our employees about sensitive data protection policies and processes, we acknowledge that we needed to do more.

As the TIGTA noted, reports of laptop losses and thefts prior to May 2006 focused on reporting the theft or loss of the computer equipment itself. We reported the laptop losses to the TIGTA, which worked with other law enforcement agencies to investigate these security incidents. While they recovered very few devices, they found no indication that the laptop losses have resulted in any cases of identity theft. As required by OMB Memorandum M-07-16 ("Safeguarding Against and Responding to the Breach of Personally Identifiable Information"), we are working closely to refine our breach notification guidelines to ensure that we have a comprehensive strategy for properly responding to incidents that involve the loss of sensitive information, and are reviewing and reducing our current holdings of all personally identifiable information to the minimum necessary for the proper performance of a documented agency function. We understand the serious consequences of identity theft, and are continuing to closely review laptop losses and thefts on a case-by-case basis to address each incident appropriately.

Since May 2006, we have implemented a rigorous reporting system that specifically enables us to ascertain potential harm to taxpayers as a result of a laptop loss or theft. The enhanced plan also includes updating and issuing numerous data protection policies, processes, and education training tools to improve employee awareness and skill levels.

- In 2006, we initiated an aggressive plan to install an automatic full disk encryption product on IRS laptops, which automatically encrypts all data on the laptop, without requiring any employee action. These laptops now contain this automatic encryption solution.
- Physical security cable locks have also been provided with the laptops, which will enable employees to better secure their laptops when they leave them unattended.
- Development of an encryption solution for data back-ups and for tapes exchanged with federal, state, and other partners, which we will complete by September 30, 2007, and an upgrade of secure mailing procedures for tape exchanges until we fully deploy encryption
- Implementation of a new security incident reporting system with executive-level review to ensure appropriate handling of any incidents that may involve the loss of sensitive information
- Establishment of a Security Services and Privacy Executive Steering Committee to provide oversight over the initiatives and plans that we develop to strengthen our security and privacy posture

- Implementation of a comprehensive communications strategy to educate employees on asset and data protection responsibilities and the use of encryption capabilities

**14. Last year the IRS paid hundreds of millions of dollars in improper tax refunds because IRS's new Electronic Fraud Detection System failed and IRS lacked a contingency plan. In March, a release of the CADE was put into production 2 months behind schedule. What assurances can you give us that the causes of these problems are being addressed and will not surface again? What happened to the Web-based EFDS? How much money did the Web-based system cost including labor hours required to get the old legacy system running?**

As noted in response to question 7, regarding assurances that the causes of our recent EFDS problems are being addressed and will not surface again, you should know that it was determined that three inter-related factors contributed to the lack of an operational EFDS system for PY 2006. These factors were: 1) lack of proper governance over development activities; 2) inadequate project management discipline; and 3) lack of proper contractor oversight.

The IRS took immediate action to review the factors leading to the EFDS implementation failure and has taken the following steps to prevent a similar situation from occurring in the future.

- Revamped our governance structure so that not only EFDS but all of IRS's 400+ IT projects report to an appropriate Executive Steering Committee (ESC). Part of the ESC's responsibility is to ensure that significant risks and issues are identified early and elevated to the appropriate executive level for effective mitigation and to approve milestone exits.
- Instituted project control disciplines whereby IT projects must complete monthly status reports using a standard template, and such "health assessment" information is monitored by our Program Management Office and accessible by all levels of management. Projects that do not meet development standards in their monthly "health assessment" are folded into the Monthly IT Project Control Review where they report out to IT and business executives and senior managers on current performance and discuss mitigation strategies for risks that are in red and yellow status.
- Took steps to ensure that the government project team members are better equipped with the requisite skills and training to provide adequate oversight and review of contract performance and deliverables. In addition, the IRS has assigned an experienced executive to oversee current efforts on EFDS and bolstered the qualifications for the position of the direct project manager.

Regarding what happened to the web-based EFDS, the IRS has begun planning activities for the modernized version of EFDS and will proceed with those activities based on priorities set forth by our business partners and funding. The EFDS Advisory Council is currently conducting a study to evaluate future alternatives for EFDS. Meanwhile, EFDS was restored for production operations, as planned, on January 16, 2007. It has been in full operation since

then and, as of March 28<sup>th</sup>, has processed approximately 73 million individual returns. EFDS has detected nearly twice the volume of fraudulent electronic returns versus this point in the filing season in 2005.

Regarding “how much money the Web-based system cost including labor hours required to get the old legacy system running,” we believe the answer you are looking for here is that the IRS spent \$20.5 million on the new EFDS (for Processing Year 2007). Although the restoration of the old EFDS system allowed for reprocessing of returns for PY2006, it could not recapture a majority of the lost tax revenues for that year. The cost of restoring the old EFDS system is \$10 million for contractor support and 40,000 IRS employee labor hours. That said, it should be noted here that MITRE’s review of the EFDS web portal work (for the “web-based system) did state that the system architecture was sound and could be production ready with some performance enhancements and application modifications.

**15. Mr. Commissioner, IRS recently established an office of identify theft.**

Response is incorporated as part of response to Question 16.

**16. What is the purpose of this office and what activities has this office undertaken and completed since its inception? What activities has this office undertaken?**

The IRS has tried to take the initiative in proactively analyzing processes to identify areas of vulnerability, and in educating taxpayers and employees about identity theft. We have teamed with other federal agencies, such as the Federal Trade Commission (FTC), the Department of Justice, and the Social Security Administration (SSA) to address identity theft crime.

In 2005 we began an aggressive strategy to research and address this growing problem. We established an Identity Theft Program Office charged with implementing the IRS’ policy on identity theft. This policy requires the IRS to take the necessary steps to provide assistance to victims of identity theft within the scope of their official duties. Our Identity Theft Program Office works with offices throughout the IRS to implement the agencies’ Identity Theft Enterprise Strategy comprised of three components—Outreach, Prevention and Victim Assistance.

*Outreach*

The IRS has undertaken several outreach initiatives to provide taxpayers, employees, and other stakeholders with the information they need to proactively prevent and resolve identity theft issues. 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 Department of 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.
- Lead 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.
- Partnered with the Treasury Inspector General for Tax Administration (TIGTA) to develop and promote 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."
- Jointly with TIGTA published 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.

#### *Victim Assistance*

We recognize that outreach alone is not enough and that we also must be prepared to assist victims when identity theft occurs. With respect to the victim assistance prong of the Enterprise Strategy:

- The IRS established a new identity theft policy that provides for 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, address, and the fact of the identity theft. These documentation standards are consistent with those required by FTC and SSA.
- The IRS has worked closely with SSA to reduce the time required to resolve cases where more than one taxpayer uses the same SSN on a tax return (called the Scrambled SSN process). The average timeframe to resolve the case is now approximately 10 months compared to 18 months previously. As of March 24, 2007, the current scrambled SSN inventory count is approximately 5,000 cases. Approximately 38,000 cases have been referred to SSA in 2003-2006.

- The IRS updated its processes and notices to help taxpayers whose name and SSN were used by an identity thief for employment purposes. When the IRS matches an identity thief's W-2 information with a legitimate taxpayer's income tax return, the IRS sends the taxpayer a notice regarding the under-reported income. This is often the first time the victim is aware of the identity theft. To aid these victims of identity theft, the under-reporter notices were updated with specific instructions on the type of documents and information needed to validate the identity theft cases.
- The IRS is taking additional steps to reduce taxpayer burden associated with identity theft. By January 2008, the IRS will implement a new service-wide identity theft indicator that will be placed on a taxpayer's account upon the authentication of identity theft. Once the new process is fully deployed, taxpayers should only have to provide identity theft authentication one time, and the IRS will be able to reject returns which do not appear to be from the legitimate owner of the SSN.

#### *Prevention*

There are three types of identity theft crimes in tax administration: refund crimes, employment and income diversion.

- Refund crimes are perpetrated by criminals who use another person's tax information to fake a return and steal a refund. The Refund Crimes Unit of the IRS' Criminal Investigation Division identifies those returns through the Questionable Refund program.
- The IRS is developing several initiatives to reduce the incidence of theft related to employment, such as working with SSA to explore initiatives to improve the accuracy of SSN reporting.
- Individuals who make false identity claims to underreport income will face additional tax and penalties, as will preparers who promote such schemes.

To augment the IRS Identity Theft Enterprise Strategy composed of outreach, assistance, and prevention, the IRS initiated a Service-wide Identity Theft Risk Assessment to qualify and quantify existing threats and vulnerabilities related to IRS processes that could directly or indirectly facilitate identity theft and/or taxpayer burden. As an output of this risk assessment, the IRS developed (and has begun the implementation of) targeted remediation strategies designed to address the identified threats and vulnerabilities.

We are also reviewing ways we can protect our employees from identity theft. As required by OMB Memorandum M-07-16 ("Safeguarding Against and Responding to the Breach of Personally Identifiable Information"), we are developing an implementation plan to eliminate unnecessary use of Social Security Numbers (SSN). This plan will incorporate the Unique Employee Identifier (UEID) initiative currently being developed by the Office of Personnel Management. Additionally, the IRS Office of Privacy is incorporating the guidance and best practices included in the June 18, 2007 memorandum from

the Office of Personnel Management (OPM), "Guidance on Protecting Federal Employee Social Security Numbers and Combating Identity Theft. We also are closely coupling privacy and identity theft protections with the agency security program, so that when we do need to collect SSNs – either employee or citizen, we can ensure that they are adequately protected within our systems.

The main focus for the annual IRS' Security Awareness Week, last November, was "Identity Theft/Fraud." Activities were focused on raising awareness and making employees aware of their responsibilities.

**17. How many fulltime employees staff this office and what are their responsibilities. What training in Identity Theft and related issues have these employees received?**

Response is incorporated as part of response to Question 18.

**18. TIGTA noted that a decision was recently made to move the Identity Theft Office from Wage and Investment to Mission Assurance. What were the reasons for this decision? How many full-time employees will staff this office and what will be their responsibilities?**

The Identity Theft Office was moved from Wage and Investment to Mission Assurance in late 2006 to enable the Service to combine both privacy and identity theft protection programs within the agency's security programs led by Mission Assurance & Security Services (MA&SS).

In July, 2007 we moved this program to an office under a new Senior Executive reporting to Deputy Commissioner, Operations Support. Given the increased nationwide attention and focus on privacy issues and the growing threat of identity theft, reporting directly to a Deputy Commissioner will provide this program the ability to reach across all IRS organizations to ensure that proper attention and discipline is given to these important security and privacy issues. The Identity Theft and Incident Management Office will be initially staffed with ten full-time employees who will be responsible for maintaining and overseeing implementation of the IRS' Enterprise Identity Theft Strategy and providing identity theft policy guidance and oversight.

**Questions from Senator Hatch:**

**19. I appreciated your update on how this tax filing season is progressing. You mentioned that about 3 million taxpayers have taken advantage of the Free File system, which allows taxpayers with adjusted gross incomes of \$52,000 or less to file electronically for free. You also mentioned some of the many benefits for both taxpayers and the IRS of electronic filing. While I understand there are some complexities involved, it seems to me that we ought to be allowing all taxpayers to file electronically at no charge. Indeed, some have suggested that we would be better off if the government**

**paid people a small incentive to file electronically. Can you comment on why it would not be a good idea to offer free electronic filing to taxpayers of all income levels, as many states do?**

Please see response to Senator Baucus number 4.

**20. In your written testimony is a brief mention of the IRS' information technology infrastructure. I recall that for many years, the Service has struggled to modernize its computers and IT systems. Can you tell us today with confidence that the IRS has achieved success in modernizing these systems, or are we still dealing with information systems that are several generations old and cannot "talk" to each other?**

While ramp-up of IRS's Business Systems Modernization (BSM) program was admittedly slow, the BSM program has sustained a very good record of success in recent years and is implementing systems that yield tangible benefits for the American taxpayers. Building on the last three years of success, in FY 2007 BSM continues to make substantial progress in meeting targets for project deliveries and has continued to build foundational processes, controls, and governance that are essential to continued success in managing our complex and complicated system development efforts. Not surprisingly, GAO highlighted the significant strides that the IRS has made in managing its systems development efforts in their February 15, 2007 report to Congress on the FY 2007 Expenditure.

There is no question that IRS is achieving success in modernizing its information technology. Today our new Master File (CADE) is processing returns for Filing Season 2007 on a modernized and secure platform and has posted more than 11 million 1040, 1040 EZ and 1040A returns with numerous schedules and forms. So far this filing season, CADE has issued over \$11 billion in refunds twice as fast as legacy for direct deposit refunds and up to 7 days quicker than legacy for paper refunds. In addition to CADE, Modernized e-File is available for the fourth season of e-filing allowing corporations (Form 1120 and 1120S filers), partnerships (Form 1065), and tax exempt organizations to file their Federal and State forms in one transaction and states to retrieve their return over MeF. To date this filing season, nearly 2 million 1120, 990 and 1065 returns and extensions have been received electronically, which is almost double from what was received in all of 2006, and feedback from our stakeholders indicates that taxpayers are satisfied with their e-Filing experience. Our suite of e-Services is providing hundreds of thousands of tax practitioners and IRS employees with on-line value-added services such as submitting Power of Attorneys, obtaining Preparer Tax ID Numbers (PTIN), Taxpayer Identification Number (TIN) matching, electronic fingerprinting, etc. On the infrastructure side, we have installed a state-of-the-art Enterprise Architecture Integration Broker, which supports our service oriented architecture by eliminating a multitude of interfaces among our legacy systems – and integrates them into one common technical solution. This technology is establishing an Enterprise Architecture (EA) standard for interfaces and will result in reduced application development, deployment and update time, reduced testing, and reduced maintenance costs.

While we have made strides over the last several years in modernizing our information technology at the IRS, we do still have a large number of older application systems and supporting infrastructure. The IRS's information technology environment is extraordinarily complex in which we support more than 450 systems and our modernization efforts do not result in a one-for-one replacement of legacy systems so in many cases we are still dealing with information systems that are several generations old and cannot "talk" to each other. For example, our Customer Service Representatives still must navigate through and process information from multiple stand-alone systems to service taxpayers, and data on a given taxpayer is not available to them real time in many cases since our legacy Integrated Data Retrieval System (IDRS) still receives only weekly batch files from the legacy master files and the service center returns and payment processing pipeline. Nonetheless, we continue on a steady track to address our generations-old technology and fragmented architecture using our Modernization Vision and Strategy and our Infrastructure Blueprint, aimed at systematically and incrementally building new technologies and replacing aged infrastructure components based on business priorities and available funding. The President's FY08 requests \$60 million to begin to address the backlog of aged infrastructure. Utilizing the Sustaining Infrastructure governance process, the IRS would prioritize the highest priority investment opportunities. Examples of some of these potential investments include:

- **Replacement of the IRS portal environment.** The FY08 budget request includes \$16 million for replacement of the current IRS portal environment. The IRS portal environment provides secure, web-based interfaces with external taxpayers and IRS employees and is disparately spread across 200 servers that are now 90% aged and experiencing significant outages. The IRS must replace this equipment, not only to avoid service disruptions, but also to handle anticipated growth of the existing projects and future modernization efforts.
- Completion of the planning and acquisition strategy for our **Automated Call Distributor hardware** that receives and routes 78 million taxpayer calls to the next available assistor, which has reached suggested end-of-life (averaging 12 years old);
- Investments of \$13 million to replace and consolidate servers to reduce operations costs and improve security and reliability of mission critical systems. These systems operate tax processing applications and solutions on aged equipment and pose a risk of permanent loss of business data as well as work stoppage of fundamental business processes.
- Investments totaling \$7 million in computing center infrastructure including establishing a **redundant power supply** to support 7x24x365 service the IRS provides to its customers. This will allow the IRS to eliminate current outages it experiences due to maintenance of its IT infrastructure components via scheduled system outage events.
- Purchase of \$25 million to replace **outdated employee desktop/laptop workstations** which results in (1) increased downtime (2) reduced capability to communicate effectively and (3) delays in retrieval and update of taxpayer data that is vital to daily compliance/enforcement activities.
- Expend \$5 million for the **maintenance of routers/switches** that are needed for IRS personnel to communicate and provide data communications



between systems; failure of these routers and switches can result in improper routing of taxpayer information or agents not being able to retrieve tax records in a timely manner.

- Purchase of \$5 million in **network printers** to replace stand-alone, aged printers that support large groups of IRS employees.

**21. It has been nearly a decade since we restructured the Internal Revenue Service. It seems we have seen the pendulum swing from more aggressive enforcement to a “kinder and gentler” IRS and now back again to more emphasis on enforcement. The IRS of today looks much different than it did a decade ago. What are the major challenges facing the Service over the next ten years, and what should this Committee be doing to help you with these challenges?**

The IRS Strategic Vision is to be a 21st Century agency with the human capital and technology capabilities to effectively and efficiently collect the taxes owed with the least disruption and burden to taxpayers.

The IRS Strategic Plan offers some insight into factors that will affect our ability to achieve that vision over the next decade. These include:

- **Globalization:** As the business world continues to globalize, tax planning is becoming increasingly focused on worldwide tax rate minimization. As a result, taxpayers often have an inherent incentive to adopt structures or arrangements that maximize U.S. expenses or shift income abroad. While many cross-border transactions are clearly addressed under U.S. domestic law or treaty provisions, others involve emerging issues that may constitute unacceptable tax avoidance or evasion. Unless adequate compliance resources are devoted to identify, develop and pursue such issues where appropriate, globalization will pose increasingly serious risks to the U.S. tax base.
- **Prevalence and Complexity of Abusive Tax Avoidance Transactions:** Abusive tax avoidance transactions present formidable compliance challenges. They have pervaded almost every aspect of our voluntary tax compliance system. They appear on many types of tax returns and range from complex, structured corporate transactions that utilize multiple entities to individual scams and schemes. Use of offshore entities and accounts is also common. The organized promotion of shelters makes them available to all types of taxpayers. The variety, size and nature of tax shelters require an organized approach to detection, deterrence and enforcement so that the use of abusive transactions can be stopped.
- **Tax-Exempt and Government Entities:** We also face challenges in the area of tax-exempt and government entities. Such entities include local community organizations and municipalities, pension funds, state and Indian tribal governments, complex tax-exempt bond financing transactions and more. They are governed by highly specialized provisions of the tax law. The IRS faces ongoing challenges in assisting

these taxpayers in complying with the complicated rules for maintaining their special tax status. Additionally, recent events have shed light on the need to ensure that charitable organizations are not used for non-charitable or illegal purposes, including financing terrorist activities.

- **Legislative Changes:** Changes in the tax law and appropriations have a major impact on how we conduct our activities, how many resources we require and how quickly we achieve our strategic goals. Generally, the tax laws are changed each year. Many of these changes have significant impact on the IRS in terms of the scope and effectiveness of service, in the cost to deliver service and in how taxpayers perceive us. We must find ways to effectively administer tax law changes in a way that minimizes complexity, burden on taxpayers and the cost of administering the tax code. Changes intended to simplify the tax code depend on a political consensus and oftentimes that consensus serves to complicate, not simplify the tax code.
- **Dealing With an Era of Electronic Communications:** The Internet has revolutionized our ability to serve taxpayers and their representatives. We have used the Internet through the creation of IRS.gov, to meet taxpayer demands for quick access, user-friendly tools and better service, and we will continue to use the Internet to reduce burden. In the future, we envision the public will be able to conduct the vast majority of tax interactions electronically. We will continue to improve electronic filing, payment and communication services via the internet. However, the internet can also be used as a tool by others who seek to steal the identity of other individuals or to create "phishing" schemes that seek to deceive legitimate taxpayers. Dealing with these schemes will remain a challenge for us as we seek to keep pace with technological developments that enhance the speed of communication.
- **Increasingly Diverse Population:** As American society becomes more diverse, there is an increase in the number of taxpayers with limited-English-proficiency (LEP). The IRS faces challenges of enhancing and expanding its products and services to meet the needs of this customer segment. The IRS must develop and implement programs that identify and meet the needs of LEP taxpayers. The IRS needs to offer education and outreach opportunities to help these taxpayers understand and comply with their obligations. The IRS also needs to effectively engage LEP taxpayers who are participating in a tax system based on self-assessment for the first time to ensure their continued voluntary participation. The IRS has established the Multilingual Initiative Strategy Office to facilitate these programs. The IRS must meet the challenges posed by small business and self-employed customers. This group of taxpayers is the fastest growing segment of taxpayers and is estimated to be the largest single contributor to the federal tax gap. In addition, IRS must deal effectively with large corporate customers that operate in an increasingly complex global environment, characterized by growing electronic commerce and intricate corporate structures resulting from mergers, acquisitions and partnerships. These complex structures can be readily used to hide corporate and individual use of abusive tax avoidance transactions.

- **Terrorism:** Terrorism remains an imminent threat to national security and future terrorist attacks aimed at critical national infrastructure, including our system of tax administration, could produce drastic results. Terrorists and their supporters may raise funds through the abuse of tax-exempt organizations and non-profit organizations ostensibly engaged in humanitarian relief or religious activities. They also use a variety of conventional criminal activities such as dealing in stolen property, insurance fraud, smuggling, and narcotics trafficking. All of these methods have an impact on our tax administration process. The IRS has a unique role in combating the use of charitable organizations to raise funds for terrorist organizations. The threat of terrorism creates an environment that demands IRS' commitment of resources to assure the safety of IRS personnel and the security and maintenance of facilities, infrastructure and taxpayer information.
- **Workforce Renewal and Development:** The growing retirement eligibility of the federal workforce poses challenges to many federal agencies. Workforce renewal is a constant challenge requiring continued improvements to remain competitive with the private sector. To achieve our performance goals, the IRS must be able to continuously renew itself by attracting and retaining the "best and the brightest." Technological systems are being developed and implemented that will allow the comprehensive tracking of the skills of our workforce so that we can identify current and future skill set gaps and develop strategies to retrain and reposition employees, attract and recruit the skills sets we need and use competition to bring new skills to the IRS.
- **Changes in Workforce:** To deal with changes in the workforce, the IRS must develop and implement a strategic human capital plan designed to ensure a link between the strategic goals of the agency with a real-life view of our organizational capacity as it relates to the strategic management of human capital. The IRS must provide a positive career path option for the mobile workforce of the future. We must institutionalize a process for replenishing the IRS workforce and ensuring leadership continuity through first class recruitment efforts and employee development. We will continue to place great emphasis on linking pay with performance to maximize the workforces' contributions to the Service's core mission and goals. We will strive to become a "first choice" employer where talented people want to work and can excel in a culture of high performance, empowerment and a quality work environment.

In terms of assisting with meeting these challenges, one of the two biggest things your Committee can do is to work to simplify the tax code.

*United States Senate*  
*Committee on Finance*



*Sen. Chuck Grassley · Iowa*  
*Ranking Member*

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Opening Statement of Senator Chuck Grassley  
Hearing, "Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure"  
Thursday, April 12, 2007

I would like to start out by thanking Chairman Baucus for calling this hearing to examine the issues affecting the current filing season and to look at the roles and responsibilities of the tax preparation community.

The only thing that I would have changed about this hearing if I were still the chairman of this Committee would have been the title. I would have called it, "Sharks in the Water – Let the Taxpayer Beware," because there seems to be an increasing amount of danger in receiving an inaccurate or even fraudulently prepared tax return.

In 2006, over 62 percent of all individual taxpayers used a paid preparer to complete their tax return. As a result, these preparers have a direct and substantial impact on tax compliance. And while I believe most tax return preparers are honest, knowledgeable individuals who serve the community well in providing sound financial advice, there are clearly some sharks lurking in the water. And these sharks are preying on innocent taxpayers – either through bad advice, incompetence, or downright fraud.

The first example that comes to my mind is the recent allegations against the Jackson Hewitt franchises. These allegations are very disturbing, considering that Jackson Hewitt is the nation's second-largest tax preparation firm.

Examples of fraud alleged in the April 3, 2007, Jackson Hewitt civil injunction cases include filing false returns claiming refunds based on phony W-2 forms; using fabricated businesses and business expenses on returns to claim bogus deductions; claiming fuel tax credits in absurd amounts for customers clearly not entitled to any credits; and massive fraud related to claiming the federal earned income tax credit.

While it is great news that the IRS and the Department of Justice are working to close down these allegedly fraudulent tax preparation shops, it would have been better – in terms of protecting more taxpayers and producing a chilling effect on fraud – if the bolts were put on the doors earlier in the filing season. As it was, by the time that the Department of Justice filed suit, there were only two weeks left in the filing season.

Last year's undercover investigation of paid preparers conducted by the Government Accountability Office (GAO) at the request of this Committee serves as yet another example of just how dangerous the tax preparation waters can be – and it also seems to indicate that the lifeguard is asleep on his chair.

In that investigation, the GAO found that out of the nineteen paid preparers investigated, not one properly prepared a tax return. Among the most serious problems that the GAO found involved paid tax preparers not reporting side income in 10 of 19 cases. Even in cases where the side income was reported, several paid preparers advised the GAO undercover investigators that reporting such

income was voluntary because the IRS would not know of it unless it was reported on the return. This type of inaccurate advice can hardly be attributed to the complexity of the tax code.

Yet, despite the GAO turning over the results of the investigation to the IRS, almost a year later the IRS has yet to complete a single audit on a single tax return filed by any of those nineteen preparers – and the IRS has not assessed preparer penalties on even one of those nineteen preparers in response to the GAO investigation.

In the meantime, hundreds, if not thousands, of innocent taxpayers unwittingly bring their most private financial information in to these same paid preparers every day. And these preparers, who gave inaccurate, if not intentionally fraudulent advice – and who have seen absolutely no repercussions from the IRS whatsoever, continue preparing tax returns – probably still giving the same bad advice.

The IRS and the Department of Justice need to pick up the pace on preparer cases. The IRS is moving at such a snail's pace on the GAO work that it appears as though they are not moving at all. This is not sending the right message to the paid preparer community. Paid preparers need to know that they will be held accountable. And the IRS and the Department of Justice need to be more proactive in getting that message across.

Another area that needs some proactive attention from the IRS is the filing of false tax returns using stolen identities. Identity theft is one of the fastest-growing crimes in the United States, and it is increasingly being used in the filing of false returns. Yet, the IRS has no systematic way of identifying cases involving claims of identity theft or what the impact of these cases are in terms of the aggregate dollar value of refunds issued. Resolution of cases involving identity theft can be time-consuming, frustrating and difficult for the victims – especially when the IRS is not reaching out to help the taxpayers who fall victim, but is instead interrogating them as though they were the crooks.

We in Congress need to do more to ensure that those who are preparing returns possess the competence and ethical standards necessary to maintain the integrity of our tax system. Last year, this committee passed a bill that would regulate paid preparers and provide better taxpayer protection and assistance, but it didn't get brought up for a full Senate vote. We need to look at getting a similar bill passed this year.

And while I understand that no amount of regulation is going to prevent outright fraud, it is essential that the IRS impose stringent oversight of the paid tax preparation community and, where applicable, impose penalties and prevent the practitioner from preparing returns and representing taxpayers before the IRS.

In looking at this bill, we need to consider whether the law as it stands today provides adequate protection to victims of identity theft whose information is used in the filing of false tax returns and what can be done better to assist these taxpayers in resolving their cases with the IRS.

And we need to consider whether the IRS is fulfilling its obligation to help taxpayers understand and comply with their tax obligations. In looking at this, we need to determine whether the free electronic filing methods that exist today are effective in assisting taxpayers to determine their correct tax liability – and if they are not, we need to determine what the proper role of the IRS should be in ensuring that such a method exists.

*STATEMENT OF EILEEN J. O'CONNOR  
ASSISTANT ATTORNEY GENERAL  
TAX DIVISION  
SENATE FINANCE COMMITTEE*

*"FILING YOUR TAXES: AN OUNCE OF PREVENTION IS WORTH  
A POUND OF CURE"  
APRIL 12, 2007*

Thank you for the opportunity to appear before you to discuss the tax enforcement work of the Tax Division of the United States Department of Justice. You have asked that I advise you, in particular, about enforcement actions aimed at fraudulent tax return preparation and the promotion of tax fraud schemes and scams.

**Background**

The attorneys of the Tax Division represent the United States in virtually all civil and criminal trial and appellate litigation arising under the internal revenue laws, in all state and federal courts except the United States Tax Court.

Tax Division attorneys are essential to IRS enforcement activity at all levels. When the IRS is examining a taxpayer's federal income tax return, for example, the IRS will need the Tax Division to, among other things, enforce and defend its summonses while the examinations are ongoing. When the examination is complete and the IRS has determined that additional tax is owed, the Tax Division will represent the United States in court, if it comes to that, to collect and defend the IRS's tax assessments. At any given time, we have nearly 7,000 civil cases in litigation. In any given year, we handle about 700 civil appeals, including those from decisions of the Tax Court.

The Tax Division's criminal prosecutors authorize all grand jury investigations and all prosecutions involving violations of the internal revenue laws and, alone, or in conjunction with Assistant United States Attorneys, investigate and prosecute the crimes. In the last few years, we have authorized between 1100 and 1800 criminal tax prosecutions per year.

During the six years since my confirmation to head the Tax Division, its workload has increased, and changed in character, as well. The cases we have now are much more labor intensive, and have much more at stake than those we faced eight or ten years ago. Not only are the dollars at stake in the cases much higher, but the cases' potential impact on the ultimate enforceability of the tax laws as a whole has grown significantly.

During the past year, we have achieved substantial and meaningful victories in the tax shelter arena:

- The Supreme Court let stand the decision of the United States Court of Appeals for the Sixth Circuit that the COLI (corporate-owned life insurance) program **The Dow Chemical Company** used to claim more than \$33 million of tax deductions was an economic sham.

- The Supreme Court also let stand the decision of the United States Court of Appeals for the Federal Circuit that the IRS was right to disallow the \$375 million loss **Coltec Industries** claimed from its “contingent liability” tax shelter.
- The United States Court of Appeals for the Second Circuit held that the IRS properly disallowed the losses **General Electric Capital Corporation** claimed from its participation in an equipment leasing tax shelter, resulting in \$62 million in additional income taxes.
- The United States District Court for the Middle District of North Carolina granted summary judgment for the United States in the first Lease In - Lease Out (LILO) tax shelter to go to court, **BB&T Corporation v. United States**.
- Ruling for the United States on an issue raised by tax shelter participants in several tax shelter refund suits, the United States Court of Appeals for the Federal Circuit, in **AD Global Fund, LLC v. United States**, ruled that the statute of limitations on the return of a person who participates in a tax shelter partnership does not expire before the statute of limitations on the partnership’s return does.

We also won three challenges to the government’s disallowance of benefits from the so-called Son-of-BOSS tax shelter: **Colm Producer Inc. v. United States** (N.D. Tex.), **Klamath Strategic Investment Fund, LLC v. United States** (E.D. Tex.), and **Cemco Investors v. United States** (N.D. Ill.).

On March 29, the law firm **Jenkins & Gilchrist** entered into a non-prosecution cooperation agreement with the United States Attorney for the Southern District of New York, admitting wrongdoing in connection with developing and marketing fraudulent tax shelters and providing fraudulent tax opinions that wrongly deprived the U.S. Treasury of significant tax revenues.

In January 2007, **Steven Michael Acosta**, a former KPMG manager, pleaded guilty to four felony tax charges in connection with his involvement in KPMG’s promotion of tax shelter transactions. In December 2006, Utah businessman **Chandler S. Moisen** pleaded guilty to conspiracy and wire fraud in connection with a criminal probe of tax shelters promoted by a group of KPMG, LLP executives.

Since 2001, the Department of Justice has successfully prosecuted hundreds of tax cheats and promoters of abusive tax schemes; it has sought and obtained more than 230 civil injunctions to stop the promotion of tax scams and the preparation of false and fraudulent tax returns. We have helped the IRS to identify and pursue hundreds of customers who engaged in abusive tax shelter transactions, while, at the same time, pursuing the professionals who designed, facilitated, or accommodated the underlying tax shelter transactions.

The President’s Budget Request for the Division for the fiscal year 2008, as did the one for fiscal year 2007, requested additional resources for the Tax Division to enable us to meet the additional challenges created by the IRS’s increased enforcement. The members of the Senate Finance Committee can appreciate more than most the importance of the Tax Division’s work. I

request your strong support for ensuring that tax law enforcement is appropriately funded, both at the IRS and the Department of Justice.

### **Criminal Prosecutions**

During fiscal year 2006, the Justice Department's Tax Division authorized the prosecution of 1,180 defendants for tax crimes, an increase of more than 34 percent over the number authorized for prosecution in 2001. The Tax Division's criminal enforcement priorities include investigating return preparers and tax professionals as well as schemes that involve:

- Using trusts or other entities to conceal control over income and assets;
- Shifting assets and income to hidden offshore accounts;
- Making false statements to the IRS in order to claim tax refunds;
- Selling and promoting fraudulent tax avoidance schemes;
- Using frivolous justifications for not filing truthful tax returns;
- Failing to withhold, report and pay payroll and income taxes;
- Failing to report income on individual and corporate returns; and
- Failing to file tax returns.

You asked us to discuss: (1) the Tax Division's acceptance rate for IRS criminal referrals, and (2) whether we are too selective. Tax Division prosecutors review IRS referrals to assure that uniform standards of prosecution are employed and that criminal tax violations warranting prosecution are prosecuted. The Tax Division's actions on criminal cases referred by the IRS, including declinations, for the last three fiscal years are as follows:

**Tax Division's Actions on Criminal Cases Referred by IRS**

	FY 2004	FY 2005	FY 2006
Prosecution authorized (defendants)	1,381	1,273	1,180
Prosecution declined	46	52	75
Percentage of targets declined	3.22%	3.92%	5.98%
Grand Jury Investigation authorized*	84	98	144

\* Occasionally, a case the IRS refers for authorization of prosecution has prosecution potential, but lacks sufficient evidence to prove the tax violation beyond a reasonable doubt. In those cases, rather than authorizing prosecution, the Division authorizes a grand jury investigation to obtain the necessary evidence to obtain an indictment and conviction.

As the chart reflects, the percentage of targets that we decline to prosecute is relatively constant and low, ranging from three to six percent over this period. Moreover, our conviction rate is high—on the order of 97 percent for the 2006 fiscal year. The low percentage of declined cases and the high conviction rate suggests that the IRS is applying the appropriate standards in its case selection and that, as a general proposition, it is satisfactorily investigating the cases that



it refers. Your staff asked us to comment on whether we are overly selective in evaluating IRS referrals. In a word, "no." The Tax Division's declination rate is not, by any definition, high. The Tax Division's judgment in authorizing tax prosecutions is invaluable. It would be inappropriate to bring charges that cannot be proven in a court of law and tax cases can be difficult to prove. In addition, because of the significance of deterrence in tax law enforcement, it would be counterproductive to prosecute tax cases that might not result in a conviction.

### Civil Injunctions

The Tax Division continues to bring civil injunction suits to stop illegal tax fraud schemes and tax preparers who prepare fraudulent tax returns. For example, on April 2, 2007, we filed civil injunction suits against five corporations that operate Jackson Hewitt tax preparation franchises, as well as 24 individuals who manage or work at the franchises. According to the four lawsuits—filed in federal courts in Chicago, Atlanta, Detroit and Raleigh, N.C.—the corporations operate under franchise agreements with Jackson Hewitt Tax Services Inc. of Parsippany, N.J., the nation’s second largest tax preparation firm. The suits allege that one of the individual defendants, **Farrukh Sohail** of Atlanta, Ga., wholly or partly owns each of the five corporations, which prepared and filed over 105,000 federal income tax returns last year. The five corporations allegedly operate more than 125 Jackson Hewitt retail tax preparation stores in the Chicago, Atlanta, Detroit and Raleigh-Durham, N.C. areas. According to the complaint, Sohail and other defendants “created and fostered a business environment” at the Jackson Hewitt franchises “in which fraudulent tax return preparation is encouraged and flourishes.” Examples of fraud alleged in the lawsuits include filing false returns claiming refunds based on phony W-2 forms; using fabricated businesses and business expenses on returns to claim bogus deductions; claiming fuel tax credits in absurd amounts for customers clearly not entitled to any credits; and massive fraud related to claiming the federal earned income tax credit. The five Jackson Hewitt franchises named in the four suits are: Chicago Suit: **Smart Tax, Inc., d/b/a Jackson Hewitt Tax Service; Ask Tax, Inc., d/b/a Jackson Hewitt Tax Service;** Atlanta Suit: **Smart Tax of Georgia, Inc., d/b/a Jackson Hewitt Tax Service;** Detroit Suit: **So Far, Inc., d/b/a Jackson Hewitt Tax Service;** and Raleigh Suit: **Smart Tax of North Carolina, Inc., d/b/a Jackson Hewitt Tax Service.**

On April 2, 2007, we also filed a suit to block **Robert L. Schulz**, of Queensbury, N.Y., from selling an alleged tax fraud scheme that is estimated to have cost the Treasury more than \$21 million. Also named in the suit are two corporations, “**We the People Foundation for Constitutional Education, Inc.**,” and “**We the People Congress, Inc.**” The complaint, filed in Syracuse with the United States District Court for the Northern District of New York, alleges that Schulz has used the two “We the People” entities to market a nationwide tax fraud scheme, called “the Tax Termination Package,” to employers and employees. According to the complaint, the Tax Termination Package includes forms the defendants falsely tell customers can be used to replace forms the IRS requires employers and employees to use in connection with federal tax withholding from wages. The suit says that Schulz and the “We the People” entities falsely state that use of the replacement forms will allow customers to legally stop tax withholding. According to the complaint, the defendants base the scheme on frivolous arguments about federal tax laws that federal courts have repeatedly rejected. These tactics are on the IRS’s 2007 list of the Dirty Dozen tax scams.

In response to the government’s suits, courts across the country have barred tax preparers from preparing inaccurate returns and promoters of tax fraud scams from selling tax-evasion schemes on the Internet, at seminars, or through other means. Since January 2001, the Justice Department has sought and obtained injunctions against more than 230 tax return preparers and promoters, including 84 since January 2006, and it has filed complaints against 285. We expect to obtain many more injunctions throughout the year. The tax scam promoters we have sought to

enjoin have cost the federal Treasury an estimated \$2.5 billion, and have had an estimated 500,000 customers. The United States recently has obtained injunctions that barred the following schemes:

- Filing tax returns that falsely report “zero income”;
- Claiming that only income from a foreign source is taxable, using a spurious interpretation of Section 861 of the Internal Revenue Code;
- Failing to withhold, report and pay payroll and income taxes;
- Claiming personal living expenses as business expenses;
- Preparing amended tax returns to claim tax refunds without customers’ knowledge or consent;
- Using trusts to conceal ownership or control of assets;
- Asserting that casino gaming proceeds paid to Native Americans are exempt from federal income tax; and
- Forming a “corporation sole” for the improper purpose of avoiding tax.

We have also obtained injunctions against employers who fail to withhold, account for and pay over employment and withholding taxes.

When we obtain an injunction in federal court, compliance with the injunction stops the harm caused by the promotion of tax fraud schemes and the preparation of false tax returns. Thus, our efforts seek to minimize the number of people who get caught up in these schemes and to assure that every American abides by their duty to pay tax. Individual taxpayers also benefit to the extent that our injunction suits help to steer them away from bad preparers because clients of these preparers are often left holding the bill with little ability to pay.

#### **Coordinated Civil and Criminal Proceedings**

The Department and the IRS bring both civil and criminal tools to bear in the fight against tax fraud. An ongoing tax scam causes continuing harm to the federal Treasury and it leaves participants owing taxes, interest and, often, penalties as well. We do not wait until a criminal case has been developed to take action to stop the scam. Rather, we bring civil injunction suits to stop both the promotion of tax scams and the preparation of false or fraudulent returns. Additionally, in appropriate cases, we bring criminal charges against the promoters, preparers, and scam participants to punish them for their unlawful conduct.

#### **Return Preparer Fraud**

Fraud committed by return preparers continues to be a significant problem. Indeed, since 2004 the IRS’s Dirty Dozen list of tax scams has warned taxpayers about return preparer fraud. The current list describes the problem in the following terms:

**Return Preparer Fraud:** Dishonest return preparers can cause many headaches for taxpayers who fall victim to their schemes. Such preparers make their money by skimming a portion of their clients’ refunds and charging inflated fees for return preparation services. They attract new clients by promising large refunds. Some

preparers promote filing fraudulent claims for refunds on items such as fuel tax credits to recover taxes paid in prior years. Taxpayers should choose carefully when hiring a tax preparer. As the old saying goes, "If it sounds too good to be true, it probably is." Remember that no matter who prepares the return, the taxpayer is ultimately responsible for its accuracy. Since 2002, the courts have issued injunctions ordering dozens of individuals to cease preparing returns, and the Department of Justice has filed complaints against dozens of others. During fiscal year 2006, 109 tax return preparers were convicted of tax crimes and sentenced to an average of 18 months in prison.

See IR-2007-37, Feb. 20, 2007 at <http://www.irs.gov/newsroom/article/0,,id=167983,00.html>.

Corrupt accountants and unscrupulous tax return preparers cause enormous losses to the tax system and to the flow of revenues to the federal Treasury. Tax professionals often commit a large number of frauds. Indeed, in a pending criminal case, the indictment alleges that the five defendants prepared more than 6,000 fraudulent income tax returns in 2003. Promises of large tax refunds are used to attract customers. For example, **Alease Marie Lewis**, a return preparer in Georgia who was convicted on September 12, 2006, of aiding and abetting the filing of false returns, boosted her return preparation business from 200 returns to over 1,000 returns by preparing and electronically filing tax returns with inflated or fictitious deductions. An attorney for a large-scale tax return preparer told us, in arguing that an injunction suit against his client was not warranted, that fraud is commonplace and everyone does it. Tax Division attorneys continue to aggressively investigate and prosecute such cases.

People who hire a tax return preparer need to be careful when they do, not only because the taxpayer is responsible for the accuracy of the return, but also because some preparers have engaged in identity theft. For example, on March 14, 2007, **Kandi Rose Roberts, aka Kandi Kroon**, pleaded guilty in Seattle to various tax crimes and identity theft. According to the plea agreement, Roberts and her husband participated in a conspiracy to defraud the United States by submitting fraudulent tax returns in the names of others. Roberts then collected more than \$40,000 in tax refunds to which she was not entitled. In addition to the scheme to defraud the IRS, the couple also conspired to commit bank fraud. The couple made use of personal identifying information of family members and others who had used Kandi Roberts' tax preparation services. Using that information they opened bank and credit accounts. They forged checks on accounts belonging to family members and ran up large credit card bills in the names of family members and others.

