

**HEARING BEFORE THE  
COMMITTEE ON APPROPRIATIONS  
SUBCOMMITTEE ON FINANCIAL SERVICES  
AND GENERAL GOVERNMENT  
U.S. HOUSE OF REPRESENTATIVES**

**“OVERSIGHT HEARING – INTERNAL REVENUE  
SERVICE”**



**Testimony of  
The Honorable J. Russell George  
Treasury Inspector General for Tax Administration**

**February 26, 2014**

**Washington, D.C.**

TESTIMONY  
OF  
THE HONORABLE J. RUSSELL GEORGE  
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION  
*before the*  
COMMITTEE ON APPROPRIATIONS, SUBCOMMITTEE ON  
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Chairman Crenshaw, Ranking Member Serrano, and Members of the Subcommittee, thank you for the opportunity to testify on our recent work related to the most significant challenges currently facing the Internal Revenue Service (IRS). These challenges include providing timely assistance to taxpayers, addressing growing attempts to commit tax fraud, implementing new laws and programs, and improving tax compliance efforts—all while operating with a reduced budget.

The Treasury Inspector General for Tax Administration, also known as TIGTA, is a nationwide organization located in offices throughout the United States. We are statutorily mandated to provide independent audit and investigative services necessary to improve the economy, efficiency, and effectiveness of IRS operations, including the oversight of the IRS Chief Counsel and the IRS Oversight Board. TIGTA’s oversight activities are designed to identify high-risk systemic inefficiencies in IRS operations and to investigate exploited weaknesses in tax administration. TIGTA’s role is critical in that we provide the American taxpayer with assurance that the approximately 93,800<sup>1</sup> IRS employees who collected over \$2.9 trillion in tax revenue, processed over 147 million individual tax returns, and issued \$364 billion in tax refunds during Fiscal Year 2013,<sup>2</sup> do so in an effective and efficient manner while minimizing the risks of waste, fraud, or abuse.

TIGTA’s Office of Audit (OA) reviews all aspects of the IRS tax administration system and provides recommendations to: improve IRS systems and operations; ensure the fair and equitable treatment of taxpayers; and prevent and detect waste, fraud, and abuse. OA places audit emphasis on statutory coverage required by the IRS

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<sup>1</sup> Total IRS staffing as of November 2, 2013.

<sup>2</sup> IRS, *Management’s Discussion & Analysis, Fiscal Year 2013*.

Restructuring and Reform Act of 1998 (RRA 98),<sup>3</sup> the American Recovery and Reinvestment Act of 2009,<sup>4</sup> and other laws, as well as areas of concern raised by Congress, the Secretary of the Treasury, the Commissioner of the IRS, and other key stakeholders. The OA has examined specific high-risk issues such as identity theft, refund fraud, improper payments, information technology, security vulnerabilities, complex modernized computer systems, tax collections and revenue, and waste and abuse in IRS operations.

TIGTA's Office of Investigations (OI) protects the integrity of the IRS by investigating allegations of IRS employee misconduct, external threats to employees and facilities, and attempts to impede or otherwise interfere with the IRS's ability to collect taxes. Misconduct by IRS employees manifests itself in many ways, including extortion, theft, taxpayer abuses, false statements, financial fraud, and identity theft. OI places a high priority on its statutory responsibility to protect all IRS employees located in over 670 facilities nationwide. In the last four years, threats directed at the IRS have become the second largest component of OI's work. Physical violence, harassment, and intimidation of IRS employees continue to pose significant challenges to the implementation of a fair and effective system of tax administration. The OI is committed to ensuring the safety of IRS employees and the security of IRS facilities.

For FY 2013, TIGTA has recovered, protected, and identified monetary benefits totaling \$16.6 billion, including cost savings, increased revenue, revenue protection, and court-ordered settlements in criminal investigations.

## **KEY CHALLENGES FACING THE IRS**

In this section of my testimony, I will discuss several of the most significant challenges now facing the IRS as it administers our Nation's tax laws, as the Subcommittee has requested.