Another return preparer case involving identity theft is an injunction suit in which a federal judge entered an order on August 8, 2006, that permanently barred **Jean-Marie Boucicaut and Marie Thelemarque** of Orlando, Florida, and Boucicaut's company, Tax Review Corporation, from preparing federal tax returns for others. The court also ordered Boucicaut and Thelemarque to return \$772,449 plus interest to the United States that they fraudulently obtained by intercepting and cashing 593 tax refund checks of other persons. The judge found that the defendants filed amended income tax returns for persons without their authorization who did not know that the defendants had filed returns on their behalf. The government alleged that the defendants obtained tax information from copies of old tax returns given to them after the defendants offered to help taxpayers recover money allegedly owed to

them by the IRS. The court stated that defendants used this information to prepare returns requesting tax refunds based on false credits and bogus deductions and directed the IRS to send the requested refund checks directly to them.

Examples of criminal cases that involved return preparation fraud (but not identity theft) include:

- On March 8, 2007, a federal judge in Fort Lauderdale, Florida, sentenced **Ellis Jerome Parker Sr.**, a Broward County tax return preparer, to 60 months in prison for preparing and presenting income tax returns to the IRS that falsifying claimed Schedule A deductions such as medical and dental expenses, charitable contributions, and employee business expenses. The scheme involved hundreds of returns.
- On October 5, 2006, a federal judge sentenced southern California tax return preparer, **Susan O'Brien**, to 125 months in prison, and her two associates, **Robert Richard Evans** and **William Dean Cook**, to 78 months and 24 months in prison, respectively, for tax fraud. In May 2006, a federal jury convicted the defendants in connection with promoting a \$1 million tax evasion scheme involving sham trusts and the preparation of false income tax returns. Five other defendants pleaded guilty to felony tax charges before the trial of these defendants.
- In May 2006, a federal judge sentenced Buffalo-area return preparer **Joseph C. Dettelis** to 50 months in prison for his conviction of aiding and assisting in the preparation of false tax returns, filing false claims with the IRS, and making false statements to the IRS. As part of the scheme, Dettelis charged his clients one-third of the fraudulent tax refunds they received from the IRS.

Examples of injunction cases against return preparers include:

- On March 19, 2007, a federal judge in Grand Rapids, Michigan, issued a temporary restraining order barring **Donald A. Gray** of Portage, Michigan, from preparing federal income tax returns for others. The court found that the man has been preparing income tax returns for customers based on the frivolous theory that wages are not income for federal tax purposes unless the wage earner works for the government based on a scheme promoted by Peter Eric Hendrickson in a self-published book entitled "Cracking the Code, The Fascinating Truth About Taxation in America."
- On February 5, 2007, a federal judge in Minnesota issued a permanent order barring **Nash Sonibare**, a Nigerian immigrant who operated Liberty Financial Group in St. Paul, Minnesota, from preparing federal income tax returns for others. The court found that Sonibare repeatedly prepared federal income tax returns for customers that contained false or inflated Schedule C expenses, false Schedule C businesses, false or inflated Schedule C business losses, false education credits, false dependency exemptions, and other fraudulent items. The complaint alleged that many of his customers were immigrants from various African countries and had limited English-language skills.

- On June 29, 2006, a federal judge in Miami, Florida barred a Jackson Hewitt franchise, its owner **Ahmad Labib Baltagi**, and two employees from preparing federal income tax returns that claim a frivolous federal income tax exemption for casino gaming proceeds paid to Native Americans. The court ordered the firm to notify all customers for whom the firm made such a claim. According to the Government's complaint, the franchise operated approximately 20 Jackson Hewitt offices and employed approximately 150 tax preparers in the Miami area

#### Schemes and Scams in General

On March 15, 2007, the IRS issued guidance identifying 40 frivolous positions that taxpayers should avoid when filing their tax returns. IR-2007-61. <http://www.irs.gov/newsroom/article/0,,id=168637,00.html>. Many, if not all, of those positions, along with the Dirty Dozen, have been marketed by promoters of tax schemes and scams, usually through the Internet. The Lead Development Center, which the IRS established in April, 2002, with the encouragement and support of this Committee, researches information items about abusive schemes and monitors the Internet to identify tax schemes and their promoters. The IRS uses that information to open investigations that eventually result in referrals to the Tax Division for injunction suits or for criminal prosecution.

The Tax Division and the IRS have developed an expedited referral process so that the cases are quickly and properly investigated. Division attorneys have participated in training hundreds of IRS agents and lawyers about developing injunction and penalty cases against tax scam promoters.

#### Domestic Schemes and Scams

Criminal tax prosecutions involving domestic schemes and scams, *i.e.*, ones without an offshore element include:

- On March 26, 2007, **Todd Eugene Strand** of Murrieta, California, pleaded guilty in a Kansas City, Kansas, federal court to conspiracy to defraud the United States in the assessment and computation of taxes and mail fraud charges for his involvement in a tax fraud scheme that involved marketing a program promoted by the Topeka-based Renaissance, The Tax People Inc. designed to sell illegal tax deductions through false and misleading representations. Renaissance claimed that its customers could lawfully reduce their income taxes by deducting personal expenses as legitimate business expenses by following this program. Renaissance promoted that the program would pay for itself through reduced federal income tax withholdings and directed customers to file amended Forms W-4 with their employers, reducing taxes withheld from their salaries.
- On March 19, 2007, a federal judge sentenced **Dennis Shollenburg** and **Hazel Hagy** to federal prison for their roles in a conspiracy, to defraud the IRS in connection with a "pure trust" tax fraud scheme. Shollenburg, the President and Chief Executive Officer of First Mountain Bank, Big Bear, California, was sentenced to 37 months in prison, and

Hazel Hagy, the bank's Executive Vice President and Chief Financial Officer, was sentenced to 21 months in prison.

- In January 2007, a federal judge sentenced **David J. Orr** and former attorneys, **Todd Cannon** and **Michael Behunin**, to prison terms of 60 months, 36 months and 29 months, for their respective roles in promoting a tax and investment fraud scheme involving trusts. In February 2007, **Lanny White** was sentenced to 60 months for his role in the scheme. The defendants promoted a fraudulent trust scheme designed to help others evade taxes. Orr and White admitted that their actions cost the federal Treasury between \$5 million and \$10 million in lost tax revenue; Cannon, \$3 million; and Behunin, more than \$1 million.
- In November 2006, Valencia, California attorneys **Martin Arnoldini** and **Jerrold Boschma** were each sentenced to 54 months in prison and ordered to pay \$900,000 in restitution for their roles in a fraudulent trust scheme designed to evade federal income taxes. In a plea agreement, they admitted that they and their co-conspirators promoted the scheme in seminars, promotional materials and opinion letters, fraudulently representing to customers that their tax liabilities could be lawfully reduced by transferring businesses, homes, investments and other assets into a trust's name. Arnoldini and Boschma admitted that their actions caused a loss of federal tax revenue totaling approximately \$3.6 million and also admitted to participating in fraudulent investment schemes that caused clients to lose approximately \$1.3 million.

Examples of domestic schemes and scams that we have successfully enjoined include:

- On December 5, 2006, a federal judge in Chicago permanently barred **Carmelo Zanfei** of Steger, Illinois, and **William Crouse** of Greenwood, Indiana, and their businesses from promoting a health care reimbursement account scheme. The scheme helped hundreds of businesses and thousands of employees avoid federal employment taxes and, in the case of the employees, resulted in the under-reporting of income. According to the court, Zanfei and Crouse sold illegal or improper health care expense reimbursement plans to hundreds of employer-customers. The court concluded that the defendants knowingly misrepresented the tax benefits to employees and employers in selling these plans. According to complaint, the IRS estimated that the defendants' schemes cost the United States Treasury losses of between \$12 million and \$63 million and would cause ongoing losses of between \$6 million to \$24 million per year if the defendants were not stopped.
- On November 29, 2006, a federal judge permanently barred **John Baptist Kotmair, Jr.**, of Westminster, Maryland, and his organization, "**Save-a-Patriot Fellowship**," from selling a tax-fraud scheme. Kotmair promoted the position that U.S. citizens need not pay any taxes on income earned within the 50 states – a view that has come to be known as the section 861 argument. The court said the defendants boasted that their operation "has grown into a complex" of property with the equipment necessary to generate large numbers of frivolous documents to file with the IRS. The court found that Kotmair and

his organization knew or had reason to know their statements to customers were false but “stubbornly choose to ignore the rulings of numerous courts.”

- On November 17, 2006, a federal judge in South Carolina barred **John Howard Alexander** of Greenville from promoting schemes that promise tax benefits based on statements to customers that United States citizens are not subject to tax, that residents of South Carolina are not required to file federal tax returns while working in the United States, and that customers can escape tax by revoking or rescinding their Social Security numbers.

#### Offshore Schemes and Scams

IRS referrals to the Tax Division for criminal prosecution or for the commencement of an injunction suit frequently involve offshore tax fraud. Criminal tax prosecutions involving offshore evasion include:

- On December 15, 2006, **Robert N. Bedford** was convicted of conspiracy to defraud the United States and to cause the filing of false tax returns. Bedford, **Paul D. Harris**, and **Lester Retherford** ran an organization called **Tower Executive Resources, Ltd.** that specialized in offshore tax evasion and to which wealthy taxpayers paid initiation fees of up to \$50,000. The Tower promoters set up shell corporations that were used to conceal more than \$11 million in taxable income. Clients transferred these millions to secret offshore bank accounts in locations such as the Turks and Caicos Islands titled in the names of nominee entities. Following their convictions, Harris and Retherford received prison sentences of 66 months and 48 months, respectively for their roles in the scheme. Bedford is awaiting sentencing.
- On June 29, 2006, a federal judge sentenced five defendants, **Dennis Poseley** (84 months), **David Trepas** (60 months), **Patricia Ensign** (18 months), **Rachel McElhinney** (16 months), and **Keith Priest** (18 months), to prison terms for their respective roles in promoting a tax evasion scheme that used offshore trusts and bank accounts. The defendants advanced their scheme through domestic and offshore seminars, a promotional website, an interactive telephone conference line, and the use of offshore banks and nominee entities. From 1996 through early 2003, the defendants received \$4.7 million in fees from the sale of 2,000 “pure trust packages” that enabled customers to hide their income and assets from the IRS.
- On May 30, 2006, a federal judge sentenced **John David Van Hove** (aka “**Johnny Liberty**”) to 27 months in prison for his role in a tax fraud and wire fraud scheme. Van Hove offered his clients various schemes for hiding income and assets from the IRS, including the use of “common law trusts” to conceal ownership and control of assets and income and the use of offshore trusts with related bank accounts in which assets would be repatriated through the use of a debit card. He also offered to set up International Business Corporations (IBCs) with no independent economic reality that did not represent actual ongoing business concerns. Van Hove also used misrepresentations and false promises to obtain money from clients.



Examples of offshore schemes or scams that we have successfully enjoined include:

- On March 22, 2007, a federal court permanently barred **Victor Carlisle Sullivan Jr.** of Albany, Ga., from promoting and organizing an alleged tax fraud scheme involving the use of offshore trusts. The government alleged in the complaint that Sullivan, a Certified Public Accountant (CPA), promoted a tax fraud scheme that used sham domestic and offshore trusts to help customers evade taxes and to conceal their income and assets. The complaint stated that the IRS estimated that the trust scheme cost the U.S. Treasury over \$5 million since 1998.
- On November 20, 2006, a federal court permanently barred **Lynn Lakers**, a Boulder City, Nevada, tax-return preparer, in connection with an alleged offshore-trust tax scam. The complaint alleged that Lakers, participating with three others, prepared false tax returns for phony trusts sold by her fellow defendants. According to the complaint, the IRS estimates that this tax fraud scheme resulted in at least \$31 million in lost revenue to the federal Treasury. According to the complaint, the scheme allegedly helped customers hide their income from the IRS in Caribbean bank accounts. The defendants' customers allegedly used phony loans and gifts to repatriate their money while concealing it from the IRS. Customers allegedly paid as much as \$14,500 to participate in the scheme.
- On April 3, 2006, a federal court in Orlando permanently barred **Pierre Gauthier** of Longwood, Fla., and his father, **Jean Jay Gauthier** of Daytona Beach Shores, from promoting an alleged tax-fraud scheme. According to the complaint, the Gauthiers helped customers set up offshore trusts and corporations to conceal their income and assets from the IRS, while using offshore debit or credit cards to repatriate the funds.

#### **Tax Crimes Committed by Federal and State Prison Inmates**

Fraudulent refund claims filed by prison inmates have been a significant tax enforcement problem for the IRS in recent years. The IRS has attempted to address this problem, in part, by obtaining lists of federal and state prisoners in an effort to screen refund claims and by working with prison officials to reduce or eliminate access to tax forms and materials.

A recent criminal prosecution illustrates one scheme for committing this crime. **Marvin Kirk Jones** and his daughter **Shanika Jones** were convicted on January 16, 2007, of conspiracy to file false refund claims. While serving a life sentence for murder as an inmate in the Georgia Department of Corrections in Nicholls, Georgia, Marvin Kirk Jones solicited or stole social security numbers from fellow inmates and used this information to create false Forms W-2 and file 30 false Forms 1040 EZ. The corresponding refunds, which were made payable to individual prisoners, were directed to addresses controlled by either Jones' ex-wife, Sylvia Jones or his daughter, Shanika Jones. The intended tax loss exceeded \$200,000.

Under current law, when IRS has information about fraudulent claims filed by an inmate, the IRS can refer the matter to the Department for prosecution or an injunction suit, but cannot disclose tax information to prison officials to prevent further false claims by a particular prisoner

because of tax confidentiality restrictions. Code section 6103(a) prohibits the disclosure of tax information with specified exceptions, and none of the exceptions permit the IRS to refer inmate tax fraud information to prison officials to prevent further violations or to impose administrative sanctions.

Criminal prosecutions or injunction suits against inmates have minimal deterrent effect, are expensive, and are not as effective as administrative remedies and punishments imposed by prison officials in preventing the misconduct. The President's 2008 budget proposal recommended enactment of legislation authorizing IRS to disclose limited return information to federal and state prison officials about tax violations committed by inmates. An amendment to H.R. 1591 authorizing disclosures to the Federal Bureau of Prisons, but not to state prison officials, was approved by the Senate on March 29, 2007. Disclosure to Federal prison officials was also included in the Taxpayer Protection Act of 2007, H.R. 1677, approved by the Ways and Means Committee on March 26, 2007.

#### **Conclusion**

Thank you again for inviting me to participate in this hearing, and thank you for your continued support for the tax enforcement efforts of the IRS and the Department of Justice. I will be pleased to answer any questions that you have.

STATEMENT OF  
MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT  
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION  
*before the*  
U.S. SENATE  
COMMITTEE ON FINANCE

“Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure”

April 12, 2007

Chairman Baucus, Ranking Member Grassley, and Members of the Committee, I thank you for the opportunity to testify today. I am Michael R. Phillips, Deputy Inspector General for Audit at the Treasury Inspector General for Tax Administration. My comments today focus on the 2007 Filing Season, identity theft, tax fraud and tax practitioners. Each of these areas presents significant challenges for the Internal Revenue Service (IRS).

**2007 Filing Season**

The 2007 Filing Season appears to be progressing without major problems. As of March 24, 2007, the IRS reported that it had received more than 73.7 million individual tax returns. Of those returns, more than 53.0 million (72.0 percent) were filed electronically. The number of electronically filed tax returns is 5.6 percent higher than at the same time last year. The IRS has issued more than 62.9 million refunds for a total of \$152.8 billion.

While the IRS has seen a growth in the number of electronically filed tax returns so far this filing season, the number of Free File returns is down slightly. As of March 24, 2007, the IRS received approximately 2.8 million tax returns through the Free File Program, compared to approximately 2.9 million returns at the same time last year.

The Free File Program provides taxpayers with access to free online tax preparation and e-filing services made possible through a partnership agreement between the IRS and the tax software industry. The IRS Restructuring and Reform Act of 1998 (RRA 98)<sup>1</sup> required the IRS to work with private industry to increase electronic filing. In response to this requirement, in 2003 the Department of the Treasury (Treasury), the Office of Management and Budget, and the IRS launched the Free File Program featuring private-sector partners that allow qualifying taxpayers to prepare and file their tax returns online for free. The Treasury, the Office of Management and Budget, and the IRS made this possible through a public-private partnership with a consortium of tax software

<sup>1</sup> Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

companies, the Free File Alliance, LLC (Alliance). Eligible taxpayers may prepare and e-file their Federal income tax returns using commercial online software provided by Alliance members. The Free File Program debuted in January 2003. According to statistics provided by the Alliance, approximately 2.8 million taxpayers used the program during its first year. In subsequent years, use of the Free File Program increased significantly to about 3.5 million taxpayers in 2004 and about 5.1 million taxpayers in 2005.

The RRA 98 established a goal for the IRS to have 80 percent of Federal tax and information returns filed electronically by 2007. Recognizing that the IRS will not meet this goal, the IRS Oversight Board recommended an extension of the goal to 2012. The IRS Oversight Board has consistently stated that the 80 percent e-file goal has been a major contributing factor to the growth of electronic filing. Based on existing trends through 2006, it is indeed unlikely that a sufficient number of taxpayers will shift to e-file in 2007 to overcome the IRS' shortfall. Nevertheless, because the goal has had such a positive effect, the IRS Oversight Board recommended that Congress extend it to 2012 and expand its scope. According to IRS Oversight Board Chairman Paul B. Jones, *"While it is clear that the IRS will not achieve the ambitious 80 percent goal this year, we do not view this as a failure. Rather, the IRS and its private sector partners have achieved continuous and significant progress in all parts of electronic tax administration very much in keeping with RRA 98's intent."*

#### *Providing Quality Customer Service*

While the IRS continues to face longstanding challenges, it deserves recognition for making progress in an area that will always be a challenge: providing quality customer service to the American taxpayer. Quality customer service is the first component of Commissioner Everson's principle for the IRS: *Service + Enforcement = Compliance*. Over the past few years, TIGTA audits have shown that the IRS has improved customer assistance in its face-to-face, toll-free telephone, tax return processing, and electronic services, including the IRS public Internet site ([www.IRS.gov](http://www.IRS.gov)).<sup>2</sup>

#### IRS.gov

IRS.gov continues to be one of the most visited Web sites in the world, especially during filing seasons. As of March 24, 2007, the IRS reported more than 97 million visits to its IRS.gov Web site. Additionally, the IRS now provides practitioners with online tools to provide better service to their customers such as electronic account resolution, transcript delivery, and disclosure authorization.

#### Toll-Free Operations

As of March 24, 2007, the IRS' assistor level of service was 83.6 percent, which is a decrease of less than 1 percent compared to the same week last year.<sup>3</sup> However, the cumulative filing season assistor level of service is currently 2.5 percent higher than the

<sup>2</sup> *Taxpayer Service Is Improving, but Challenges Continue in Meeting Expectations* (TIGTA Reference Number 2006-40-052, dated February 2006).

<sup>3</sup> Assistor level of service is the primary measure of providing service to taxpayers. It is the relative success rate of taxpayers who call for services on the IRS' toll-free telephone lines.

IRS' planned assistor level of service of 81.1 percent. The IRS answered 10.3 million calls compared to 10.5 million at this time last year. The IRS also completed 14.4 million automated calls; a decrease of 5.7 percent from last year's 15.3 million. It appears that automation demand is materializing slightly later than last year.

#### Taxpayer Assistance Centers

Taxpayer Assistance Centers (TAC) are walk-in sites where taxpayers can receive answers to both account and tax law questions, as well as receive assistance in preparing their returns. TIGTA is currently in the process of making anonymous visits to TACs to determine if taxpayers are receiving quality service, including correct answers to their questions. As of March 24, 2007, there was approximately the same number of walk-in contacts as there was for the same period last year.

#### Volunteer Income Tax Assistance (VITA) Program

The Volunteer Income Tax Assistance (VITA) Program plays an increasingly important role in the IRS' efforts to improve taxpayer service and facilitate participation in the tax system. The VITA Program provides no-cost Federal tax return preparation and electronic filing to underserved taxpayer segments, including low income, elderly, disabled, and taxpayers with limited proficiency in English. These taxpayers are frequently involved in complex family situations that make it difficult to correctly understand and apply tax law.

For Filing Season 2007, TIGTA is including the American Association of Retired Persons-sponsored Tax Counseling for the Elderly sites in its testing of VITA sites. TIGTA plans to visit 39 VITA sites to determine if taxpayers received quality service, including the accurate preparation of their individual income tax returns. TIGTA developed scenarios designed to present volunteers with a wide range of tax law topics that taxpayers may need assistance with when preparing their tax returns. These scenarios included the characteristics (e.g., income level, credits claimed, etc.) of tax returns typically prepared by the VITA Program volunteers based on an analysis of the Tax Year 2005 VITA-prepared tax returns.

As of March 30, 2007, TIGTA has had 33 tax returns prepared with a 48 percent accuracy rate, compared to the 39 percent accuracy rate reported for the 2006 Filing Season. TIGTA's observations are that volunteers did not always use the tools and information available when preparing returns. TIGTA will report its final results in August 2007. See Figure 1 for comparisons of VITA Program activities for the 2006 and 2007 Filing Seasons through March 24, 2007.

**Figure 1 Year-to-Date Comparisons of the Returns Prepared  
During the 2006 and 2007 Filing Seasons  
Through March 24, 2007**

	2006 Actual	2007 Actual	% Change
Volunteer Return Preparation (in millions)	1.5	1.7	12.3%
Volunteer E-File (percent)	91.2%	92.2%	1.1%

*Source: IRS 2007 Filing Season Weekly Reports.*

TIGTA is also conducting limited tests to determine if VITA sites are in compliance with privacy and security guidelines for the protection of taxpayer information. TIGTA's results as of March 30, 2007, show:

- 97 percent (32 of 33) of volunteer computers were password-protected.
- 39 percent (13 of 33) of volunteer computers had encryption software.

For Fiscal Year 2008, the IRS is requesting an additional \$5 million and 46 Full Time Equivalent<sup>4</sup> to expand the VITA Program. According to the IRS, this will help "expand the IRS' volunteer return preparation, outreach and education, and asset building services to low-income, elderly, Limited English Proficient, and disabled taxpayers."

#### *Telephone Excise Tax Refunds*

The telephone excise tax refund is the most wide-reaching refund in the history of the IRS. It is a one-time refund that the IRS estimated would affect between 151 million and 189 million people, including many without a filing requirement. The IRS developed a process to refund these monies on a timely basis and made the refund request process relatively easy for most taxpayers. At the same time, the IRS wanted to minimize refunds in excess of taxes collected and discourage overstated refund requests.

To minimize the number of overstated refund requests and the administrative burden on individual taxpayers, the IRS decided to offer individuals standard refund amounts. Use of the standard amounts should significantly reduce taxpayer burden since no records are needed to support taxpayers' requests. Individuals do not have to assemble 41 months of telephone bills to determine their refund amounts. Requesting the standard amounts requires the completion of only one additional line on the tax return.

However, taxpayers are not required to request the standard amounts. If taxpayers do not choose to claim the standard amounts, they must file Form 8913, Credit for Federal Telephone Excise Tax Paid, with their U.S. Individual Income Tax Return (Form

<sup>4</sup> A measure of labor hours in which 1 FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FY 2005, 1 FTE was equal to 2,088 hours.

1040 series). Taxpayers must attach Forms 8913 to their Forms 1040 to support any claims for more than the standard amount.

The standard amounts developed by the IRS have proved to be very effective. Through the week ending March 24, 2007, IRS records indicate that 99.6 percent of telephone excise tax refund claims filed was for standard amounts. However, through this same time period, just over 30 percent of the individual tax returns filed contained no claim for a telephone excise tax refund, which indicates that many taxpayers may not be aware of their opportunity to claim this refund. TIGTA will be monitoring the steps the IRS takes to address this issue.<sup>5</sup>

#### Processing Claims

TIGTA has raised the following concerns to the IRS regarding the processing of returns claiming telephone excise tax refunds for non-standard amounts:

- Thresholds were set too high for the IRS to take action when taxpayers claimed refunds for more than the standard amounts but did not provide the required Form 8913 to substantiate their claims.
- Thresholds were set too high for the IRS to take action when taxpayers' entries on their tax returns (Form 1040 series) did not correspond with amounts on Form 8913, i.e., taxpayers claimed one amount on their tax return and a different amount on their Form 8913.

When TIGTA reported these issues, the IRS took immediate steps to address the problems.

#### Compliance Efforts

The IRS also developed a compliance strategy to address egregious claims. The strategy includes identifying tax returns with claims for telephone excise tax refunds exceeding certain dollar thresholds and freezing the telephone excise tax portion of the refunds associated with those returns until the claims could be audited.

TIGTA has also raised concerns with the IRS' implementation of its compliance strategy related to these claims. In TIGTA's opinion, the dollar threshold used to identify potentially egregious claims is again set too high. TIGTA first raised this concern to the IRS on February 16, 2007. TIGTA analyzed over 23,000 claims that requested telephone excise tax refunds for amounts considered to be highly questionable but that did not meet the IRS' criteria for further review. The analysis revealed the following:

- The amount of telephone excise tax refunds on these claims totaled more than \$21 million.
- Taxpayers making most of these claims (68 percent) would have had to pay long distance or bundled telephone service charges equal to more than 25 percent of their total annual income to justify their claims.

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<sup>5</sup> *Telephone Excise Tax Refund* (TIGTA Audit Number 200630036).

- Taxpayers making 11 percent of these claims would have had to pay more for long distance or bundled telephone services in a year than their annual income to justify their claims.
- As of March 24, 2007, over 39,000 such claims had been received that did not meet the IRS' criteria for review. The amount of telephone excise tax refunds on these claims totaled over \$33.8 million. Over 30,000 of these claims were on tax returns with no Schedules C, E or F,<sup>6</sup> which makes the claimed amounts even more questionable.

The IRS set its threshold high because its examination resources are limited and because it believes that examinations of returns claiming the Earned Income Credit (EITC)<sup>7</sup> and other discretionary examinations will result in higher assessment rates than examinations of the telephone excise tax refund claims. However, other factors may need to be considered. For example:

- Many taxpayers filing large claims appear to be entering the total amount billed for long distance and bundled service rather than the Federal excise tax associated with those amounts. This may be due to taxpayers misunderstanding the instructions on Form 8913. Taxpayers making legitimate mistakes may very well be willing to self-correct their returns if the IRS informs them that they appeared to have claimed their entire phone bill or long distance bill rather than only the Federal excise tax associated with their bill. Addressing many of these cases may not require examination resources.
- Because telephone excise tax refund claims are not subject to the regular assessment process, most of these claims should be worked before refunds are issued. Discretionary examination programs can be worked after refunds are issued, if necessary.
- If worked prior to the refunds being issued, these cases represent dollars that can be immediately recognized by the Federal Government as improper refunds not issued. In contrast, other examination cases represent assessments that may or may not be collected. A recent TIGTA report found that in FY 2004, the IRS assessed more than \$2.1 billion in additional taxes on high-income taxpayers through its examination program. The report estimated that approximately \$1.2 billion (57 percent) of that amount was either abated or not collected after an average of 608 days from the date of assessment.<sup>8</sup>
- The telephone excise tax refund is a high profile issue. For example, inappropriate telephone excise tax refund claims are now the Number One item in the IRS' "Dirty Dozen" list of tax scams. In a news release issued early in the filing season, Commissioner Everson stated, "*People requesting an inflated*

<sup>6</sup> Various schedules may be attached to a tax return, if needed. Schedule C is for reporting Profit or Loss From Business; Schedule E is for Supplemental Income and Loss; and Schedule F is for Profit or Loss From Farming.

<sup>7</sup> The Earned Income Tax Credit (EITC) is a refundable credit designed to help move low-income taxpayers above the poverty level.

<sup>8</sup> *While Examinations of High-Income Taxpayers Have Increased, the Impact on Compliance May Be Limited* (TIGTA Reference Number 2006-30-105, dated July 25, 2006)



*amount will likely see their refund frozen, may have their entire tax return audited and even face criminal prosecution where warranted. We won't stand idly by while some people try to cheat their neighbors and make off with money they don't deserve."* Allowing fraud to go unchecked in an area that the IRS has declared as a major priority may have a very negative effect on taxpayer compliance in the future.

Taking into consideration the preceding factors, TIGTA recommended that the IRS re-examine all options at its disposal to address significantly more inappropriate telephone excise tax refund claims, including offering taxpayers the opportunity to self-correct their returns, postponing some examination work, and having non-examination employees work (or partially work) some of the simpler cases.

The IRS responded to TIGTA's concerns, stating that it does not plan to make adjustments to the threshold amounts. The IRS' written response did not address TIGTA's recommendation to allow taxpayers to self-correct their returns; however, during discussions IRS officials stated that they had no plans to issue notices to taxpayers and allow them to self-correct their errors because IRS officials believe: such notices would be ineffective; the IRS has limited resources to work the responses; and there would be many "no response" cases for them to work.

Given the opportunity, many taxpayers overclaiming the telephone excise tax refund based on a misunderstanding of the instructions for Form 8913 may voluntarily self-correct the error. However, the time for IRS to develop a process and notice to facilitate this is limited and may actually be past.

TIGTA has also shared concerns about paid preparers and the telephone excise tax refund with the IRS. As of March 24, 2007, a paid preparer had filed over 1,300 other returns with telephone excise tax refund claims exceeding the standard amounts. Only 8 of this preparer's claims have exceeded the IRS' tolerance. TIGTA referred this preparer to the IRS' Criminal Investigation function. The IRS requested information from TIGTA regarding on other questionable preparers that may be avoiding IRS scrutiny. TIGTA provided the requested information to the IRS on other preparers. Among them:

- One preparer has filed 1,019 claims totaling over \$677,000. The claims are all under IRS' tolerance, and most of the claims are for one of five amounts that are repeated on the filed claims.
- One preparer has filed 1,138 claims. The preparer has filed returns for taxpayers in 31 different States. In addition to telephone excise tax refund claims, over 95 percent of the returns also claim employee business expenses.

#### *Notice Trends*

Many taxpayers who are 65 years or older (seniors), taxpayers who have claimed the EITC, and taxpayers who have computed self-employment tax have received repetitive math error notices (i.e., the taxpayers had received a notice addressing the same issue in the prior year). Taxpayers who receive repetitive notices may not understand or are repeatedly overlooking specific instructions provided by the IRS. These taxpayers may also not understand an area of tax law. Additionally, the current filing information

available to these taxpayers, including notices, may be inadequate. Notices should not only inform taxpayers of their errors but should also educate them on the issues, and be a means to ensure that the errors do not occur in the future. Unclear or inadequate tax information and notices create an additional burden on taxpayers and often result in additional work and expense for the IRS.

Annually, the IRS sends over 100 million notices to taxpayers; the IRS estimates this costs more than \$400 million.<sup>9</sup> Over 7 million of these notices are math error notices, which inform taxpayers that changes were made to their tax returns as a result of mathematical or clerical errors. The notices explain the nature of the changes and include account statements showing how the changes affect the returns. Overall, the vast majority of taxpayers receiving these notices do not repeat their errors in subsequent years. Further, very few business taxpayers receive repeat math error notices. The notices with a higher repeat rate are those sent to individual taxpayers and are related to a few areas of tax law. Five notices accounted for 40 percent of all repetitive math error notices issued to individual taxpayers, despite being only 13 percent of the total number issued.

- Senior taxpayers repeatedly made two errors when computing their taxes: (1) miscomputing their taxable amounts of Social Security benefits and (2) claiming an incorrect standard deduction. Random non-statistical samples of 80 senior taxpayers making one of these two errors showed that 95 percent had prepared their own returns. The average age of these taxpayers was 72, and 24 percent of them were 80 years of age or older.
- Taxpayers repeatedly made two errors related to the EITC. Most of these taxpayers made calculation errors, and others inappropriately claimed the EITC after having been prohibited from doing so and not recertifying that they were qualified for the EITC. Taxpayers making the repetitive calculation errors had either: (1) used the EITC Tables incorrectly year after year; or (2) filed a Profit or Loss From Business (Schedule C) but, for two or three years in a row, had failed to deduct one-half of their self-employment tax from the earned income amounts before computing the EITC. The issue regarding recertification for the EITC has been reported in prior TIGTA audit reports, and the IRS is working on corrective actions; therefore, TIGTA made no recommendations concerning the issue.
- Taxpayers made repetitive errors when computing or reporting their self-employment tax. Many of the taxpayers in TIGTA's sample calculated the self-employment tax correctly but repeatedly carried the wrong amounts forward to their U.S. Individual Income Tax Returns (Form 1040). Other taxpayers calculated the self-employment tax incorrectly. A common cause was that taxpayers did not begin the computation by multiplying the self-employment earnings by 92.35 percent, as instructed.

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<sup>9</sup> Based on a 2001 IRS estimate.

TIGTA recommended that the IRS modify the math error notices that have been sent repeatedly to taxpayers, to provide a clearer and more informative explanation of the errors taxpayers are making. In addition, TIGTA recommended that the IRS make changes to the forms and instructions associated with the provisions that have resulted in issuance of an inordinate number of repetitive notices. Finally, the IRS should continue to build on the research and analysis already performed to develop the most effective ways to simplify tax preparation for senior taxpayers.<sup>10</sup>

#### *Customer Account Data Engine*

The Customer Account Data Engine (CADE) project will provide the foundation for managing taxpayer accounts to achieve the IRS' modernization vision. The CADE consists of databases and related applications that will replace the IRS' existing Master File processing systems, which are the IRS' official repository of taxpayer information.

Congress authorized \$54 million in Fiscal Year (FY) 2005 and \$60 million in FY 2006 for the CADE. Additionally, the IRS requested \$85 million in FY 2007 for the CADE, but this amount has been reduced to about \$58 million. Through FY 2007, CADE project release costs total about \$233.9 million. The IRS initiated the CADE project in September 1999 and began delivering releases in August 2004.

During Calendar Year (CY) 2006, the CADE posted over 7.3 million tax returns and generated more than \$3.4 billion in refunds. This is a significant increase over the 1.4 million tax returns posted in CY 2005 that generated refunds totaling more than \$427 million. The CADE is now in the process of completing delivery of Release 2.2. Release 2.2 will process 2007 Filing Season tax law revisions (Tax Year 2006) and additional tax forms.<sup>11</sup>

On February 27, 2007, the IRS and the PRIME<sup>12</sup> contractor put Release 2.2 into production, but because computer reports on the number of returns received did not match the number of returns posted, the CADE was turned off and tax returns were sent back to the current IRS processing system. The IRS reports that a major portion of Release 2.2 was successfully put into production on March 6, 2007, (seven weeks late). On the first day, it posted over 571,000 tax returns of which 566,332 contained refunds. Because of the late start into production, the IRS goal of using the CADE to process 33 million tax returns will not be met. According to IRS officials, the latest estimate is that the IRS will complete the deployment of Release 2.2 by the end of April 2007, and it will post between 16 million to 19 million returns during the 2007 Filing Season.

#### *Electronic Fraud Detection System*

The Electronic Fraud Detection System (EFDS) is the primary information system used to support the Criminal Investigation Division's Questionable Refund Program,

<sup>10</sup> Draft Report *Opportunities Exist to Help Seniors and Many Other Taxpayers That Repeatedly Make Mistakes on Their Individual Income Tax Returns* (TIGTA Audit Number 200630004, dated March 20, 2007).

<sup>11</sup> *Customer Account Data Engine* (TIGTA Audit Number 200620012).

<sup>12</sup> The PRIME contractor is the Computer Sciences Corporation, which heads an alliance of leading technology companies brought together to assist with the IRS' efforts to modernize its computer systems and related information technology.

which is a nationwide program established in January 1997 to detect and stop fraudulent and fictitious claims for refunds on income tax returns. Last year, the EFDS was not operational because the IRS and its contractors were unable to launch a Web-based version of the EFDS application (Web EFDS), resulting in an estimated \$318.3 million in fraudulent refunds being issued as of May 19, 2006.<sup>13</sup>

On April 19, 2006, all system development activities for the Web EFDS were stopped, and all efforts were focused on restoring the client-server EFDS for use on January 16, 2007. The restoration effort required the contractors to prepare the EFDS and the related databases for 2007 by starting with the 2005 EFDS and updating it with the 2006 and 2007 tax law changes.

In October 2006, TIGTA initiated an audit to determine whether the IRS was adequately monitoring the contractor's development efforts in 2006 to ensure that a system was delivered in time for the 2007 Filing Season. TIGTA found that the IRS improved controls over the EFDS restoration activities, including executive governance and project management. As a result, project risks were being identified and mitigation actions were being taken to ensure that the EFDS was implemented and fraudulent refunds stopped during 2007.<sup>14</sup>

On January 16, 2007, the IRS and its contractors put the EFDS into production. The IRS reported that the telephone excise tax refund, split refund, and extender legislation requirements were implemented as scheduled on January 29, 2007. The IRS also reported that the EFDS continues to operate without critical problems.

### **Identity Theft**

Identity theft is a growing national problem, but the percentage of identity theft cases affecting tax administration is still relatively small. Out of the 246,035 identity theft complaints reported to the Federal Trade Commission in 2006, approximately 20 percent (49,699 complaints) have had some impact on tax administration. The remaining identity theft complaints were related to credit card fraud, telephone and utilities fraud, bank fraud, Government benefits fraud, and other forms of fraud. While the overall number of taxpayers affected by identity theft related to tax administration is small, it can be very frustrating and time consuming for each victim to resolve his or her situation with the IRS.

There are two primary types of identity thefts that relate to tax administration. The first type involves an individual using another person's name and Social Security number to file a fraudulent tax return in order to steal a tax refund. The second type involves using another person's Social Security number to obtain employment.

According to the identity theft complaints that the Federal Trade Commission received during 2002-2006,<sup>15</sup> the number of fraudulent tax returns filed as a result of an

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<sup>13</sup> *The Electronic Fraud Detection System Redesign Failure Resulted in Fraudulent Returns and Refunds Not Being Identified* (TIGTA Reference Number 2006-20-108, dated August 9, 2006).

<sup>14</sup> *Draft Report Sufficient Emphasis Was Not Placed on Resolving Security Vulnerabilities When Restoring the Electronic Fraud Detection System* (TIGTA Audit Number 200720028, date April 3, 2007).

<sup>15</sup> FTC Identity Theft Victim Complaint Data Figures and Trends January 1 - December 31, 2002; FTC National and State Trends in Fraud & Identity Theft January - December 2003, dated January 22, 2004;

identity theft has steadily increased from 3,075 to 15,254 (396 percent increase). The number of complaints on employment-related identity theft fraud more than doubled from 15,049 to 34,445 (129 percent) during the same time period.

In July 2005, TIGTA reported<sup>16</sup> that the IRS lacked a corporate strategy to adequately address identity theft issues. In response to some of TIGTA's recommendations, the IRS agreed to develop: (1) updated agency-wide communication tools to be used to educate and assist taxpayers with information about identity theft; (2) agency-wide standards to ensure that the information taxpayers were asked to provide to substantiate identity theft claims is consistent throughout the IRS; (3) specific closing codes for cases involving identity theft that would allow the IRS to track and monitor the effect of identity theft on tax administration; and (4) processes to proactively identify instances of identity theft.

In response to TIGTA's report, the IRS established the Identity Theft Program Office in October 2005 to provide centralized development of policy and procedural guidance within tax administration and to implement an agency-wide strategy composed of three components: outreach, prevention and victim assistance. The Office was established in the Wage and Investment Division to facilitate cross-functional coordination.

During the past two years, the Identity Theft Program Office has predominantly focused on outreach and education efforts. For example, the Office created the Identity Theft Webpage on IRS.gov and prepared various publications and a DVD on identity theft. In addition, the Office has drafted a memorandum for IRS employees, standardizing the following documentation requirements for taxpayers to substantiate identity theft:

- Authentication of identity – a copy of one of more valid U.S. Federal or State government-issued forms of identification (i.e., social security card, passport, driver's license, and State identification card).
- Evidence of identity theft – a copy of a police report or Affidavit of Identity Theft filed with the Federal Trade Commission.

Although TIGTA recommended in its 2005 report that the IRS standardize the requirements for taxpayers to support their identity theft claims, as of April 2007, the memorandum that the IRS created to disseminate this information to its employees is still under review and has not yet been issued.

The IRS currently does not have a uniform process in every function for identifying cases closed as a result of identity theft. In response to TIGTA's recommendation, the IRS agreed to refine certain coding to identify some identity theft case closures. For example, starting with Tax Year 2003, the IRS began using unique codes in one of its databases for identity theft case closures that resulted in no change in the tax liability (thus indicating that the actual taxpayer did not underreport; rather the

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and FTC Consumer Fraud and Identity Theft Complaint Data January – December 2006, dated February 2007.

<sup>16</sup> *A Corporate Strategy Is Key to Addressing the Growing Challenge of Identity Theft* (TIGTA Reference Number 2005-40-106, dated July 2005).

underreporting came as a result of another person using the number for employment). However, the special codes are not readily identifiable as identity theft closures to most IRS employees. The IRS is currently in the process of establishing a universal identity theft code. This coding will allow anyone looking at an account on the Master File to see if a taxpayer has previously reported to the IRS that his or her identity had been stolen.

Given the limited identity theft case tracking information currently available, the IRS, in TIGTA's opinion, still lacks the comprehensive data needed to determine the impact that identity theft has on tax administration. More importantly, the IRS is unable to identify specific identity theft trends or take proactive steps to identify these cases in order to reduce the burden on taxpayers.

TIGTA is currently reviewing the IRS' identity theft efforts. During TIGTA's on-going review, the Identity Theft Program Office has stated that the IRS does not use the Federal Trade Commission's Identity Theft Clearinghouse database because all information is self-reported by the taxpayer without any form of data validation, and a majority of the identity theft complaints are for consumer fraud (i.e. stolen credit cards) rather than tax administration. According to an October 20, 2006, IRS briefing document, leveraging the identity theft information gathered from agencies such as the Federal Trade Commission to better identify taxpayers who have been victims of identity theft was rated as one of the lowest scoring strategies.

The IRS has not performed analyses to identify employers who consistently report wages for employees using stolen Social Security numbers. The IRS' actions are therefore largely re-active in assisting victims of identity theft after they contact the IRS as a result of notice or enforcement action. The Identity Theft Program Office does not track the number of identity theft referrals to the Criminal Investigation function. However, the Criminal Investigation function only investigates identity theft issues in conjunction with other criminal offenses.

The problem of using a stolen Social Security Number for employment is compounded by the limited actions that employers may take. The Social Security Administration's Web site directs employers not to use the Social Security Number Verification Service "*to take punitive actions against an employee whose name and Social Security Number do not match Social Security's records.*" The Web site also states:

- *"A mis-match does not imply that you or the employee intentionally provided incorrect information.*
- *A mis-match does not make any statement about an employee's immigration status and is not a basis, in and of itself, for taking any adverse action against an employee. Doing so could subject you to anti-discrimination or labor law sanctions."*

The IRS is in the process of moving the Identity Theft Program Office from the Wage and Investment Division to the Mission Assurance and Security Services (Mission Assurance) organization. According to the December 21, 2006, Memorandum of Understanding between Mission Assurance and the Wage and Investment Division, "*...Identity Theft will be incorporated as part of enterprise information protection and*

*will not be managed as a stand alone program office.*” In fact, none of the Identity Theft Program staff are moving to Mission Assurance. Mission Assurance “*may facilitate but will not direct activities determined to be tax administration or individual taxpayer assistance in nature.*” Mission Assurance’s specific role will be further refined as the organization engages with the business divisions.<sup>17</sup>

The impact of the Identity Theft Program Office reorganization is unclear. However, TIGTA believes that in the short-term the IRS’ assistance to individual taxpayers victimized by identity theft will not improve from this realignment.

TIGTA is also currently conducting an audit to determine the progress the IRS has made in ensuring the privacy and security of personally identifiable information. The assessment will be based on prior audits of significant privacy-related issues that TIGTA reported during the past four fiscal years.

The IRS processes over 130 million tax returns and processes personally identifiable information on approximately 240 computer systems. Almost all of its employees and contractors have access to at least some of this information, making the protection of the data a significant challenge. The sensitivity of the data also makes IRS computer systems an attractive target for hackers and others who could use the information for identity theft.

The IRS has taken several actions to protect personally identifiable information in its possession and to make the IRS a more security conscious organization.

- The IRS has established a Security Service and Privacy Executive Steering Committee to serve as the primary governance body for all matters relating to security and privacy issues in the IRS.
- Communications from the IRS Commissioner have set the tone to create a strong security environment by advising IRS managers that employees need to be reminded of their responsibilities to safeguard personally identifiable information and by dispelling the perception that security is solely the responsibility of the Mission Assurance and Security Services organization.
- The importance of protecting personally identifiable information will be emphasized in a video scheduled for distribution to IRS employees in the third quarter of Fiscal Year 2007. The video will include statements by the IRS Commissioner and the Treasury Inspector General for Tax Administration.
- The IRS has made significant improvements in its certification and accreditation<sup>18</sup> process. For Fiscal Year 2006, the IRS reported its computer systems had a certification and accreditation rate of 95 percent, which is an improvement over

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<sup>17</sup> Memorandum of Understanding, dated December 21, 2006, Mission Assurance and Security Services and Wage and Investment, Identity Theft Program Transition.

<sup>18</sup> Security certification is a comprehensive assessment of the management, operational, and technical security controls in an information system, made in support of an accreditation, to determine the extent to which the controls are implemented correctly and operating as intended. Accreditation is the official management decision given by the owner of the information system to authorize the operation of the system and to explicitly accept the risks.

Fiscal Year 2005 when only 35 percent of the systems were certified and accredited.

- The IRS has made steady progress in recent years in complying with the requirements of the Federal Information Security Management Act of 2002. During 2006, the IRS reassessed the security risks of its computer systems, and TIGTA is confident that the inventory is substantially complete and the risk categorizations of the computer systems are accurate.
- The IRS satisfied a major requirement of the Consolidated Appropriations Act of 2005<sup>19</sup> by appointing a Chief Privacy Officer to assume responsibility for privacy and data protection policies. The Chief Privacy Officer completed a comprehensive assessment of the IRS' privacy and data protection procedures and made recommendations to strengthen the controls.

However, TIGTA's reviews during the past four fiscal years identified persistent computer security weaknesses that continue to jeopardize the security of personally identifiable information. IRS managers and employees are not complying with established security procedures. Furthermore, IRS executive management is not holding managers and employees accountable for carrying out their responsibilities and for ensuring that managers and employees are aware of the security risks associated with their positions. The following are some of the security issues that TIGTA identified during the last four fiscal years.

- Employees were not encrypting personally identifiable information on their laptop computers and other electronic media.
- Employees did not properly report incidents of lost or stolen computers and personally identifiable information.
- The Office of Privacy and Information Protection did not take steps to ensure that the privacy of sensitive data was evaluated for all computer systems processing personally identifiable information.
- Managers were not consistently reviewing audit trail information to identify unauthorized accesses to taxpayer accounts.
- Managers and employees were susceptible to social engineering techniques.
- Employees were not following the email use policy.
- The IRS and its contractors were not integrating security controls into modernized computer systems.

In addition, the foundation of computer security within an organization starts with strong policies and procedures that dictate what employees can and cannot do while performing their jobs. The IRS' policies do not explicitly identify rules that govern physical removal of and remote access to personally identifiable information. The lack of a detailed organizational policy increases the likelihood that employees are unaware of risks and are not adequately protecting personally identifiable information.

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<sup>19</sup> Pub. L. No. 108-447, 118 Stat. 2809.



## Fraud and Noncompliance

The IRS estimates that fraudulent refund claims exceed \$500 million a year. Congress has held hearings urging the IRS to devote additional resources to improve its detection of fraudulent refunds, particularly claims filed by prisoners. At the same time, the National Taxpayer Advocate (Advocate) reported that actions taken by the IRS adversely affected taxpayers' rights.

The Criminal Investigation function reported that, as of December 1, 2005, it identified 132,945 fraudulent refund returns claiming \$515.5 million in refunds during Processing Year 2005.<sup>20</sup> In contrast, through September 29, 2006, the Criminal Investigation function identified only 44,788 fraudulent returns claiming \$232.3 million in refunds during Processing Year 2006. The dramatic decrease occurred because the redesigned EFDS Web-based application was not implemented due to a lack of adequate oversight and monitoring of the project, as TIGTA previously reported.<sup>21</sup>

### *Questionable Refund Program and Prisoner Fraud*

TIGTA has repeatedly reported over the last seven years that additional controls and procedures were necessary to identify instances of potential fraud.<sup>22</sup> TIGTA concluded in a recent draft report that changes during Processing Year 2006 had a detrimental impact on identifying fraudulent returns and will have an undeterminable affect on Processing Year 2007.<sup>23</sup> TIGTA is continuing its efforts, through a separate review, to evaluate the new procedures and the validity of the scoring methodology used by the Criminal Investigation function to identify potentially fraudulent returns and compiling demographic profiles of taxpayers to determine the effectiveness of the IRS' screening process.<sup>24</sup>

In April 2005, the House Ways and Means' Subcommittee on Oversight expressed concerns about the increase in refund fraud committed by individuals incarcerated in Federal and State prisons. TIGTA issued a report in response to that request, citing that the number of fraudulent prisoner returns identified by the Criminal Investigation function grew 318 percent, from about 4,300 during Processing Year 2002

<sup>20</sup> The year in which taxpayers file their returns with the IRS. For example, most Tax Year 2004 returns were filed in Processing Year 2005.

<sup>21</sup> *The Electronic Fraud Detection System Redesign Failure Resulted in Fraudulent Returns and Refunds Not Being Identified* (TIGTA Reference Number 2006-20-108, dated August 9, 2006).

<sup>22</sup> Audit reports previously issued: *The Internal Revenue Service Can Improve the Effectiveness of Questionable Refund Detection Team Activities* (Reference Number 2000-40-018, dated December 1999); *Revised Questionable Refund Program Procedures Were Not Consistently Implemented* (Reference Number 2001-40-025, dated January 2001); *Improvements Are Needed in the Monitoring of Criminal Investigation Controls Placed on Taxpayers' Accounts When Refund Fraud Is Suspected* (Reference Number 2003-10-094, dated March 2003); and *The Internal Revenue Service Needs to Do More to Stop the Millions of Dollars in Fraudulent Refunds Paid to Prisoners* (Reference Number 2005-10-164, dated September 2005).

<sup>23</sup> Draft Report *Actions Have Been Taken to Address Deficiencies in the Questionable Refund Program; However, Many Concerns Remain, With Millions of Dollars at Risk* (TIGTA Audit Number 200610003).

<sup>24</sup> *Questionable Refund Program Phase II* (TIGTA Audit Number 200710024).

to over 18,000 during Processing Year 2004.<sup>25</sup> Statistics obtained from the Criminal Investigation function show that during PY 2005, almost 20,000 prisoner returns claimed over \$834 million in refunds, including \$407 million in the EITC.

Due to the failures of the EFDS in Processing Year 2006, the Criminal Investigation function was unable to identify prisoner returns through data mining techniques. Instead, the Criminal Investigation function used various criteria to freeze prisoner refunds for tax returns on which the identifying information on the returns matched prisoner information for the Federal, State, and local prisons.

As a result, only 4,235 prisoner returns claiming about \$19 million in refunds were identified as fraudulent in Processing Year 2006 and only \$11.5 million in refunds were stopped. In contrast, during Processing Year 2004, 18,159 prisoner returns claiming \$68.2 million in fraudulent refunds were identified and 14,033 refunds totaling \$53.5 million were stopped. This shows the potential magnitude of the IRS' lost ability to detect and stop fraudulent prisoner refunds during Processing Year 2006. TIGTA remains concerned about how fraudulent prisoner returns are identified. The Criminal Investigation function requested programming changes to the EFDS for Processing Year 2007 that effectively eliminated a certain category of prisoner refunds from the screening process, believing prisoners in this category were less likely to commit fraud.

TIGTA is pleased to note that an amendment to H.R. 1677 was approved by the U.S. House of Representatives on March 28, 2007. The amendment would revise Internal Revenue Code § 6103 to temporarily allow the IRS to share prisoners' tax information with the Federal Bureau of Prisons to prevent Federal tax fraud schemes originating from prisons. While this is an important step to combat refund fraud by prisoners, TIGTA is concerned that the amendment is limited only to disclosures to the Federal Bureau of Prisons. Analysis during TIGTA's previous audits determined that about 85 percent of fraudulent prisoner returns were filed by inmates in State prisons. TIGTA recommends that Congress and the Department of the Treasury consider including disclosure to State prisons as well.

Identity theft is a growing problem with refund fraud. Of the 44,788 refunds verified as fraudulent during Processing Year 2006 through September 29, 2006, the Criminal Investigation function indicated 7,957 (17.8 percent) involved identity theft. The Advocate's 2005 Report to the Congress took exception to the Criminal Investigation function's policy of automatically freezing the current and future years' refunds of identity theft victims. The Advocate expressed concern that this policy is overly broad and causes significant and continuing inconvenience. The Advocate's report indicated a need for an IRS-wide system that identifies which taxpayers are the victims of identity theft. In response to the Advocate's concern, the IRS no longer freezes accounts involving identity theft for subsequent years.

TIGTA recently reported that the greatest problem associated with identity theft cases was the Criminal Investigation function's inability to identify identity theft victims whose tax accounts are frozen in future years and to timely determine if the taxpayers are

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<sup>25</sup> *The Internal Revenue Service Needs to Do More to Stop the Millions of Dollars in Fraudulent Refunds Paid to Prisoners* (TIGTA Reference Number 2005-10-164, dated September 2005).

again the victims of identity theft. In TIGTA's opinion, the policy to not freeze the subsequent years' accounts will not significantly reduce taxpayer inquiries and could result in additional lost revenue and significant taxpayer burden.

If the Criminal Investigation function properly identifies identity theft freezes, notifies the taxpayers of the freezes, and timely resolves the freezes, the IRS will be providing a valuable service to the taxpayer while at the same time protecting Federal revenue.

#### *Noncash Charitable Contributions*

In recent years, the legitimacy of the values placed on some noncash donations has been questioned by the IRS and Congress. As a result, Congress passed legislation adding additional reporting requirements to substantiate the value of some of these donations. Individual taxpayers are required to file a Noncash Charitable Contributions (Form 8283) if their charitable deductions claimed for noncash contributions exceed \$500. The amount of substantiation to be provided with the Form increases as the value of the deduction increases.

We found that the IRS revised tax forms and publications and provided training and information to employees to facilitate implementation of the new requirements for claiming noncash charitable contributions. However, taxpayers and tax practitioners still need to be better educated concerning requirements for claiming charitable contributions. Also, additional procedures need to be established to identify noncompliance with charitable contribution requirements during returns processing. Better education of taxpayers and preparers and additional returns processing procedures will enable the IRS to address potential noncompliance, as Congress intended in its legislation. TIGTA estimated that 101,236 taxpayers could have claimed unsubstantiated noncash contributions totaling approximately \$1.8 billion for the period January 15 through September 21, 2006.<sup>26</sup>

TIGTA recommended that IRS officials coordinate to develop a comprehensive outreach plan on the reporting requirements for noncash charitable contributions for the affected taxpayers and tax practitioners, and develop procedures to correspond with taxpayers to obtain missing Forms 8283 and supporting documentation.

In their response to the report, IRS officials agreed with the first recommendation to supplement their outreach plans and partially agreed with the second recommendation. The IRS plans to continue to correspond with taxpayers who claim noncash charitable contributions over a specific threshold dollar amount and whose Forms 8283 are missing. In addition, the IRS agreed to use a specific indicator to identify for Examination returns claiming noncash contributions over the same threshold dollar amount but with no attached Forms 8283.

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<sup>26</sup> *The Internal Revenue Service Needs to Improve Procedures to Identify Noncompliance With the Reporting Requirements for Noncash Charitable Contributions* (TIGTA Reference Number 2007-30-049, dated March 5, 2007).

However, TIGTA believes that the IRS' dollar threshold for corresponding with taxpayers or examining returns with missing information is still too high and that few instances of unsubstantiated deductions will be addressed by the IRS' actions. Taking action only when the deduction exceeds this threshold and only when the Form 8283 is missing (rather than incomplete) is not in keeping with Congress' intent when passing legislation related to this issue.

### **Tax Practitioners**

Tax practitioners play a critical role in the Federal tax system. Many taxpayers depend on tax practitioners to prepare returns, advise them on tax-related matters, and represent them before the IRS to resolve tax issues.

#### *Office of Professional Responsibility*

The IRS Office of Professional Responsibility has an oversight role to ensure licensed tax practitioners (attorneys, certified public accountants (CPA), enrolled agents, enrolled actuaries, and appraisers) who practice before the IRS adhere to standards of conduct and professionalism.<sup>27</sup> This includes the responsibility for investigating allegations of misconduct by licensed tax practitioners who represent taxpayers in matters before the IRS.

In performing its oversight role, the Office of Professional Responsibility relies heavily on referrals involving tax practitioner misconduct from several sources including IRS employees, taxpayers, tax practitioners, law enforcement agencies, and State licensing authorities.<sup>28</sup> Depending on information provided and the results of the Office's investigation, the Office of Professional Responsibility can apply disciplinary actions including a private reprimand, censure (public reprimand), suspension, or disbarment. A tax practitioner may consent to the proposed disciplinary action, or the case can be sent for an administrative hearing.

When the Office of Professional Responsibility takes a disciplinary action against a tax practitioner, it maintains the action on its case management system. The Office also records the information on its Intranet Web site and informs the public through Internal Revenue Bulletins. If the disciplinary action involves an enrolled agent, the Office will also update its enrolled agent database.<sup>29</sup> Furthermore, if the disciplinary action suspends or revokes the practitioner's eligibility to practice before the IRS, the Office will notify the appropriate IRS unit to update the Centralized Authorization File.<sup>30</sup> The Centralized Authorization File is the computer system used by IRS employees to determine the scope of authority granted by the taxpayers, direct copies of tax notices and correspondence to

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<sup>27</sup> The Office of Professional Responsibility was established in January 2003 to replace what was formerly the Office of the Director of Practice.

<sup>28</sup> A referral can be sent to the Office of Professional Responsibility using a Report of Suspected Practitioner Misconduct (Form 8484) or a written statement. In addition, the IRS public Web site, IRS.gov, has a link for tax professionals and taxpayers to submit referrals.

<sup>29</sup> The Enrolled Practitioner Program System is used to record and monitor individuals granted enrolled agent status by the IRS.

<sup>30</sup> Taxpayers can authorize individuals to represent them on tax returns or other tax-related issues by submitting a Power of Attorney and Declaration of Representative (Form 2848) to the IRS that is recorded on the Centralized Authorization File.

taxpayer representatives, and obtain contact information to communicate with taxpayer representatives. There are approximately 1.4 million representatives on the Centralized Authorization File with an estimated 407,000 of these listed as licensed tax practitioners.

Recently, the IRS has placed a greater emphasis on the oversight of tax practitioners. In its Fiscal Year 2005-2009 Strategic Plan, the IRS included a number of strategies to ensure attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law. These strategies include outreach and education to tax practitioners and IRS operating divisions related to the standards of conduct, the IRS role in enforcing the standards, and the use of disciplinary actions when appropriate. To help ensure adequate resources are devoted to provide this oversight, the IRS substantially increased the budget and staffing of the Office of Professional Responsibility. In Fiscal Year 2002, the Office had a budget of \$1.8 million and a staff of 15. By Fiscal Year 2005, the Office had a budget of \$5 million and a staff of 56. During this time, the number of disciplinary actions by the Office also increased, primarily because of expedited suspensions, which are generally used by the Office in response to action already taken by Federal or State Government agencies to convict or disbar a tax practitioner or to revoke a practitioner's license.

One area in which the IRS has focused its enforcement is on tax practitioners who promote abusive tax avoidance transactions such as abusive tax shelters. This emphasis is in response to a growing problem with the promotion and use of abusive tax shelters. A number of IRS divisions and functions have taken a coordinated approach in addressing this problem. Furthermore, Treasury guidelines were revised to impose stricter standards on individuals and firms that provide advice related to transactions intended to shelter income from taxation. The new rules strengthen the standards to help ensure practitioners analyze and address carefully whether a particular transaction has a legitimate business reason and is not solely for tax benefits. In addition, monetary penalties can be imposed on promoters of abusive tax shelters in addition to any suspension, disbarment, or censure of a practitioner.<sup>31</sup>

Notwithstanding the increases in enforcement activity, there are still a significant number of tax practitioners whose conduct appears to warrant disciplinary action by the IRS but who have not been identified by the Office of Professional Responsibility. TIGTA's audit of the Office of Professional Responsibility in 2006 determined that the IRS needs to improve its ability to identify such practitioners so it can take appropriate disciplinary actions.<sup>32</sup> Some tax practitioners who have been convicted of tax-related crimes or whose licenses have been suspended or revoked by State authorities were not suspended from practice before the IRS.

In addition, the IRS did not have an adequate method to notify the Office of Professional Responsibility of tax practitioners who were not compliant with their own tax obligations. In a statistical sample of 750 of the approximately 407,000 licensed tax practitioners, there were 34 (4.5 percent) who were not compliant with their individual

<sup>31</sup> American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004) and Treasury Department Circular No. 230 (new regulations in effect June 20, 2005).

<sup>32</sup> *The Office of Professional Responsibility Can Do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners* (TIGTA Reference Number 2006-10-066, dated March 2006).

tax obligations. These 34 practitioners had a total of 81 tax periods with balances due of \$826,709 and 34 tax periods for which required tax returns had not been filed.<sup>33</sup> Based on the sample, TIGTA estimated there were approximately 22,500 licensed tax practitioners who were not compliant with their tax obligations but who had not been identified for referral to the Office of Professional Responsibility.

TIGTA previously reviewed the Office of Professional Responsibility in 2001 (the Office of Professional Responsibility was then known as the Office of the Director of Practice) and reported problems with the lack of information needed to assess or manage the resources used for the disciplinary proceedings program.<sup>34</sup> TIGTA reported that the case management system was not used effectively to monitor program activities and resources and that case information was not always updated or accurate. During the 2006 review, TIGTA found the Office had not implemented some of the recommendations from the 2001 audit. Consequently, the problems reported in 2001 still existed. The Office still did not have information needed to effectively monitor program activities and resources, and the case management system still contained unreliable information.

In addition to recommending that the IRS implement recommendations from TIGTA's 2001 audit report, TIGTA recommended that the Director, Office of Professional Responsibility, work with other law enforcement agencies, including the Department of Justice, to improve the referral process and develop a process to obtain relevant information on State disciplinary actions by coordinating with State licensing authorities such as State bar associations and boards of accountancy. TIGTA also recommend that the Director work with other IRS functions to develop a method of uniquely identifying representatives on the Centralized Authorization File and use the information to notify the Office of Professional Responsibility when representatives are not compliant with their individual tax obligations. The IRS agreed with TIGTA's recommendations.

#### *Electronic Return Originators*

E-file Providers, including Electronic Return Originators, originate the electronic submission of income tax returns to the IRS. E-file Providers electronically submit income tax returns that are either prepared by them or collected from a taxpayer. As of November 17, 2006 there were 164,958 active e-file Providers.

The primary means the IRS uses to regulate e-file Providers are the application screening process and the monitoring program. E-file Providers must meet age and citizenship requirements, pass a criminal background check or have a professional certification,<sup>35</sup> and pass tax compliance verifications. The monitoring program is designed to ensure e-file Providers are in compliance with e-file regulations.

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<sup>33</sup> A tax period is a measure of time for which a tax return is required to be filed.

<sup>34</sup> *Improved Case Monitoring and Taxpayer Awareness Activities Can Enhance the Effectiveness of the Tax Practitioner Disciplinary Proceedings Program* (TIGTA Reference Number 2001-10-027, dated January 2001).

<sup>35</sup> A fingerprint card is not required if the applicant has a professional certification. For applicants that do submit fingerprint cards, only one in four is sent for a Federal Bureau of Investigation criminal background check.

In Fiscal Year 2004, TIGTA assessed the IRS' regulation of Electronic Return Originators and reported it authorized individuals to participate in the e-file Program without ensuring they met all required screening checks.<sup>36</sup> For the limited number of individuals that were subjected to a criminal background check, procedures did not ensure the results from the criminal background check were properly analyzed before making a decision regarding acceptance in the program. In addition, the monitoring program did not include requirements to perform periodic criminal background checks or to analyze and use the results of the percentage of an Electronic Return Originator's rejected returns<sup>37</sup> as an indicator of noncompliance.

In response, the IRS agreed to: (1) validate both the Social Security Number and date of birth during the e-file application process; (2) ensure criminal background checks are obtained electronically; (3) request the Federal Bureau of Investigation perform a background check using name and other available information on unprocessable fingerprint cards; (4) ensure individuals who provide professional certifications are in current standing; and (5) use e-file reject rates for selecting monitoring visits. The IRS did not agree to periodic criminal background checks of e-file Providers stating checks are done initially.

TIGTA is currently conducting an audit to follow up on these actions and to determine whether the IRS' screening and monitoring of e-file Providers is effective. TIGTA plans to report the results in August 2007.

### **Conclusions**

While the 2007 Filing Season appears to be progressing without major problems, TIGTA is concerned that changes in the Free File Agreement and the elimination of Telefile Program in 2005 may be contributing to a significant slowing of the growth in electronic filing this year. The IRS discontinued the Telefile program for individual taxpayers in August 2005. The TeleFile Program allowed taxpayers with the simplest tax returns<sup>38</sup> to file their returns by telephone.

This slowed growth comes at a time when the IRS is still far from reaching Congress' goal of 80 percent electronic filing by 2007. Slower growth in electronic filing will defer the efficiency gains for the IRS that result from electronic filing.

Additionally, TIGTA is concerned about the IRS' telephone excise tax refund program. While the IRS took corrective actions to address concerns about processing thresholds, the IRS declined to re-examine all options at its disposal to address significantly more inappropriate telephone excise tax refund claims, including offering taxpayers the opportunity to self-correct their returns, the postponement of some

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<sup>36</sup> *Improvements Are Needed in the Screening and Monitoring of E-File Providers to Protect Against Filing Fraud* (TIGTA Reference Number 2004-40-013, dated November 2003).

<sup>37</sup> When an e-filed return is transmitted to the IRS, it is run through a series of validity and error checks. These checks look for such things as names and Social Security Numbers that match IRS records, math errors, and other common errors. If errors are found, the return is rejected back to the originator to fix the error and resubmit the return. The percentage of returns transmitted versus returns rejected is known as the "reject rate."

<sup>38</sup> Forms 1040EZ.

examination work, and the working (or partial working) of some of the simpler cases by non-examination employees.

Furthermore, TIGTA is concerned about the growth in tax fraud and identity theft. These concerns are heightened during the filing season. Identity theft for tax fraud purposes is trending up and the IRS needs to ensure it effectively addresses this growth. While the IRS has begun to address the problem of identity theft, there is still much that needs to be done.

I hope my discussion of some of the 2007 Filing Season and identity theft issues will assist you with your oversight of the IRS. Mr. Chairman and Members of the Committee, thank you for the opportunity to share my views.



**SENATE COMMITTEE ON FINANCE  
HEARING ON  
“Filing Your Taxes: An Ounce of Prevention Is Worth A  
Pound of Cure”**

April 12, 2007

**Questions for Michael R. Phillips  
Deputy Inspector General for Audit  
Treasury Inspector General for Tax Administration**

**Questions from Chairman Baucus:**

**1. What are the primary impediments to increasing the use of electronic filing? How can they be mitigated?**

Cost, lack of access to a computer and the internet, taxpayer concerns about the security of tax information, and taxpayer concerns that e-filed returns receive additional scrutiny by the IRS, are the primary impediments to increasing electronic filing. The IRS' current e-file program relies almost entirely on third-party transmitters, either in the form of a preparer or tax return preparation software, and there is often a fee associated not only with the purchase of the software, but also with the transmission of the return to the IRS. Many taxpayers are uncomfortable “sharing” their information with a third party as part of the return filing process.

The primary free electronic filing option is the Free File Program which is available to taxpayers with an adjusted gross income of \$52,000 or less. However, use of the Program is very low. Of the approximately 96 million taxpayers eligible for Free File, only about 3.7 million (3.9 percent) had used it as of April 28, 2007.

In 2005, 72.5 percent of paper filers prepared their returns using tax preparation software or a tax professional. Some of these taxpayers do not want to pay the fee to transmit their return in addition to paying to prepare it. Additionally, there has been some taxpayer concern that e-filed returns receive additional scrutiny by the IRS, which can be avoided by filing a paper return.

As for mitigating these impediments, either an IRS portal to which taxpayers could send their electronic tax returns directly to the IRS free of charge or imposing a limit/prohibition on fees charged to transmit a tax return electronically may help. In addition, as some states have already implemented, the IRS could set up a “fill-in-the-blanks” tax return on its web site, especially for simpler returns such as the 1040EZ and 1040A, so that people who otherwise fill out and file a paper return could fill out the on-line return and file it electronically.

TIGTA believes the IRS could expand use of the Free File Program by focusing its marketing efforts on eligible nonusers who filed paper returns. There are also some other areas that need to be addressed. The Free File Program software did not always accurately compute taxes due, and the Guide Me To a Company feature that helps taxpayers select a Program vendor was not always complete or accurate. Errors and omissions in the tax preparation software and the tools provided by the IRS to aid taxpayers when using the Program could undermine taxpayers' confidence in the Program and negatively affect the IRS' efforts to reach its goal of increasing the use of electronic filing.

Notwithstanding the concern that e-filed returns receive additional scrutiny by the IRS, TIGTA contends that the process to screen electronically filed tax returns for errors benefits taxpayers and the IRS. For example, in Tax Year 2004, approximately 5.7 million returns were submitted electronically with error conditions that caused them to be rejected by the IRS. These error conditions often related to Social Security Numbers (SSNs) that did not match the taxpayer, spouse or dependent names or are used on more than one tax return. Subsequently, approximately 4.5 million were corrected, resubmitted electronically, and accepted by the IRS. The error identification process is generally working as intended and benefits taxpayers filing electronically by providing immediate notification of any error requiring correction.

The screening process also helps the IRS protect tax revenues. More than 600,000 rejected returns were electronically re-filed with the duplicate SSN removed. This helps the IRS protect tax revenues by ensuring taxpayers claim only the tax benefits to which they are entitled. Conversely, taxpayers who file paper returns with errors encounter processing delays, IRS correspondence, and corrections to the amount of tax owed or refund due.

## **2. What are the potential benefits from a federal I-file system for individual income tax returns?**

Taxpayers may be more inclined to file electronically if they knew the data was being sent directly to the IRS rather than to a third party, and if they did not have to pay a fee to file the return. A federal I-File system would eliminate the cost to taxpayers who currently file their returns electronically, and would also alleviate the concerns of some taxpayers who are uncomfortable transmitting their personal and financial information to the IRS through a third party. TIGTA's reviews of the IRS' Free File Program also noted that the Program may be difficult for less computer-proficient taxpayers to negotiate. Taxpayers who use that system must first access IRS.gov and then choose a provider. Once they make a choice, taxpayers are actually directed to that provider's webpage to complete and file their return. Depending on how an I-File system is designed, it may be easier for taxpayers to use as well.

There are also benefits to the IRS. The IRS estimates it saves \$2.37 per return for each paper return that is later filed electronically. If the 39 million taxpayers who prepared their returns using software or tax professionals but filed on paper in 2006 were to file electronically, it would significantly reduce IRS processing costs. TIGTA cannot yet determine whether there would be net savings after considering the start up and maintenance costs of the I-File system.

There are pros and cons with an IRS I-file system. Proponents of such a system state that the system would provide faster and more direct access. Such a system also would:

- reduce processing costs to the IRS,
- potentially eliminate costs to taxpayers for preparation of returns,
- reduce costs for national archive storage of documents by moving to a paperless system,
- reduce risks of computer viruses,
- enhance the potential for simultaneous filings of state income tax returns (Fed-State program),
- increase the sense of security to the taxpayer, and
- comply with national mandates for E-Government.

Disadvantages also exist to such a system. The approach would:

- put the IRS in direct competition with commercial software companies, and
- bypass the opportunity for tax advisory services by a qualified preparer.

**3. Are there lessons that could be learned for how IRS handled TETR claims that could be applied to other issues?**

TIGTA auditors have not fully developed their findings regarding this question. However, based on its analysis to date, it appears that there are several lessons learned that could be applied to other issues:

1. IRS' outreach methods were effective in reaching the majority of taxpayers; however, they left many taxpayers uninformed.  
Lesson learned: The IRS needs to explore other non-traditional outreach options if it needs to get information to all taxpayers.
2. Credit for Federal Telephone Excise Tax Paid (Form 8913) might have been misunderstood by many taxpayers who appear to have claimed their entire phone bill rather than just the excise tax portion. In TIGTA's opinion, if the IRS had focus tested the form (even on a very quick and informal basis, given the limited amount of time available to develop the form) it might have discovered that the form was easily misunderstood.  
Lesson learned: New forms, particularly those of a complex nature, should be focus tested on some level before issuance.
3. Many taxpayers simply did not pay attention to the message on the front of the income tax package or in the "What's New" section of the instructions regarding TETR. The message was accurate, but not informative enough, and did not attract taxpayers' attention. Knowing that most households qualified for the credit, the IRS could have let the taxpayers know just that. Also, the IRS needs to leverage other techniques to grab taxpayers' attention, such as use of color when appropriate. By telling the taxpayers, "You most likely qualify for a one time refund of taxes paid on your long distance phone bill," and by setting this message off in a different color, the IRS could have ensured that more taxpayers were aware of this important message.  
Lesson learned: In its printed media, the IRS needs to explore new methods to emphasize its most important messages.

4. Through April 14, 2007, there were approximately 45,000 individual returns that did not meet the IRS threshold for additional scrutiny but which appeared to have TETR claims that were not reasonable for an average taxpayer. The TETR amounts claimed on these returns amounted to approximately \$39 million. The IRS' threshold was based on its estimate of the number of cases that could be worked by its limited Examination resources. TIGTA believes many of the 45,000 taxpayers claiming excessive TETR amounts below the IRS' tolerance level may have mistakenly claimed the amount of their whole telephone bill rather than just the excise tax portion that they are entitled to claim. Based on this, TIGTA also believes that many of these taxpayers may have self-corrected their TETR claims had the IRS notified them of their potential error.

Lesson learned: Faced with limited Examination resources, the IRS needs to utilize other methods to address compliance, particularly when taxpayers' non-compliance may result from misunderstanding.

**4. What specific concerns has TIGTA identified in the Telephone Excise Tax Refund Program?**

- A significant number of individuals and businesses are not claiming the TETR. Over 30 percent of individuals filing a Form 1040 series return have not claimed TETR, while over 85 percent of businesses that have filed a return have not claimed the refund. TIGTA is conducting further audit tests to determine the possible reasons taxpayers are not claiming the refunds.
- TIGTA is concerned if and how the IRS has planned to deal with those taxpayers that did not claim the credit. TIGTA is conducting further audit tests to determine if the IRS expects to conduct any outreach efforts to these taxpayers. TIGTA will also determine how the IRS plans to handle any future or amended returns claiming TETR.
- The dollar tolerance established by the IRS for selecting individual returns claiming the TETR for examination/audit is too high. More details concerning this issue can be found in response to question #5.
- Many taxpayers filing large claims appear to be entering the total amount of their telephone bills or the total amounts billed for long distance and bundled services rather than just the federal excise tax associated with those amounts. Valid TETR claims should be no more than 3 percent of a taxpayer's bill for long distance and bundled services. Through April 14, 2007, TIGTA identified over 59,000 taxpayers with questionable claims. Based on the TETR amounts claimed, about 43 percent of these taxpayers would have to have paid long distance or bundled telephone service charges amounting to more than 50 percent of their total annual income to justify their claims. In addition, 21 percent would have to have paid more in a year than their whole annual income. These taxpayers are either fraudulently filing these amounts or they do not understand how to figure the correct amount. Only 14,000 of these returns met the IRS's criteria for potential audit selection.

Instructions for Form 8913 expressly state that taxpayers are to claim the amount of federal excise tax on long distance or bundled service only. However, the column headings for taxpayers to enter those amounts are labeled, "Long distance service," and

“Bundled service.” Taxpayers and preparers may be misunderstanding those column headings and entering in the total telephone bill amounts for each. TIGTA has not fully developed its findings regarding this issue. However, more audit work will be conducted to find out if taxpayers misunderstood the Form 8913 or its instructions.

- Based on TIGTA’s analysis, the dollar tolerance was set too high for stopping certain TETR claims during the processing of individual returns. One of the controls established to prevent erroneous claims from being processed includes computer routines to identify returns claiming TETR refunds for more than the standard amount, but without the required Form 8913. This control was established to ensure that amounts claimed for other than the standard amount are substantiated on the Form 8913. A second control included comparisons of TETR claims entered on Forms 1040, 1040A or 1040EZ-T with amounts entered on Forms 8913 (e.g., if a taxpayer’s TETR claim on the Form 1040 was \$200, but the amount shown on the Form 8913 was \$150). If these entries disagree by more than a specified amount, the returns are routed to the IRS’ Error Resolution function for action. During TIGTA’s review, it found the dollar tolerances established for these controls were set too high. After sharing its concerns with the IRS early in the processing season, the IRS substantially lowered the dollar tolerances for both controls.

**5. Are IRS filters to detect fraudulent Telephone Excise Tax Refunds adequate to stop false refunds from being issued? Will special processes be required to recoup incorrect refunds that have been issued, and, if so, please describe what they are?**

Controls established by the IRS to detect and stop fraudulent/erroneous TETR claims appear adequate for those returns where the refund claims exceed the dollar tolerances set by the IRS. However, TIGTA believes the IRS set this tolerance too high in regard to individual tax returns. Through April 14, 2007, there were approximately 14,000 individual returns exceeding the established dollar tolerance. The TETR amounts claimed on these returns amounted to approximately \$38 million. For the same time period, there were approximately 45,000 individual returns that did not meet the established tolerance and that appear to have TETR claims that were not reasonable for an average taxpayer. The TETR amounts claimed on these returns amounted to approximately \$39 million. TIGTA believes many of the 45,000 taxpayers claiming TETR amounts below the established tolerance are mistakenly claiming the amount of their whole telephone bill rather than just the excise tax portion that they are entitled to claim. The tolerance amount established by the IRS was based more on its resources and what could be assessed by working returns in other program areas rather than the reasonableness of the TETR claim itself. Although it is true that there are other program areas where the IRS can assess more dollars, more questionable TETR claims may be getting refunded than stopped.

A TETR claim that is subsequently determined to be in error may only be recovered through the erroneous refund process. This would require the Federal Government to file a suit for refund to recover any amount that the taxpayer did not voluntarily repay. There is a two-year statute of limitations on the erroneous refund process. The amount of the refund as well as other factors would need to be considered before pursuing such litigation. Therefore, the IRS is focusing compliance activities on

pre-refund screening and examination with the expectation that very few, if any, refund suits will be filed.

**6. To what extent is the existing IRS refund fraud detection system (EFDS) effective? What is the status and timeline of IRS plans to develop and implement a new EFDS system?**

TIGTA cannot say with any certainty. However, statistics from the Criminal Investigations function show that as of April 23, 2007, about 67 percent (138,140 of 207,084) of the returns sent to employers for verification of wages and withholding have indicated a discrepancy that requires further verification with the taxpayer.

On January 16, 2007, the IRS and its contractors put the restored EFDS into production for the 2007 Filing Season. During weekly conference calls, the IRS reported the EFDS continued to operate without critical problems. The EFDS uses several criteria to identify potentially fraudulent tax refunds. However, TIGTA has not conducted audit work to determine the effectiveness of the criteria used.

The IRS is currently developing the EFDS requirements for the 2008 Filing Season using the current system. The Web-based EFDS application development will not be considered until after the 2008 requirements are finalized.

**7. How well has the IRS implemented the requirement for taxpayers to substantiate the value of non-cash charitable contributions?**

Currently, taxpayers who may not be entitled to deductions for non-cash contributions are reducing their tax liabilities and may receive refunds regardless of whether they provide the required substantiation.

TIGTA recently addressed this issue in an audit report (Ref #2007-30-049).<sup>1</sup> In response to the report, IRS officials agreed with the first recommendation to supplement their outreach plans and agreed to continue to correspond with taxpayers who claim non-cash charitable contributions over a specific threshold dollar amount and whose Forms 8283 are missing. In addition, the IRS agreed to use a specific indicator to identify for Examination returns claiming non-cash contributions over the same threshold dollar amount but with no attached Forms 8283.

However, TIGTA believes few instances of unsubstantiated deductions will be addressed by these actions. The dollar threshold, which remains unchanged, has been set too high and needs to be lowered to ensure most of the returns claiming unsubstantiated deductions are addressed in concert with Congressional concerns. Also, the IRS does not plan any additional actions concerning incomplete documentation, such as missing signatures and appraisals. Based on

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<sup>1</sup> *The Internal Revenue Service Needs to Improve Procedures to Identify Noncompliance With the Reporting Requirements for Noncash Charitable Contributions* (Reference Number 2007-30-049, dated March 5, 2007)

TIGTA's sampling, it estimates that less than one percent of the returns with non-cash charitable contribution deductions are above the IRS' dollar threshold.

**8. Why does the IRS accept and process tax returns when taxpayers have failed to attach required forms, including Forms 8282 and 8283, to the tax return? What effect does this have on tax compliance?**

During discussions with TIGTA, the IRS said it was hesitant to suspend processing and correspond for missing forms to substantiate non-cash charitable contributions because of problems created the previous year as result of the refunds stopped by the Questionable Refund Detection Team. Also, the IRS seems concerned about the impact on its resources by the additional actions necessary to substantiate non-cash contributions.

The effect on compliance is difficult to determine because TIGTA does not have sufficient information to determine how many of the taxpayers with unsubstantiated deductions were actually entitled to them.

Potentially, not substantiating these deductions could result in a loss of revenue to the Federal Government and inequitable treatment of taxpayers. TIGTA estimated 101,236 taxpayers could have claimed unsubstantiated noncash contributions totaling approximately \$1.8 billion for the period January 15 through September 21, 2006.

**9. How does the IRS plan to increase the number of taxpayers who take advantage of the split refund option to increase savings?**

In its May 2006 announcement of the split refund option, the IRS recognized that the effort to have the form accepted would be a two-year project. The IRS stated that its first year objectives are to:

- Start simple – at this point in the year, the IRS did not have much leeway to add “bells and whistles,”
- Make it work – the IRS is reviewing its current processes now and making critical decisions about what is needed to put the option in place, and
- Educate taxpayers – taxpayers need to understand and be comfortable exercising their refund options. Form 8888 instructions, publications, IRS website, and interactions with IRS staff and volunteers are part of the equation, but partners and stakeholder need to help in explaining this further in their tax preparation software, at the point of tax preparation, and so on.

During the second year, the IRS plans to modify and enhance the process. It plans to contact its partners and stakeholders again next year to identify what worked and what can be improved. The IRS wants feedback on practitioners' direct experiences with customers and clients during the filing season.

**10. The IRS increasingly is relying on volunteers to prepare tax returns for low income and elderly people. A TIGTA sample found a 100% error rate of volunteer-prepared returns. What is the IRS doing to enhance the quality of volunteer tax preparation?**

The centerpiece of IRS improvements is the development and continued refinement of the Volunteer Return Preparation Program (VRPP) Quality Improvement Process. The core principles of the VRPP are to ensure all VITA volunteers understand their respective roles and responsibilities to ensure accurate tax return preparation. Enhancements to the VRPP for Filing Season 2007 include the development of Minimum Quality Site Requirements. The Minimum Quality Site Requirements are not new; rather, the Stakeholder Partnerships, Education, and Communication (SPEC) function will now require adherence to existing procedures and process requirements for each site. These requirements are designed to ensure consistent operation of VITA sites and to provide taxpayers with confidence that they are receiving accurate tax return preparation and quality service.

**11. Describe IRS support and oversight efforts at volunteer tax preparation sites. How does the IRS test and measure service and accuracy at volunteer sites? What are the most recent accuracy rates for volunteer tax preparers?**

Oversight of the VITA Program is the responsibility of the IRS Stakeholder Partnerships, Education and Communication (SPEC) function. The SPEC function is responsible for determining policies and procedures, developing products and training material, and monitoring and managing VITA Program activity. The SPEC function's business objectives include increasing access to VITA sites for low-income taxpayers, increasing *e-filing*, and enhancing tax return accuracy. For the 2007 Filing Season, the IRS conducted three types of quality reviews to monitor and evaluate the volunteer tax return preparation program. They include: 1) Site Reviews, which are used to assess procedure and site readiness; 2) Tax Return Reviews, which involve an on-site review of the tax return for accuracy after it has been through the site's quality review and while the taxpayer is present; and 3) Shopping Reviews, which measure the taxpayer's qualitative experience.

- Site Reviews - As of April 13, 2007, 349 (87 percent) site reviews have been conducted. Of the sites reviewed, 53.9 percent were found to be in compliance with the nine minimum quality site requirements.
- Tax Return Reviews - As of April 13, 2007, 1,248 (84 percent) tax return reviews have been conducted. The tax return review accuracy rate is 91.4 percent.
- Shopping Reviews - As of April 19, 2007, 39 tax returns were prepared. The overall accuracy rate is 64 percent.

In addition, TIGTA conducted anonymous visits to 39 volunteer sites to have a tax return prepared. Of the 39 tax returns prepared, 22 (56 percent) were prepared correctly.