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<sup>3</sup> Pub. L. No. 105-206, 112 Stat. 685. 1998 (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.).

<sup>4</sup> Pub. L. No. 111-5, 123 Stat. 115. 2009.

## TAXPAYER SERVICE

Providing quality customer service is the IRS's first step to achieving taxpayer compliance. One of Congress' principal objectives in enacting the RRA 98 was to mandate that the IRS do a better job of meeting the needs of the taxpayers. In the past, TIGTA has evaluated the IRS's efforts in providing quality customer service, providing recommendations for areas of improvement. Although the IRS has implemented certain procedures to better assist the American taxpayer, funding reductions pose a significant challenge.

As a result of the Balanced Budget and Emergency Deficit Control Act,<sup>5</sup> the IRS was required to reduce planned spending from its appropriated accounts by \$594 million for FY 2013. The IRS was also required in FY 2013 to reduce planned spending from its appropriated accounts by \$24 million as the result of an across-the-board rescission.<sup>6</sup> These funding reductions represent a total decrease of \$618 million to the IRS's budget of \$11.8 billion, resulting in a revised annual budget of \$11.2 billion. Overall, the IRS's FY 2013 budget was over \$1 billion less than its FY 2010 budget as a result of the FY 2013 rescission and sequestration<sup>7</sup> and declines in its FY 2011 and FY 2012 budgets.

These continuing budget constraints make it difficult for the IRS to effectively assist taxpayers. As demand for taxpayer services continues to increase, resources have decreased, thereby affecting the quality of customer service that the IRS is able to provide. I would like to provide you with some specific examples.

First, the IRS continues to struggle in providing high quality customer service over the phone. These struggles result in long customer wait times, customers abandoning calls, and customers redialing the IRS toll-free telephone lines<sup>8</sup> for service. Despite other available options, most taxpayers continue to use the telephone as the primary method to make contact with the IRS. In September 2013, TIGTA reported<sup>9</sup> that IRS assistors, as of May 4, 2013, answered approximately 15.6 million calls and

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<sup>5</sup> Pub. L. No. 112-25, 125 Stat. 240. 2011.

<sup>6</sup> A rescission cancels part of an agency's discretionary budget authority and is usually established as a percentage reduction to the budget authority.

<sup>7</sup> Sequestration involves automatic spending cuts of approximately \$1 trillion from FY 2013 through FY 2021 across the Federal Government that took effect on March 1, 2013.

<sup>8</sup> The IRS refers to the suite of 29 telephone lines to which taxpayers can make calls as "Customer Account Services Toll-Free."

<sup>9</sup> TIGTA, Ref. No. 2013-40-124, *Late Legislation Delayed the Filing of Tax Returns and Issuance of Refunds for the 2013 Filing Season* (Sep. 2013).

achieved an approximate 70 percent Level of Service with an Average Speed of Answer of approximately 14 minutes.<sup>10</sup> The IRS plans to provide a 72 percent Level of Service for FY 2014. As of February 1, 2014, approximately 8.8 million taxpayers had contacted the IRS by calling the various customer service toll-free telephone assistance lines. IRS assistors have answered 2.1 million calls and have achieved a 75 percent Level of Service with a 12 minute Average Speed of Answer.

Second, the IRS's ability to process taxpayer correspondence in a timely manner has also declined. Assistors who answer the toll-free telephone lines also handle taxpayer correspondence (including processing amended tax returns and working identity theft cases). During the filing season when call demand is usually at its highest, more resources are shifted to the telephones to answer calls, and correspondence inventory processing is placed on hold until call demand subsides. As call volumes have increased and assistors have been moved to answer telephone calls, the backlog of paper correspondence inventories has substantially increased. This correspondence inventory rose from approximately 628,000 at the end of FY 2010 to almost 2.7 million at the end of FY 2013, representing an increase of nearly 330 percent.