**12. What specific concerns has TIGTA identified in the IRS' generating math error notices?**

During a recent audit, TIGTA found that many taxpayers that are age 65 or over (seniors), taxpayers that have claimed the Earned Income Credit (EIC), and taxpayers that have computed self-employment tax have received repetitive math error notices (i.e., the taxpayers had received



a notice addressing the same issue in the prior year). This condition may indicate that taxpayers do not understand or are repeatedly overlooking specific instructions provided by the IRS; taxpayers do not understand an area of tax law; or the current filing information available to the taxpayers, including notices, is inadequate. Notices should not only inform taxpayers of their errors but should also educate them on the issues, and be a means to ensure the errors do not occur in the future. Unclear or inadequate tax information and notices create additional burden on taxpayers and often result in additional work and expense for the IRS.<sup>2</sup>

Senior taxpayers repeatedly made two errors when computing their taxes:

1) miscalculating their taxable amounts of Social Security benefits, and 2) claiming an incorrect standard deduction. Also, taxpayers repeatedly made two errors related to the EIC. Most of these taxpayers made calculation errors, and others inappropriately claimed the EIC after having been prohibited from doing so and not recertifying that they were qualified for the EIC.

Taxpayers making the repetitive calculation errors had either: 1) used the EIC Tables incorrectly year after year, or 2) filed a Profit or Loss From Business (Schedule C) but, for 2 years or 3 years in a row, had failed to deduct one-half of their self-employment tax from the earned income amounts before computing the EIC. The issue regarding recertification for the EIC had been reported in prior TIGTA audit reports.

Taxpayers also made repetitive errors when computing or reporting their self-employment tax. Many of the taxpayers in TIGTA's sample calculated the self-employment tax correctly but repeatedly carried the wrong amounts forward to their Form 1040. Other taxpayers calculated the self-employment tax incorrectly. A common cause was that the taxpayers did not begin the computation by multiplying the self-employment earnings by 92.35 percent, as instructed.

The draft report for this audit included a number of recommendations to modify and improve the notices, forms, and instructions relative to our findings. TIGTA recently received IRS management's response to the recommendations, and they declined to make any substantive changes. TIGTA's comments to the response will be included in the final report, which is forthcoming.

### **13. What is TIGTA's interest and jurisdiction in identity theft?**

TIGTA's primary interest and jurisdiction in identity theft is focused on protecting taxpayer data entrusted to the IRS for tax administration purposes, and is accomplished through proactive and reactive investigative methods. TIGTA has investigative responsibility for the detection and investigation of unauthorized access of taxpayer information (UNAX) violations in accordance with the Taxpayer Browsing Protection Act of 1997, as well as any disclosures by IRS employees that are in violation of section 6103 of the Internal Revenue Code. The term UNAX refers to the unauthorized access to taxpayer information and/or the disclosure thereof by IRS employees, as well as other Federal and State employees and private contractors.

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<sup>2</sup> DRAFT Audit Report - *Opportunities Exist to Help Seniors and Many Other Taxpayers That Repeatedly Make Mistakes on Their Individual Income Tax Returns* (Audit Number 200630004, dated March 20, 2007).

Through the use of the IRS Integrated Data Retrieval System (IDRS) audit trail reviews, TIGTA operates a UNAX detection program that proactively identifies IRS employees who exceed their authorized access to confidential taxpayer information. Cases of potential UNAX violations are investigated by TIGTA. Employees found to have committed UNAX violations are subject to Federal prosecution, termination of employment, and/or other disciplinary action. TIGTA has conducted on average 464 UNAX investigations per year over the past nine years.

TIGTA is also involved in the investigation of individuals who attempt to obtain Personally Identifiable Information from taxpayers by impersonating the IRS (see question 15 for further elaboration).

TIGTA's role in protecting the IRS and taxpayers from identity theft continues to evolve. For example, a recent collaborative venture between TIGTA and the IRS Computer Security Incident Response Center (CSIRC) was established as a result of the increased reporting of thefts of Government-owned computers. This working group coordinates activities with the CSIRC to reduce or eliminate any negative impact on tax administration due to lost and/or stolen IRS Information Technology (IT) assets. TIGTA provides daily downloads to CSIRC informing them of any IT asset losses reported to TIGTA. This immediate notification to CSIRC promotes a swift response and possible preemptive measures to protect sensitive information.

TIGTA also protects the sanctity of taxpayer data through its Systems Intrusion and Network Attack Response Team (SINART). The SINART investigates individuals who attempt to hack into IRS data systems and also conducts proactive security assessments of IRS data systems to identify potential vulnerabilities that could be exploited by hackers.

TIGTA's investigations of identity theft focus primarily on indications of IRS employee involvement. TIGTA also receives reports of identity theft such as stolen SSN information from the IRS Taxpayer Advocate's Office when that office becomes involved in adjusting a taxpayer's IRS account. For the most part, these complaints involve issues wherein one taxpayer utilizes the SSN of another for wage reporting purposes and this causes erroneous earnings to be posted to the innocent taxpayer's IRS account. This erroneous reporting causes the innocent taxpayer to contact the IRS to straighten out their wage earning records. In cases such as these, TIGTA relies on the Memorandum of Understanding (MOU) with the IRS' Criminal Investigation function to delineate the duties of each office as it pertains to substantive tax matters. For these types of crimes, where the identity theft is based upon the filing of fictitious forms with the Secretary of the Treasury, TIGTA refers these matters to the Criminal Investigation function for investigation pursuant to the MOU.

In short, TIGTA's role in combating identity theft is limited to the investigation of willful unauthorized access, inspection, or disclosure of taxpayer information maintained by the IRS.

**14. What computer security weaknesses has TIGTA found that continue to jeopardize the security of personally identifiable information?**

Computer security is a significant challenge for the IRS and has been considered a material weakness since 1997. The bureau annually receives personally identifiable information from over 130 million taxpayers. This information is stored and processed on approximately 240 systems and 1500 databases and is available to most of the approximately 100,000 employees and contractors working for the IRS.

Security policies and procedures are generally adequate in the IRS. Most of the security weaknesses TIGTA identifies are a result of employees and contractors not complying with those policies and procedures. Considering the sensitivity and value of the data they process, TIGTA believes IRS employees and contractors are not sufficiently "security conscious." The following weaknesses support this conclusion:

- Employees did not safeguard laptop computers from January 2003 to June 2006. Sufficient documentation was not available to evaluate the circumstances surrounding most of the losses, but employee negligence contributed to many of those. For example, laptops were left in unlocked vehicles, buses, and trains, and some were checked as luggage at airports.
- Employees did not encrypt sensitive information on laptops despite the availability of encryption tools. TIGTA tested 100 laptop computers and found that 44 contained unencrypted personally identifiable information. TIGTA also found that 54 of the employees assigned to these computers also stored unencrypted personally identifiable information on floppy disks, CDs, and DVDs.
- Managers and employees are susceptible to social engineering techniques. TIGTA has conducted three audits within the past six years and posed as help desk employees and asked IRS employees and managers to change their passwords to one TIGTA suggested, a clear violation of IRS procedures. In August 2001, 71 percent of IRS employees and contractors were willing to change their passwords. In December 2004, 35 percent changed their passwords and, in March 2007, 60 percent were willing to change their passwords.
- Many employees were not following the IRS e-mail use policy. In a test of e-mails received between June and August 2005, 74 percent of the employees had messages in their mailboxes that violated IRS policies. The inappropriate e-mails placed the IRS network at risk. For example, malicious software could be attached to these e-mails that could disrupt computer operations and enable unauthorized persons to access personally identifiable information.
- Managers did not limit system access to employees who needed it to carry out their responsibilities. In an audit of 5 major systems, 21 percent of the employees who had access to the systems did not need it to carry out their job responsibilities. In addition, 25 percent of those who should have had access were not formally approved. The IRS uses an automated process for providing and removing access to all systems. When this process is circumvented to provide access privileges, it is likely that managers will not be aware of their employees' privileges and will not know to remove them when the employees no longer need access. These privileges could then remain active which will increase the likelihood they could be used to gain unauthorized access to sensitive data.
- Managers did not review audit trail information to detect unauthorized accesses to taxpayer accounts. For one month in 2005, TIGTA determined that only 42 percent of managers

certified reports indicating they had determined why their employees had accessed another employee's or an employee's spouse's account on one of IRS' most sensitive systems. These reports are not generated for the other sensitive systems in the IRS due to a lack of emphasis or concern.

- Functional managers and employees did not carry out their responsibilities for testing their systems annually as required by the National Institute of Standards and Technology and the Department of the Treasury. Currently, systems are only tested once every three years. As a result, computer security weaknesses could go undetected for long periods.
- Functional managers have accredited approximately 95 percent of the IRS systems, meaning they have accepted the security risks associated with those systems. These results seem inconsistent with the fact that the IRS has declared security to be a material weakness since 1997. If security is a material weakness, TIGTA would expect the percentage of accredited systems to be much lower.
- Key security employees, such as system and database administrators, were not following security procedures. For example, they shared accounts and passwords. These employees have complete control over systems and should be monitored to identify potential abuses. By using shared accounts, accountability for any actions could not be associated with the person taking the action. TIGTA continues to identify high-risk vulnerabilities that could allow unauthorized persons to access personally identifiable information. Many of these weaknesses are sensitive and could be exploited by hackers.

The IRS continues to provide awareness activities to advise IRS managers, employees, and contractors of the risks associated with their duties. However, some employees are not adhering to the policies and procedures. Accordingly, TIGTA has made recommendations that the IRS consider taking disciplinary actions to encourage compliance.

TIGTA has also noted that the IRS and its contractors were not integrating security controls into new computer systems. TIGTA identified security weaknesses in five modernization systems it reviewed (i.e., e-Services, Internet Refund Fact of Filing, Modernized e-File, Custodial Accounting Project, and Customer Account Data Engine). For example, audit trails were not functioning to detect unauthorized accesses, and disaster recovery plans were not considered. Waiting until systems are implemented to address security controls will most likely cost significantly more than if security controls had been considered during the design and development of the systems. Due to the cost and other priorities, some controls may never be implemented, thus enabling the unauthorized disclosure of personally identifiable information. For example, on the Electronic Fraud Detection System, the IRS was aware that authentication controls were weak and audit trails were not available to detect unauthorized accesses but accredited the system anyway.

**15. What role has TIGTA played in attempting to protect taxpayers from becoming victims of identity theft through Internet *phishing* scams?**

TIGTA investigates incidents involving impersonation of the IRS, the misuse of the Treasury name or symbol (generally as it pertains to the IRS), and the theft of taxpayer identity information that results from the impersonation or misuse of the Treasury name or symbol.

*Phishing* is a crime that can include impersonation of the IRS and the misuse of the Treasury (IRS) name and symbol. False personation is a violation of Title 18 U.S.C. 912, and the misuse of the Treasury name or symbol is a violation of Title 31 U.S.C. 333.

Recently, TIGTA has played a significant role in attempting to protect taxpayers from becoming victims of identity theft through Internet *phishing* scams. Early in the 2006 Filing Season, TIGTA and the IRS noted that a new *phishing* scheme based on the IRS "Where's My Refund" Internet screen started appearing with regularity. From late November 2005 through March 2007, TIGTA and the IRS Computer Security and Incident Response Center received 19,725 complaints/inquiries about *phishing* scams. TIGTA investigations identified the *phishing* scams on 283 host sites targeting taxpayers which originated in 42 different countries. This *phishing* scam involved the sending of hundreds of thousands of e-mails to taxpayers falsely claiming to be the IRS. The e-mail messages advise the recipients that they are under investigation by the IRS or that they have a refund pending from the IRS. The e-mail then asks the intended victim to click on a link contained within the e-mail to "access the IRS website." The link connects the victim to a site that, from all outward appearances, is the legitimate IRS domain and then prompts the victim to provide personal identifiers, credit card numbers and credit card PIN numbers. The *phishing* sites appear legitimate because most of the content is obtained from an actual page on the IRS website, which is then modified by those *phishing*.

**16. Identify the five up-front actions (before or during return-filing) that the IRS could take to most effectively improve tax compliance?**

TIGTA has not performed an assessment to determine the most effective actions that could be taken before taxpayers file to improve tax compliance. However, in the course of TIGTA's audit work, it has gained insights into actions that assist taxpayers in filing timely and accurate returns. Since TIGTA has not performed an analysis, the actions are not ranked in an order:

- 1) Third party information reporting to taxpayers and the IRS (When taxpayers receive information documents they are better able to file accurate tax returns. Compliance is significantly improved when information documents are provided);
- 2) Clear forms, instructions and publications;
- 3) Availability of toll-free customer service tax assistance;
- 4) Effective outreach to media and practitioners on tax law changes; and
- 5) Legislative expansion of math error authority to disallow obvious errors, such as with the Telephone Excise Tax Credit on this year's return.

**17. What is the IRS policy for processing tax returns with stolen or false social security numbers?**

If the IRS receives a tax return with a legitimate SSN and the name control matches, the IRS will process the return under the assumption that the person filing the return is the rightful owner of the SSN and it is a legitimate tax return. If another tax return with the same SSN and name control is filed after the first one, then the IRS would flag the second one as a duplicate return and would try to determine who is the legitimate return filer. In cases involving fraud, the second return is often the legitimate return and the IRS has to identify who actually filed the first return and attempt to recover any refunds issued for the first return (which is usually difficult).

Generally, if a person files a tax return with a false SSN, the name/SSN match procedure would not allow the return to be processed either because the SSN does not exist, or if the SSN exists, the name control does not match. For an electronically filed return, if the SSN is invalid and/or the name control is wrong, the IRS will not accept the return. Notwithstanding, the IRS e-file system has been changed to allow returns being filed with an Individual Taxpayer Identification Number (ITIN) to show wages reported to an SSN. It is now possible to e-file a return with an ITIN/SSN mismatch. In the past, these returns could only be filed on paper (See Response to #22).

The IRS is obligated by statute to accept returns filed on paper. Paper returns received with false SSNs that do not match information from the Social Security Administration (SSA) are identified as invalid and may be suspended for resolution of the SSN and refunds may be frozen and not mailed. Electronically submitted returns are checked for SSN validity and may be rejected if found invalid.

The IRS does not have a processing approach to systemically bar returns submitted with a stolen identity. Returns are accepted based upon information from the SSA. Returns that pass the validity tests may be accepted. Subsequently, if other processing controls identify discrepancies, those are resolved via the erroneous refund procedures.

**18. To what extent does the IRS policy concerning stolen or false social security numbers comply with all applicable laws, including making false statements or misprision of a felony?**

The IRS could do more in this area. The IRS does not notify employers when the Form W-2 information they send into the IRS contains identity information (like SSN and name) that is obviously erroneous. The IRS does not pursue the issue of misreported income that ends up on taxpayer accounts, other than to remove the income on the account of the legitimate owner of the SSN only if the taxpayer responds to the Automated Underreporter or Automated Substitute for Return notice. In addition, the IRS' Criminal Investigation function only investigates identity theft if it is related to some other tax crime it is investigating.

**19. Why has the IRS adopted a policy that tolerates, even encourages, the use of stolen identities, without consequences to the identity thief?**

According to the IRS "...the Internal Revenue Code does not distinguish between legal or illegal income. Regardless of how the income was earned, if it is taxable income, the person who received the income is required to file a federal tax return and report the income. Individuals with ITIN/SSN mismatches on their tax returns have always been required to file." From this perspective, it appears the IRS' efforts to ensure that everyone who earns income also files a tax return is the overriding factor in determining its policies.

**20. How many IRS resources are devoted to combating identity theft?**

When the Identity Theft Program Office was in the Wage and Investment (W&I) Division of the IRS, the Office consisted of a Program Chief and three staff members. As stated during the

April 12, 2007 testimony, the IRS is in the process of moving the Identity Theft Program Office to the Mission Assurance and Security Services (Mission Assurance) organization. According to the December 21, 2006, MOU between Mission Assurance and the W&I Division, "... Identity theft will be incorporated as part of enterprise information protection and will not be managed as a stand alone program office." As such, TIGTA does not know the level of resources that Mission Assurance plans to devote to identity theft issues. The IRS actions in its compliance functions are largely re-active in the form of providing assistance to victims of identity theft after they have contacted the IRS as a result of a notice or enforcement actions. There are no resources specifically devoted to identity theft in the compliance functions.

**21. Are there tools that IRS needs to more cost effectively combat identity theft?**

Policy changes could allow the IRS to notify employers that the name/SSN information they submitted to the IRS on an employee's Form W-2 was incorrect and could also legislate tougher penalties for employers who continue to submit incorrect information after being notified by the IRS.

Changes related to the verification of SSNs by employers might also help. However, some legislative or policy changes are outside the scope of TIGTA's oversight authority and responsibility. For example, changes could be made that would protect employers and allow them to terminate or not hire applicants that the SSA could not verify as being the legitimate owners of the SSNs. However, the SSA's Web site warns employers using the SSN Verification Service to not "... take punitive actions against an employee whose name and Social Security number do not match Social Security's records." The website also states:

- "A mismatch does not imply that you or the employee intentionally provided incorrect information;" and
- "A mismatch does not make any statement about an employee's immigration status and is not a basis, in and of itself, for taking any adverse action against an employee. Doing so could subject you to anti-discrimination or labor law sanctions."

By allowing employers to either terminate or not hire employees whose name/SSN could not be verified by the SSA would help to prevent people from illegally using someone else's SSN to gain employment.

**22. A tax return filed under an ITIN, with a W-2 attached containing an SSN, should be a signal that something is awry. Explain why the IRS accepts these returns, and made it easier to file them electronically in 2007.**

TIGTA concurs that a tax return filed under an ITIN with a W-2 attached containing an SSN suggests that the filer may not be authorized to work in the United States. TIGTA has not evaluated why the IRS decided to accept these returns electronically. However, these returns have always been accepted on paper. There is a positive aspect to accepting the returns in this manner since the IRS can actually investigate cases involving stolen identities easier. The SSN on the Form W-2 can be researched back to the tax return under which it was filed so that innocent taxpayers could get faster case resolution.

There are risks in processing these returns because of the opportunity for fraud. In Tax Year 2000, 353,000 tax returns included an estimated 309,000 paper filed returns with two different identification numbers: an ITIN on the Form 1040 and a SSN on one or more of the attached Forms W-2. These returns raise concerns about identity theft, perjury, and fraud. For Tax Year 2000, TIGTA estimated that 82,000 unauthorized resident aliens (1 in 4 return filers) did not report income from wages and non-employee compensation of \$324 million, an average of almost \$4,000 per return.<sup>3</sup>

**23. How many cases of identity theft were reported to the IRS last year?**

The IRS currently does not have a uniform process throughout its functions for identifying cases closed as a result of identity theft. The only information TIGTA has is for the Automated Underreporter Program. As of November 2006, according to the IRS, the AUR Program has closed a total of 27,345 cases as identity theft since identity theft coding was implemented in this function two years ago.

The IRS plans in the future to implement a universal account code for cases closed as identity theft in every function. However, to TIGTA's knowledge, no other functions are currently capturing identity theft closures.

**24. To what extent does the IRS notify an individual when someone else is using his or her SSN?**

The IRS does not proactively notify taxpayers when someone else is using their SSN. Taxpayers will receive an Automated Underreporter notice or a Withholding Compliance notice for income being attributed to them as a result of someone using the SSN for employment. At this point, the taxpayer may realize that his/her identity has been stolen. The IRS does not proactively tell him/her that there is a possibility that his/her identity has been stolen, because the IRS does not know if the taxpayer is intentionally underreporting the income or under withholding tax on his/her income. Similarly, if a taxpayer files a tax return after someone else has already filed a tax return using that SSN, the second filer will receive a notice telling him/her that he/she filed a duplicate return. Then the rightful owner of the SSN must prove that he/she is the person entitled to file the legitimate return.

**25. How does the IRS prevent the use of stolen identities to file tax returns? What else can the IRS do to protect the taxpayers' identities?**

Identity theft typically is a crime in which the victim is not aware of the situation until he/she is notified of the transactions which he/she did not initiate. As such, one focus for the IRS outreach is to improve awareness. Publications and telephone contact procedures are in place to assist a taxpayer in identifying when possible identity theft has occurred and to help the taxpayer resolve it.

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<sup>3</sup> *The Internal Revenue Service's Individual Taxpayer Identification Number Creates Significant Challenges for Tax Administration* (TIGTA Reference Number 2004-30-023, dated January 2004).



Currently, the IRS does not match Form W-2 information provided by the employer before processing returns and issuing refunds. While this would help identify fraudulent returns it would also significantly delay the issuance of refunds. It is unlikely the IRS will have this capability in the near future.

The IRS' Questionable Refund Program is designed to help identify and stop refund schemes. The IRS also has procedures in place to prevent duplicate filing with the same SSN; unfortunately, in cases involving identity theft fraud, the second return is often the legitimate return, and the IRS has to identify who actually filed the first return and attempt to recover any refunds issued for the first return (which is usually difficult).

One option that the IRS should consider is the use of an IRS-assigned PIN that only the IRS and taxpayer would know. This would help prevent some people from filing fraudulent tax returns based on identity information they may have stolen or obtained through public records.

**26. What actions could the IRS take to prevent the type of fraud perpetrated by Mr. Evangelos Soukas, who testified before the Committee at today's hearing?**

Based on the testimony, it appears the fraud was committed during the 2001 Filing Season, before he was a prisoner, and refunds were sent to his bank account using SSNs he had stolen for use in previous crimes. It also appears the IRS identified the scheme, but only after \$43,000 in refunds were issued. It also appears that some refunds were stopped. TIGTA does not know if there were other common factors, such as similar wages, withholding, addresses, employers, etc.

Without knowing the specific details of what transpired back in 2001, it is difficult to answer this question. However, the EFDS was not fully operational until the 2002 Filing Season. TIGTA believes the Criminal Investigation function and the EFDS are more effective at identifying and stopping fraudulent returns. Although there is currently no system to prevent stolen identities or the filing of fraudulent returns using stolen identities, TIGTA believes the IRS is in a better position to stop the fraudulent refunds from being issued.

**27. How could the IRS revise its policies and processes to discourage the use of identity theft in connection with filing a tax return?**

In a recently issued draft report, TIGTA noted that 7,957 of the 44,788 refunds (17.8 percent) verified as fraudulent by the Criminal Investigation function during Processing Year 2006 through September 29, involved identity theft.<sup>4</sup> In prior years, the Criminal Investigation function would have placed a freeze on these accounts to prevent future filing by the identity thieves. The National Taxpayer Advocate's 2005 Annual Report to Congress took exception to the Criminal Investigation function's policy of automatically freezing the current and future years' refunds of identity theft victims. The Advocate expressed concern that this policy is overly broad and causes significant and continuing inconvenience. The draft report indicated a

<sup>4</sup> DRAFT Audit Report - *Actions Have Been Taken to Address Deficiencies in the Questionable Refund Program; However, Many Concerns Remain, With Millions of Dollars at Risk* (Audit Number 200610003, dated March 26, 2007).

need for an IRS-wide system that identifies which taxpayer is the victim of identity theft. In response to the report, a Criminal Investigation freeze will no longer be placed on subsequent years' returns of accounts involving identity theft.

TIGTA agrees there is a need for an IRS-wide system that identifies which taxpayer is the victim of identity theft. TIGTA recommended that the IRS reconsider placing a freeze on the subsequent year's account of taxpayers who are the victims of identity theft. TIGTA believes that if the Criminal Investigation function properly identifies identity theft freezes, notifies the "good" taxpayer of the freezes, and timely resolves the freezes, the IRS will be providing a valuable service to the taxpayer while at the same time protecting Federal Government revenue.

**28. Given the importance of paid preparers in our tax administration system, would it be useful for IRS to devote more resources to oversight of the paid preparer industry?**

The IRS Office of Professional Responsibility (OPR) regulates licensed preparers (Enrolled Agents, Enrolled Actuaries, Certified Public Accountants (CPA) and attorneys). As of August 2006, the OPR had a budget of \$5 million dollars and a staff of 56 people to perform its oversight duties. However, the OPR only regulates a small portion of the paid preparer industry. As of February 2005, approximately 407,000 licensed practitioners were authorized to represent taxpayers before the IRS. This figure does not account for unenrolled preparers – those not enrolled with the IRS. The total number of paid preparers is unknown, but based on the number of major preparation companies currently operating and individuals preparing returns, the figure could be substantial.

**29. To what extent do you believe up-front taxpayer services affect the rate of tax compliance, and the need for enforcement action down the road?**

- From the IRS' Taxpayer Assistance Blueprint issued April 2006 – the strategic plan is focused on the use of relevant data to make well-informed investment decisions. It is integrated with the Treasury Department's tax gap strategy, which calls for combining enforcement activities with quality taxpayer service.
- IRS services are evaluated against a set of balanced measures. While all IRS service channels evaluate performance against the balanced measures categories, the definitions of similar performance metrics, such as "accuracy," differ across channels, as do the availability, collection processes, and quality of the data, which all limit cross-channel comparative analysis. Additionally, there is no specific set of data or a methodology to measure the long-term business outcomes of effective service delivery as it relates to the accomplishment of the IRS' mission, the impact of a specific event across all channels, or the ultimate impact of service on compliance.
- While establishing a credible quantifiable link between service and compliance may be unattainable, developing a body of reasonable proxy measures based on reasonable causal inferences is not. Such metrics should reinforce the long-term outcome of supporting compliant taxpayers to remain compliant and provide the means for non-compliant taxpayers to fulfill their tax obligations. In addition, the IRS lacks good information on the cost of

providing its various services to taxpayers; prior to Fiscal Year 2005, it did not have a cost accounting system to accumulate and report the reliable cost information that managers needed to make informed decisions. In Fiscal Year 2005, the IRS implemented a cost accounting system as part of the first release of its Integrated Financial System that will serve as a major building block to help it make informed resource allocation decisions.

**30. To what extent do current IRS policies, priorities and staffing recognize the value of up-front services and oversight?**

- Compliance vs. Customer Service Program Priorities - This continues to be a difficult question to answer because the IRS has not defined the level of enforcement actions needed to attain tax compliance. Rather, the IRS schedules its compliance workload to match available resources, which can vary widely year-to-year since the IRS is subject to single-year budgets. That being said, there is little doubt that if the IRS had more resources, it could accomplish more tax compliance activities. In the past several years the IRS has reversed the trend and provided fewer compliance resources to customer service programs.
  
- The IRS reported in the *Fiscal Year 2007 Taxpayer Assistance Blueprint Phase II*, issued in April 2007, that it is now much more knowledgeable about the needs, preferences, and behaviors of taxpayers, tax practitioners, and IRS employees. This knowledge has informed the creation of a multi-year plan and an iterative process focused on ongoing performance assessment and refinement of the recommended strategies. The work started with the Blueprint will continue as the IRS expands and refines its knowledge, and continues its commitment to balancing quality service with effective enforcement to maximize compliance.

**31. Two years ago, the IRS abandoned plans to shut down 70 Taxpayer Assistance Centers. What are the IRS' current and future plans for Taxpayer Assistance Centers?**

In the *Fiscal Year 2007 Taxpayer Assistance Blueprint Phase II*, issued in April 2007, the IRS recognizes the importance of offering viable service options for all taxpayers, and is committed to improving face-to-face service within the scope of the TAC Strategic Plan. The limited implementation of the Facilitated Self-assistance Model will provide valuable data to further clarify the TAC user profile and to assess the feasibility of migrating current TAC users to alternative channels. In addition, the IRS will employ a phased evaluative process to make decisions about the TAC geographic footprint. As the future vision for service delivery is tested and evaluated, implementation of the taxpayer value-based investment decision process will provide IRS management with the needed information to make decisions in full consideration of stakeholder input and impact.

New TAC performance measures that support Government value outcome measures:

- Level of Service – the success rate of taxpayers who seek assistance from customer service representatives. The level of service will expand beyond the telephone channel to cover other service delivery channels.

- Accuracy Percentage – percentage of customer inquiries accurately addressed by IRS within each service delivery channel.
- Taxpayer Self-Assistance Rate – percentage of contacts in the assistance category resolved by taxpayer self-assistance (automated calls answered plus internet services completed).

**32. How can a taxpayer really know whether his tax preparer is competent?**

There are no laws that regulate all tax preparers. Any person is allowed to prepare a tax return for a fee. In January 2007, the IRS posted the following information on its website designed to help taxpayers choose reputable return preparers:

- Be careful with tax preparers who claim they can obtain larger refunds than other preparers.
- Avoid preparers who base their fee on a percentage of the amount of the refund.
- Stay away from preparers who claim that many, if not most, phone customers can get hundreds of dollars or more back under the telephone tax refund program.
- Use a reputable tax professional who signs your tax return and provides you with a copy for your records.
- Consider whether the individual or firm will be around to answer questions about the preparation of your tax return months, or even years, after the return has been filed.
- Review your return before you sign it and ask questions on entries you don't understand.
- No matter who prepares your tax return, you (the taxpayer) are ultimately responsible for all of the information on your tax return. Therefore, never sign a blank tax form.
- Find out the person's credentials. Only attorneys, CPAs and enrolled agents can represent taxpayers before the IRS in all matters including audits, collection and appeals. Other return preparers may only represent taxpayers for audits of returns they actually prepared.
- Find out if the preparer is affiliated with a professional organization that provides its members with continuing education and resources and holds them to a code of ethics.
- Ask questions. Do you know anyone who has used the tax professional? Were they satisfied with the service they received?

The IRS also noted that reputable preparers will ask to see taxpayers' receipts and will ask taxpayers multiple questions to determine their qualifications for expenses, deductions and other items. By doing so, the IRS is trying to help taxpayers avoid penalties, interest or additional taxes that could result from an IRS examination.

**33. What are the three primary actions the IRS is taking to ensure that tax preparers are generating accurate tax returns?**

- 1) The IRS has considered a nationwide database to track complaints made against tax preparers, which would contain complete information on reported preparers and would be accessible by all IRS functions with preparer oversight responsibility.<sup>5</sup> TIGTA has not conducted audit work to determine the status of capabilities of the proposed database.

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<sup>5</sup> The National Taxpayer Advocate's 2006 Annual Report to Congress, December 2006, page 207.

- 2) The IRS has taken disciplinary actions against tax practitioners for filing fraudulent returns. In Calendar Year 2005, the OPR suspended or disbarred or obtained resignation for 235 licensed tax practitioners that included CPAs, attorneys, and enrolled agents. The disciplinary actions increased to 400 in Calendar Year 2006 and 99 actions have been taken so far in Calendar Year 2007. It is unknown how many referrals and investigations were initiated during any of these years.
- 3) The OPR regulates licensed tax practitioners. TIGTA determined the OPR should do more to notify the public when a licensed tax practitioner has been disciplined. During a 2006 audit, TIGTA identified that the OPR receives referrals regarding tax practitioner misconduct from a wide variety of sources that includes the Department of Justice, the IRS Criminal Investigation function, and State licensing authorities.<sup>6</sup> The OPR maintains an Intranet web site that lists the disciplinary actions that it has taken and also publishes the disciplinary action taken in the Internal Revenue Bulletin publication. At the time of TIGTA's review, OPR Management was considering the creation of a public Internet web site with disciplinary actions listed. TIGTA believes if this action is implemented, it would be a sufficient improvement or benefit to help taxpayers better identify and protect themselves from hiring a disreputable licensed practitioner.

**34. Are IRS preparer oversight efforts sufficient to protect taxpayers from unscrupulous or incompetent preparers?**

Oversight efforts for protection of taxpayers could be improved. According to the IRS OPR Intranet web site, in Calendar Year 2005, the OPR suspended, disbarred or obtained resignations for 235 licensed tax practitioners that included CPAs, attorneys, and enrolled agents. The disciplinary actions taken increased to 400 in calendar year 2006 and indicate 99 actions have been taken so far in 2007. It is unknown how many referrals and investigations were initiated during any of these years.

In March 2006, TIGTA reported that despite increases in enforcement activity, there was still a significant number of tax practitioners whose conduct appeared to warrant disciplinary action by the IRS but who had not been identified by the OPR.<sup>7</sup> Some tax practitioners who had been convicted of tax-related crimes or whose licenses had been suspended or revoked by State authorities had not been suspended from practice before the IRS. TIGTA also estimated that there were approximately 22,500 licensed tax practitioners who were not compliant with their tax obligations but who had not been identified for referral to the OPR. TIGTA made recommendations to improve the OPR's work with other law enforcement agencies to improve the referral process and to automate the detection of tax practitioners who are not compliant with their own taxes.

**35. What is the number of paid tax preparers?**

<sup>6</sup> *The Office of Professional Responsibility Can Do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners* (Reference Number 2006-10-066, dated March 2006).

<sup>7</sup> *The Office of Professional Responsibility Can Do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners* (Reference Number 2006-10-066, dated March 2006).

TIGTA has not completed any work in this area and has no data on the number of paid tax preparers.

**36. How many preparers did the IRS investigate last year? Given that there may be as many as 1 million preparers, do you think this level of investigation by the IRS is sufficient to detect and deter bad behavior or incompetence?**

The OPR reported that in Calendar Year 2005 it suspended or disbarred or obtained resignations for 235 licensed tax practitioners that included CPAs, attorneys, and enrolled agents. The disciplinary actions taken increased to 400 in Calendar Year 2006 and 99 actions have been taken so far in Calendar year 2007.

In addition, the IRS Criminal Investigation function reported the following statistics<sup>8</sup> regarding abusive return preparers:

	FY 2006	FY 2005	FY 2004
<b>Investigations Initiated</b>	197	248	206
<b>Prosecution Recommendations</b>	153	140	167
<b>Indictments/Informations</b>	135	119	121
<b>Sentenced</b>	109	118	90
<b>Incarceration Rate*</b>	89.0%	85.6%	84.4%
<b>Avg. Months to Serve</b>	18	18	19

\*Incarceration may include prison time, home confinement, electronic monitoring or a combination.

<sup>8</sup> Statistics taken from the Criminal Investigation function enforcement statistics posted on [www.irs.gov](http://www.irs.gov).

The following represents the Criminal Investigation function's investigative efforts involving promoters, clients and other individuals involved in abusive trust schemes:

	FY 2006	FY 2005	FY 2004
<b>Investigations Initiated</b>	152	197	131
<b>Prosecution Recommendations</b>	103	126	127
<b>Indictments/Informations</b>	93	70	82
<b>Sentenced</b>	88	70	45
<b>Incarceration Rate*</b>	79.5%	82.9%	73.3%
<b>Avg. Months to Serve</b>	31	38	36

The IRS need to do more to detect and deter bad behavior and incompetence by preparers. As discussed in Questions 33 and 34, TIGTA has made recommendations to improve the OPR's work with other law enforcement agencies to improve the referral process and to detect and deter tax practitioners who are not compliant with their own taxes.

**37. Recent information from the IRS does not reflect the number of preparer penalties asserted in tax years prior to 2006. How can the IRS say it takes the quality of tax preparation seriously if it doesn't track the penalties it asserts?**

The IRS is considering an increase or expansion for preparer penalties as stated in its Fiscal Year 2008 revenue proposals. The scope of the existing preparer penalties would be expanded from income tax returns to include employment, excise, exempt organization, estate and gift tax returns and related documents. The per failure penalty would be increased from \$50 to \$150. The \$250 penalty would be increased to the greater of \$1,000 or 50 percent of the preparer's fee. The \$1,000 penalty would be increased to the greater of \$5,000 or 50 percent of the preparer's fee.

The proposal would be effective for returns filed on or after January 1, 2008. The reason for the proposed change is because unscrupulous preparers facilitate the reporting of unreasonable and unrealistic positions on various types of returns in addition to income tax returns. Expanding the penalty to other types of returns and increasing the amount of applicable penalties will help to ensure the accountability of preparers.

**38. TIGTA estimates that as many as 22,500 attorneys, CPAs and enrolled agents have their own, personal tax problems, but the IRS has done nothing to sanction them. Why is that? What is the IRS doing to improve the Office of Professional Responsibility's oversight?**

Currently, the IRS does not have an adequate method to identify and notify the OPR that a licensed tax practitioner is not compliant in their own tax obligations. Licensed practitioners, as a community, are vehemently opposed to including their unique SSN on the taxpayer's Power of Attorney authorization citing privacy and identity theft issues. As such, there is no way to uniquely identify or correlate an individual's non compliance to their status as a licensed practitioner.

In March 2006, TIGTA issued a report<sup>9</sup> recommending that the Director, OPR, coordinate with the Wage and Investment Division and the Modernization and Information Technology Services organization in developing a method of uniquely identifying representatives on the Centralized Authorization File that does not require representatives to use Social Security Numbers on a Power of Attorney and Declaration of Representative (Form 2848). If such a method can be developed, then the IRS can use the information to notify the OPR when representatives are not compliant with their individual tax obligations. The expected completion date for management action on the proposed recommendation is September 2007.

**39. IRS statistics show that 230,000 electronic filing numbers (EFINs) have been issued to authorized Electronic Return Originators. 101,000 of those EFINs belong to only 17 EROs. That works out to almost 6,000 EFINs per ERO. These 17 businesses generated 44% of the individual returns filed. How can the IRS effectively monitor this many EFINs when it doesn't know who has been delegated the authority to use them?**

Per Publication 3112, *IRS e-file Application and Participation*, a Delegated User is not required to meet the same suitability standards as a Principal or Responsible Official. The actions of the Delegated User are the responsibility of the Principal or Responsible Official who appoints the individual. Large firms with multiple Delegated Users on a single IRS *e-file* Application should limit the number of Delegated Users to 100. Delegated users can only be listed on the application when it is submitted on-line.

The Electronic Return Originator designates a Responsible Official on the e-file application who is an individual with authority over the provider's IRS *e-file* operation at a location, is the first point of contact with the IRS, and has authority to sign revised IRS *e-file* applications. A Responsible Official ensures the provider adheres to the provisions of the revenue procedure as well as all publications and notices governing IRS *e-file*.

Each individual who is a Principal or Responsible Official must:

- Be a United States citizen or an alien lawfully admitted for permanent residence (legal resident alien) as described in 8 U.S.C. § 1101(a)(20) (1994);
- Be 21 years of age as of the date of application; and
- Meet applicable state and local licensing and/or bonding requirements for the preparation and collection of tax returns.

<sup>9</sup> *The Office of Professional Responsibility Can Do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners* (Reference Number 2006-10-066, dated March 2006).



**40. Does the IRS have any plans to tighten up its ERO process so that all ERO applicants and delegated users are subject to background checks?**

During the current TIGTA audit on the screening and monitoring of EROs, TIGTA has determined that the IRS is still performing background checks on every fourth applicant (principals and responsible officials) who submit a fingerprint card or who indicate they have a criminal background.<sup>10</sup>

In response to the TIGTA audit report dated June 2002, IRS management stated that they did not plan to perform background checks on all applicants. Management stated that they believed additional Federal Bureau of Investigation checks and background investigations were not necessary and they cited an IRS business case study which showed that, while 10 percent of the investigations revealed information, it was usually not significant enough to deny participation in the e-file Program.<sup>11</sup>

Per the IRS e-file Application and Participation (Publication 3112) dated November 2004, a Delegated User is an individual within a firm/organization, other than a Principal or Responsible Official, who is authorized to use one or more of the e-services products. A Principal or Responsible Official appoints an individual as a Delegated User on the IRS *e-file* Application available on the IRS web site. A Delegated User should be an employee, partner, or other member of the Firm/Organization or have a business relationship with the Firm/Organization.

A Delegated User may be authorized by a Principal or Responsible Official with authorities, which include the following:

- viewing, updating, signing, and submitting IRS *e-file* Applications;
- accessing e-services incentive products (Disclosure Authorization, Electronic Account Resolution and Transcript Delivery System);
- transmitting Forms 990, 1120, and 1120-POL through the Internet (Internet Transmitter);
- requesting a new password (Security Manager);
- viewing Software Developer information; and
- a Delegated User is not required to meet the same suitability standards as a Principal or Responsible Official. The actions of the Delegated User are the responsibility of the Principal or Responsible Official who appoints the individual.

**41. Why aren't 100% of the fingerprints submitted with ERO applications submitted to the FBI as part of the background check? Doesn't this open the door for unscrupulous persons to e-file fraudulent returns?**

In response to a TIGTA audit report, IRS management stated that they did not plan to perform background checks on all applicants. Management stated that they believed additional Federal Bureau of Investigation checks and background investigations were not necessary, and they cited

<sup>10</sup> Audit Number 200740020.

<sup>11</sup> *E-File Providers Are Not Adequately Screened* (Reference Number 2002-40-111, dated June 2002).

an IRS business case study which showed that, while 10 percent of the investigations revealed information, it was usually not significant enough to deny participation in the e-file program.<sup>12</sup>

**42. Why did the IRS design an ERO system that has no way of knowing how many delegated users are filing tax returns under the ERO's identification number? Why don't the delegated users have to go through background checks?**

TIGTA does not know why the IRS designed the ERO system this way. TIGTA has not performed any audits in this area, but Publication 3112 states that a Delegated User is not required to meet the same suitability standards as a Principal or Responsible Official. The actions of the Delegated User are the responsibility of the Principal or Responsible Official who appoints the individual.

**43. Does the IRS have any plans to revise its ERO process so all fingerprints are checked, and the names of the delegated users are provided to the IRS?**

To TIGTA's knowledge, the IRS does not have any plans to revise its ERO process so all fingerprints are checked.

Per Publication 3112, a Delegated User is not required to meet the same suitability standards as a Principal or Responsible Official. The actions of the Delegated User are the responsibility of the Principal or Responsible Official who appoints the individual. Large firms with multiple Delegated Users on a single IRS *e-file* Application should limit the number of Delegated Users to 100.

**44. Are current civil and criminal penalties sufficient to deter unscrupulous or incompetent preparers?**

The IRS is considering an increase or expansion for preparer penalties as stated in its Fiscal Year 2008 revenue proposals. The IRS believes expanding the penalty to other types of returns and increasing the amount of applicable penalties will help to ensure the accountability of preparers.

**45. How would increased regulation of paid preparers, including competency standards and continuing education, improve the quality of tax preparation?**

Currently there are no provisions in the law to regulate unenrolled tax return preparers. The IRS provides oversight to licensed practitioners (CPAs, Enrolled Agents, Enrolled Actuaries and attorneys) within the OPR. The National Taxpayer Advocate introduced legislation to regulate income tax return preparers. This process would include registration, examinations, certification and an enforcement program. TIGTA believes this type of increased regulation would help improve the tax preparation profession.

**46. What percentage of IRS's resources is devoted to oversight of the paid preparer industry including education, monitoring, and compliance enforcement?**

As of August 2006, the OPR had a budget of \$5 million dollars and a staff of 56 people to perform its oversight duties. However, the OPR only regulates a small portion of the paid

<sup>12</sup> *E-File Providers Are Not Adequately Screened* (Reference Number 2002-40-111, dated June 2002).

preparer industry. The Criminal Investigation function devotes resources to the enforcement of return preparer investigations and abusive tax schemes. While TIGTA does not know the exact resource commitment dedicated to these activities, the Criminal Investigation function has reported that 8.4 percent of direct investigative time was spent on return preparer investigations and 6.2 percent direct investigative time was spent on abusive tax schemes during Fiscal Year 2006.

**47. Given the importance of paid preparers to tax administration in the United States, how does IRS measure and track the performance of the paid preparer industry?**

The IRS has taken steps to detect fraud within the return preparer industry. The IRS Return Preparer Program focuses on enhancing compliance in the return-preparer community by investigating and referring criminal activity by return preparers to the Department of Justice for prosecution and/or asserting appropriate civil penalties against unscrupulous return preparers.

**48. The GAO characterized access to IRS' telephone assistors as being stuck in the low 80 percent range for 5 years now. Does this mean that IRS thinks an 80 percent level of service is acceptable?**

The IRS sets customer service goals based on budget allocations rather than the taxpayer needs/requirements. Since the IRS does not have accurate measures for and costs of its services, and does not have sound business cases for all services provided, it makes decisions on the amount of funds allocated. For example, each year, the IRS allocates Full Time Equivalents to the Accounts Management function for operation of the toll-free telephone program. Based on these budgeted resources, the IRS plans for the number of taxpayer calls that will be answered by assistors and the numbers of services taxpayers may need during the calls. These goals are acceptable because the IRS does not plan to answer all calls from taxpayers since it does not have the resources to provide service to all taxpayers that call. Instead, it attempts to provide a set Level of Service.

**49. What was the impact of the delay in the implementation of CADE on 2007 Filing Season processing?**

The delivery of Customer Account Data Engine (CADE) Release 2.2 was postponed from the start of the 2007 Filing Season, January 16, 2007, until March 6, 2007, to make required performance improvements and complete filing season updates. During this period, tax returns eligible for processing by the CADE were sent back to the IRS' current processing system, known as the Individual Master File. Therefore, approximately 17.2 million potential CADE tax returns filed through February 16, 2007, did not have an opportunity for processing by the CADE. As a result, Release 2.2 will not process its goal of 33 million tax returns and a significant number of taxpayers will not receive the benefits of expedited refunds.

**50. How does this year's "delay" and possible delays in future releases of CADE, affect other systems, including the Accounts Management System?**

Using the Information Technology Modernization Vision and Strategy as a model, the Project team and the Wage and Investment Business Modernization Office have aligned the CADE multi-year release plan with the Accounts Management Services project. Delays in deploying CADE releases will affect the ability of the two projects to support each other's capabilities.

**51. What, if any, impact has the delay had on the planned functionality of future releases of CADE?**

Recent delays in deploying CADE Release 2 have impacted the functionality of future releases. In the short-term, the ability to process split refunds was scheduled for implementation in Release 2. Because of design and development problems, this requirement was first deferred to Release 3, and subsequently deferred to Release 4. In the long-term, the CADE may not be able to replace the existing individual taxpayer account database, the Individual Master File, by Calendar Year 2012.

**52. What assurances can you give us that the causes of these problems are being addressed and will not surface again?**

Since October 2002, the TIGTA has reported on the Project's development and deployment of the CADE in six audits. Corrective actions have been implemented to various degrees to address the causes of the problems we identified. Although the Project has taken actions on previously reported problems, at this time TIGTA cannot assure that identified problems will be adequately resolved.

**53. What effect might tax preparer registration have on tax fraud prevention initiatives, and do you favor this approach?**

The National Taxpayer Advocate proposed legislation to regulate income tax return preparers. This process would include registration, examinations, certification and an enforcement program. TIGTA does not take a position on tax preparer registration since the Secretary of the Treasury has delegated to the Assistant Secretary for Tax Policy exclusive authority to determine the Department's position on all tax policy matters.

**54. Has the GAO preparer investigation revealed any significant new quality control elements that could be implemented by the tax preparer community?**

In the GAO report<sup>13</sup>, the Chain preparers made several types of errors during the GAO site visits with tax consequences that were sometimes significant. In addition, recently the Justice Department sued to shut down 125 franchises of the No. 2 American tax preparer, Jackson Hewitt Tax Service Inc. The IRS accused the outlets of submitting thousands of fraudulent returns that cost the government more than \$70 million. If anything, current reports and events indicate that some regulation and or a certification process could benefit the taxpayer, the IRS, as well as the tax preparer community.

<sup>13</sup> *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* (Reference Number GAO-06-563T, dated April 4, 2006).

**55. Is there a matching system that looks for taxpayers having the same addresses where dependents appear to be shuffled between taxpayers to optimize refunds? If so how is that working? What improvements are planned?**

The IRS does have a system that identifies multiple refunds generated from tax returns that have the same address, but it is not specific to use of dependents. The multiple refunds are held and reviewed by the Criminal Investigation function for indications of fraud or other abuse. As for improper use of dependents, the IRS has two systems that identify the multiple uses of Social Security Numbers. The Duplicate TIN database is used to identify tax returns that contain an SSN that had previously been claimed on another tax return. This system identifies both duplicate claims of dependent SSNs and duplicate claims of Primary and Spouse SSNs. There is a second system used to specifically identify duplicate uses of dependent SSNs for the purposes of claiming the Earned Income Tax Credit. This Duplicate Dependent database matches dependents and parents from previous year's tax returns, and identifies any additional uses of a dependent's SSN during the same year, or claims of a dependent's SSN by a different "parent" to qualify for the EITC. The Office of Audit has reviewed both of these systems over the past few years, and both were working generally as intended to identify potential improper uses of SSNs that the IRS can investigate. OA has also recommended actions to improve the validity and use of these systems, to which the IRS has agreed.

**Questions from Ranking Member Grassley:**

1. **The IRS estimates that fraudulent refund claims exceed \$500 million a year. The IRS experienced a dramatic decrease in the amount of fraudulent refund claims from 2005 to 2006 because the redesigned Electronic Fraud Detection System's Web-based application was not implemented. TIGTA determined that this was due to lack of adequate oversight and monitoring of the project. What steps has the IRS taken to ensure that Criminal Investigation is able to detect fraudulent refund claims filed during this filing season? What is the future of the Web-based application?**

On April 19, 2006, all system development activities for the Web EFDS were stopped and all efforts were focused on restoring the client-server EFDS for use on January 16, 2007. The IRS improved controls over the EFDS restoration activities including executive governance and project management. As a result, project risks were identified and mitigation actions were taken to ensure the EFDS was implemented and fraudulent refunds stopped during the 2007 Filing Season. On January 16, 2007, the IRS and its contractors put the EFDS into production. During weekly conference calls, the IRS reported the EFDS continued to operate without critical problems during the filing season.

The IRS is currently developing the EFDS requirements for the 2008 Filing Season using the current system. The Web-based EFDS application development will not be considered until after the 2008 requirements are finalized.

2. **It is my understanding that TIGTA analyzed the Free File Alliance programs during its filing season review. In that evaluation, did TIGTA review the accuracy of the Free File Alliance programs in determining the correct tax liability? If so, please comment on this analysis.**

TIGTA conducted limited testing of the accuracy of the software provided by the Free File Alliance members. The scenarios tested incorporated common taxpayer characteristics related to filing status and dependency issues as well as special legislation related to the 2005 Hurricane Katrina victims.

TIGTA found that the software sometimes did not compute the correct tax. Software provided by 25 percent of the members would not allow taxpayers to take either the Earned Income Tax Credit or the Child and Dependent Care Credit without also taking the dependency exemption. According to *Earned Income Credit (EIC)* (Publication 596), a taxpayer who meets the qualifications for the Earned Income Tax Credit and the Child and Dependent Care Credit may claim them even if the taxpayer does not claim a related dependency exemption. One member's software allowed a dependency exemption that should not have been allowed. TIGTA also found that software provided by 45 percent of the members did not have adequate interview questions to determine if the taxpayer could take the dependency exemption. However, the software properly computed the return if the taxpayer already knew he or she did not qualify for the exemption.

**3. Given the importance of paid preparers in our tax administration system, would it be useful for IRS to devote more resources to oversight of the paid preparer industry?**

The OPR regulates licensed preparers (Enrolled Agents, Enrolled Actuaries, CPAs). As of August 2006, the OPR had a budget of \$5 million dollars and a staff of 56 people to perform its oversight duties. However, the OPR only regulates a small portion of the paid preparer industry. As of February 2005, approximately 407,000 licensed practitioners were authorized to represent taxpayers before the IRS. This figure does not account for unenrolled preparers – those not enrolled with the IRS. The total number of paid preparers is unknown, but based on the number of major preparation companies currently operating and individuals preparing returns, the figure could be substantial.

**Questions from Senator Hatch:**

**1. You spoke about the goal of 80 percent of all tax returns being filed electronically and how we have fallen short of that goal. In your view, how much better might we do in the area if free electronic filing were available to taxpayers of all income levels?**

The IRS currently offers the Free File Program to all taxpayers with an Adjusted Gross Income of \$52,000 or less (roughly 96 million taxpayers). However, only 3.9 percent (approximately 3.7 million) of eligible taxpayers have used the Program as of April 28, 2007. Making the current Free File Program available to all taxpayers and improving its marketing would likely increase electronic filing, but the extent of the increase is hard to predict. In 2006, approximately 18 percent of the taxpayers who used the Program were new to electronic filing.

A significant improvement appears to be possible if the IRS were able to provide free transmission for all taxpayers, especially if it were to provide direct transmission. During 2006, approximately 39 million taxpayers (or their tax preparers) used a software package to prepare their returns but filed the returns on paper. Clearly, these taxpayers had their returns in electronic format, but chose instead to print and mail their return.

**2. I noted from your biography that one of your duties as Deputy IG for Audit is to focus on improving employee satisfaction. As you know, I have a significant number of constituents working in the Ogden Service Center. While the Ogden Center is renowned for its high levels of productivity, I worry that some IRS workers suffer from low morale. I have met with a number of them and have heard some of their complaints. What can Commissioner Everson do and what can we on this Committee do to improve the working conditions and thus the productivity of our dedicated IRS employees?**

The IRS should look for opportunities to expand its Telework program which could provide positive effects on employee productivity and morale.

TIGTA was recently ranked number 20 out of 222 Federal Government organizations on the *Best Places to Work in the Federal Government* rankings. The rankings are based on a comprehensive assessment of employee engagement in the Federal Government. The rankings were produced by the Partnership for Public Service and American University's Institute for the

Study of Public Policy Implementation. A significant contributor to this high ranking is TIGTA's Telework program.

TIGTA piloted its Telework program in 2000. After a successful pilot, TIGTA implemented the program organization-wide. In 2006, TIGTA received the First Annual 2006 Tele-Vision Award for Leadership in Telework from the Telework Exchange.

TIGTA employees interested in Telework work closely with their managers to identify the parameters of participation and to develop performance expectations, in addition to receiving specialized training. TIGTA used a scheduled technology replacement to substitute dockable laptops with secure communications for the older desktop computers. High-speed Internet and telephone costs are subsidized, and printers are provided to those who Telework at least two days per week. Through Telework, TIGTA has achieved reductions in space and overhead costs, which outweigh the costs of the program.

TIGTA employees value the flexibility and reduced commuting stress Telework provides. This is evidenced by the increased productivity displayed over the past few years and the high employee satisfaction rating. Over 87% of TIGTA's Office of Audit employees responded in a recent survey that Telework has contributed to employee retention. Additionally, survey results and anecdotal evidence indicate that employees are able to stay better focused by having the ability to do work where the work can be done the best and by reducing stress related to daily commuting. TIGTA is very proud of the success it has achieved through its Telework program, and telecommuting has become a pivotal program for attracting and retaining a skilled and an increasingly diverse workforce.

In February 2007, TIGTA reported its results of a review of the closing of the IRS National Headquarters building due to a flood in June 2006. While the flood displaced over 2,200 IRS personnel who worked in the Headquarters building, TIGTA found no measurable impact on taxpayers and tax administration. However, while the IRS successfully continued operations following the flood and closure of its Headquarters building, TIGTA noted an area that the IRS may find useful in preparing for and responding to future emergencies. TIGTA recommended that the IRS consider increasing the availability of laptop computers for telecommuting so more IRS personnel can continue working during emergencies. Many IRS personnel who were displaced by the flood were either unable to telecommute or unable to do so effectively, which resulted in granting IRS personnel approximately 101,000 hours of administrative leave (excused absence from work with no loss of pay) that may have otherwise lowered the \$4.2 million of salary costs associated with the leave.

Increasing the ability of IRS employees to telework would not only serve the IRS well in any future emergencies but would also allow the IRS to capitalize on the positive effects of telecommuting on employee productivity and morale.



**STATEMENT OF EVANGELOS DIMITROS SOUKAS**  
**April 12, 2007**

My name is Evangelos Dimitros Soukas. I am currently serving time for wire fraud, mail fraud, fraudulent use of another person's means of identification, and identity theft in result making false claims to the IRS.

To hijack the personal information of someone is not hard at all. Social Security numbers are available in many places for a common thief to obtain. For example a telephone company, insurance card, work place, school records, and that list goes on. The system in my eyes is inviting criminals like myself to steal from the IRS, banks, etc.

In March 2000, I came across an advertisement on the internet that stated, receive your tax refund within days of filing.

For a criminal already on the run from the FBI, this was an easy way to make money quickly if I was successful. So I clicked on the advertisement and was directed to the H&R Block web site.

After looking around on the web site I had started to file a tax return for myself by entering all my personal information, then making up a W-2 entry on the web site which I had copied from my mother's tax return. It took me a couple of hours to work it out to make the tax return look legitimate.

Then I came across a problem, the site requested of a nine-digit tax code for the employer filed. I didn't want to use my mother's employer code, so I contacted one of my past employers human resources and requested the nine-digit code. I got the code instantly and continued the process on the web site.

When I was finished with the preparation I had a refund of \$3614.00, then sent the filing to the IRS via the H&R block web site.

Then I got an offer to apply for an anticipation loan and to receive my refund within a few days of approval of the IRS. So I applied for the simple loan, and a few days later I received the money in my checking account.

I didn't know if this scheme was going to work but it was worth a try to see if it was going to happen. In only a few hours of work I had made \$3614.00. My first thoughts where that this is a really easy way to get money and if I wanted to I would be able to hijack other people's identity and never get caught if I where to take the necessary precautions.

The following year after January 1st I went into overdrive and quickly started filing false claims to the IRS through numerous web sites, with other people's personal information that I had used on my past crimes of identity theft.

I was successful on many attempts that netted me \$43,600.00 in 2001, by simply doing the same thing as the year before but using hijacked identities. But that year I was doing at an average of 2 hours to file for each return. I was a little careless about depositing the money into my own checking account.

I could have easily opened up a false checking account online and have the money sent into a fraudulent account and never be traced back to me. But I had this mentality

that I was in Greece and the FBI was not able to capture me so I really didn't care if I was using my personal information.

On few occasions I called into the IRS call center. I was checking on the status of the false returns I had placed. Most of the time the automated service would answer my request by entering in the Social Security number and the exact amount of the refund and then would tell me the status of the refund.

On a few filings I was denied, and I wanted to see what had happened, so I requested to speak to an IRS representative to request what had happened to my tax return. I would give the information that was wanted to grant access to the IRS file by stating that I was the John Doe and gave the Social security number with the exact amount of the return.

Then the IRS representative would state that problem to me and tell me I would have to file the return by paper, which I never did.

I would have continued this scheme in the following years, but I had moved onto bigger and better things to make more money in different areas of fraud.

In 2003 an IRS agent had made contact with my sister to find out where I could be found. My sister informed the agent I was on the run from the FBI, and to contact the FBI agent in charge of my case in Seattle.

My sister gave me the contact information to the IRS agent and I had given him a call for the reasoning to find out what he had on me pertaining to the IRS. I spoke to him briefly and I was honest to him, and the one question that stuck to my head was that he asked if I had any professional training in tax preparation. I simply responded by saying no, I just have a high school diploma and never took any training in tax preparation.

The agent found it hard to believe I was able to do what I was doing with no education in taxes, and simply called me a genius. I simply responded by telling him that it does not take a rocket scientist to do what I had done. After that I had ended the call and never heard from him again.

After my arrest 2 years later I had seen my discovery from the prosecutor's office that showed in the report. The IRS had spent countless hours investigating me with many field agents taking statements from the victims of my crime. If my memory serves me correctly the IRS spent around 250 hours on my case in total, from what is said from the IRS agent report.

In my eyes, it doesn't take an Einstein to file false tax claims. It is actually pretty easy. If I really wanted to continue in this field I could have safeguarded my true identity and never been caught.

What I don't understand is, why doesn't the IRS have some type of security measure by issuing out a pin number or even using a mother's maiden name when filing electronically or even calling in the call center? There should be some type of extra measure to safe guard the people's tax records, in my opinion.

United States Government Accountability Office

**GAO**

Testimony  
Before the Committee on Finance,  
U.S. Senate

For Release on Delivery  
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## 2007 TAX FILING SEASON

# Interim Results and Updates of Previous Assessments of Paid Preparers and IRS's Modernization and Compliance Research Efforts

Statement of James R. White  
Director  
Strategic Issues

Statement of David A. Powner  
Director  
Information Technology Management Issues



April 12, 2007

## 2007 TAX FILING SEASON

## Interim Results and Updates of Previous Assessments of Paid Preparers and IRS's Modernization and Compliance Research Efforts



### Highlights

Highlights of GAO-07-720T, testimony before the Committee on Finance, U.S. Senate

#### Why GAO Did This Study

The Internal Revenue Service's (IRS) tax filing season performance is a key indicator of how well IRS serves taxpayers. This year's filing season was expected to be risky because of tax system changes, including the telephone excise tax refund (TETR) which can be requested by all individuals and entities that paid the excise tax. GAO was asked to describe IRS's service to taxpayers so far this filing season (including the impact of this year's tax systems changes). GAO was also asked to provide updates of previous assessments of the performance of paid tax preparers, IRS's efforts to modernize its information systems, and what IRS is doing to better measure taxpayer compliance. GAO compared IRS's filing season performance to prior years' and goals and based analyses of paid preparers, information systems, and compliance research efforts on recent reports.

#### What GAO Recommends

GAO is not making any new recommendations, but notes relevant past recommendations and their implementation status.

[www.gao.gov/cgi-bin/gettrpt?GAO-07-720T](http://www.gao.gov/cgi-bin/gettrpt?GAO-07-720T)

To view the full product, including the scope and methodology, click on the link above. For more information, contact James R. White at (202) 512-9110 or [whitej@gao.gov](mailto:whitej@gao.gov).

#### What GAO Found

IRS's interim filing season performance is improved in some areas. The number of individual income tax returns processed to date is comparable to last year, and the number filed electronically is almost 6 percent greater. Taxpayers' ability to reach an IRS telephone assistor was somewhat less than last year, but the accuracy of answers to taxpayers' questions was about the same. Use of IRS's Web site increased, important because it is available 24 hours a day and is less costly than some other types of assistance. However, there have been challenges. Taxpayers' use of the Free File program, which provides free tax preparation and electronic filing through IRS's Web site—is 5.2 percent below last year at this time. Also, the Customer Account Data Engine (CADE), a modern tax return processing system, became operational 2 months behind schedule. IRS still expects to post 17 -19 million taxpayer accounts to CADE, which is about two and a half times more than last year. Tax systems changes have not had a significant effect on filing season performance. For example, IRS has received a fraction of the TETR-related telephone calls it expected to date.

Because paid preparers prepared over 62 percent of all individual income tax returns last year, they are a critical quality control for tax administration by helping to prevent noncompliance. Last year, GAO reported to this Committee about errors made by paid preparers. Some of the most serious errors involved not reporting business income and failing to itemize deductions. GAO's limited work last year did not permit observations about the quality of the work of paid tax preparers in general and undoubtedly, many preparers do their best to prepare tax returns that are compliant with tax laws. In response to GAO's report, IRS has scheduled compliance reviews of some preparers. In addition, recent Justice Department suits to stop fraudulent return preparation at more than 125 outlets of one preparation chain for allegedly taking part in tax preparation scams highlight the importance and obligations of paid preparers.

Despite progress made in implementing Business Systems Modernization projects, including CADE, and improving modernization management controls and capabilities, significant challenges and serious risks remain. Delays in the latest release of CADE resulted in continued contention for key resources and will likely impact future releases. Also, IRS has more to do to fully address GAO's prior recommendations such as developing a long-term strategy that would include timeframes for retiring legacy computer systems.

GAO has long supported IRS's research to better understand taxpayers' compliance. IRS's fiscal year 2008 budget request includes a proposal for annual research instead of larger but intermittent efforts. GAO considers this to be a good approach because it will allow compliance data to be continually refreshed and should reduce costs by eliminating the need to plan new studies every few years.

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Mr. Chairman and Members of the Committee:

We appreciate this opportunity to support your oversight of the Internal Revenue Service (IRS) and the broader tax administration system.

The annual tax return filing season is when IRS provides much of its service to taxpayers. From January through April, IRS will process well over 100 million individual tax returns and issue refunds, handle tens of millions of phone queries from taxpayers, and provide forms and answers to questions for tens of millions of taxpayers on its Web site. Smaller numbers of taxpayers will be assisted at IRS's walk-in sites or at sites operated by other organizations and staffed by volunteers.

While it is always a massive undertaking, the IRS Commissioner stated that this year's filing season is high risk for several reasons, including challenges in implementing the new telephone excise tax refund (TETR), split refund option (refunds can now be directly deposited to up to three separate accounts), and several tax law extensions that were enacted in December of 2006.<sup>1</sup>

We have reported that IRS has made significant progress improving taxpayer service since the passage of the IRS Restructuring and Reform Act of 1998 (RRA 98),<sup>2</sup> including increased electronic filing, better access to IRS's telephone assistants, and more accurate answers to taxpayers' questions. The progress has been due, in part, to IRS bringing modern information systems on line. However, we have also described taxpayer service challenges including the quality of assistance at walk-in and volunteer sites, delays in some new information systems, and fully implementing our prior recommendations on the management of systems acquisition and development.

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<sup>1</sup> The Tax Relief and Health Care Act of 2006 signed into law in December 2006 extended some provisions that expired at the end of calendar year 2005. These changes include extensions of three tax deductions: (1) state and local sales tax, (2) higher education tuition and fees, and (3) educator expenses. Pub. L. No. 109-432, Dec. 20, 2006.

<sup>2</sup> See, for example, GAO, Tax Administration: *IRS Improved Some Filing Season Services, but Long-term Goals Would Help Manage Strategic Trade-offs*, GAO-06-51 (Washington, D.C.: Nov. 14, 2005), *Internal Revenue Service: Assessment of the Interim Results of the 2006 Filing Season and Fiscal Year 2007 Budget Request*, GAO-06-615T (Washington, D.C.: Apr. 6, 2006), and *Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings*, GAO-07-27 (Washington, D.C.: Nov. 15, 2006).

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In addition to the IRS, tax administration in the U.S. relies heavily on the private sector including the paid preparer industry, the tax preparation software industry, and third parties who withhold taxes or submit information returns. Last filing season, over 60 percent of returns were prepared by paid preparers, and another one-fourth use commercial tax preparation software.

IRS's Business Systems Modernization (BSM) program, a multibillion-dollar, high-risk, highly complex effort for delivering modern information systems, is critical to supporting IRS's taxpayer service and enforcement goals and reducing the tax gap.<sup>3</sup>

The ultimate goal of taxpayer service is to help taxpayers understand and comply with their tax obligations. However, we have reported that IRS lacks quantitative estimates of the impact of taxpayer service on voluntary compliance by taxpayers as well as on the impact of enforcement on compliance. As a necessary first step to gaining more understanding of the impact of service on compliance, we have strongly supported IRS's ongoing National Research Program (NRP) to measure compliance and estimate the tax gap.

As agreed, our statement will describe IRS's service to taxpayers so far this filing season (including the impact of this year's tax system changes) and provide updates of previous assessments of the performance of paid tax preparers in our tax administration system, IRS's ongoing efforts to modernize its information systems, and what IRS is doing to better measure taxpayer compliance with the tax laws including the impact of service on compliance.

To assess IRS's filing season performance for processing, telephones, face-to-face assistance and its Internet Web site, we obtained and analyzed IRS's performance and production data and compared it to annual goals and prior years' performance. Our work also included direct observations of key filing season operations, and interviews with IRS officials and external stakeholders.

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<sup>3</sup> The tax gap is an estimate of the difference between what taxpayers pay in taxes voluntarily and on time and what they should pay under the law. IRS estimated the gross tax gap to be \$345 billion for tax year 2001. After late payments by taxpayers and revenue brought in by IRS's enforcement efforts, the resulting net tax gap is estimated to be \$290 billion.

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Our work was done primarily at IRS's National Office operating divisions, the Joint Operations Center in Atlanta, Ga. and processing centers and call sites in Atlanta, Ga. and Andover, Ma. We reviewed relevant external documentation, our reports, and reports of the Treasury Inspector General for Tax Administration (TIGTA). Our analyses of Internet return preparation and electronic filing options, TETR compliance, BSM, and NRP is based upon the results of our recent reports.<sup>4</sup> We reviewed IRS's efforts to address our prior year recommendations related to our annual filing season, paid preparer, and BSM work.

In past work, we assessed IRS's filing season performance data. We considered filing season performance measures and data to be objective and reliable based on our prior work. Since sources and procedures for producing this year's data have not significantly changed from prior years, we determined that the data were sufficiently reliable for the purposes of this report. Data limitations are discussed where appropriate. We performed our work from December 2006 through March 2007 in accordance with generally accepted government auditing standards.

In summary, we make the following major points:

- IRS's interim filing season performance is improved in some areas, although there have been challenges. As of March 30, 2007, IRS had processed 76.8 million individual income tax returns and issued over 68 million refunds, about the same number as last year. The number of returns filed electronically was almost 6 percent greater than this time last year. However, taxpayers' use of the Free File program, accessible through IRS's Web site and which allows for free on line tax preparation and electronic filing, is 5.2 percent below last year at this time. IRS's latest release of the Customer Account Data Engine (CADE), a modern tax return processing system that issues faster refunds, was delayed—it became operational 2 months behind schedule. IRS expects to post approximately 17 – 19 million taxpayer returns to CADE in 2007. Although this is less than the 33 million

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<sup>4</sup> See, for example, GAO, *Taxpayer Service: State Experiences Indicate IRS Would Face Challenges Developing an Internet Filing System with Net Benefits*, GAO-07-570 (Washington, D.C.: Apr. 5, 2007), GAO, *Tax Administration: Telephone Excise Tax Refund Requests Are Fewer Than Projected and Have Had Minimal Impact on IRS Services*, GAO-07-695 (Washington, D.C.: Apr. 11, 2007), GAO, *Business Systems Modernization: Internal Revenue Service's Fiscal Year 2007 Expenditure Plan*, GAO-07-247 (Washington, D.C.: Feb. 15, 2007) and GAO, *Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap*, GAO-07-488T (Washington, D.C.: Feb. 16, 2007).

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planned, it is almost two and a half times the approximately 7.4 million taxpayer accounts posted last year on CADE. With respect to taxpayer service, call volume continued to decline, taxpayers' ability to reach an IRS assistor was somewhat less than last year, but the accuracy of answers to taxpayers' questions was about the same as last year. Use of IRS's Web site continues to increase, important because it is available around the clock and is lower cost than most other types of assistance. About 69 percent of individual income tax returns filed to date included TETR requests. The impact of TETR on taxpayer services has been much less than IRS anticipated. For example, IRS has received a fraction of the TETR-related telephone calls it expected to date.

- Because they help the majority of taxpayers prepare their returns, paid preparers are a critical quality control checkpoint for the tax system. Last year, over 62 percent of all individual income tax returns were prepared by paid preparers. However, we reported to this Committee last year about errors made by paid preparers.<sup>5</sup> In visits to 19 outlets of several commercial chain preparers, we found that paid preparers made mistakes in every one of our visits, with tax consequences that were sometimes significant. Some of the most serious problems involved preparers not reporting business income and failing to itemize deductions at all or failing to claim all available deductions. The limited data did not permit observations about the quality of the work of paid tax preparers in general. Undoubtedly, many paid preparers do their best to provide their clients with tax returns that are compliant with the tax law. IRS has initiated some enforcement actions in response to our findings with audits of some preparers' returns scheduled to begin in April 2007. Recent Justice Department suits to stop fraudulent return preparation at more than 125 outlets of one preparation chain for allegedly taking part in preparation scams highlight the obligations of paid preparers. Their due diligence has the potential to prevent noncompliance and reduce IRS's cost and intrusiveness.
- IRS continues to make progress in implementing BSM projects and meeting cost and schedule commitments, but two key projects—CADE (discussed above) and Modernized e-File (a new electronic filing system)—experienced significant cost overruns during 2006. Future BSM project releases face serious risks, which IRS is working to mitigate. For example, delays in deploying the latest release of CADE have resulted in contention for key resources and will likely impact the

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<sup>5</sup> GAO, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T (Washington, D.C.: Apr. 4, 2006).



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design and development of the next two important releases, which are scheduled to be deployed later this year. IRS has made significant progress in implementing our prior recommendations and improving its modernization management controls and capabilities. However, critical controls and capabilities related to requirements development and management and post-implementation reviews of deployed BSM projects have not yet been fully implemented. In addition, more work remains to be done by the agency to fully develop a long-term vision and strategy for completing the BSM program, including establishing time frames for consolidating and retiring legacy systems.

- Continued compliance research is essential to IRS's ability to effectively focus its service and compliance efforts, and we have long been a supporter of such research. Well-designed compliance research gives IRS and Congress an important measure of taxpayer compliance and it allows IRS to better target enforcement resources towards noncompliant taxpayers. IRS's fiscal year 2008 budget request includes a proposal for a rolling sample of individual returns (small annual samples that would replace larger but intermittent efforts) and a dedicated cadre of examiners to review the returns. We consider this to be a good approach to refreshing research compliance data because doing compliance studies once every few years does not provide information in the intervening years. A rolling sample should also reduce costs by eliminating the need to plan new studies every few years.

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**IRS's Filing Season Performance Is Improved in Some Areas with Challenges in Others, and the Effect of Tax System Changes Has Been Minimal**

IRS's key filing season efforts are processing electronic and paper individual income tax returns and issuing refunds, as well as providing assistance or services to taxpayers. As already noted, processing and assistance were complicated this year by three tax system changes: TETR, the split refund option, and enactment in December 2006 of tax law changes.

**Returns Processing Is Comparable to Last Year, Despite Delays with CADE and Implementation of Tax System Changes**

From January 1 through March 30, 2007, IRS processed 76.8 million returns, about the same number as last year, and issued 68.3 million refunds for \$163.4 billion compared to 66.7 million refunds for \$154.4 billion at the same time last year. Over 69.3 percent of all refunds were directly deposited into taxpayers' accounts, up 6.2 percent over the same time last year. Direct deposits are faster and more convenient for taxpayers than mailing paper checks.

According to IRS data and officials, performance is comparable to last year. IRS is meeting most of its performance goals, including deposit error rate, which is the percentage of deposits applied in error, such as being posted to the wrong tax year. Groups and organizations we spoke with, including the National Association of Enrolled Agents, the American Institute of Certified Public Accountants, and a large tax preparation company, corroborated IRS's view that filing season performance is comparable to last year.

**CADE Will Expedite Refunds for Millions of Taxpayers, but Delays in Implementation Caused Millions More Not to Benefit**

IRS uses two systems for storing taxpayer account information—the antiquated Master File legacy system and CADE. The latest release of CADE became operational in early March, 2 months behind schedule because of problems identified during testing. IRS had originally planned to post 33 million taxpayer returns to CADE and the remaining 100 million individual returns on the legacy system. However, as a result of the delay, officials expect to post approximately 17 -19 million taxpayer returns to CADE. Although this is significantly less than planned, it is almost two and a half times the approximate 7.4 million taxpayer accounts posted last year on CADE. Taxpayers eligible for a refund this year whose returns are posted to CADE will benefit from CADE's faster processing, receiving their refunds 1-5 days faster for direct deposit and 4-8 days faster for paper checks than if their return had been processed on the legacy system. The remaining 14 - 16 million returns that were to have been processed on CADE were instead processed by the legacy system and thus did not receive the benefit of faster refunds. The CADE setback may impact IRS's ability to deliver the expanded functionality of future versions of CADE, thus delaying the transition to the new processing system (discussed further in the BSM section of this testimony).

**Electronic Filing is Higher than Last Year, Despite a Decline in the Free File Program**

The growth rate for electronic filing is up from the same period last year. As of March 30, over 56.9 million (74.1 percent) of all individual income tax returns were filed electronically. This is up 5.3 percent over the same time last year, and an increase over the previous years' growth of 3.3 percent.

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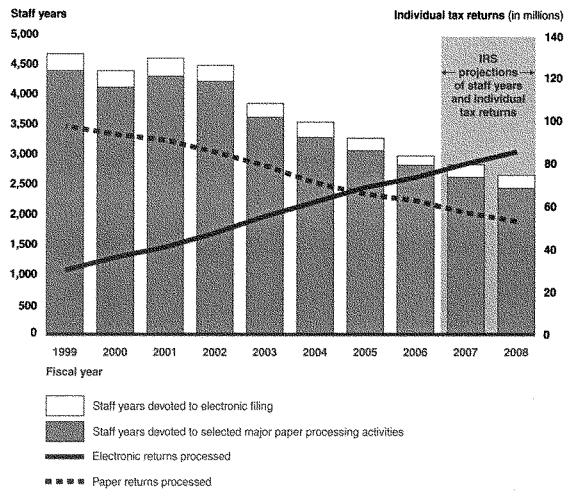
We previously reported that state mandates for electronic filing of state tax returns also encourage electronic filing of both state and federal tax returns and last year, we suggested that Congress consider mandating electronic filing by paid tax preparers meeting criteria such as a threshold for number of returns filed.<sup>6</sup> Last year, electronic filing of federal returns increased 27 percent for the three states (New York, Connecticut, and Utah) with new 2006 mandates. This year, state mandates are likely to continue to show a positive effect on federal electronic filing because, with the addition of West Virginia, 13 states now have state mandates.

Compared to processing paper returns, electronic filing reduces IRS's costs by reducing staff devoted to processing. In 2006, IRS used almost 1,700 (36 percent) fewer staff years for processing paper tax returns than in 1999, shown in figure 1. IRS estimates this saved the agency \$78 million in salary, benefits, and overtime in 2006. Electronic filing also improves service to taxpayers. Returns are more accurate because of built-in computer checks and reduced transcription errors (paper returns must be transcribed in IRS's computers—a process that inevitably introduces errors). Electronic filing also provides faster refunds.

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<sup>6</sup> GAO-07-27.

**Figure 1: Number of Individual Returns and IRS Staff Years for Individual Paper and Electronic Processing, Fiscal Years 1999 – 2008**



Source: GAO analysis of IRS data.  
 Notes: Staff years and full-time equivalents are units of measurement that are often used interchangeably. According to IRS, a full-time equivalent is the equivalent of one person working full-time for one year with no overtime. A staff year includes overtime. Therefore, the cost of one staff year is equal to the cost of one full-time equivalent plus overtime. Projections for 2007 do not include Form 1040 EZ-Ts.

Although electronic filing continues to grow, taxpayers' use of the Free File program continues to decline.<sup>7</sup> The Free File program, accessible through IRS's Web site, is an alliance of companies that have an agreement with IRS to provide free on-line tax preparation and electronic filing on

<sup>7</sup> IRS does not have the capability to receive electronic returns directly from taxpayers. Taxpayers can electronically file their returns by using a paid tax preparer, commercial tax preparation software, or the Free File program. Paid preparers and tax preparation software companies may charge for the service.

States' Internet Return  
Preparation and Electronic  
Filing Benefits and Costs Were  
Modest

their Web sites for taxpayers below an adjusted gross income ceiling of \$52,000 in 2007. About 95 million (70 percent) of all taxpayers are eligible for free file. Under the agreement, companies are not allowed to offer refund anticipation loans and checks, or other ancillary products, to free file participants. Although IRS has increased its marketing efforts, the agency has not been successful in increasing free file use. As of March 17, 2007, IRS processed about 2.6 million free file returns, which is a decrease of 5.2 percent from the same period last year. While all 19 companies participating in the Free File program allow for TETR requests, only 3 of the 19 companies offer Form 1040 EZ-T requests.<sup>8</sup>

We recently reported to this Committee on states' experience with return preparation and electronic filing on their Web sites.<sup>9</sup> These systems, called I-file, provide taxpayers with another option for preparing and electronically filing their tax returns. To the extent that the I-file systems convert taxpayers from paper to electronic filing, the costs of processing returns are reduced.

For the eight states we profiled, I-file benefits and costs were relatively modest. While state I-file systems generated benefits, such as increased electronic filing, the overall benefits were limited by low usage, which ranged from about 1 percent to just over 5 percent of eligible taxpayers. Restrictions on taxpayer eligibility and system features helped keep costs modest. States varied in whether they used contractors to develop and operate the I-file system. For the states we profiled, it is unclear whether benefits were greater than costs, in part, because of the low number of taxpayers who converted from paper to electronic filing.

IRS's potential to realize net cost savings from an I-file system depends on the costs of developing the system and the number of taxpayers converted from paper. IRS's costs to provide a new I-file service could be higher than states' for several reasons: (1) the federal tax system is more complex, (2) unlike some states that already had transactional Web sites, IRS would need to develop the capability to receive tax returns on its Web site, and (3) developing an I-file system could further stretch IRS's capability to manage systems development, an area we have designated high risk since 1995. The key to IRS achieving a net cost savings depends on the number

<sup>8</sup> Individuals who do not normally file tax returns but paid the tax can request the refund on Form 1040EZ-T (Request for Refund of Federal Telephone Excise Tax).

<sup>9</sup> GAO-07-570.

**Tax System Changes Have Had Less Impact on Returns Processing Than Projected**

of individuals converted from paper to electronic filing and the savings per return estimated to be \$2.36 by IRS.<sup>10</sup> It is uncertain how many of the 58 million taxpayers who filed on paper would convert. The over 13 million taxpayers who self-prepare their returns on a computer but print them out and mail them to IRS are an attractive target for I-file because they already have access to a computer and may be more willing to try I-file. However, IRS's Free File program, designed to attract similar taxpayers, had low use in 2006, with only 4 million users (about 3 percent of total taxpayers and 4 percent of eligible taxpayers).

TETR and split refund volume have been less than IRS projected. Almost 69 percent of individuals who filed individual income tax returns by the end of March have requested TETR, although all who paid the excise tax were eligible for the refund. IRS projected that 10 to 30 million individuals who did not have a tax filing obligation could claim TETR. Approximately 410,000 individuals from this group have asked for a TETR refund (2.8 percent of the 14.5 million IRS expected by this time).<sup>11</sup>

As of March 24, fewer than 61,000 individual taxpayers chose to split their refunds into different accounts out of the 44.8 million taxpayers who had their refunds directly deposited. This volume compares to the 3.8 million IRS projected for the filing season.

IRS delayed processing a small number of returns claiming tax extender provisions until February 3 to complete changes to its tax processing systems.

**Call Volume Continues to Decline, but Performance Is Mixed**

The number of calls to IRS's toll-free telephone lines has been less than last year and is significantly less than in 2002 for both automated and live assistance (see table 1). Similar to last year, IRS assistants answered about 40 percent of the total calls, while the rest of the calls were answered by an automated menu of recordings.

<sup>10</sup> We have previously reported that we cannot independently verify this estimate and its basis is unclear because IRS's cost accounting system is not yet able to support preparation of such cost estimates. See GAO, *Tax Administration: IRS Improved Performance in the 2004 Filing Season, but Better Data on the Quality of Some Services are Needed*, GAO-05-67 (Washington, D.C.: Nov. 15, 2006).

<sup>11</sup> We are in the process of obtaining additional information to evaluate IRS projections on TETR and split refund volumes.

Table 1: IRS Telephone Volume in the Filing Seasons, 2002 through 2007

Volume in thousands	2002	2003	2004	2005	2006	2007
Telephone assistance *						
Total calls	34,489	27,905	29,085	23,340	21,616	20,732
Answered by assistors	9,206	9,434	10,143	9,421	8,653	8,434
Answered by automated menu of recordings	25,281	18,471	18,942	13,919	12,963	12,298

Source: IRS.

\* Telephone assistance data are based on actual counts from January 1 to March 15, 2002; March 15, 2003; March 13, 2004; March 12, 2005; March 11, 2006; and March 10, 2007.

Taxpayers' ability to access IRS's telephone assistors is somewhat less than last year, but IRS is meeting its goals. As shown in table 2, the percentage of taxpayers who attempted to reach an assistor and actually got through and received services—referred to as the level of service—was one percentage point less than the same time period last year. This level of performance is slightly greater than IRS's fiscal year goal of 82 percent which is the same as last year's goal. Average speed of answer, which is the length of time taxpayers wait to get their calls answered, is just over 4 minutes, almost 40 percent longer than last year, but is better than IRS's annual goal of 4.3 minutes.

Taxpayer disconnects, which is the rate at which taxpayers waiting to speak with an assistor abandoned their calls to IRS, increased to 12.3 percent to about 1.4 million calls compared to the same time period last year. While IRS disconnects are a smaller percentage of all calls it receives, those disconnects were down from approximately 491,000 at this time last year to 148,000 (a 70 percent decline).

Using a statistical sampling process, IRS estimates that the accuracy of telephone assistors' responses to tax law and account questions to be comparable to the same time period last year. IRS officials noted that there was unprecedented hiring for fiscal year 2007, and while every employee working tax law applications completes a requisite certification process, new employees will be less productive than seasoned employees. IRS has implemented several initiatives, such as targeted monitoring of staff and mini-training sessions, to assist the new hires.

**Table 2: IRS Telephone Performance in the Filing Season, 2002 through 2007**

	2002	2003	2004	2005	2006	2007
<b>Telephone performance-access<sup>a</sup></b>						
Assistor level of service <sup>b</sup>	69%	82%	84%	83%	84%	83%
Average speed of answer (in minutes) <sup>c</sup>	3.8	3.1	3.3	3.9	3.0	4.2
<b>Telephone performance-accuracy<sup>d</sup></b>						
Accounts customer accuracy rate estimates	88.3%	87.9%	89.1%	91.7%	92.7%	92.9%
	+/- 0.9%	+/- 0.7%	+/- 0.8%	+/- 0.7%	+/- 0.7%	+/- 0.9%
Tax law customer accuracy rate estimates	83.5%	81.2%	75.8%	87.5%	90.2%	88.7%
	+/- 0.7%	+/- 1.0%	+/- 1.3%	+/- 1.0%	+/- 1.0%	+/- 1.5%

Source: IRS.

<sup>a</sup> Telephone performance access data are based on actual counts from January 1 to March 16, 2002; March 15, 2003; March 13, 2004; March 12, 2005; March 11, 2006; and March 10, 2007.

<sup>b</sup> Assistor level of service is the percentage of taxpayers who wanted to talk with an assistor and actually got through and received services.

<sup>c</sup> The number of minutes a taxpayer waits in queue to speak with an assistor.

<sup>d</sup> Based on a representative sample estimate at the 90 percent confidence interval for January and February 2006 and 2007. The percentage of calls in which telephone assistors provided accurate answers for the call type and took the appropriate action.

IRS officials reported that tax system changes have had minimal impact on telephone operations so far this filing season. TETR-related calls are a small fraction of what IRS projected. Between January 1 and March 10, 2007, IRS expected 7.5 million TETR-related calls, but received about 370,000. This represented 1.8 percent of total calls received by IRS.