Third, the number of taxpayers assisted by Taxpayer Assistance Centers (TACs) will decrease this fiscal year. Each year, many taxpayers seek assistance from one of the IRS's 386 walk-in offices, called TACs. The IRS assisted over 6.5 million taxpayers in FY 2013 and plans to assist 5.6 million taxpayers in FY 2014, which is 14 percent fewer than in FY 2013. Budget cuts and the IRS's strategy of not offering services at TACs that can be obtained from other service channels, such as the IRS's website, will reduce the number of taxpayers the IRS plans to assist at TACs. In FY 2014, the primary service performed at TACs will consist of answering taxpayers' inquiries about their tax accounts.

In FY 2014, TACs will no longer prepare tax returns, provide tax transcripts, or provide the status of tax refunds. In addition, TAC assistors will answer only basic tax law questions during the filing season and will not answer any tax law questions outside of the filing season. Taxpayers will be referred to Volunteer Income Tax Assistance sites for free tax return preparation or to applications on the IRS's public website to obtain the other services that TACs are no longer providing. For example, tax transcripts can be obtained using the new online "Get Transcript" application; refund status checks can be performed using the "Where's My Refund" application; and

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<sup>10</sup> The average amount of time for an assistor to answer the call after the call is routed to a call center staff.

taxpayers can obtain answers to basic tax law questions from the Interactive Tax Assistance application.

The IRS also assists taxpayers who have been victimized by identity theft. In September 2013, we issued a follow-up report on this issue.<sup>11</sup> Our review evaluated a statistically valid sample of 100 identity theft tax accounts (cases) closed August 1, 2011 through July 31, 2012. We determined that the IRS identified the rightful owner of the Social Security Number in all cases. However, taxpayers continued to face long delays in having their cases resolved. For the 100 cases reviewed, the IRS took an average of 312 days to resolve the case with inactivity (*i.e.*, no work was being performed to resolve the case) averaging 277 days.

## **IMPROPER PAYMENTS**

The Improper Payments Information Act of 2002<sup>12</sup> requires Federal agencies, including the IRS, to estimate the amount of improper payments made each year. Agencies must report to Congress on the causes of and the steps taken to reduce improper payments and address whether they have the information systems and other infrastructure needed to reduce improper payments. The Improper Payments Elimination and Recovery Act of 2010<sup>13</sup> amended the Improper Payments Information Act of 2002 by redefining the definition of improper payments and strengthening agency reporting requirements. TIGTA is required to review annually the IRS's compliance with the Act's reporting requirements.

The first step in an agency's estimation of improper payments is to conduct annual improper payment risk assessments to identify programs at risk for significant improper payments. TIGTA has reported that the risk assessment process performed annually by the IRS may substantially underestimate the amount of improper payments in tax administration. Specifically, the IRS performed a risk assessment of 15 revenue program funds selected by the Department of the Treasury to evaluate the risk of improper payments. Revenue program funds represent specific individual credits or payments (line items on the tax returns). In January 2013, we reported that, although the IRS completed its Fiscal Year 2011 risk assessments, the method used does not fully consider the risks associated with tax refund payments.<sup>14</sup> As a result, the IRS

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<sup>11</sup> TIGTA, Ref. No. 2013-40-129, *Case Processing Delays and Tax Account Errors Increased Hardship for Victims of Identity Theft* (Sep. 2013).

<sup>12</sup> Pub. L. No. 107-300, 116 Stat. 2350.

<sup>13</sup> Pub. L. No. 111-204, 124 Stat. 2224.

<sup>14</sup> TIGTA, Ref. No. 2013-40-015, *Improper Payments Elimination and Recovery Act Risk Assessments of Revenue Programs Are Unreliable* (Jan. 2013).

does not have a reliable assessment of the risk of improper payments in its revenue program funds. For each of the 15 revenue program funds reviewed, the IRS identified that the fund had a low risk for improper payments. The only program the IRS has designated as high risk is the Earned Income Tax Credit (EITC) Program.