IRS hired 650 full-time equivalents in fiscal year 2007, with the expectation that those hires would be used to cover anticipated attrition in 2008. Their first assignment was answering TETR telephone calls. They were also trained to handle other accounts calls and paper inventory should the demand for TETR assistance not materialize.<sup>12</sup>

<sup>12</sup> In addition to answering telephones, IRS's telephone assistors also work on paper correspondence, such as amended returns. According to IRS officials, staff is working more paper correspondence than anticipated. From October 1, 2006 through March 24 2007, receipts of paper inventory were up about 6 percent and IRS had closed 10 percent more paper inventory than at the same time period last year.



IRS anticipated little impact on telephone service from the split refund option and tax provision extenders. For split refunds, IRS anticipated it would receive about 7,000 calls compared to the 70 million total calls it receives each year. IRS did not have projections for tax provision extenders.

#### Use of Some Web Site Applications Continues to Increase, and Performance Remains High

Use of IRS's Web site has increased so far this filing season compared to prior years except for downloads of forms and publications and tax law questions. From January 1 through February 28, IRS's Web site was visited more often and the number of searches increased. The number of downloaded forms and publications has decreased 14 percent over the same period compared to last year. According to IRS officials, it is too early in the filing season to determine why downloads have decreased. In terms of new features, IRS added a state deduction calculator this filing season, which IRS wants to use as a new standard for developing other on line calculators. Web site assistance is important because it is available to taxpayers 24 hours a day and it is less costly to provide than telephone and walk-in assistance.

**Table 3 IRS Web Site Use, 2006 and 2007 (data are in thousands)**

Uses	2006	2007	Percentage change
Visits <sup>a</sup>	66,571	72,979	9.6
Downloads <sup>b</sup>	56,405	48,449	-14.1
Searches <sup>c</sup>	35,917	41,435	15.4
Where's My Refund <sup>d</sup>	19,776	24,724	25.0
Number of TETR-related visits <sup>e</sup>	N/A	3,283	N/A

Source: GAO analysis of IRS data.

Note: N/A means not applicable.

<sup>a</sup> Web site visits and searches and downloads from January and February 2006 and 2007. A visit begins when a visitor views their first page on IRS.gov, and ends when the visitor leaves the site. A visit is not a count of the number of unique individuals who have accessed the site.

<sup>b</sup> For January 1 through March 20, 2006, and 2007.

<sup>c</sup> Visits to a Web page specific to TETR, which was not operational in 2006. For October 1, 2006, through March 10, 2007.

In addition to the Free File program, IRS's Web site offers several important features, such as Where's My Refund, which allows taxpayers to check on the status of their refunds. This year, the feature allows taxpayers to check on the status of split refunds, and tells the taxpayer if one or more of the deposits were returned from the bank because of an

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incorrect routing or account number. However, for certain requests, the feature is not useful. For example, IRS stopped some refunds related to TETR requests, but Where's My Refund informed taxpayers that their refunds had been issued. Further, if taxpayers make a mistake calculating the amount of their refund the feature would indicate that IRS corrected the refund amount, but will not show the new amount. IRS is considering providing more information about taxpayer accounts on its Web site as part of IRS's strategy to improve taxpayer services at reduce costs.

There is further evidence that IRS's Web site is performing well as these examples show.

- According to the American Customer Satisfaction Index,<sup>13</sup> IRS's Web site is scoring above other government agencies, nonprofits, and private sector firms for customer satisfaction (74 for IRS versus 72 for all government agencies surveyed and 71 for all Web sites surveyed).
- An independent weekly study by Keynote, a company that evaluates Web sites, reported that IRS's Web site has repeatedly ranked in the top 6 out of 40 government agency Web sites evaluated in terms of average download time. Last year, IRS consistently ranked second for the same time period. Average download time remained about the same for IRS compared to last year, indicating that IRS is not performing worse but that other government agencies are performing better.
- On the basis of our own searches, we found IRS's Web site to be readily accessible, easy to navigate, and easy to search.

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<sup>13</sup> The American Customer Satisfaction Index tracks trends in customer satisfaction and is considered to be an industry leader.

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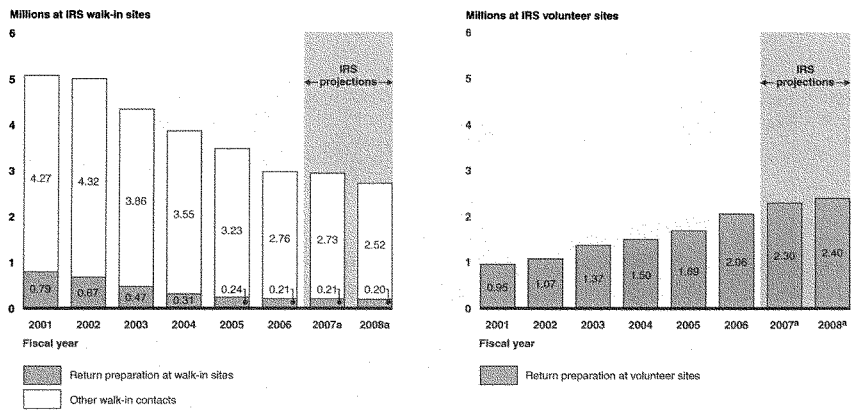
Limited Data on the  
Quality of Face-to-Face  
Assistance Show  
Improvement, but  
Concerns Remain

As of March 17, 2007, approximately 2 million taxpayers used IRS's 401 walk-in sites, which is comparable to the same period last year. Figure 2 shows the trend in walk-in site use for the entire filing season including a slight projected decline in 2007. At walk-in sites, staff provide taxpayers with information about their tax accounts, answer a limited scope of tax law questions about, for example, to income and filing status, and provide limited tax return preparation assistance.<sup>14</sup> As of March 10, 6,700 taxpayers have requested TETR on Form 1040EZ-T at walk-in sites, which is 5.3 percent of the 126,000 individuals IRS expected.

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<sup>14</sup> IRS provides limited return preparation assistance to those who meet an IRS-specified income requirement that approximates the amount for claiming the Earned Income Tax Credit or less than \$39,000.

**Figure 2: Assistance Provided at IRS Walk-in Sites and Volunteer Sites, 2001–2008 (contacts in millions)**



Source: GAO analysis of IRS data.

Notes: "Other walk-in contacts" includes assistance for account notices, tax law inquiries, forms, and compliance work, but not return preparation. For the walk-in sites, the time periods covered are December 31, 2000, through April 28, 2001; December 30, 2001, through April 27, 2002; December 29, 2002, through April 26, 2003; December 28, 2003, through April 24, 2004; and December 26, 2004, through April 23, 2005. For volunteer sites, the time period covered for 2001 is January 1, through April 21, 2001; December 30, 2001, through April 27, 2002; December 29, 2002, through April 26, 2003; December 28, 2003, through April 24, 2004; December 26, 2004, through April 23, 2005; and January 1, through April 23, 2006.

\*Fiscal years 2007 and 2008 are IRS projections. For walk-in sites, projections cover the time periods of December 31, 2006, through April 28, 2006, and January 1, through April 30, 2008. For volunteer sites, projections cover the time periods from January 1 through April 30, 2007 and 2008. For volunteer sites, projections cover the time periods from October 1 through September 30 for 2007 and 2008. According to IRS, most taxpayers having their returns prepared at volunteer sites do so during the filing season, which is from January 1 through April 30.

IRS officials attribute this year's projected decline in walk-in use to taxpayers' increased use of tax preparation software and IRS.gov. This decline has allowed IRS to devote 4 percent fewer full-time equivalents compared to last year for walk-in assistance (down from 187 to 179 full-time equivalents).

Volunteer sites, often run by community-based organizations and staffed by volunteers who are trained and certified by IRS, do not offer the range

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of services provided at walk-in sites. Instead, volunteer sites focus on preparing tax returns primarily for low-income and elderly taxpayers and operate chiefly during the filing season. The number of taxpayers getting return preparation assistance at over 11,000 volunteer sites has increased to approximately 1.3 million, up 8 percent from last year and continuing a trend since 2001. Although no projections have been made for TETR claims, over 33,000 taxpayers have claimed this credit at these locations. We have reported that the shift of taxpayers from walk-in to volunteer sites is important because it has allowed IRS to transfer time-consuming services, such as return preparation, from IRS to other less costly alternatives that can be more convenient for taxpayers.

While IRS is collecting better data on the quality of service at walk-in sites, concerns about quality of the data and service remain. According to IRS, it is measuring the accuracy of tax law and accounts assistance. IRS has reported a goal for tax law accuracy, and plans to use data collected for 2007 to set an annual goal for accounts accuracy.<sup>15</sup> While IRS provides return assistance for 125,000 taxpayers, it lacks information on the accuracy of that assistance. For volunteer sites, as of March 2, for a small non-statistical sample, IRS reported a 69 percent accuracy rate for return preparation, compared to its goal of 55 percent. Independent from IRS, but using similar methods, TIGTA showed a 60 percent accuracy rate.

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#### IRS Is Addressing TETR Compliance Issues During the Filing Season

TETR is the only one of the three tax changes that created new compliance concerns for IRS (filers could request greater TETR amounts than they are entitled to). The split refund option does not create compliance concerns for IRS since it relates to the accounts into which taxpayers want their refunds deposited rather than to complying with tax provisions.<sup>16</sup> Since the provisions extending the tax laws already existed, IRS anticipates that any compliance concerns for 2006 returns will be the same as for previous years'.

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<sup>15</sup> As of March 10, IRS reported tax law and accounts assistance accuracy rates of 74 and 85 percent respectively. However, because IRS could not provide confidence intervals for these estimates, we do not know how precise these estimates are and, whether the tax law accuracy rate of 74 percent would achieve the goal if a confidence interval were considered.

<sup>16</sup> While there are no compliance concerns, there is a potential for errors due to taxpayers entering incorrect account numbers on Form 8888 (Direct Deposit of Refund to More Than One Account) or IRS incorrectly transcribing the account numbers or the dollar amounts to be deposited into each account.

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IRS developed a plan before the filing season began, to audit suspected TETR overclaims before issuing refunds. IRS's plan for TETR was consistent with good management practices identified in previous GAO reports. IRS's plan included appointing an executive, developing an implementation plan for TETR that included standard amounts that individuals could request, developing a compliance plan to select TETR requests for audit, and monitoring and evaluating compliance by using real-time data to adjust TETR compliance efforts. For example, each week, IRS reviews the requests for TETR and selects some for audit and revises the criteria for audit selection as necessary.

As of March 24, about 211,000 individuals had requested the actual amount of telephone excise tax paid for a total of \$98.8 million. IRS selected about 5 percent of these requests for audit, involving about \$29 million.<sup>17</sup> IRS has closed four of the individual audits with the taxpayer agreeing to accept the standard amount, and has not completed the remaining individual audits or any of the business audits.<sup>18</sup> About 189,000 businesses had requested TETR for a total of about \$74.7 million. IRS selected about 560 for audit, involving about \$5.6 million. IRS reassigned about 77 full-time equivalent staff from discretionary audits and earned income tax credit audits to conduct TETR audits. Additionally, Criminal Investigation has spent 13 full-time equivalent staff on TETR activities in 2007.

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### **Paid Preparers Play a Major Role in Tax Administration but They Make Errors**

Many taxpayers choose to pay others to prepare their tax returns rather than prepare their own returns. Sixty-two percent of all the individual tax returns filed for the 2006 filing season used a paid preparer.

In most states, anyone can be a paid preparer regardless of education, training, or licensure. However, there are different types of preparers. Paid preparers who hold professional certificates include CPAs and attorneys. Other preparers vary in their backgrounds. Some have extensive training and experience and others do not.

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<sup>17</sup> According to IRS officials, as of March 17, 2007, only individuals claiming the actual amount of telephone excise tax paid have been selected for audit. None claiming the standard amount were selected for audit.

<sup>18</sup> Individuals can claim a standard amount ranging from \$30 to \$60, depending on the number of exemptions they claim or they can use Form 8913 (Credit for Federal Telephone Excise Tax Paid) to claim the actual amount paid.

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In 2003 we reported to this Committee that while many taxpayers who used paid preparers believed they benefited from doing so, some were poorly served.<sup>19</sup> Last year we reported to this Committee on errors made by commercial chain preparers, including the results of undercover visits to 19 locations.<sup>20</sup>

In our visits to 19 outlets of several commercial chain preparers, we found that paid preparers made mistakes in every one of our visits, with tax consequences that were sometimes significant. The errors resulted in unwarranted extra refunds of up to almost \$2,000 in five instances, while in two cases they cost the taxpayer over \$1,500. Some of the most serious problems involved preparers

- not reporting business income in 10 of 19 cases;
- not asking about where a child lived or ignoring our answer to the question and, therefore, claiming an ineligible child for the earned income tax credit in 5 out of the 10 applicable cases;
- failing to take the most advantageous postsecondary education tax benefit in 3 out of the 9 applicable cases; and
- failing to itemize deductions at all or failing to claim all available deductions in 7 out of the 9 applicable cases.

At the time, IRS officials responded that, had our undercover investigators been real taxpayers filing tax returns, many of the preparers would have been subject to penalties for such things as negligence and willful or reckless disregard of tax rules and some may have risen to the level of criminal prosecution for willful preparation of a false or fraudulent return. The taxpayers in these cases would also have been potentially exposed to IRS enforcement action.

The limited data did not permit observations about the quality of the work of paid tax preparers in general. Undoubtedly, many paid preparers do their best to provide their clients with tax returns that are both fully

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<sup>19</sup> GAO, *Tax Administration: Most Taxpayers Believe They Benefit from Paid Tax Preparers, but Oversight for IRS is a Challenge*, GAO-04-70, (Washington, D.C.: Oct. 31, 2003).

<sup>20</sup> GAO-06-563T.

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compliant with the tax law and cause them to neither overpay nor underpay their federal income taxes.

IRS and the paid preparer community have taken some actions as a result of our work. After we provided the results of our 19 visits to IRS, IRS determined that 4 of these cases warranted a Program Action Case. In a Program Action Case, IRS selects 30 tax returns from a preparer and audits them to look for a pattern of compliance problems. IRS officials told us that these audits would begin in April 2007. Other cases were referred to the office responsible for monitoring earned income tax credit compliance, and we have been told that 10 preparers that we visited will receive visits to check for compliance with the due diligence requirements of that program. IRS also referred the cases to the office that monitors electronic filing compliance.

We also presented our findings at all six of its nationwide tax forums last year, large educational conferences for the paid preparer community. In addition, we have been told that some tax preparation chains and preparer organizations have incorporated the results of our work into their educational materials. Finally, we recommended that IRS conduct research to determine the extent to which paid preparers live up to their responsibilities to file accurate and complete tax returns based on information they obtain from their customers. IRS officials have described plans to develop data to use to research paid preparer compliance issues, including whether tax preparers who are noncompliant themselves are more likely to prepare client returns that are noncompliant. To date, this research has not been completed. While this may be useful research, we do not believe such research would determine the extent to which paid preparers live up to their responsibilities.

Recent suits filed by the Justice Department highlight the obligations of paid preparers. The Justice Department filed suits to stop fraudulent return preparation at more than 125 outlets in four states of one preparation chain for allegedly taking part in preparation scams that led to fraudulent returns.

Because they help the majority of taxpayers prepare their returns, paid preparers are a critical quality control checkpoint for the tax system. Due diligence by paid preparers has potential to prevent non-compliance and reduce IRS's cost and intrusiveness.



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### Progress Made in BSM Implementation, but Challenges and Risks Remain

BSM is critical to supporting IRS's taxpayer service and enforcement goals and reducing the tax gap. For example, BSM includes projects to allow taxpayers to file and retrieve information electronically and to provide technology solutions to help reduce the backlog of collections cases. Despite progress made in implementing BSM projects and improving modernization management controls and capabilities, significant challenges and serious risks remain, and further program improvements are needed, which IRS is working to address.

Over the past year, IRS has made further progress in implementing BSM projects and in meeting cost and schedule commitments, but two key projects experienced significant cost overruns during 2006—CADE and Modernized e-File. During 2006 and the beginning of 2007, IRS deployed additional releases of the following modernized systems that have delivered benefits to taxpayers and the agency: CADE, Modernized e-File, and Filing and Payment Compliance (a tax collection case analysis support system). Each of the five associated project segments that were delivered during 2006 were completed on time or within the targeted 10 percent schedule variance threshold, and two of them were also completed within the targeted 10 percent variance threshold for cost. However, one segment of the Modernized e-File project as well as a segment of the CADE project experienced cost increases of 36 percent and 15 percent, respectively. According to IRS, the cost overrun for Modernized e-File was due in part to upgrading infrastructure to support the electronic filing mandate for large corporations and tax-exempt organizations, which was not in the original projections or scope.

IRS has also made significant progress in implementing our prior recommendations and improving its modernization management controls and capabilities, including efforts to institutionalize configuration management procedures and develop an updated modernization vision and strategy and associated 5-year plan to guide information technology investment decisions during fiscal years 2007 through 2011. However, critical controls and capabilities related to requirements development and management and post implementation reviews of deployed BSM projects have not yet been fully implemented. In addition, more work remains to be done by the agency to fully address our prior recommendation of developing a long-term vision and strategy for completing the BSM program, including establishing time frames for consolidating and retiring legacy systems. IRS recognizes this and intends to conduct further analyses and update its vision and strategy to address the full scope of tax administration functions and provide additional details and refinements on the agency's plans for legacy system dispositions.

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Future BSM project releases continue to face significant risks and issues, which IRS is taking steps to address. IRS has reported that significant challenges and risks confront its future planned system deliveries. For example, delays in deploying the latest release of CADE to support the current filing season have resulted in continued contention for key resources and will likely impact the design and development of the next two important releases, which are planned to be deployed later this year. The potential for schedule delays, coupled with the reported resource constraints and the expanding complexity of the CADE project, increase the risk of scope problems and the deferral of planned functionality to later releases. Maintaining alignment between the planned releases of CADE and the new Accounts Management Services project is also a key area of concern because of the functional interdependencies.<sup>21</sup> The agency recognizes the potential impact of these project risks and issues on its ability to deliver planned functionality within cost and schedule estimates and, to its credit, has developed mitigation strategies to address them. We will, however, continue to monitor the various risks IRS identifies and the agency's strategies to address them and will report any concerns.

IRS has also made further progress in addressing high-priority BSM program improvement initiatives during the past year, including efforts related to institutionalizing the Modernization Vision and Strategy approach and integrating it with IRS's capital planning and investment control process, hiring and training 25 entry-level programmers to support development of CADE, developing an electronic filing strategy through 2010, establishing requirements development/management processes and guidance (in response to our prior recommendation), and defining governance structures and processes across all projects. IRS's high-priority improvement initiatives continue to be an effective means of assessing, prioritizing, and incrementally addressing BSM issues and challenges. However, more work remains for the agency to fully address these issues and challenges.

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<sup>21</sup>Accounts Management Services (AMS) is a strategic project intended to deliver improved customer support and functionality by leveraging existing IRS applications and new technologies to bridge the gap between modernization initiatives, such as CADE, and legacy systems. AMS is to enhance CADE by providing applications for IRS employees and taxpayers to access, validate, and update accounts on demand. The development and implementation of the AMS project is also essential to enabling CADE to accept more complicated tax returns and to deal with taxpayer issues. AMS project releases are to provide functional components synchronized with the CADE development schedule as well as other components delivered independent of the CADE schedule.

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In addition, we recently reported that IRS could improve its reporting of progress in meeting BSM project scope (i.e., functionality) expectations by including a quantitative measure in future expenditure plans.<sup>22</sup> This would help to provide Congress with more complete information on the agency's performance in implementing BSM project releases. IRS recognizes the value of having such a measure and, in response to our recommendation, is in the process of developing it.

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### Continued Research Is Essential to Estimating the Impact of IRS's Service and Enforcement on Compliance and the Tax Gap

Continued compliance research is essential to IRS's ability to effectively focus its service and compliance efforts, and we have long been a supporter of such research. Well designed compliance research gives IRS and Congress an important measure of taxpayer compliance and it allows IRS to better target enforcement resources towards noncompliant taxpayers. Taxpayers benefit as well, because properly targeted audits mean fewer audits of compliant taxpayers and more confidence by all taxpayers that others are paying their fair share.

IRS develops its tax gap estimates by measuring the rate of taxpayer compliance—the degree to which taxpayers complied with their tax obligations fully and on time. That rate is then used, along with other data and assumptions, to estimate the dollar amount of taxes not timely and accurately paid. For instance, IRS most recently estimated a gross tax gap of \$345 billion for tax year 2001 and that underreporting of income represented over 80 percent of the gap.<sup>23</sup> IRS developed these estimates using compliance data collected through its 2001 NRP study, which took several years to plan and execute.

In that study, IRS reviewed the compliance of a random sample of about 46,000 individual taxpayers and used those results to estimate compliance for the population of all individual taxpayers and identify sources of noncompliance. IRS also used the 2001 NRP results to update its computer models for selecting likely noncompliant tax returns and used that model to select cases beginning with returns filed in 2006. IRS's fiscal year 2008 budget request states that this improved targeting of audits has increased

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<sup>22</sup>GAO-07-247.

<sup>23</sup> IRS has concerns with the certainty of the overall tax gap estimate in part because some areas of the estimate rely on old data and IRS has no estimates for other areas of the tax gap. For example, IRS used data from the 1970s and 1980s to estimate underreporting of corporate income taxes and employer-withheld employment taxes.

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dollar-per-case yield and reduced "no change" audits of compliant taxpayers. IRS now has a second NRP study underway, this one looking at 5,000 S corporation tax returns filed in 2003 and 2004.<sup>24</sup>

IRS's fiscal year 2008 budget request includes a proposal for a rolling NRP sample of individual taxpayers and a dedicated cadre of examiners to conduct these research audits. Using a rolling sample, IRS plans to replicate the 2001 NRP study by conducting audits of a smaller sample size. At the end of 5 years, IRS would have a comparable set of results to the 2001 study and continue to update the study annually by sampling the same number of taxpayers, dropping off the oldest year in the sample, and adding the new years' results every year. We support this approach. In previous GAO products, we have observed that doing compliance studies once every few years does not give IRS or others information about what is happening in the intervening years, and that a rolling sample should reduce costs by eliminating the need to plan entirely new studies every few years or more and train examiners to carry them out.<sup>25</sup> Compliance research in this way will also give Congress, IRS, and other stakeholders more frequent and more current information about IRS's progress towards its long term compliance goals.

Mr. Chairman, this concludes my prepared statement. We would be happy to respond to questions you or other members of the Committee may have at this time.

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## Contacts and Acknowledgments

For further information regarding this testimony, please contact James R. White, Director, Strategic Issues, at 202-512-9910 or [whitej@gao.gov](mailto:whitej@gao.gov) or David A. Powner, Director, Information Technology Management Issues at 202-512-9296 or [pownerd@gao.gov](mailto:pownerd@gao.gov). Contacts for our Offices of Congressional Relations and Public Affairs may be found on the last page

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<sup>24</sup> IRS has no estimates for other areas of the tax gap, and it is inherently difficult to measure some types of noncompliance. The tax gap estimate for areas such as corporate income tax and employer-withheld employment tax underreporting rely on decades-old data.

<sup>25</sup> GAO, *Internal Revenue Service: Assessment of the Interim Results of the 2006 Filing Season and Fiscal Year 2007 Budget Request*, GAO-06-499T (Washington, D.C.: Apr. 27, 2006); *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753 (Washington, D.C.: July 18, 2005); and *Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies*, GAO-05-527T (Washington, D.C.: Apr. 14, 2005).

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of this statement. Individuals making key contributions to this testimony include Joanna Stamatiades, Assistant Director; Amy Dinger; Timothy D. Hopkins; Robyn Howard; Matthew Kalmuk; David L. Lewis; Frederick Lyles; Jennifer McDonald; Signora May; Veronica Mayhand; Paul B. Middleton; Sabine R. Paul; Cheryl Peterson; Neil Pinney; Shellee Soliday; and Tina L. Younger.



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May 11, 2007

The Honorable Max Baucus  
Chairman  
The Honorable Charles E. Grassley  
Ranking Member  
Committee on Finance  
United States Senate

The Honorable Orrin G. Hatch  
United States Senate

Thank you for the opportunity to testify before your Committee at the April 12, 2007, hearing "Filing Your Taxes: An Ounce of Prevention Is Worth a Pound of Cure." Enclosed are our answers to the questions for the record that we received after the hearing. We have not done substantial work to provide answers for Chairman Baucus questions 9, 14, 17, 18, 25-32, 34, 35, 43 and believe either the IRS or Treasury Inspector General for Tax Administration is in a better position to provide answers. Also, after discussions with your staff, we agreed not to answer questions 7 or 10.

If you require any additional information, or if we can be of further assistance, please feel free to contact James R. White on (202) 512-9110 or David A. Powner on (202) 512-9286.

James R. White  
Director, Tax Issues  
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Enclosure

**Responses to April 17, 2007, Questions from the Senate Committee on Finance**

Our responses to questions from Chairman Baucus, Senator Grassley, and Senator Hatch have been combined where appropriate.

**Questions from Chairman Baucus**

**Question 1, Senator Grassley Question 6, and Senator Hatch Question 2: What are the primary impediments to increasing the use of electronic filing? How can they be mitigated? What opportunities exist for increasing electronic filing? In your view, what would it take for IRS to meet the goal of having 80 percent of all tax returned filed electronically? Is it achievable, say in the next four or five years?**

The best opportunity for increasing the use of electronic filing (e-filing) relate to taxpayers whose individual income tax returns are prepared on a computer but then printed and filed on paper.

In 2006, 73 percent of the 58 million paper individual tax returns were prepared on a computer but then filed on paper. These tax returns are known as v-coded because IRS codes them with a "v" in order to track them. Paid tax preparers prepared over two-thirds of v-coded returns.

Taxpayers who file v-coded returns are an attractive target for conversion to e-filing because these taxpayers or their preparers already use computers to prepare their returns, a prerequisite for e-filing. If 76 percent of the v-coded returns had instead been e-filed in 2006, IRS would have met the 80 percent goal.

According to an IRS Oversight Board survey conducted in 2006, some taxpayers reported not feeling comfortable filing taxes electronically. These taxpayers reported not having confidence that the Internet is secure or their privacy is protected. Also, these taxpayers cited other reasons, including the complexity of the Internet, e-filing fees, and a desire to use paper.

Opportunities for increasing electronic filing exist:

- Last year, IRS officials stated that the agency was considering creating a secure electronic mailbox to help convert v-coders to e-filing. Preparers could send a return to the mailbox, and the taxpayer could review and sign it and then e-file it with IRS. Alternatively, the taxpayer could send the return back to the preparer for further work before e-filing.
- Last year, we reported that mandates have demonstrated success in increasing electronic filing; for example, state mandates for electronic filing of state tax returns have increased electronic filing of both state and federal tax returns.<sup>1</sup> According to

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<sup>1</sup>GAO, *Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for*

IRS officials, this increased growth is because paid tax prepares converted their entire practices to electronic filing. Because mandates drive significant electronic filing increases, we suggested that the Congress should mandate electronic filing by paid tax prepares meeting criteria such as a threshold number of returns filed.

**Questions 2, 3, and Senator Grassley Question 8: What are the potential benefits from a federal I-file system for individual income tax returns? What lessons from states' experiences with I-file systems should be kept in mind when considering developing such a system? As you know, some on this Committee are proponents of Internet return preparation and filing, also known as I-file. Your recent report is cautious on the benefits and costs to states that have developed their own I-file systems. What are the potential benefits from a federal I-file system and what lessons should be kept in mind when considering developing such a system?**

We recently reported that I-file systems generate benefits by increasing electronic filing and reducing filing fees for taxpayers.<sup>2</sup> Specifically, the benefits to tax agencies include reducing the costs of processing paper returns plus reducing the related costs of math and transcription errors and contacting the taxpayers about such errors. Taxpayers who convert from paper to electronic filing because of the availability of I-file receive the benefits of electronic filing, such as faster refunds. Some taxpayers would benefit by not having to respond to notices for math errors, by having lower compliance burdens, and by getting electronic confirmation that the tax agency received their returns. Some may also benefit by saving on electronic filing fees.

For the eight states we profiled, I-file benefits and costs were relatively modest.<sup>3</sup> While state I-file systems generated benefits, such as increased electronic filing, the overall benefits were limited by low usage, which ranged from about 1 percent to just over 5 percent of all taxpayers. For the states we profiled, it was unclear whether the benefits were greater than the costs. The available data, combined with the decision by three states to discontinue their I-file systems, raise the possibility that in at least some states benefits were less than costs. If such a system were to be considered for federal taxes, both the benefits and costs for IRS could be different than we found for the states. IRS's benefits would depend on the extent that paper filers could be converted to I-filing. IRS's costs could be higher than the states' for several reasons. IRS would have to build a transactional Web site with the associated security costs, something several states we profiled had in place prior to developing their I-file systems. The federal tax code is more complex than states' codes. Many of the states we profiled had excess capacity in the computer systems and taxpayer support operations, which reduced the costs of building and operating their I-file systems. IRS officials told us that the agency does not

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*Additional Savings*, GAO-07-27 (Washington, D.C.: Nov. 15, 2006).

<sup>2</sup>These potential benefits are described in GAO, *Taxpayer Service: State Experiences Indicate IRS Would Face Challenges Developing an Internet Filing System with Net Benefits*, GAO-07-570 (Washington, D.C.: Apr. 5, 2007), 18-22, 32-49.

<sup>3</sup>GAO-07-570, 18, 25-26.



have such excess capacity.

**Questions 4 and 5: How long would it take for IRS or an outside contractor to design, install and implement a direct portal? What is the estimated cost of a direct portal with (a) fillable .pdf files, and (b) .html with simple calculators?**

The time and costs to design, install, and implement a direct IRS portal would depend on a number of factors specific to IRS. One factor would be the details of the design of an IRS portal. Such details include whether it would include return preparation or only e-filing, the types of taxpayers and tax returns eligible, and features such as the ability to save a partially completed return or import data from prior years' returns. Decisions about the extent of ancillary services, such as taxpayer education, marketing, and help desk assistance, would also affect costs. Another factor would be the time and cost of developing a transactional Web site, something IRS does not currently have but that many of the states we profiled had before developing their I-file systems. Transactional Web sites have additional security and other costs. A third factor influencing the time and cost of development would be the extent IRS could make available the management attention needed for developing a portal. While IRS has made noteworthy progress improving its systems management capability, it has had a history of cost increases and schedule delays that led us to designate systems modernization as high risk. In 2005, we reported that balancing the scope and pace of modernization activities with IRS's ability to manage them remained a challenge.<sup>4</sup> Crucial management controls and capabilities have still not yet been fully implemented or institutionalized. Before proceeding, IRS would need to consider the impact of a program to develop a portal on its existing portfolio of systems development projects.

State experiences with the time and cost of developing their I-file systems may not provide a basis for estimating IRS's time and costs to develop a portal. The state systems' included return preparation, whereas an IRS portal might or might not include return preparation. In many of states we profiled, I-file systems were built using excess systems capacity. According to IRS officials, the agency does not have such excess capacity.

**Question 6 and RMM Grassley Question 3: Are there lessons that could be learned for how IRS handled TETR claims that could be applied to other issues? Mr. White, the implication of your statement is that compliance with TETR is not a serious concern. Are there lessons that could be learned for how IRS handled TETR claims that could be applied to other issues?**

IRS could use the good management practices that it used to manage TETR when managing other programs. These management practices are described in our recent report.<sup>5</sup> In addition, although IRS has completed some audits resulting in the claimants

<sup>4</sup>GAO, *High-Risk Series: An Update*, GAO-05-207 (Washington, D.C.: January 2005).

<sup>5</sup>GAO, *Tax Administration: Telephone Excise Tax Refund Requests Are Fewer Than Projected and Have Had Minimal Impact on IRS Services*, GAO-07-695 (Washington, D.C.: Apr. 11, 2007), 3-4, 20-21, 33.

receiving smaller refunds than originally claimed, it is too early to determine whether there are serious compliance concerns related to TETR.

**Question 8: Are IRS filters to detect fraudulent Telephone Excise Tax Refunds (TETR) adequate to stop false refunds from being issued? Will special processes be required to recoup incorrect refunds that have been issued, and, if so, please describe what they are?**

Similar to other deductions and credits, without auditing every TETR claim, IRS cannot ensure that no fraudulent TETR claims are made or false refunds issued. IRS has had a process in place for the beginning of the filing season to flag certain TETR claims as suspicious claims, and subsequently auditing such claims. IRS officials said they set the criteria for suspicious claims taking into account the opportunity costs of transferring staff from other audits. According to IRS officials, once a TETR is issued, the refund is not subject to the processes IRS usually follows to request repayment of an incorrect refund. For overpaid TETR refunds, IRS would have to file a case in the District Court in order to obtain repayment and the Department of Justice would have to agree to accept the case. After that process, IRS could offset the tax liability against the next year's refund.

**Questions 11 and 12: IRS increasingly is relying on volunteers to prepare tax returns for low-income and elderly people. A TIGTA sample found a 100 percent error rate of volunteer-prepared returns. What is IRS doing to enhance the quality of volunteer tax preparation? Describe IRS support and oversight efforts at volunteer tax preparation sites. How does IRS test and measure service and accuracy at volunteer sites? What are the most recent accuracy rates for volunteer tax preparers?**

Based on TIGTA reports, the accuracy rates for return preparation at sites staffed by volunteers have improved from 0 percent for the 2004 filing season to 56 percent for the 2007 filing season.<sup>6</sup> However, these rates are based on very small nonstatistical samples—fewer than 40 in any year out of the 2 million prepared each year. Because of the sampling method used and variations in the number of returns reviewed, caution should be exercised when making generalizations about the overall improvement in the accuracy and quality of returns prepared at VITA sites.<sup>7</sup>

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<sup>6</sup> The rate for 2007 is based on a 2004 TIGTA audit wherein it sampled 35 returns for accuracy and found errors in all returns.

<sup>7</sup> While nonprobability sampling, such as that conducted by both TIGTA and IRS, is a viable option to determine the presence of a condition in a population, the conclusions drawn from the method only allow statements about the sample units selected.

TIGTA VITA Site Accuracy Rates by Year

Year	2004	2005	2006	2007
Number of returns reviewed	35	35	36	39
Accuracy rate (percentage)	0	34	39	56

Source: TIGTA.

In addition, for the 2007 filing season, to enhance the quality of volunteer tax preparation, IRS began implementing a quality review plan to ensure that each volunteer site meets IRS's minimum site requirements for quality. IRS has begun conducting three types of reviews:

- **site reviews**, which it uses to determine if its sites are following prescribed administrative procedures;
- **return reviews**, which are onsite reviews used to assess the accuracy of returns; and,
- **shopping reviews**, which involve unannounced visits by IRS reviewers posing as taxpayers.

We have not yet assessed the results of these reviews for this filing season.

**Question 13 and Senator Grassley Question 5: Identify the five up-front actions (before or during return filing) that IRS could take to most effectively improve tax compliance? What up-front actions (before or during return filing) could IRS or Congress take to increase compliance?**

We previously reported that multiple approaches are needed to reduce the tax gap and improve tax compliance.<sup>8</sup> Specifically the tax gap could be reduced by (1) simplifying or reforming the tax system; (2) providing IRS additional enforcement authority and tools, such as information reports and tax withholding, through changes to the tax laws; and (3) devoting additional resources to enforcement under the existing tax laws.

Further, we identified specific areas where additional withholding or information reporting requirements could help improve compliance by requiring

- tax withholding and more or better information return reporting by organizations that make payments to independent contractors for services provided;
- information return reporting on payments made to corporations for services provided; and,
- reporting the purchase price, or other cost basis data, as well as the sales price for stocks and bonds, on information returns dealing with capital gain.<sup>9</sup>

<sup>8</sup>GAO, *Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap*, GAO-07-488T (Washington, D.C.: Feb. 16, 2007).

<sup>9</sup>GAO, *Tax Gap: Multiple Strategies, Better Compliance Data, and Long Term Goals are Needed to Improve Taxpayer Compliance*, GAO-06-208T (Washington, D.C.: Oct. 26, 2005).

Finally, it is widely acknowledged that effective tax administration requires a combination of taxpayer service and enforcement. Although the exact mix is unknown, in its 2008 budget request, IRS is researching the impact of taxpayer service on improving voluntary compliance.

**Question 15: What message do you think it sends to other preparers when IRS fails to take prompt action even on such high-profile cases? Isn't this a missed opportunity for IRS?**

Although the indirect effect of IRS enforcement programs on voluntary compliance is unknown, several research studies suggest that indirect revenue might exceed direct revenues gained.<sup>10</sup> Still, IRS must balance the resources it spends on high-profile cases with the resources it spends on all other enforcement actions. As with all enforcement actions, the more resources it spends in one area, the less it has to spend in others. Even if it spends resources on high-profile cases, IRS can only publicize these cases if they pass the point at which sensitive tax information can be disclosed.

**Questions 16, 22, 24, 33, and 41; Senator Grassley Questions 4 and 7; and Senator Hatch Question 3: Given the importance of paid preparers in our tax administration system, would it be useful for IRS to devote more resources to oversight of the paid preparer industry? Are IRS preparer oversight efforts sufficient to protect taxpayers from unscrupulous or incompetent preparers? Given that there may be as many as 1 million preparers, do you think this level of investigation by IRS is sufficient to detect and deter bad behavior and incompetence? How would increased regulation of paid preparers, including competency standards and continuing education, improve the quality of tax preparation? What effect might tax preparer registration have on tax fraud prevention initiatives, and do you favor this approach? Given the importance of paid preparers in our tax administration system, would it be useful for IRS to devote more resources to oversight of the paid preparer industry? What additional research should IRS be doing on paid preparers, and how might that include compliance? Do you think we should make legislative changes regarding paid preparers?**

In 19 visits to commercial tax return preparers for our testimony last year, paid preparers often prepared returns that were incorrect, with tax consequences that were sometimes significant.<sup>11</sup> However, our limited review and the problems we found did not allow us to generalize about the quality of work of paid preparers. Nevertheless, we noted that paid preparers are a critical quality control check point in the tax system and they may make errors throughout a filing season on many returns. Further, taxpayers who are given bad advice by paid preparers may spread that misinformation among their friends and

<sup>10</sup>GAO-07-488T.

<sup>11</sup>GAO, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T (Washington, D.C.: Apr. 4, 2006).

neighbors. Therefore, we recommended that the Commissioner of Internal Revenue conduct necessary research to determine the extent to which paid preparers live up to their responsibility to file accurate and complete tax returns based on information they obtain from their customers. After, IRS could determine the causes of those problems. Once the causes are determined, decision makers would have better information for deciding whether IRS should devote more resources to oversight of the area, otherwise enhance its oversight efforts, take more action to deter bad behavior, do more research, or obtain more help through legislative change.

**Question 19: Two years ago, IRS abandoned plans to shutdown 70 Taxpayer Assistance Centers. What are IRS's current and future plans for Taxpayer Assistance Centers?**

As part of the Taxpayer Assistance Blueprint (TAB) Phase II, IRS has developed what it calls an Optimization Methodology to determine which TACs provide the best coverage rates for its three target populations.<sup>12</sup> IRS estimates that this methodology will result in the elimination of at least 6 of its TACs. TAB Phase II also presents a scenario to relocate 100 TACs, and says it will consider a TAC's capacity to cover a target population, cost of renting a space, and so forth when making such decisions. However, TAB Phase II does not provide details as to which TACs would be closed or provide a time frame indicating when it would begin closing TACs.

**Question 20: How can a taxpayer really know whether his tax preparer is competent?**

We testified last year that taxpayers can take common sense steps when choosing or working with paid preparers, such as:

- when searching for a preparer, obtain recommendations from people you trust;
- check out your preparer's qualifications;
- make sure you understand the services you will be getting, how much they cost, and how much they will benefit you;
- make sure your preparer understands your personal circumstances and reviews your official tax documents; and
- review your completed return before you sign it.<sup>13</sup>

**Questions 21 and 24: What are the three primary actions IRS is taking to ensure that tax preparers are generating accurate tax returns? How many preparers did IRS investigate last year?**

<sup>12</sup>According to Phase II, coverage rate is defined as the proportion of a specified target population that is within a given distance of the nearest TAC. Distance is defined in terms of approximate travel time and uses 30 minutes for the distance radius. IRS defined its target populations as taxpayers with low-income returns, taxpayers with problem returns, and the estimated total 2006 population.

<sup>13</sup>GAO-06-563T.

IRS operates three offices that oversee paid tax preparers.

First, the Office of Professional Responsibility (OPR) administers the rules set forth in Department of the Treasury Circular 230.<sup>14</sup> Circular 230 governs paid preparers who choose to represent taxpayers before IRS. OPR may censure, suspend, or disbar any practitioner from practice before IRS if the practitioner violates any Circular 230 regulation, is shown to be incompetent or disreputable, or misleads or threatens a client with intent to defraud. OPR receives complaints from taxpayers and IRS employees regarding tax preparers. We testified last year that in fiscal year 2005 OPR investigated 719 practitioners, resulting in 320 sanctions.<sup>15</sup>

Second, IRS's Small Business/Self-Employed Division is responsible for assessing and collecting monetary penalties against paid preparers that do not comply with civil tax laws when filing returns. The American Jobs Creation Act of 2004 added the authority to impose a monetary penalty on a practitioner who violates section 230, and an employer or firm if it knew, or should have known, of the misconduct.<sup>16</sup>

Third, IRS's Criminal Investigation Division (CI) investigates paid preparers suspected of violating criminal tax laws. According to IRS, CI uses many techniques, including its undercover program, search warrants, and local law enforcement to pursue investigations of unscrupulous return preparers. As we testified last year, in fiscal year 2005, CI conducted 248 investigations under its Return Preparer Program, with 140 of the investigations resulting in recommended prosecutions.<sup>17</sup>

**Question 23: What is the number of paid tax preparers?**

Without registration or some indication of who is actively engaged in tax return preparation, available data do not permit a precise count of paid preparers. We testified generally last year about the numbers of various kinds of paid tax return preparers.<sup>18</sup> According to IRS officials, as of March 2006, several hundred thousand certified public accountants and attorneys were authorized to practice before IRS, and there were about 41,000 active enrolled agents.<sup>19</sup> In 2003, the National Taxpayer Advocate said the number

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<sup>14</sup>Department of the Treasury, Circular No. 230, *Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the Internal Revenue Service* (Washington, D.C.: June 20, 2005).

<sup>15</sup>GAO-06-563T.

<sup>16</sup>Pub. L. No. 108-357, October 22, 2004.

<sup>17</sup>GAO-06-563T.

<sup>18</sup>GAO-06-563T.

<sup>19</sup>Enrolled agents are approved by IRS once the agents pass an examination on tax matters or demonstrate past IRS employment experience.

of unenrolled preparers ranged from 300,000 to 600,000. On the basis of scanning major preparation company Web sites for our testimony last year, we know the major preparation companies have thousands of offices nationwide. In most states, anyone can be a paid preparer regardless of training and licensure.

**Question 36: GAO characterized access to IRS's telephone assistors as being stuck in the low 80 percent range for 5 years now. Does this mean that IRS thinks an 80 percent level of service is acceptable?**

IRS officials have noted that they set and try to achieve performance goals according to the budget received and approved by the Congress. For the past 2 years, IRS has established a goal of 82 percent for access to telephone assistors. IRS officials note that during the filing season they work to reach, but not necessarily exceed, this goal. To fully determine if this level of service is appropriate, IRS would need to examine the costs and benefits of increasing access to telephone assistors.

**Question 37: What was the impact of the delay in the implementation of CADE on 2007 filing season processing?**

As we reported in our written testimony before this Committee, IRS had originally planned to post 33 million taxpayer returns on the Customer Account Data Engine (CADE) and the remaining 100 million individual returns on the legacy Master File system.<sup>20</sup> However, as a result of the 2-month delay in deploying the latest release of CADE, IRS officials expect to post far fewer taxpayer returns on CADE during the 2007 filing season. Taxpayers eligible for a refund this year whose returns are posted to CADE will benefit from faster processing, receiving their refunds 1-5 days faster for direct deposit and 4-8 days faster for paper checks than if their returns had been processed on the legacy system. Many of the returns that were to have been posted on CADE have been processed by the legacy system and thus did not receive the benefit of faster refunds.

**Question 38: How does this year's delay and possible delays in future releases of CADE, affect other systems, including the Accounts Management Services?**

In our testimony, we reported that maintaining alignment between the planned releases of CADE and the new Accounts Management Services (AMS) project is a key area of concern because of the functional interdependencies.<sup>21</sup> AMS project releases are to provide functional components synchronized with the CADE development schedule. As a result, delays in the delivery of future releases of CADE and/or the deferral of planned CADE functionality to later releases or both will likely directly affect IRS's ability to

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<sup>20</sup> GAO, *2007 Tax Filing Season: Interim Results and Updates of Previous Assessments of Paid Preparers and IRS's Modernization and Compliance Research Efforts*, GAO-07-720T (Washington, D.C.: Apr. 12, 2007), 6.

<sup>21</sup> GAO-07-720T, 22.

deliver planned AMS functionality.

**Question 39: What, if any, impact has the delay had on the planned functionality of future releases of CADE?**

Our testimony also noted that delays in deploying the latest release of CADE have resulted in continued contention for key resources and will likely affect impact the design and development of the next two important releases, scheduled to be deployed later this year.<sup>22</sup> Reported resource constraints and the expanding complexity of the CADE project increase the risk of deferring functionality. It is too early to know, however, the specific impact of the recent delay on the planned functionality of future CADE releases. According to IRS, the CADE project team is replanning the next two releases (3.1 and 3.2) and assessing the impact on subsequent future releases of CADE.

**Question 40: What assurances can you give us that the causes of these problems are being addressed and will not surface again?**

We cannot provide any assurances that the causes of the problems associated with the CADE delay will not surface again because some of these causes stem from systemic weaknesses with IRS's internal management capacity and contractor performance. We know, however, that IRS is working to address them. Specifically, IRS recently determined the causes of the delay and identified solutions for addressing them. Officials told us they are working on these solutions.

**Question 42: Has the GAO preparer investigation revealed any significant new quality control elements that could be implemented by the tax preparer community?**

Because the sample we used in our paid preparer work last year was limited, we have no basis for generalizing about effective quality control elements. However, we have been told that some tax preparation organizations have incorporated the results of our work into their educational materials. To the extent that a particular preparer organization finds other changes justified, it could increase its centralized monitoring and in-depth reviews of local offices' performance and its use of use of field audits, centralized monitoring, and secret shoppers posing as taxpayers.

**Questions from Senator Grassley:**

**Questions 1-2 and 9: Mr. Powner, last year, IRS paid hundreds of millions of dollars in improper tax refunds because IRS's new Electronic Fraud Detection System failed and IRS lacked a contingency plan. In March, a release of the Customer Account Data Engine (CADE)—a critical processing system—was put into production 2 months behind schedule. The technical complexity of CADE is expected to increase with each release. Do you believe that these incidences are symptomatic of systemic problems with IRS's ability to effectively manage**

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<sup>22</sup> GAO-07-720T, 22.



**its systems? Based on your review of the BSM program, what confidence do you have in IRS's ability to successfully manage development of this and other systems?**

We believe these incidences are symptomatic of systemic problems with IRS's ability to effectively manage its systems, which we and the TIGTA have been reporting on for the past few years. However, IRS has been working to address these problems. In addition, it has improved its ability to identify and address them early on. Specifically, IRS has established a fairly rigorous governance process for its modernization program that includes monthly executive-level reviews of projects' status, risks, and issues. IRS has indicated that one key issue that reportedly contributed to the failure of EFDS is that the project was not managed within the same rigorous governance process that has been established for the major modernization projects. As a result, the severity of the technical risks and issues affecting EFDS did not receive the proper high-level management attention until very late. In an effort to rectify this and to try to prevent similar failures in the future, IRS is now extending its governance process across all information technology projects, including EFDS. In the case of CADE, while IRS attributed the recent delay of the project to weaknesses in internal management and contractor performance, these problems were identified relatively early through the modernization governance process, and according to officials, they are being addressed.

With respect to the BSM program, as we reported in our testimony, IRS continues to make progress in deploying additional releases of modernized systems (e.g., CADE, Modernized e-File, and Filing and Payment Compliance) and meeting cost and schedule commitments.<sup>23</sup> IRS has also made significant progress in implementing our prior recommendations and improving its modernization management controls and capabilities. However, critical controls and capabilities related to requirements development and management and postimplementation reviews of deployed BSM projects have not yet been fully implemented. In addition, IRS has reported that significant challenges and risks confront its future planned system deliveries. Therefore, although IRS is making progress, we are not confident it will successfully deliver future releases of CADE until the weaknesses in management controls and capabilities are fully addressed and the challenges and risks facing the program are no longer significant.

**Questions from Senator Hatch:**

**Question 1: Mr. White, you mentioned the importance of gathering compliance data so we can more accurately measure the tax gap. Can you comment on the National Research Program and whether you think this will lead to the kind of data we need to maximize compliance and reduce the tax gap?**

Resumption of systematic compliance research with the 2001 NRP is an important step. Such research gives IRS and Congress an important measure of taxpayer compliance and

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<sup>23</sup> GAO-07-720T, 21.

it allows IRS to better target enforcement resources toward noncompliant taxpayers. GAO has long been a supporter of such research. It is important, however, for IRS to move forward with additional research because the compliance landscape is not static. The nature of noncompliance changes, and so must IRS's efforts to identify and pursue that noncompliance to reduce the tax gap. As we noted above, IRS's fiscal year 2008 budget request includes a proposal for a rolling sample of individual returns (small annual samples that would replace larger but intermittent efforts) and a dedicated cadre of examiners to review the returns. We reported that we consider this to be a good approach to refreshing research compliance data because doing compliance studies once every few years does not provide information in the intervening years.<sup>24</sup> A rolling sample should also reduce costs by eliminating the need to plan new studies every few years.

**Question 4: Could you elaborate on your comments concerning IRS's efforts to modernize its information technology? Can we see the light at the end of the tunnel in finally getting the systems up and running and working effectively?**

Although IRS has made progress modernizing its information technology, more work remains to deploy additional releases of CADE, Modernized e-File, and other projects. In addition, future project releases are expected to be increasingly more complex, making it more challenging to ensure they are delivered successfully. Finally, more work remains to be done by IRS to fully address our prior recommendation of developing a long-term vision and strategy for completing the BSM program, including establishing time frames for consolidating and retiring legacy systems. Therefore, although initial releases have been deployed successfully, fully modernizing IRS's technology remains a long-term endeavor.

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<sup>24</sup> GAO-07-720T.

## COMMUNICATIONS

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### AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

#### STATEMENT SUBMITTED TO SENATE FINANCE COMMITTEE

#### Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure April 12, 2007

The American Institute of Certified Public Accountants thanks the Senate Finance Committee for the opportunity to submit this statement for the record of the public hearing on "Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure," held on April 12, 2007. For purposes of this hearing, we are pleased to provide comments on legislative initiatives designed to address both tax administration and the tax gap.

The AICPA is the national, professional organization of certified public accountants comprised of approximately 330,000 members. Our members advise clients on federal, state, and international tax matters and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, and small and medium-sized businesses, as well as America's largest businesses.

#### GENERAL COMMENTS

The AICPA commends the Senate Finance Committee for its focus on tax administration and tax gap initiatives. We also welcome the opportunity to join in a public/private partnership in developing an "overall strategy" to address the tax gap, like the one proposed by the IRS Oversight Board; and we are ready to provide our expertise and input in tackling the estimated \$290 billion net tax gap. We are committed to this common effort of mitigating the tax gap and fostering efficient tax administration. In this context, we are pleased to announce that the AICPA plans to survey our Tax Section members in the next few weeks to assess the perspective of CPAs on ways to address the tax gap.

The AICPA notes the Senate Finance Committee's significant work on tax administration and tax gap initiatives, particularly the measures contained in last year's committee bill (S. 1321), the Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006. And, we acknowledge that the Finance Committee has continued these efforts in 2007 through hearings and legislation, including (H.R. 2) the Small Business and Work Opportunity Act.

The AICPA would be pleased to share our views with the Finance Committee at any time on any of the tax administration provisions contained in S. 1321 or in bills currently pending in the Senate (like H.R. 2). At this time, we are providing comments on 5 provisions contained in S. 1321: (1) the understatement of taxpayer's liability by tax return preparers; (2) the penalty for

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<sup>1</sup> In general, (H.R. 2) the Small Business and Work Opportunity Act was added on March 27, 2007 on the Senate floor as a second-degree amendment to the Kennedy amendment (SA 680) which then became part of the (S. 1591) the U.S. Troops Readiness, Veterans' Health and Iraq Accountability Act.

aiding and abetting the understatement of tax liability; (3) the doubling of certain penalties, fines, and interest on underpayments relating to certain offshore financial arrangements; and (4) two proposals involving Internal Revenue Code sections 6713 and 7216.

***Tax Penalties and the Tax Gap***

A number of legislative proposals involving tax penalties are being raised in 2007 under the guise of closing the tax gap. Similarly, numerous proposals contained in S. 1321 involve tax penalties; and such proposals are beginning to resurface as tax gap initiatives. In this context, we are concerned that many of these penalty proposals are being raised by Congress and the Administration in a narrow, rifle-shot perspective. Instead, we believe greater levels of tax compliance could be achieved among the public if Congress established a legislative oversight process similar to that which was used to enact the Improved Penalty Administration and Compliance Tax Act, which ultimately became law as part of the Omnibus Budget and Reconciliation Act of 1989. The fundamental purpose of the 1989 penalty reform was to overcome the piecemeal approach to legislating penalty changes.

In our opinion, establishing a broad legislative oversight (penalty) review process would not only achieve higher levels of tax compliance, but should also result in greater numbers of taxpayers believing that tax fairness has been achieved. This is consistent with a 2006 statement by J. Russell George, Treasury Inspector General for Tax Administration (TIGTA), that "...it is often difficult to ascertain whether a taxpayer has intentionally evaded taxes, or whether there was an honest misunderstanding. Therefore, the IRS use of punitive penalties must be tempered to ensure taxpayers are not penalized for honest misunderstandings."<sup>2</sup>

Prior to the passage of the 1989 tax penalty reforms, penalties were seen by taxpayers and tax professionals as (1) an IRS tool for punishing taxpayers and a bargaining chip in examinations and (2) a means of raising revenues for the U.S. Treasury. Before 1989, penalties were also viewed as being applied unevenly in differing regions of the U.S., as well as lacking in coordination and overlapping in application.<sup>3</sup> Representative J.J. Pickle, one of the main proponents of penalty reform at the time, viewed the 1989 reform measures as fairer and less complex than the current penalty regime, and an inherent extension of tax reform and simplification.<sup>4</sup>

**1. Understatement of Taxpayer's Liability by Tax Return Preparers (S. 1321, Section 407)**

The bill makes a number of modifications to the tax return preparer penalties under sections 6694 and 6695 of the Internal Revenue Code. Under this proposal, the scope of present law

<sup>2</sup> Statement of the Honorable J. Russell George, Treasury Inspector General for Tax Administration, on "A Closer Look at the Size and Sources of the Tax Gap, Before the Senate Finance Committee, Subcommittee on Taxation and IRS Oversight, July 26, 2006; see document section entitled, "Reduce the Complexity of the Code."

<sup>3</sup> "Tax Politics and a New Substantial Understatement Penalty," by Dennis J. Ventry, Jr., Tax Notes Today, October 3, 2006.

<sup>4</sup> *Ibid.*

preparer penalties are broadened to cover the preparation of estate and gift tax, employment tax, excise tax, and exempt organization returns. The AICPA supports this extension in the scope of the preparer penalties and believes such penalty expansions should increase tax compliance.

The standards of conduct for avoiding imposition of the penalties for preparing a return with respect to an understatement of tax are also altered under the proposal. First, the current law realistic possibility standard for *undisclosed positions* is replaced with a requirement that the preparer have a reasonable belief that a potential position to be taken on a return is more likely than not the proper treatment. For *disclosed positions*, the provision replaces the non-frivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position. Further the bill imposes a penalty on a tax return preparer for the portion of a claim for refund or credit that is disallowed if there is no reasonable basis for the disallowed portion of such claim for refund or credit.

We think this shift in the standards of conduct is unwise and thus, we do not support the shift. For an undisclosed position on a return, the AICPA believes that the tax return preparer should have a good faith belief that the tax return position being recommended has a realistic possibility of being sustained administratively or judicially on its merits, rather than the higher “more likely than not” standard. In general, under this standard, the preparer should have a good faith belief that the taxpayer’s position is warranted by existing law or can be supported by a good faith argument.

The AICPA is concerned that elevating the reporting standard for tax return preparers on **all return items** to the very highest standard that now is imposed only on tax shelter items – the “more likely than not” standard – would ultimately become an unworkable burden for the entire tax system. This elevation would not necessarily create the desired result of weeding out abuses in the system but would create the unintended consequence of encouraging tax return preparers to recommend that taxpayers consider filing disclosures on virtually any return item on which there is the slightest question of uncertainty in the ultimate tax result. Clearly, this is not a desired outcome, nor is it likely to focus attention on potentially abusive tax avoidance transactions. The IRS would be swamped with paper; e-filing would be undermined; important disclosures would be overlooked; and a large percent of these voluminous disclosures would be meaningless.<sup>5</sup>

We do not believe that a change in the preparer standard for routine transactions is warranted. In a self-assessment system such as ours, taxpayers are expected to report their transactions in accordance with the rules prescribed by the income tax laws. However, given the complexity of our tax laws and the many issues awaiting administrative guidance from the Treasury Department and the IRS, Congress has wisely built flexibility into the system to allow for reasonable interpretations of the law’s many gray areas without the threat of having penalties imposed where such interpretations are challenged by the IRS and tax deficiencies assessed.

The current notion that the taxpayer should bear ultimate responsibility for the contents of the tax return is the proper rule, since we believe the preparer is generally not in the position to

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<sup>5</sup> See “IRS Seeing Overdisclosure of Reportable Transactions, Officials Say,” by Crystal Tandon, Tax Notes Today, October 12, 2006.

determine the correctness or completeness of all information being placed on the return. This is consistent with Circular 230, section 10.34(c) which states “A practitioner advising a client to take a position on a return, or preparing or signing a tax return as a preparer, *generally may rely in good faith without verification upon information furnished by the client.*” [Emphasis added.]

The AICPA also has serious concerns about replacing the current non-frivolous standard for a disclosed position on a return with the requirement that there be a reasonable basis for the tax position. As long as a position is not advanced in bad faith or improper, i.e. the position is not frivolous, a preparer should generally be able to prepare and sign a return as long as the position is appropriately disclosed on the return.

The Federal tax law is always changing and as a result, there is often limited or no authority or guidance for a particular return position at the time the return is filed. Even if there is some authority, it may be extremely difficult for taxpayers and preparers to know the probable correctness of many return positions given the exceedingly complex and dynamic nature of the tax law.

It is not only unrealistic, but in many cases impossible, to ensure the high degree of accuracy required should Congress pass legislation imposing a “more likely than not standard” on preparers in the case of undisclosed positions or even a “realistic possibility of success” standard for disclosed positions. We believe that the unfortunate result will be that taxpayers will be forced to avoid otherwise meritorious positions on their returns or make voluminous boilerplate disclosures that will not improve the overall compliance process.

We would also like to point out a troubling anomaly under the proposal. If these changes are enacted, the tax return preparer’s reporting standard would exceed the taxpayer’s reporting standard (substantial authority) for **most** transactions. As a result, a tax return preparer could be subject to a section 6694 penalty even though the taxpayer was not penalized. Historically, the preparer standard has been below that of the taxpayer in order to provide an environment where taxpayers have access to the full range of competent, professional advice necessary to navigate through a very complicated tax system. Elevating the preparer standard above the taxpayer standard, particularly for routine transactions, is quite troubling in that the preparer could not sign a tax return reflecting a position that would be proper if the taxpayer prepared the tax return without professional assistance.

Additionally, the bill increases the section 6694(a) penalty (understatements due to unrealistic positions) from \$250 to the greater of \$1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer from the preparation of a return or claim with respect to which the penalty is imposed. Moreover, the legislation increases the section 6694(b) penalty (willful and reckless conduct) from \$1,000 to the greater of \$5,000 or 50 percent of the income derived (or to be derived) by the tax preparer. Based on the lack of empirical evidence indicating that the current flat-dollar penalty is not effective, we do not support the proposed increases in these two section 6694 preparer penalties. Rather we support retaining the two-tier, flat dollar penalty under current law. We believe that deterrence for preparers results, not from a dollar penalty, but from the possible adverse impact on the ability to practice and on their reputation for integrity and ethical behavior.

**2. Penalty for Aiding and Abetting the Understatement of Tax Liability (S. 1321, Section 408)**

This proposal expands the scope of the section 6701 “aiding and abetting” penalty. In general, the proposal applies the penalty: (1) to aiding and abetting that occurs with respect to a tax liability reflected in a tax return and (2) for each instance of aiding and abetting; and (3) it increases the amount of the penalty to a maximum of 100 percent of the gross income derived (or to be derived) from the aiding and abetting. The AICPA is not opposed to these modifications in the penalty as we believe the modifications should encourage an increase in tax compliance and will likely act as an economic deterrence for persons susceptible to wrong-doing.

The provision also states that if more than one person is liable for the penalty, all such persons will be jointly and severally liable for the penalty. As a general proposition, we do not have a problem with the imposition of joint and several liability on persons subject to the section 6701 penalty. However, we believe the legislative language should be clarified with respect to the impact of joint and several liability on members of professional firms that are organized as a limited liability company, S corporation, or a partnership. As currently drafted, the language is not clear as to whether (under certain circumstances) all members of a professional firm could be determined to be liable for the penalty without regard to their actual conduct or knowledge. We recommend that the legislation clarify that: (1) the members of a firm who have little or no knowledge of the advice or transactions in question are not subject to joint and several liability under the penalty and (2) the penalty should not be treated as a simple firm (entity) debt such that all members of the firm would be liable for the debt.

**3. Doubling of Certain Penalties, Fines, and Interest on Underpayments Related to Certain Offshore Financial Arrangements (S. 1321, Section 410)**

This proposal is intended to stem the promotion of, and participation in, certain abusive offshore financial arrangements by both individuals and corporations. The provision doubles the amount of civil penalties, interest, and fines related to a taxpayer’s underpayment of U.S. income tax liability through the direct or indirect use of certain offshore financial arrangements.

The AICPA is very supportive of legislative efforts to stem the use of abusive tax schemes and the imposition of sanctions to encourage and accomplish this goal. However, we offer the following comments with regard to this proposal; a provision that is also found in section 208 of S. 349, the Small Business and Work Opportunity Act of 2007.

This proposal provides that penalties arising from these transactions shall be imposed without regard to the reasonable cause relief provisions under current Code section 6664. In effect, the provision imposes a strict and absolute penalty. An exception to this strict liability concept is available if it is determined that the use of such offshore payment mechanisms is incidental to the transaction and, in addition, in the case of a trade or business, such use is conducted in the ordinary course of the type of trade or business of the taxpayer.

As a fundamental principle, the AICPA is opposed to strict liability penalties because such penalties are unduly harsh and don't allow for an abatement due to reasonable cause (such as to reflect a taxpayer's inadvertent actions). We believe that taxpayers may become involved in transactions that they do not envision as abusive. At the same time, the IRS may determine that these same transactions fall outside of the taxpayer's "ordinary course" of business and are considered abusive. In such situations, the imposition of a strict liability penalty may not necessarily result in the desired outcome of stemming the participation in abusive schemes. We believe that fairness and effective tax administration require the IRS to retain discretion in assessing this penalty. This discretion should provide for a more reasonable and effective implementation of the proposal and protect taxpayers who may have made an inadvertent error.

Section 410(a)(2)(A)(i)(II) defines transactions as including "any offshore financial arrangement (including any arrangement with foreign banks, financial institutions, corporations, partnerships, trusts, or other entities)." The breath of this language appears to reach beyond the identified abuse of unreported income in offshore financial accounts accessed through credit or debit cards or other financial arrangements in order to avoid or evade Federal income tax. Accordingly, the definition of "offshore financial arrangement" is a critical issue under the proposal; and thus, the term should be further clarified so as not to be overly broad. The breadth of the current language ought to make Congress very reluctant to prescribe a "strict liability" penalty regime which eliminates a taxpayer's right, in the context of a reasonable cause showing, to demonstrate that its conduct and/or the transaction was not abusive.

#### **4. Internal Revenue Code Sections 6713 and 7216**

##### ***Background***

The legislative proposals addressed below are in some significant respects more restrictive and potentially problematic than those contained in the proposed IRS regulations.<sup>6</sup> The AICPA submitted extensive comments on the proposed regulations on March 8, 2006 and urged the IRS to further engage the professional tax advisor community before finalizing the regulations. We similarly urge Congress to seek input from advisors and taxpayers alike on the practical impacts and, in many cases, impediments associated with the legislative proposals in S. 1321.

In particular we encourage Congress to carefully evaluate the wisdom of regulating the disclosure arena through the vehicle of criminal sanctions. In our view a civil penalty regime is a more effective way to encourage compliance and influence behavior. Civil penalties provide the IRS with an opportunity to modulate its reaction to account for inadvertent, and/or isolated incidents of noncompliance. One possible alternative would be to look to Internal Revenue Code section 6713 as the home for the general rules in this area while reserving Code section 7216 to address preparer behavior that would satisfy the "knowing or reckless" standards that are required to justify criminal sanctions.

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<sup>6</sup> See proposed amendments to the regulations under Section 7216 of the Internal Revenue Code, Federal Register Volume 70, Number 235, December 8, 2005, page 72954.



**a. *Expanded Definition of Return Preparer for Purposes of Sections 6713 and 7216 (S. 1321, Section 511)***

For purposes of sections 6713 and 7216, the provision replaces the current definition of tax return preparer with a broader definition. First, the definition is expanded to generally include the preparation of all types of tax returns, instead of to just income tax returns. Second, the definition is expanded to include any person who assists in preparing tax returns for compensation or holds himself out as preparing or assisting in the preparation of returns, regardless of whether preparation is the person's sole business activity or whether a fee is charged for the return preparation. Third, the provision expands the definition of tax return preparer to include (among others): (1) persons who develop tax software; (2) electronic return originators (EROs); and (3) contractors who perform services in connection with return preparation.

The AICPA agrees that it is appropriate to bring all types of federal tax returns within the scope of the return preparation definition. We also agree that it is appropriate for the return preparation definitions to acknowledge and encompass the roles played by those associated with tax return software development and deployment as well as other third party service providers who are associated with return preparation. Thus, we believe the expanded definitions are appropriate. We are concerned, however, that an expanded definition of the term "tax return preparer" for purposes sections 6713 and 7216 might cause confusion with definition of tax return preparer under other Tax Code sections. Accordingly, we suggest that the drafters of the legislation consider using a different term for parties subject to the disclosure rules of sections 6713 and 7216.

**b. *Restrict the Use and Disclosure of Taxpayer Information by Return Preparers for Non-Tax Purposes and Offshore Disclosures (S. 1321, Section 512)***

Overall, we believe this provision introduces unnecessary burden and complexity that is at odds with well established modern business practices. Furthermore, we are concerned the proposal has the potential to actually undermine the range and quality of professional tax services available to many taxpayers. We understand the Congressional concerns that emanate from instances in which unscrupulous or unethical return preparers have abused their access to tax return information and the AICPA remains resolute in its commitment to the privacy of taxpayers' return information. However, if this proposal were to pass in its current form, it would reverberate well beyond the offensive conduct at which it is aimed and negatively impact the fundamental relationships between taxpayers and their chosen professional advisors.

***Disclosure for Non-tax Purposes***

Under the proposal, a taxpayer may not consent to have its tax advisor use or disclose return information for a purpose other than return preparation. This is a highly unusual, if not unprecedented, restraint on taxpayer judgment and choice. In the name of stamping out the potential for some range of abusive use or disclosure, the provision outlaws a wide spectrum of normal, informed and ethical practices that have long been at the heart of the professional relationships between many taxpayers and their tax advisors.

Advisors are often engaged by clients precisely because of the breadth of skills and services they and their firms are capable of providing. Reg. section 301.7216-2(e)(1) generally permits the disclosure of use of tax return information by attorneys and accountants “without [the] formal consent of the taxpayer” when such information is disclosed to another member of the preparer’s firm for purposes of rendering other legal or accounting services to the taxpayer; that is, services that are other than the preparation of the tax return. This regulation section also states that in “the normal course of rendering” legal or accounting services for the taxpayer, the attorney or accountant may make the tax return information available to third parties “with the express or implied consent of the taxpayer.” For example, the tax return information may generally be provided by the tax preparer to another professional in the accounting firm or to a third party in order to (1) render estate planning, financial planning, or investment services to the client, (2) respond to requests from lenders to the client’s family or business, or (3) to provide a client’s stockholders or management with appropriate financial information.

This is a long established and well founded rule. We believe that taxpayers who select an attorney or accountant as a return preparer often do so because they **expect** the attorney or accountant to act upon the information obtained during return preparation to ensure that the client is properly advised with respect to specific return positions as well as other aspects of the client’s tax planning and compliance needs, including the client’s business and personal financial affairs. To legislate away a taxpayer’s right to authorize a trusted advisor to use or disclose tax return information, regardless of the taxpayer’s needs, desires and willingness to provide such informed consent, can result in the taxpayer being under-served by its current advisors or forced to go through the expense and inconvenience of engaging tax advisors who play no role in return preparation. Clearly this cannot be the public policy result that best serves either taxpayers or the tax system as a whole.

We suggest that the proposal be modified to acknowledge the reality that CPAs and attorneys are already subject to a higher level of ethical standards. As an example, the AICPA Statements on Standards of Tax Services (SSTS) lay out in explicit detail the obligations that are incumbent on the CPA/return preparer. We urge the committee to acknowledge the reality of the professional expectations and duties that underpin the relationships between taxpayers and their lawyers and accountants. In that context we believe taxpayers should not be denied the ability to consent to their advisors use and disclosure of tax return information.

#### ***Offshore Disclosure***

The legislative proposal would preclude the disclosure or use of information to or by any tax return preparer located outside of the United States unless the taxpayer grants explicit consent to such disclosure. The proposal further specifies the type of consent required to authorize such a disclosure. This proposal tracks proposed IRS regulations insofar as it calls for taxpayers to be informed by an explicit consent that would employ conspicuous language which, among other things, informed clients their information will be disclosed/located outside the U.S. and that federal law may not protect the taxpayer from unauthorized use. This proposal would require taxpayers and advisors to employ the same consent regime regardless of the nature of the disclosure or use involved. As an example, it would treat disclosures and use among and

between affiliated firms or to trusted international third parties the same as disclosures made to totally unknown or unrelated parties.

While the Institute recognizes the special issues and sensitivity that potentially accrue to the international movement of return information we do not believe the proposal adequately recognizes the world within which modern accounting and legal advice is rendered. Our clients operate and have employees and interests all over the world. Any regulation of the movement of tax information should acknowledge and be in step with the best global business practices of our clients and the tax advisory profession. At the very time in which the capital markets and policy makers call for additional transparency in financial reporting, a consent regime like that inherent in this proposal will unnecessarily complicate the process by which professionals and their multinational clients provide and receive crucial financial reporting advice.

The current proposal is significantly out of step with the roles that many accounting firms currently perform for their multinational business clients. Most business clients consciously choose advisors who are able to provide multinational services. It is very typical for a tax professional located in the U.S. working on the tax return of a U.S. or non-U.S. multinational company with offices in the United States and overseas, to consult with a tax professional located overseas in order to properly complete the company's tax return. In such a circumstance it would seem counterproductive to require specific consents --- complete with their warnings that information may not be able to be protected --- in order to essentially place the advisor in a position to do the job it was engaged to do. Given the additional interplay among and between audit and tax firms who are called upon to advise their clients in such areas as the implementation of FIN 48, any artificial wall built at the country's edge can only make it more difficult for firms to efficiently serve their multi-national clients.

The proposed legislation will also negatively impact on the processes by which the thousands of U.S. expatriates stationed around the world employed by U.S. and non-U.S. multinational companies, and an ever growing number of foreigners employed in the United States, are served. These taxpayers often have very complex tax filing requirements in their host countries and in the United States. To assist them in meeting their various tax filing obligations, multinational employers typically employ a U.S. based CPA firm to prepare tax returns for their employees for each jurisdiction. U.S. based firms are familiar with U.S. laws and regulations and are subject to the jurisdiction of the IRS and the U.S. courts. At the same time, U.S. based tax practitioners are generally not familiar with the preparation of foreign tax returns for their expatriate clients, and may frequently find themselves expected by their clients to ensure that the foreign firm has the necessary return information to ensure the employee files an accurate return.

There are two other aspects of the proposal that we believe are problematic and noteworthy. First, the limitations on disclosure -- including the proposed approaches to consent -- do not recognize or adequately reflect the various forms under which large accounting and legal firms are organized in today's global market. Second, that part of the proposal that relates to the form of the required consents for international disclosure creates a significant misimpression. The proposal would require that clients be warned in a way that could suggest the advisor has no responsibility or recourse for wrongful disclosures. In fact firms with global capabilities have

adopted an entire range of sophisticated business protocols to ensure that they can enforce a broad spectrum of information security-related contractual obligations and duties.

The proposal appears more designed to address, at least in part, the concerns of those who want to prevent outsourcing of U.S. jobs. Even with respect to such concerns, it should be noted that, unlike other circumstances in which jobs are located abroad primarily to reduce labor costs, many accounting firms employ international resources because of staffing challenges in the U.S. The return preparation business has long been confronted by intense workload compression issues that derive from the peak-season nature of their business. A law that constructs artificial barriers to the use of international resources to augment domestic return preparation capabilities will make it difficult for some advisors to meet the needs of their current clients.

#### *Alternative Approaches*

For purposes of the disclosure or use of tax return information by tax preparers involving multinationals and employees on overseas assignments, we recommend that the tax preparer (or advisor) use an engagement letter that would: (a) explicitly identify the extent to which tax information may go offshore during the preparation/consultation process, (b) require some form of specific acknowledgement within the engagement letter that affirms the client's understanding that its information may leave the country, and (c) a statement on the part of the accountant as to its ethical and legal responsibility to reasonably ensure that no unauthorized disclosure occurs.

As a point of reference, the AICPA has adopted three ethics rulings which address a member's responsibilities when utilizing services of a third-party service provider. In general, a third-party service provider is defined as any entity that an AICPA member individually or collectively with his firm, does not control and any individual who is not employed by the CPA member or his firm. Accordingly, the AICPA standards apply to all independent contractors used by the firm; regardless of whether the contractor is situated within the United States or overseas.

Our ethics ruling under Rule 102, *Integrity and Objectivity*, of the AICPA Code of Professional Conduct requires that, prior to sharing confidential client information (such as a tax return) with a third-party service provider, the AICPA member must inform the client, preferably in writing, that he or she may be using a third-party service provider when providing professional services to the client. In addition, our ethics ruling under Rule 201, *General Standards*, and Rule 202, *Compliance With Standards*, states the AICPA's longstanding belief that members who use third-party service providers in providing professional services to clients remain responsible for the work performed by the service provider.

**National Association of Enrolled Agents<sup>1</sup>**  
**Comments for the Record**  
**Senate Finance Committee Hearing**  
***Filing Your Taxes: an ounce of prevention is worth a pound of cure***  
**April 12, 2007**

Mr. Chairman, Ranking Member Grassley and the members of the Committee on Finance, thank you for this opportunity to submit comments for the record. The National Association of Enrolled Agents (NAEA) is the premier organization representing the interests of the 46,000 enrolled agents (EAs) across the country. EAs are the only practitioners for whom the IRS directly attests competency and ethical behavior. NAEA is dedicated to increasing the professionalism of its members and the integrity of the tax administration system as a whole. In this capacity, NAEA endorsed Senator Jeff Bingaman's legislation, S. 832<sup>1</sup>, reported out of this committee in the second session of the 109<sup>th</sup> Congress.

Each year, it seems as if we see more and more news stories about either unscrupulous or simply incompetent tax return preparers. Some of these paid preparers are overstating deductions or fabricating Schedules C in order to maximize earned income credits. Others are looking the other way when it comes to cash income or even selling financial products – including refund anticipation loans and IRAs – of dubious value.

The situation has recently reached a point where the entire industry – both current Circular 230 practitioners and the unenrolled – needs to get behind strong federal level reforms as quickly as possible. Should federal action not occur soon, we face the strong probability that individual states may step forward to clean up this problem in a piecemeal fashion.

As alarming as the recent headlines have been, however, they tend to miss an equally troubling trend: forum shopping. Our members regularly report that taxpayers select preparers based on their ability to maximize a taxpayer's refund (to the detriment of both the tax administration system and the Treasury). Enrolled agents increasingly see taxpayers pick up their records and end the professional relationship once the EA begins asking due diligence questions with respect to the return. These taxpayers then move on down the street looking for a preparer who will not be as scrupulous and will "pump-up" their refund. Signs posted in the windows of unlicensed tax preparers making outrageous guarantees on refunds, such as "Come to us and we promise you \$1,000 back from Uncle Sam," are now a common sight in many cities. Suddenly the taxpayer is taking phony home office or business deductions, or finding long lost children.

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<sup>1</sup> Senator Bingaman introduced S. 832, The Taxpayer Protection and Assistance Act of 2005 (<http://thomas.loc.gov/cgi-bin/query/D?c109:1:./temp/-c109A5nUQM:>), on April 18, 2005.

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The message to taxpayers, and frankly to unlicensed preparers, is "everyone is doing it and you are crazy if you don't." As practitioners licensed to practice before IRS, we too often end up representing these taxpayers once IRS catches up with them. Unfortunately, unlicensed paid return preparers are just as often ignored by regulatory bodies governing competency and/or ethical behavior. It is our contention that addressing the issue of cheating on one's taxes is essential to maintaining, and even to restoring, taxpayer faith in a fair and equitable tax collection system.

To address this situation, Mr. Chairman, we urge the committee to move expeditiously to report out once again S. 832, requiring all paid tax return preparers to demonstrate competency and ethical standards through licensure and continuing education.

NAEA believes that such legislation will greatly aid all taxpayers, but especially low income taxpayers, in complying with the tax code by helping to ensure access to competent and ethical tax preparation services. In her 2006 annual report, the National Taxpayer Advocate noted that over 61 percent of the 130 million individual taxpayers paid return preparers to prepare their returns. She further stated, "Although the exact number is unclear, it is likely that unenrolled preparers handled a large percentage of those returns."<sup>2</sup> Shockingly, the Taxpayer Advocate noted in her 2003 annual report that at least 57 percent of EITC earned income overclaims were attributable to returns prepared by unlicensed paid preparers<sup>3</sup>, resulting in billions of dollars in lost revenue to the government.

NAEA supported S. 832 in the 109<sup>th</sup> Congress because we believe the bill would have ensured the integrity of the tax system by promoting licensed tax professionals to the general public and ensuring strong enforcement against the unlicensed and unethical. The key reasons for our unqualified support for the legislation are as follows:

**A. Contributed significantly to taxpayer access to competent and ethical tax preparation services**

The legislation would have required all paid preparers to pass an exam testing their understanding of basic tax laws and ethical standards. Further, paid preparers would have had to undergo annual continuing education and be subject to the ethical requirements of Circular 230.

This would have helped ensure that only qualified and ethical individuals would be preparing returns.

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<sup>2</sup> National Taxpayer Advocate's 2006 Annual Report to Congress, page 197.

<sup>3</sup> More specifically, "Of the \$11 billion of EITC overclaims identified in the Tax Year 1999 EITC compliance study, over 57 percent was attributable to returns prepared by paid preparers." National Taxpayer Advocate's 2003 Annual Report to Congress, page 271.

**B. Built on the existing regulatory framework and consolidated enforcement under one entity**

Rather than constructing a parallel regulatory framework and enforcement entity for different groups of paid preparers, the legislation would have consolidated all persons preparing returns (attorneys, CPAs, EAs, and other paid preparers) under the current regulations (Circular 230) and the existing Office of Professional Responsibility. In other words, there would have been one code of ethics, coordinated exams that would allow for advancement within the profession, and standardized continuing education requirements all administered centrally.

We believe that this consolidation would have ensured uniformity of standards and enforcement across all preparers.

**C. Ensured adequate resources for administration, promotion and – most importantly – for enforcement**

The legislation would have allowed OPR to retain all registration fees for administration of the program, including policing all practitioners and preparers under its jurisdiction. Most importantly, the authorization to retain these fees would have ensured that the office had adequate resources to investigate and penalize unlicensed individuals.

Additionally, the bill would have authorized OPR to retain penalties administered under the program for promotion of all Circular 230 preparers to the general public. This would have assisted the public in understanding the importance of retaining only licensed individuals for tax preparation and would also have assisted the public in understanding the difference between the various categories of persons allowed to prepare tax returns for hire.

**D. Struck the correct balance for creating a new tax practice credential**

Congress needs to be cognizant of the ramifications of creating a new credential in the world of tax administration. Currently, the general public is presented with three options for individuals that are licensed to practice before IRS: attorneys, certified public accountants and enrolled agents. Circular 230 is very specific as to how these individuals may advertise and generally present themselves to the public. A credential that implies a higher level of authority and competency than merely preparing basic individual tax returns would cause confusion and undermine the general intent of the legislation.

Since the passage of the IRS Restructuring and Reform Act, there has been a great deal of confusion as to the credentials and *bona fides* of Electronic Return Originators or EROs. IRS has issued signage denoting official endorsement of individuals qualifying as EROs, as well as financed a public awareness campaign in support of the program. Anecdotal evidence (the appearance of billboards and bus stop signage) in poorer neighborhoods

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demonstrates the danger of presenting to the public confusing titles or credentials that overstate competency.

Additionally, state regulators would be very leery if not outright hostile to the creation of a new credential in the accounting/tax preparation marketplace. States regulate the use of credentials and many list a litany of titles (e.g., certified tax consultant, chartered accountant, registered accountant) and abbreviations likely or intended to be confused with CPA that may not be used. After years of conflict, the majority of state boards of accountancy have accepted that a person recognized by IRS as being enrolled may use the enrolled agent name and EA abbreviation. Creating nomenclature that might overstate the intended mission is quite likely to re-ignite this battle, and at the very least potentially counter the underlying intent of the legislation.

Finally, NAEA strongly opposes the grandfathering of any paid return preparers not currently regulated by Circular 230. The unenrolled should not be exempted from the testing requirements of S. 832. Congress needs to be very cautious when creating any new credential, which would be perceived by the public as an endorsement by the federal government of the competency and integrity of a paid preparer. The government has the duty to ensure that anyone holding this credential has in fact met the requirements for eligibility. Logically, the fact that an unregulated preparer is presently doing business simply does not speak to the crucial question of whether he or she is doing business competently, and with integrity. Any provision for broad grandfathering of paid return preparers would put in question the legitimacy of such a credential and would potentially cause great harm to taxpayers who relied on the government's judgment in granting it.

In closing, Mr. Chairman and members of the committee, the National Association of Enrolled Agents and its members stand prepared to work with you and IRS in ensuring a strong tax administration system and improving voluntary compliance.

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<sup>i</sup> The **National Association of Enrolled Agents (NAEA)** is the professional society representing enrolled agents (EAs), which number some 46,000 nationwide. Its 12,000+ members are licensed by the U.S. Department of the Treasury to represent taxpayers before all administrative levels of the Internal Revenue Service (IRS), including examination, collection and appeals functions.

While the enrolled agent license was created in 1884 and has a long and storied past, today's EAs are the only tax professionals tested by IRS on their knowledge of tax law and regulations. They provide tax preparation, representation, tax planning and other financial services to millions of individual and business taxpayers. EAs adhere to a code of ethics and professional conduct and are required by IRS to take Continuing Professional Education. Like attorneys and certified public accountants, enrolled agents are governed by Treasury Circular 230 in their practice before IRS.

Since its founding in 1972, NAEA has been the enrolled agents' primary advocate before Congress and the IRS. NAEA has affiliates and chapters in 42 states. For additional information about NAEA, please go to our website at [www.naea.org](http://www.naea.org).



**Senate Finance Committee**

**Statement for the Record**

**National Society of Accountants  
1010 North Fairfax Street  
Alexandria, VA 22314**

**April 12, 2007**

**Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure**

The National Society of Accountants (NSA) is a voluntary association of certified public accountants, enrolled agents, licensed public accountants, other licensees of state Boards of Accountancy, tax practitioners who are licensed by state agencies, and accountants and tax practitioners who hold credentials from a nationally recognized credentialing body. NSA and its affiliated state organizations represent more than 30,000 practitioners who provide accounting advisory and tax related services to more than 19 million individuals and small businesses while voluntarily subscribing to a strict code of professional and ethical conduct.

It is precisely because of our long-standing commitment to professional conduct and continuing education that we were troubled to learn of the recent allegations lodged against individuals operating as franchisees of the nation's second largest tax preparation firm. NSA appreciates the opportunity to comment on the issues and to again urge the Committee to pass NSA's suggested legislation to regulate professional tax preparers.

The Committee is well aware that there is a large body of tax preparers who do not belong to any professional organization. The commitment of these individuals to ethics, professionalism, and continuing education is unknown but the recent allegations should spur members of this body to enact legislation to establish broader regulation of firms and individuals who prepare federal income tax returns. This issue was addressed in the last Congress in S. 832 and we urge members of the Committee to consider introducing a similar bill this year. We believe this would have a major impact on addressing the types of issues that necessitated this hearing.