However, prior TIGTA reports indicate that the risk of improper payments for some of these program funds could in fact be significant enough to warrant reporting and tracking under the Improper Payments Information Act of 2002. For example, we reported in September 2011 that the IRS may have erroneously allowed approximately \$3.2 billion in American Opportunity Tax Credits.<sup>15</sup> Moreover, other issues, such as insufficient verification of identity or income, can also pose a significant risk for improper payments. Yet the risk of these types of improper payments is not estimated by the IRS despite prior TIGTA reports which indicate that this risk could be significant. Improper payments due to identity theft are the most significant example of a category that is not estimated by the IRS. As such, we believe the IRS's identification of EITC as the only high risk of improper payments may significantly underestimate the risk of improper payments to tax administration.

In addition to the EITC, the IRS administers numerous other refundable tax credits.<sup>16</sup> The number of these credits has varied over time because some credits are available for a limited period that is set by law. Refundable credits were designed to help low-income individuals reduce their tax burden or to provide incentives for other activities. The EITC, created in 1975,<sup>17</sup> is used to offset the impact of Social Security taxes on low-income families and to encourage them to seek employment. Congress later created the Child Tax Credit and the Additional Child Tax Credit (ACTC)<sup>18</sup> to reflect a family's reduced ability to pay taxes as family size increases. Other refundable credits provide incentives for specific activities, such as obtaining a college education or purchasing health insurance. For example, the American Opportunity Tax Credit allows individuals to receive a credit for higher education expenses. More

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<sup>15</sup> TIGTA, Ref. No. 2011-41-083, *Billions of Dollars in Education Credits Appear to Be Erroneous* (Sep. 2011).

<sup>16</sup> The maximum benefit an individual will receive if a nonrefundable credit is claimed inappropriately is to fully offset his or her tax liability resulting in the individual owing nothing. Refundable credits do not have such limitations. Refundable credits can result in tax refunds even if no income tax is withheld or paid; that is, the credits can exceed the tax liability.

<sup>17</sup> Tax Reduction Act of 1975 § 204, 26 U.S.C § 32.

<sup>18</sup> The ACTC is the refundable portion of the Child Tax Credit. This credit phases out for taxpayers depending upon their income level. Taxpayers with earned income of less than \$3,000 may be eligible for a refundable credit if they have three or more qualifying children and have paid Social Security taxes that exceed their EITC.

recently, the Patient Protection and Affordable Care Act<sup>19</sup> and the Health Care and Education Reconciliation Act of 2010 (Affordable Care Act) includes the Premium Tax Credit that provides for a tax credit beginning in Tax Year (TY) 2014 to offset an individual's health insurance expenses.

Although refundable credits provide benefits to individuals, the unintended consequence of these credits is that they can result in the issuance of improper payments and can be the targets of unscrupulous individuals who file erroneous claims for these credits.

I would now like to highlight some of our work relating to the refundable credits still in existence, providing improper payment estimates and amounts when available; the IRS's actions to address these improper payments; and recommendations we have made to reduce these payments.

**Earned Income Tax Credit** – The IRS continues to report that more than 20 percent of EITC payments are issued improperly each year. In FY 2013, the IRS estimates it issued between \$13 and \$15 billion in improper EITC payments.

The IRS is unlikely to achieve any significant reduction in EITC improper payments despite having implemented numerous processes to identify and prevent such payments. For FY 2013, the IRS reported that its efforts protected approximately \$4 billion in erroneous EITC payments and identified more than 10,000 paid tax return preparers who were not complying with EITC due diligence requirements.<sup>20</sup> Although significant amounts of the EITC are being protected, the IRS has made little improvement in reducing improper EITC payments as a whole since it has been required to report estimates of these payments to Congress. The IRS acknowledged in its Fiscal Year 2012 Improper Payment report to TIGTA<sup>21</sup> that further reductions in the EITC improper payment rate will be difficult to achieve.

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<sup>19</sup> Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of U.S. Code), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.

<sup>20</sup> Due diligence requirements require paid tax return preparers to gather, verify, and maintain specific information when filing a tax return claiming the EITC.

<sup>21</sup> IRS, *Report on Earned Income Tax Credit (EITC) Improper Payments Executive Order 13520: Reducing Improper Payments* (March 14, 2013).



However, we have conducted a number of audits that have identified specific actions that the IRS could take to reduce EITC improper payments.<sup>22</sup> While the IRS has implemented some of our recommendations, it has not taken action to address key recommendations aimed at preventing or reducing improper EITC payments. For example, we reported in December 2008<sup>23</sup> that the IRS did not have the resources needed to examine each of the potentially erroneous claims it identifies, resulting in the majority of the improper claims being paid. We recommended that the IRS conduct a study to identify alternative processes that would expand its ability to effectively and efficiently identify and adjust erroneous EITC claims. This included working with the Assistant Secretary of the Treasury for Tax Policy to obtain authority for an improved process that can make use of its success in combining external data with filters that identify EITC claims as likely being erroneous. The IRS agreed with our recommendation and also agreed to work with the Assistant Secretary of the Treasury for Tax Policy to obtain the authority necessary to implement alternative compliance processes. However, the IRS's FY 2012 EITC Improper Payment report to TIGTA indicated that it has not taken any steps to identify or implement alternative compliance methods.

The IRS estimates that two-thirds of EITC claims are prepared with the assistance of paid tax return preparers. As such, the IRS established the Return Preparer Program and began implementing new preparer requirements in FY 2011. These requirements include: 1) requiring all individuals who sign a tax return as a paid tax return preparer to register and obtain a Preparer Tax Identification Number (PTIN); and 2) establishing competency testing for all paid tax return preparers. The IRS stated in its 2012 report to TIGTA on EITC improper payments that the regulation of tax preparers will drive increased EITC compliance, decrease fraud, and reduce the improper payment rate.

There have been some legal challenges to these new tax preparer regulations. The U. S. Court of Appeals for the Eleventh Circuit recently held that the IRS has the

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<sup>22</sup> TIGTA, Ref. No. 2005-40-133, *Administration of the Earned Income Tax Credit Program Has Improved, but Challenges Continue* (Aug. 2005); TIGTA, Ref. No. 2006-40-103, *Controls Can Be Improved to Ensure Advance Earned Income Credit Reported on Individual Income Tax Returns Is Accurate* (July 2006); TIGTA, Ref. No. 2009-40-024, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* (Dec. 2008); TIGTA, Ref. No. 2010-41-116, *Actions Can Be Taken to Improve the Identification of Tax Return Preparers Who Submit Improper Earned Income Tax Credit Claims* (Sep. 2010).

<sup>23</sup> TIGTA, Ref. No. 2009-40-024, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* (Dec. 2008).

authority to charge a user fee for tax return preparers to obtain and renew a PTIN.<sup>24</sup> However, in another case, the U. S. Court of Appeals for the District of Columbia affirmed the lower court's ruling that the IRS does not have the authority to issue a regulation requiring registration, examination and continuing education for tax return preparers.<sup>25</sup>

Despite the court's ruling in the District of Columbia case, the IRS has penalty authority that can be used to reduce EITC improper payments. Beginning with the 2012 Filing Season, paid tax return preparers who prepare a tax return claiming the EITC must include Form 8867, *Paid Preparer's Earned Income Credit Checklist*, with the tax return. Preparers who do not adhere to this requirement can be assessed a \$500 due diligence penalty for each tax return they submit without the required Form 8867. However, we found that the IRS has yet to implement the expanded EITC due diligence penalties.

We reported in September 2013<sup>26</sup> that many paid tax return preparers continue to not comply with EITC due diligence requirements. As of May 2, 2013, we identified 708,298 tax returns claiming more than \$2 billion in the EITC where the IRS determined that the tax return preparer either did not include the required Form 8867 or included an incomplete Form 8867. We reported similar noncompliance by paid tax return preparers during the 2012 Filing Season.<sup>27</sup> As of May 3, 2012, there were almost 534,000 tax returns with EITC claims totaling more than \$1.5 billion that were filed without the required Form 8867.