S. 832 proposed new regulation for the federal tax preparation industry. This legislation would have had a significant impact on the profession and the Internal Revenue Service. Estimates of the number of tax practitioners required to register in the first year of the program range from 200,000 to as high as 600,000. S. 832 instructed the Treasury Department to develop and administer an eligibility examination designed to test the knowledge and technical competency of individuals who prepare federal tax returns. Importantly, rather than developing a new examination, the bill also adopted NSA's recommendation to give the Treasury Department and the IRS the authority to approve examinations offered by nationally recognized credentialing bodies such as the Accreditation Council for Accountancy and Taxation.

NSA has a long-standing policy that favors additional regulation of tax preparers provided certain principled concepts are enacted including the following:

1. A separate administrative entity should be established to examine and register tax preparers.
2. A professional tax preparer must have taken and passed a national examination, whether offered by the Treasury Department or by a nationally recognized credentialing body such as the Accreditation Council for Accounting and Taxation.
3. A requirement for ongoing continuing professional education and registration renewal every three years to ensure that such educational standards are met.
4. A waiver of initial examination for individuals who are recognized under regulations issued by the Treasury Department as:
  - a. Holding current credentials offered by nationally recognized credentialing bodies; or
  - b. Holding a current license to practice accountancy from a Board of Accountancy in any state; or
  - c. Holding a current license to practice law in any state; or
  - d. Holding a tax return preparation license established under state law.
5. The clarification of the Enrolled Agent credential.
6. Using the title "Registered Federal Tax Return Preparer" or similar term as a descriptor.

NSA recognizes that this regulatory structure may take a two to three year time period to develop and implement. We have taken the liberty of preparing a model bill that uses S.832 as a base but adds the concepts outlined above. A copy is attached.

We ask that the Committee give serious consideration to this proposal and are confident that prompt enactment would preclude the necessity of holding a similar hearing in the future.

**(Model)****Taxpayer Protection and Assistance Act of 20xx****SECTION 1. SHORT TITLE**

- (a) Short Title- This Act may be cited as the "Taxpayer Protection and Assistance Act of 20xx".
- (b) Amendment of 1986 Code – Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

**SEC. 2. LOW-INCOME TAXPAYER CLINICS.**

- (a) Grants for Return Preparation Clinics-
  - (1) IN GENERAL- Chapter 77 (relating to miscellaneous provisions) is amended by inserting after section 7526 the following new section:

**`SEC. 7526A. RETURN PREPARATION CLINICS FOR LOW-INCOME TAXPAYERS.**

- `(a) In General- The Secretary may, subject to the availability of appropriated funds, make grants to provide matching funds for the development, expansion, or continuation of qualified return preparation clinics.
- `(b) Definitions- For purposes of this section--
  - `(1) QUALIFIED RETURN PREPARATION CLINIC-
    - `(A) IN GENERAL- The term 'qualified return preparation clinic' means a clinic which--
      - `(i) does not charge more than a nominal fee for its services (except for reimbursement of actual costs incurred), and
      - `(ii) operates programs which assist low-income taxpayers, including individuals for whom English is a second language, in preparing and filing their Federal income tax returns, including schedules reporting sole proprietorship or farm income.
    - `(B) ASSISTANCE TO LOW-INCOME TAXPAYERS- A clinic is treated as assisting low-income taxpayers under subparagraph (A)(ii) if at least 90 percent of the taxpayers assisted by the clinic have incomes which do not exceed 250 percent of the poverty level, as determined in accordance with criteria established by the Director of the Office of Management and Budget.
  - `(2) CLINIC- The term 'clinic' includes--
    - `(A) a clinical program at an eligible educational institution (as defined in section 529(e)(5)) which satisfies the requirements of paragraph (1) through student assistance of taxpayers in return preparation and filing,
      - and

- (B) an organization described in section 501(c) and exempt from tax under section 501(a) which satisfies the requirements of paragraph (1).
- (c) Special Rules and Limitations-
- (1) AGGREGATE LIMITATION- Unless otherwise provided by specific appropriation, the Secretary shall not allocate more than \$10,000,000 per year (exclusive of costs of administering the program) to grants under this section.
- (2) OTHER APPLICABLE RULES- Rules similar to the rules under paragraphs (2) through (7) of section 7526(c) shall apply with respect to the awarding of grants to qualified return preparation clinics.'
- (2) CLERICAL AMENDMENT- The table of sections for chapter 77 is amended by inserting after the item relating to section 7526 the following new item:  
'Sec. 7526A. Return preparation clinics for low-income taxpayers.'
- (b) Grants for Taxpayer Representation and Assistance Clinics-
- (1) INCREASE IN AUTHORIZED GRANTS- Section 7526(c)(1) (relating to aggregate limitation) is amended by striking '\$6,000,000' and inserting '\$10,000,000'.
- (2) USE OF GRANTS FOR OVERHEAD EXPENSES PROHIBITED-
- (A) IN GENERAL- Section 7526(c) (relating to special rules and limitations) is amended by adding at the end the following new paragraph:  
'(6) USE OF GRANTS FOR OVERHEAD EXPENSES PROHIBITED- No grant made under this section may be used for the overhead expenses of any clinic or of any institution sponsoring such clinic.'
- (B) CONFORMING AMENDMENTS- Section 7526(c)(5) is amended--  
(i) by inserting 'qualified' before 'low-income', and  
(ii) by striking the last sentence.
- (3) PROMOTION OF CLINICS- Section 7526(c), as amended by paragraph (2), is amended by adding at the end the following new paragraph:  
'(7) PROMOTION OF CLINICS- The Secretary is authorized to promote the benefits of and encourage the use of low-income taxpayer clinics through the use of mass communications, referrals, and other means.'
- (c) Effective Date- The amendments made by this section shall apply to grants made after the date of the enactment of this Act.

### SEC. 3. CLARIFICATION OF ENROLLED AGENT CREDENTIALS.

- (a) In General- Chapter 77 (relating to miscellaneous provisions) is amended by adding at the end the following new section:

#### 'SEC. 7529. ENROLLED AGENTS.

- (a) In General- The Secretary may prescribe such regulations as may be necessary to regulate the conduct of enrolled agents in regards to their practice before the Internal Revenue Service.
- (b) Use of Credentials- Any enrolled agents properly licensed to practice as required under rules promulgated under subsection (a) shall be allowed to use the credentials or designation as 'enrolled agent', 'EA', or 'E.A.'.

(b) Clerical Amendment- The table of sections for chapter 77 is amended by adding at the end the following new item:

'Sec. 7529. Enrolled agents.'

(c) Prior Regulations- The authorization to prescribe regulations under the amendments made by this section may not be construed to have any effect on part 10 of title 31, Code of Federal Regulations, or any other related Federal rule or regulation issued before the date of the enactment of this Act.

(d) Effective Date- The amendments made by this section shall take effect on the date of the enactment of this Act.

#### **SEC. 4. REGULATION OF INCOME TAX RETURN PREPARERS.**

(a) Authorization- Section 330(a)(1) of title 31, United States Code, is amended by inserting '(including compensated preparers of tax returns, documents, and other submissions)' after 'representatives'.

(b) Requirement-

(1) IN GENERAL- Not later than 1 year after the date of the enactment of this Act, the Secretary of the Treasury shall prescribe regulations under section 330 of title 31, United States Code--

(A) to regulate those compensated preparers not otherwise regulated under regulations promulgated under such section on the date of the enactment of this Act, and

(B) to carry out the provisions of, and amendments made by, this section.

(2) EXAMINATION- In promulgating the regulations under paragraph (1), the Secretary shall develop (or approve) and administer an eligibility examination designed to test--

(A) the technical knowledge and competency of each preparer described in paragraph (1)(A)--

(i) to prepare Federal tax returns, including individual and business income tax returns, and

(ii) to properly claim the earned income tax credit under section 32 of the Internal Revenue Code of 1986 with respect to such individual returns, and

(B) the knowledge of each such preparer regarding such ethical standards for the preparation of such returns as determined appropriate by the Secretary.

(3) WAIVER OF EXAMINATION --

(A) IN GENERAL -- The regulations under paragraph (1) shall provide for a waiver of the examination described in paragraph (2) in those cases where an applicant for registration can demonstrate that their technical knowledge and competency has been established through a state licensing activity or by obtaining a credential from a nationally recognized credentialing body in accountancy or taxation; provided the applicant has passed an examination administered by such credentialing body.

(B) CONCURRENCY -- An applicant for registration who requests a waiver of examination shall be required to submit evidence that

establishes the fact that their license or credential is currently valid and that they have currently completed such continuing education requirements as may be required to maintain their license or credential.

(4) CONTINUING ELIGIBILITY-

(A) IN GENERAL- The regulations under paragraph (1) shall require a renewal of eligibility every 3 years and shall set forth the manner in which a preparer described in paragraph (1)(A) must renew such eligibility.

(B) CONTINUING EDUCATION REQUIREMENTS- As part of the renewal of eligibility, such regulations shall require that each such preparer show evidence of completion of such continuing education requirements as specified by the Secretary.

(C) NONMONETARY SANCTIONS- The regulations under paragraph (1) shall provide for the suspension or termination of such eligibility in the event of any failure to comply with the requirements for such eligibility.

(c) Tax Preparer Oversight Board-

(1) ESTABLISHMENT - There is established an administrative entity designated as the Tax Preparer Oversight Board, to develop, implement, and manage a national tax preparer regulatory system. The Board shall be a body corporate, operate as a nonprofit corporation, and have succession until dissolved by an Act of Congress.

(2) STATUS - The Board shall not be an agency or establishment of the United States Government, and, except as otherwise provided in this Act, shall be subject to, and have all the powers conferred upon a nonprofit corporation by, the District of Columbia Nonprofit Corporation Act. No member or person employed by, or agent for, the Board shall be deemed to be an officer or employee of or agent for the Federal Government by reason of such service.

(3) DUTIES OF THE BOARD - The Board shall, subject to action by the Secretary of the Treasury, and once a determination is made by the Secretary under subsection (d) of this section—

(i) register tax preparers who prepare federal income tax returns for a fee or other compensation;

(ii) establish or adopt, or both, by rule, ethics and other professional standards relating to the preparation of federal income tax returns;

(iii) conduct investigations and disciplinary proceedings concerning registered tax preparers, and impose appropriate sanctions where justified;

(iv) perform such other duties or functions as the Board (or the Secretary, by rule or order) determines are necessary or appropriate to promote high professional standards among, and improve the quality of services offered by, registered tax preparers and associated persons thereof, or otherwise to carry out this Act, in order to protect citizens, or to further the public interest;

(v) enforce compliance with this Act, the rules of the Board, professional standards, and the Internal Revenue Code;

(vi) set the budget and manage the operations of the Board and the staff of the Board.

(4) SECRETARY'S DETERMINATION.—The members of the Board shall take such action (including hiring of staff and proposal of rules as may be necessary or appropriate to enable the Secretary to determine, not later than 270 days after the date of enactment of this Act, that the Board is so organized and has the capacity to carry out the requirements of this Act, and to enforce compliance with this Act by registered tax preparers and associated persons thereof. The Secretary shall be responsible, prior to the appointment of the Board, for the planning for the establishment and administrative transition to the Board's operation.

(5) BOARD MEMBERSHIP - The Board shall have 5 members, appointed from among prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of taxpayers and the public, provided that none of the Board members shall be regulated income tax preparers.

(6) APPOINTMENT OF BOARD MEMBERS -

(i) INITIAL BOARD - Not later than 90 days after the date of enactment of this Act, the Secretary, shall appoint the chairperson and other initial members of the Board, and shall designate a term of service for each;

(ii) VACANCIES - A vacancy on the Board shall not affect the powers of the Board, but shall be filled in the same manner as provided for appointments under this section.

(7) TERM OF SERVICE -

(i) IN GENERAL - The term of service of each Board member shall be 5 years, and until a successor is appointed, except that the terms of office of the initial Board members (other than the chairperson) shall expire in annual increments, 1 on each of the first 4 anniversaries of the initial date of appointment; and any Board member appointed to fill a vacancy occurring before the expiration of the term for which the predecessor was appointed shall be appointed only for the remainder of that term.

(ii) TERM LIMITATION.—No person may serve as a member of the Board, or as chairperson of the Board, for more than 2 terms, whether or not such terms of service are consecutive.

(iii) REMOVAL FROM OFFICE.—A member of the Board may be removed by the Secretary from office for good cause shown before the expiration of the term of that member.

(8) ANNUAL REPORT TO THE SECRETARY - The Board shall submit an annual report (including its audited financial statements) to the Secretary, and the Secretary shall transmit a copy of that report to the United States Senate Committee on Finance and the House Ways and Means Committee Subcommittee on Oversight, not later than 30 days after the date of receipt of that report by the Secretary.

(9) HEARING - Any hearing on an action initiated by the Tax Preparer Oversight Board to impose a sanction under regulations promulgated under this section shall be conducted in accordance with sections 556 and 557 of title 5 by 1 or more administrative law judges appointed by the Secretary of the Treasury under section 3105 of title 5.

(10) INFORMATION ON SANCTIONS TO BE AVAILABLE TO THE PUBLIC-

(i) **SANCTIONS INITIATED BY ACTION**- When an action is initiated by the Tax Preparer Oversight Board, to impose a sanction under regulations promulgated under this section, the pleadings, and the record of the proceeding and hearing shall be open to the public (subject to restrictions imposed under subparagraph (C)).

(ii) **SANCTION NOT INITIATED BY ACTION**- When a sanction under regulations promulgated under this section (other than a private reprimand) is imposed without initiation of an action, the Tax Preparer Oversight Board, shall make available to the public information identifying the representative, employer, firm or other entity sanctioned, as well as information about the conduct which gave rise to the sanction (subject to restrictions imposed under subparagraph (C)).

(iii) **RESTRICTIONS ON RELEASE OF INFORMATION** - Information about clients of the representative, employer, firm or other entity and medical information with respect to the representative shall not be released to the public or discussed in an open hearing, except to the extent necessary to understand the nature, scope, and impact of the conduct giving rise to the sanction or proposed sanction. Disagreements regarding the application of this subparagraph shall be resolved by the administrative law judge or, when a sanction is imposed without initiation of an action, by the Tax Preparer Oversight Board.

(11) **FEES** - Any fees imposed under regulations promulgated under this section shall be available without fiscal year limitation to the Tax Preparer Oversight Board for the purpose of reimbursement of the costs of administering and enforcing the requirements of such regulations.

(d) **Penalties-**

(1) **INCREASE IN CERTAIN PENALTIES**- Subsections (b) and (c) of section 6695 (relating to other assessable penalties with respect to the preparation of income tax returns for other persons) are each amended by striking '\$50' and inserting '\$500'.

(2) **USE OF PENALTIES**- Unless specifically appropriated otherwise, there is authorized to be appropriated and is appropriated to the Tax Preparer Oversight Board for each fiscal year for the administration of the public awareness campaign described in subsection (f) an amount equal to the penalties collected during the preceding fiscal year under sections 6694 and 6695 of the Internal Revenue Code of 1986 and under the regulations promulgated under section 330 of title 31, United States Code (by reason of subsection (b)(1)).

(e) **Coordination With Section 6060(a)**- The Secretary of the Treasury shall coordinate the requirements under the regulations promulgated under section 330 of title 31, United States Code, with the return requirements of section 6060 of the Internal Revenue Code of 1986.

(f) **Public Awareness Campaign**- The Secretary of the Treasury shall conduct a public information and consumer education campaign, utilizing paid advertising--

(1) to encourage taxpayers to use for Federal tax matters only professionals who establish their competency under the regulations promulgated under section 330 of title 31, United States Code, and



(2) to inform the public of the requirements that any compensated preparer of tax returns, documents, and submissions subject to the requirements under the regulations promulgated under such section must sign the return, document, or submission prepared for a fee and display notice of such preparer's compliance under such regulations.

(g) Additional Funds Available for Compliance Activities- The Secretary of the Treasury may use any specifically appropriated funds for earned income tax credit compliance to improve and expand enforcement of the regulations promulgated under section 330 of title 31, United States Code.

(h) Effective Date- The amendments made by this section shall take effect on the date of the enactment of this Act.

**SEC. 5. CONTRACT AUTHORITY FOR EXAMINATIONS OF PREPARERS.**

The Secretary of the Treasury is authorized to contract for the development or administration, or both, of any examinations under the regulations promulgated under section 330 of title 31, United States Code.

**SEC. 6. REGULATION OF REFUND ANTICIPATION LOAN FACILITATORS.**

(a) Regulation of Refund Anticipation Loan Facilitators-

(1) IN GENERAL- Chapter 77 (relating to miscellaneous provisions), as amended by this Act, is amended by inserting at the end the following new section:

**SEC. 7530. REFUND ANTICIPATION LOAN FACILITATORS.**

(a) Registration- Each refund loan facilitator shall register with the Secretary on an annual basis. As a part of such registration, each refund loan facilitator shall provide the Secretary with the taxpayer identification number of such facilitator.

(b) Disclosure- Each refund loan facilitator shall disclose to a taxpayer both orally and on a separate written form at the time such taxpayer applies for a refund anticipation loan the following information:

(1) NATURE OF THE TRANSACTION- The refund loan facilitator shall disclose--

(A) that the taxpayer is applying for a loan that is based upon the taxpayer's anticipated income tax refund,

(B) the expected time within which the loan will be paid to the taxpayer if such loan is approved,

(C) the time frame in which tax refunds are typically paid based upon the different filing options available to the taxpayer,

(D) that there is no guarantee that a refund will be paid in full or received within a specified time period and that the taxpayer is responsible for the repayment of the loan even if the refund is not paid in full or has been delayed,

`(E) if the refund loan facilitator has an agreement with another refund loan facilitator (or any lender working in conjunction with another refund loan facilitator) to offset outstanding liabilities for previous refund anticipation loans provided by such other refund loan facilitator, that any refund paid to the taxpayer may be so offset and the implication of any such offset,

`(F) that the taxpayer may file an electronic return without applying for a refund anticipation loan and the fee for filing such an electronic return, and

`(G) that the loan may have substantial fees and interest charges that may exceed those of other sources of credit and the taxpayer should carefully consider--

    `(i) whether such a loan is appropriate for the taxpayer, and

    `(ii) other sources of credit.

`(2) FEES AND INTEREST- The refund loan facilitator shall disclose all refund anticipation loan fees with respect to the refund anticipation loan. Such disclosure shall include--

    `(A) a copy of the fee schedule of the refund loan facilitator,

    `(B) the typical fees and interest rates (using annual percentage rates as defined by section 107 of the Truth in Lending Act (15 U.S.C. 1606)) for several typical amounts of such loans,

    `(C) typical fees and interest charges if a refund is not paid or delayed, and

    `(D) the amount of a fee (if any) that will be charged if the loan is not approved.

`(3) OTHER INFORMATION- The refund loan facilitator shall disclose any other information required to be disclosed by the Secretary.

`(c) Fines and Sanctions-

    `(1) IN GENERAL- The Secretary may impose a monetary penalty on any refund loan facilitator who--

        `(A) fails to register under subsection (a), or

        `(B) fails to disclose any information required under subsection (b).

    `(2) MAXIMUM MONETARY PENALTY- Any monetary penalty imposed under paragraph (1) shall not exceed--

        `(A) in the case of a failure to register, the gross income derived from all refund anticipation loans made during the period the refund loan facilitator was not registered, and

        `(B) in the case of a failure to disclose information, the gross income derived from all refund anticipation loans with respect to which such failure applied.

    `(3) REASONABLE CAUSE EXCEPTIONS- No penalty may be imposed under this subsection with respect to any failure if it is shown that such failure is due to reasonable cause.

`(d) Definitions- For purposes of this section--

    `(1) REFUND LOAN FACILITATOR-

        `(A) IN GENERAL- The term 'refund loan facilitator' means any electronic return originator who--

- '(i) solicits for, processes, receives, or accepts delivery of an application for a refund anticipation loan, or
- '(ii) facilitates the making of a refund anticipation loan in any other manner.

'(B) ELECTRONIC RETURN ORIGINATOR- For purposes of subparagraph (A), the term 'electronic return originator' means a person who originates the electronic submission of income tax returns for another person.

'(2) REFUND ANTICIPATION LOAN- The term 'refund anticipation loan' means any loan of money or any other thing of value to a taxpayer in connection with the taxpayer's anticipated receipt of a Federal tax refund.

#### **SEC.8. STATE PREEMPTION**

To the extent that any State laws or requirements are inconsistent with this Act or the regulations prescribed by the Secretary of the Treasury hereunder affecting or pertaining to the regulation or examination of federal tax return preparers, this Act and the Secretary of the Treasury's regulations on such matters shall preempt such State laws and requirements.



**Statement of Colleen M. Kelley**  
**National President**  
**National Treasury Employees Union**

**On**

**" Filing Your Taxes: An Ounce of Prevention is Worth a  
Pound of Cure"**

Submitted to

**U.S. Senate Committee on Finance**

**April 12, 2007**

Chairman Baucus, Ranking Member Grassley, and distinguished members of the Committee, I would like to thank you for allowing me to provide comments on the 2007 Tax Filing Season and the Administration's FY '08 budget request for the Internal Revenue Service (IRS). As President of the National Treasury Employees Union (NTEU), I have the honor of representing over 150,000 federal workers in 30 agencies including the men and women at the IRS.

#### **IRS FY '08 Budget Request**

Mr. Chairman, as you know, the IRS budget forms the foundation for what the IRS can provide to taxpayers in terms of customer service and how the agency can best fulfill its tax enforcement mission. Without an adequate budget, the IRS cannot expect continued improvement in customer service performance ratings and will be hampered in its effort to enhance taxpayer compliance. I would like to applaud the Administration for acknowledging in its FY '08 Budget in Brief (page 65) that "assisting the public to understand their tax reporting and payment obligations is the cornerstone of taxpayer compliance and is vital for maintaining public confidence in the tax system." However, I was disappointed in the Administration for failing to request a budget for FY '08 that meets the needs of the Agency to meet its customer service and enforcement challenges. In fact, the President's budget anticipates a "savings" equal to nearly 1,200 full-time equivalent positions, including 1,147 in enforcement and taxpayer service programs.

Although it's widely recognized that additional funding for enforcement provides a great return on the investment, the Administration seems reluctant to request an adequate budget for the IRS. In addition, despite citing a lack of resources as the primary rationale for contracting out a number of inherently governmental activities, such as the collection of taxes, the Commissioner of the IRS has told Congress that the IRS does not need any additional funding above the President's budget request.

NTEU believes that Congress must provide the IRS with a budget that will allow the Service to replenish the depleted workforce, particularly with respect to enforcement personnel.

History has shown that the IRS has the expertise to improve taxpayer compliance but lacks the necessary personnel and resources. The President's own fiscal 2008 budget proposal trumpets the increased tax collections produced by IRS's own employees and cites the increased collections of delinquent tax debt from \$34 billion in 2002 to \$49 billion in 2006, an increase of 44 percent. Unfortunately, instead of providing additional resources to hire more enforcement staff, IRS personnel resources have been slashed in recent years resulting in a 36% decline in combined collection and examination function enforcement staff between 1996 and 2003. In addition, these staffing cuts have come at a time when the IRS workload has dramatically increased.

According to IRS's own annual reports and data, taxpayers filed 114.6 million returns in 1995. After a steady annual climb, eleven years later, the Service saw more than 132 million

returns filed. Yet, between 1995 and 2005, total numbers of IRS employees shrunk from 114,000 to 94,000. Even more alarming is that during that period, revenue officers and revenue agents – two groups critical to IRS enforcement and compliance efforts – shrunk by 32 and 23 percent respectively. Revenue officers who collect large delinquent accounts went from 8,139 to 5,462 and revenue agents who do audits fell from 16,078 to 12,355. Unfortunately, instead of reversing this trend, the IRS has continued efforts to reduce its workforce and has moved forward with downsizing in several different areas which have targeted some of the service's most productive employees.

These include last year's re-organization of the Estate and Gift Tax Program which sought the elimination of 157 of the agency's 345 estate and gift tax attorneys – almost half of the agency's estate tax lawyers—who audit some of the wealthiest Americans. The Service pursued this drastic course of action despite internal data showing that estate and gift attorneys are among the most productive enforcement personnel at the IRS, collecting \$2,200 in taxes for each hour of work.

The IRS decision to drastically reduce the number of attorneys in the estate and gift tax area flies in the face of several reports made to Congress by Treasury and IRS officials over the past few years, indicating that tax evasion and cheating among the highest-income Americans is a serious and growing problem. In fact, an IRS study found that in 1999, more than 80 percent of the 1,651 tax returns reporting gifts of \$1 million or more that were audited that year understated the value of the gift. The study found that the average understatement was about \$303,000, on which about \$167,000 in additional gift taxes was due. This alone cost the government about \$275 million. Consequently, it is difficult to understand why the IRS sought the elimination of key workforce positions in an area that could produce significant revenue to the general treasury.

In addition, the Service continues to move forward with its plan to close five of its ten paper tax return submission facilities by 2011. The IRS originally sought the closings of the five paper return submission centers due to the rise in the use of electronic filing (e-filing) and in order to comply with the IRS Restructuring and Reform Act of 1998 (RRA 98) which established a goal for the IRS to have 80 percent of Federal tax and information returns filed electronically by 2007. But in their recent report to Congress on e-filing, the IRS Oversight Board noted that the IRS will fall well short of the 80 percent goal and urged Congress to extend the deadline to 2012. The report noted that in 2006 just 54 percent of individuals e-filed their returns, well short of the 80 percent goal. Furthermore, the report cited a decline in 2006 in the number of e-file returns received from individual taxpayers who self-prepared their taxes. And finally a recent GAO report on the 2006 filing season noted the year over year percentage growth in individual e-filing slowed to a level lower than any of the previous three years.

While overall use of e-filing may be on the rise, the number of taxpayers opting to use this type of return is not increasing as rapidly as the IRS had originally projected. Combined with the fact that almost a third of American taxpayers do not even have internet access and changes to the IRS Free File Program that are expected to increase the number of paper filing returns, it is clear that paper submission processing facilities are still necessary and that serious thought and consideration must be given before any additional closings are undertaken.

Mr. Chairman, it is clear that drastic reductions in some of the agency's most productive tax law enforcement employees directly contradict the Service's stated enforcement priority to discourage and deter non-compliance, particularly among high-income individuals. In addition, we believe these staffing cuts have greatly undermined agency efforts to close the tax gap which the IRS recently estimated at \$345 billion. As Nina Olson, the National Taxpayer Advocate noted, this amounts to a per-taxpayer "surtax" of some \$2,000 per year to subsidize noncompliance. And while the agency has made small inroads and the overall compliance rate through the voluntary compliance system remains high, much more can and should be done. NTEU believes that in order to close the tax gap, the IRS needs additional employees on the frontlines of tax compliance and customer service. In addition, we believe Congress should establish a dedicated funding stream to provide adequate resources for those employees.

#### **NTEU Staffing Proposal**

In order to address the staffing shortage at the IRS, NTEU supports a two percent annual net increase in staffing (roughly 1,885 positions per year) over a five-year period to gradually rebuild the depleted IRS workforce to pre-1998 levels. A similar idea was proposed by former IRS Commissioner Charles Rossotti in a 2002 report to the IRS Oversight Board. In the report, Rossotti quantified the workload gap in non-compliance, that is, the number of cases that should have been, but could not be acted upon because of resource limitations. Rossotti pointed out that in the area of known tax debts, assigning additional employees to collection work could bring in roughly \$30 for every \$1 spent. The Rossotti report recognized the importance of increased IRS staffing noting that due to the continued growth in IRS' workload (averaging about 1.5 to 2.0 percent per year) and the large accumulated increase in work that should be done but could not be, even aggressive productivity growth could not possibly close the compliance gap. Rossotti also recognized that for this approach to work, the budget must provide for a net increase in staffing on a sustained yearly basis and not take a "one time approach."

Although this would require a substantial financial commitment, the potential for increasing revenues, enhancing compliance and shrinking the tax gap makes it very sound budget policy. One option for funding a new staffing initiative would be to allow the IRS to hire personnel off-budget, or outside of the ordinary budget process. This is not unprecedented. In fact, Congress took exactly the same approach to funding in 1994 when Congress provided funding for the Administration's IRS Tax Compliance Initiative which sought the addition of 5,000 compliance positions for the IRS. The initiative was expected to generate in excess of \$9 billion in new revenue over five years while spending only about \$2 billion during the same period. Because of the initiative's potential to dramatically increase federal revenue, spending for the positions was not considered in calculating appropriations that must come within annual caps.

A second option for providing funding to hire additional IRS personnel outside the ordinary budget process could be to allow IRS to retain a small portion of the revenue it collects. The statute that gives the IRS the authority to use private collection companies to collect taxes allows 25 percent of collected revenue to be returned to the companies as payment, thereby circumventing the appropriations process altogether. Clearly, there is nothing magical about revenues collected by private collection companies. If those revenues can be dedicated directly

to contract payments, there is no reason some small portion of other revenues collected by the IRS could not be dedicated to funding additional staff positions to strengthen enforcement.

While NTEU agrees with IRS' stated goal of enhancing tax compliance and enforcement, we don't agree with the approach of sacrificing taxpayer service in order to pay for additional compliance efforts. That is why we were disappointed to see that the President's proposed budget calls for the elimination of 527 taxpayer services positions. NTEU believes providing quality services to taxpayers is an important part of any overall strategy to improve compliance and that reducing the number of employees dedicated to assisting taxpayers meet their obligations will only those efforts. The Administration's own budget proposal for 2008 notes that in FY 2006, IRS' customer assistance centers answered almost 33 million assistor telephone calls and met the 82 percent level of service goal, with an accuracy rate of 91 percent for tax law questions. In addition, a recent study commissioned by the Oversight Board found that more than 80 percent of taxpayers contacted said that IRS service was better than or equal to service from other government agencies. And while these numbers show that IRS taxpayer services are being effective, more can and should be done.

Mr. Chairman, in order to continue to make improvements in taxpayer services while simultaneously processing a growing number of tax returns and stabilizing collections and examinations of cases, it is imperative to reverse the severe cuts in IRS staffing levels and begin providing adequate resources to meet these challenges. With the future workload expected to continue to rise, the IRS will be under a great deal of pressure to improve customer service standards while simultaneously enforcing the nation's tax laws. NTEU strongly believes that providing additional staffing resources would permit IRS to meet the rising workload level, stabilize and strengthen tax compliance and customer service programs and allow the Service to address the tax gap in a serious and meaningful way.

#### **Span of Control**

And while it is imperative that Congress provide the IRS with sufficient staffing resources, we also believe that the IRS should look at the management to bargaining unit employee ratio to find additional resources for increased frontline tax compliance efforts. As noted previously, while the number of employees at the IRS has decreased by almost 20,000 since 1995, the number of managers who supervise these employees has *increased* over this same period. If we just look at the period between 2000 and 2005, we see that the number of bargaining unit employees, the frontline employees who do the work, decreased by 4,756, a decrease of 5.1%. During that same time, the number of managers and management officials increased by 170, an increase of 1%. If the IRS decreased the number of managers and management officials at the same rate as it decreased its rank and file employees during that period, there would be 5.1% *fewer* managers and management officials or a savings of 808 Full time Equivalent (FTE's) that could be saved and redirected to the frontlines. While the IRS has previously cited concerns about the number of employees that would have to be taken offline to train additional frontline employees, we believe this training could be done with minimal disruption to current operations. One possibility would be to use the increasing number of managers and management officials to do the training. This would ensure that these employees



are afforded the best possible training while allowing current operations to continue to run efficiently.

### **Private Tax Collection**

Mr. Chairman, as stated previously, if provided the necessary resources, IRS employees have the expertise and knowledge to ensure taxpayers are complying with their tax obligations. That is why NTEU continues to strongly oppose the Administration's private tax collection program, which began in September of last year. Under the program, the IRS is permitted to hire private sector tax collectors to collect delinquent tax debt from taxpayers and pay them a bounty of up to 25 percent of the money they collect. NTEU believes this misguided proposal is a waste of taxpayer's dollars, invites overly aggressive collection techniques, jeopardizes the financial privacy of American taxpayers and may ultimately serve to undermine efforts to close the tax gap.

NTEU strongly believes the collection of taxes is an inherently governmental function that should be restricted to properly trained and proficient IRS personnel. When supported with the tools and resources they need to do their jobs, there is no one who is more reliable and who can do the work of the IRS better than IRS employees.

As you may know, under current contracts, private collection firms are eligible to retain 21% to 24% of what they collect, depending on the size of the case. In testimony before Congress, the IRS Commissioner, Mark Everson, has twice acknowledged that using private collection companies to collect federal taxes will be more expensive than having the IRS do the work itself. The Commissioner's admission directly contradicts one the Administration's central justifications for using private collection agencies --- that the use of private collectors is cost efficient and effective.

In addition to being fiscally unsound, the idea of allowing private collection agencies to collect tax debt on a commission basis also flies in the face of the tenets of the IRS Restructuring and Reform Act of 1998. Section 1204 of the law specifically prevents employees or supervisors at the IRS from being evaluated on the amount of collections they bring in. But now, the IRS has agreed to pay private collection agencies out of their tax collection proceeds, which will clearly encourage overly aggressive tax collection techniques, the exact dynamic the 1998 law sought to avoid. Furthermore, the IRS is turning over tax collection responsibilities to an industry that has a long record of abuse. For example, in 2006, consumer complaints about third-party debt collectors increased both in absolute terms and as a percentage of all complaints that consumers filed with the Federal Trade Commission (FTC). Last year the FTC received 69,204 consumer complaints about debt collection agencies -- giving debt collectors the impressive title of the FTC's most complained-about industry.

NTEU believes that a better option would be to provide the IRS with the resources and staffing it needs. There is no doubt that IRS employees are -- by far -- the most reliable, cost-effective means for collecting federal income taxes. As noted previously, the IRS Commissioner himself has admitted that using IRS employees to collect unpaid tax debts is more efficient than using private collectors. In addition, the 2002 budget report submitted to the IRS Oversight

Board, former Commissioner Charles Rossotti made clear that with more resources to increase IRS staffing, the IRS would be able to close the compliance gap.

This is not the first time the IRS has tried this flawed program. Two pilot projects were authorized by Congress to test private collection of tax debt for 1996 and 1997. The 1996 pilot was so unsuccessful it was cancelled after 12 months, despite the fact it was authorized and scheduled to operate for two years. A subsequent review by the IRS Office of Inspector General found that contractors participating in the pilot programs regularly violated the Fair Debt Collection Practices Act, did not adequately protect the security of personal taxpayer information, and even failed to bring in a net increase in revenue. In fact, a 1997 GAO report found that private companies did not bring in anywhere near the dollars projected, and the pilot caused a \$17 million net loss.

Despite IRS assurances that it has learned from its past mistakes, two recent reports indicate otherwise. A March 2004 report by the Treasury Inspector General for Tax Administration raised a number of questions about IRS' contract administration and oversight of contractors. The report found that "a contractor's employees committed numerous security violations that placed IRS equipment and taxpayer data at risk" and in some cases, "contractors blatantly circumvented IRS policies and procedures even when security personnel identified inappropriate practices." (TIGTA Audit #200320010). The proliferation of security breaches at a number of government agencies that put personal information at risk further argue against this proposal. These security breaches illustrate not only the risks associated with collecting and disseminating large amounts of electronic personal information, but the risk of harm or injury to consumers from identity theft crimes.

In addition, a September 2006 examination of the IRS private collection program by the Government Accountability Office (GAO) reveals that like the 1996 pilot, the program may actually lose money by the scheduled conclusion of the program's initial phase in December 2007. The report cited preliminary IRS data showing that the agency expects to collect as little as \$56 million through the end of 2007, while initial program costs are expected to surpass \$61 million. What's more, the projected costs do not even include the 21-24 percent commission fees paid to the collection agencies directly from the taxes they collect.

In addition to the direct costs of the program, I am greatly concerned about the potential negative effect that the private tax collection program will have on our tax administration system. In her recent report to Congress, the National Taxpayer Advocate voiced similar concern about the unintended consequences of privatizing tax collection. Olson cited a number of "hidden costs" that private tax collection has on the tax system including reduced transparency of IRS tax collection operations, inconsistent treatment for similarly situated taxpayers, and reduced tax compliance. Clearly the negative effects of contracting out tax collection to private collectors hampers the agency's ability to improve taxpayer compliance and will only serve to undermine future efforts to close the tax gap.

NTEU is not alone in its opposition to the IRS' plan. Similar proposals allowing private collection agencies to collect taxes on a commission basis have been around for a long time and have consistently been opposed by both parties. In fact, the Reagan Administration strongly opposed the concept of privatizing tax collections warning of a considerable adverse public

reaction to such a plan, and emphasizing the importance of not compromising the integrity of the tax system. (Treasury Dept. Statement to House Judiciary Comm. 8/8/86). More recently, opposition to the private tax collection program has been voiced by a growing number of members of Congress, major public interest groups, tax experts, as well as the Taxpayer Advocacy Panel, a volunteer federal advisory group—whose members are appointed by the IRS and the Treasury Department. In addition, the National Taxpayer Advocate, an independent official within the IRS recently identified the IRS private tax collection initiative as one of the most serious problems facing taxpayers and called on Congress to immediately repeal the IRS' authority to outsource tax collection work to private debt collectors (National Taxpayer Advocate 2006 Report to Congress).

Instead of rushing to privatize tax collection functions which jeopardizes taxpayer information, reduces potential revenue for the federal government and undermine efforts to close the tax gap, the IRS should increase compliance staffing levels at the IRS to ensure that the collection of taxes is restricted to properly trained and proficient IRS personnel.

#### **IRS Audits of High-Income Individuals and Large Businesses and Corporations**

Mr. Chairman, the final issue that I would like to discuss is IRS enforcement efforts with regard to high-income individuals and large businesses and corporations. I previously noted the drastic staff reductions in the estate and gift tax division that occurred last year and will obviously hamper the Service's ability to achieve greater compliance from the wealthiest Americans. In addition, recent IRS data shows that IRS audits of high-income individuals have dropped dramatically over the past decade. The audit rate for face-to-face audits fell from 2.9 percent of high-income tax filers in FY 1992 to 0.38 percent in FY 2001 and then drifted down to 0.35 percent in FY 2004. While the audit rate has rebounded somewhat in the last two years, it is still far below the level of the mid-1990's. These facts seem to directly contradict claims by the IRS that the Service's first enforcement priority is to discourage and deter non-compliance, with an emphasis on high-income individuals.

We are seeing similar troubling trends with respect to large corporations. While this issue has just started receiving public attention in recent weeks, it has long been of concern to IRS employees that believe recent IRS currency and cycle time initiatives are resulting in the premature closing of audits of large companies, possibly leaving hundreds of millions of dollars of taxes owed on the table. IRS data shows the thoroughness of IRS enforcement efforts for the nation's largest corporations — measured by the number of hours devoted to each audit — has substantially declined since FY 2002. IRS data also show that the annual audit rates for these corporations, all with assets of \$250 million or more, while increasing in FY 2004 and 2005, receded in 2006 to about the level it was in 2002 and is much lower than levels that prevailed a decade or more ago.

Although the number of the largest corporations is small, they are a very significant presence in the American economy. In FY 2002, the largest corporations were responsible for almost 75 percent of all additional taxes the IRS auditors said were owed the government. By

comparison, low and middle income taxpayers in the same year were responsible for less than 10 percent of the total.

Agency data shows that audit attention given those corporations with \$250 million or more in assets has substantially declined in the last five years. In 2002, an average of 1,210 hours were devoted to each of the audits of the corporations in this category. The time devoted to each audit dropped sharply in 2004 and by 2006 the number of hours per audit remained 20% below what it was in 2002.

But what may be most disturbing is that according to IRS' own data, while the coverage rate of large corporation returns( identified as those with assets of \$10 million and higher) increased in FY 2004 and 2005, the number of audits for these corporations actually *decreased* in 2006. Clearly, the rationale the IRS is using to justify a reduction in time and scope of large corporation audits, that is, to allow for expanding the total number of companies audited is not working.

IRS officials have continued to point to a rise in additional tax recommended for each hour of audit as a sign that the policy is working, but most auditors know that this rise can be primarily attributed to the proliferation of illegal tax shelters which makes it easier to find additional taxes due.

Warnings about the potential negative consequences of such policy decisions were made by a number of IRS employees in a recent New York Times article and are not new. In fact, when the IRS first began limiting the time and scope of business audits through implementation of the Limited Issue Focused Examination (LIFE) process in 2002, the former chief counsel of the IRS said that the IRS' proposed reductions in cycle time of corporate audits would "virtually guarantee that IRS auditors would miss tax dodges, fail to explore suspicious transactions, or even walk away from audits that are on the verge of finding wrongdoing."

In addition, IRS employees have raised concerns about this shift in approach to the auditing of business tax returns since its implementation several years ago. Their concerns are multi-fold. Primarily, employees' feel that their experience and professional judgment is being ignored when the scope of audits is limited and cycle times are reduced. Revenue agents need flexibility to determine the scope of an audit and need the ability to expand the examination time when necessary. The men and women of the IRS that perform these audits are highly experienced employees who know which issues to examine and when more time is necessary on a case. But under current IRS policies, this is just not the case.

Mr. Chairman, we have heard directly from a number of our members about the detrimental effect this policy has had not just on efforts to ensure corporations are in full compliance, but also how this misguided policy is damaging employee morale. In one instance, an IRS agent with 29 years of experience, including 19 as an international specialist examining tax returns of large, multinational corporations was given an unreasonably short period of time to examine three tax years of a very large company. The agent reported being constantly harassed for refusing to further limit the scope of the examination beyond that which was set at the beginning of the audit, even though he had successfully completed two prior examinations of the same taxpayer in a timely manner. The employee knew the issues and how to examine them but

also knew they would need more than the allotted time to complete his part of the examination. But, despite past successes, management refused to provide the employee with additional time to complete his portion of the audit and labeled the employee as uncooperative and not a "team player." Although the employee refused to compromise, he believed that other members of the examination team had been pressured into dropping issues which likely would have resulted in additional tax.

Mr. Chairman, in the face of a rising tax gap and exploding federal deficits, it is imperative that the agency is provided with the necessary resources to allow IRS professionals to pursue each and every dollar of the taxes owed by large businesses and corporations. Allowing these corporations to pay just a fraction of what they owe in taxes greatly hinders efforts to close the tax gap and is fundamentally unfair to the millions of ordinary taxpayers that dutifully pay their taxes. Only by increasing the overall number of IRS employees that do this work can the Service ensure that businesses and large corporations are complying with their tax obligations and that the tax gap is being closed.

#### **Conclusion**

It is an indisputable fact that the IRS workforce is getting mixed signals regarding its value to the mission of the Service and the level of workforce investment the Service is willing to make. NTEU believes that the drastic reductions of some of the IRS's most productive employees, reliance on outside contractors to handle inherently governmental activities such as the collection of taxes, and a shift in philosophy which focuses enforcement efforts too much on wage earners and not enough on high-income individuals and large businesses and corporations, only serve to undermine the agency's ability to fulfill its tax enforcement mission and hamper efforts to close the tax gap.