As of November 13, 2013, the IRS stated that it was considering a number of options for assessing the due diligence penalty but had not yet determined how to proceed. The IRS indicated that its goal is to assess applicable penalties before the next filing season based on time and resources. A lack of an effective process to assess these penalties is of concern as the IRS continues to report billions of dollars in improper EITC payments each year.

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<sup>24</sup> Brannen v. United States, 682 F.3d 1361 (11th Cir. 2012).

<sup>25</sup> Loving v. Internal Revenue Service, 2014 U.S. App. LEXIS 2512 (D.C. Cir. Feb. 11, 2014), *aff'g* 917 F. Supp.2d 67 (D.D.C. 2013).

<sup>26</sup> TIGTA, Ref. No. 2013-40-124, *Late Legislation Delayed the Filing of Tax Returns and Issuance of Refunds for the 2013 Filing Season* (Sep. 2013).

<sup>27</sup> TIGTA, Ref. No. 2012-40-119, *The Majority of Individual Tax Returns Were Processed Timely, but Not All Tax Credits Were Processed Correctly During the 2012 Filing Season* (Sep. 2012).

**Additional Child Tax Credit** – In 2009, we reported a significant increase in ACTC claims by filers who were ineligible or unable to obtain a Social Security Number.<sup>28</sup> These individuals are not authorized to work in the United States and filed tax returns using an Individual Taxpayer Identification Number (ITIN).<sup>29</sup> The ACTC claims made by these filers have grown substantially. While ITIN filers are no longer eligible to claim the EITC, ITIN filers can claim the ACTC.

For Processing Year<sup>30</sup> 2005, a total of 796,000 ITIN filers claimed ACTCs totaling \$924 million. This grew to 2.3 million ITIN filers who claimed ACTCs totaling \$4.2 billion for Processing Year 2010. The increase was due in part to changes in the law which increased the amount of the ACTC that can be claimed as well as making more individuals eligible for the credit. Our review of these claims found that a significant number of ITIN filers are filing multiple claims to obtain the ACTC for prior year tax returns (e.g., filing returns for TYs 2007, 2008, and 2009 at the same time). For example, in Processing Year 2010, approximately 238,000 ITIN filers submitted more than 608,000 tax returns for multiple years at the same time and claimed more than \$1 billion in ACTCs on those returns.<sup>31</sup>

With this increase in claims for the ACTC, there has also been an increased demand for ITINs in order to file these returns. For Fiscal Year 2011, the IRS processed more than 2.2 million ITIN applications.<sup>32</sup> Along with the increased demand for ITINs comes an increased risk that individuals may submit questionable applications to obtain an ITIN for use in filing a tax return to erroneously claim the ACTC. In July 2012, we reported that the ITIN application review and verification process was so deficient that there was no assurance that ITINs were not being assigned to individuals who submitted questionable applications.<sup>33</sup> This, in turn, could allow individuals to use these ITINs to file tax returns to commit tax refund fraud.

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<sup>28</sup> TIGTA, Ref. No. 2009-40-057, *Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims* (Mar. 2009).

<sup>29</sup> An Individual Taxpayer Identification Number is available to individuals who are required to have a taxpayer identification number for tax purposes, but do not have and are not eligible to obtain a Social Security Number because they are not authorized to work in the United States.

<sup>30</sup> The calendar year the tax return or document is processed by the IRS.

<sup>31</sup> TIGTA, Ref. No. 2011-41-061, *Individuals Who Are Not Authorized to Work in the United States Were Paid \$4.2 Billion in Refundable Credits* (July 2011).

<sup>32</sup> ITIN processing uses the full-time equivalent of 463 IRS employees.

<sup>33</sup> TIGTA, Ref. No. 2012-42-081, *Substantial Changes Are Needed to the Individual Taxpayer Identification Number Program to Detect Fraudulent Applications* (July 2012).

In a May 2013 follow-up review,<sup>34</sup> we reported that the IRS initiated corrective actions to address the majority of recommendations included in our prior audit report. These actions significantly improved the identification of questionable ITIN applications. After the new procedures were put into place, the number of applications rejected as questionable increased from 226,011 for the period July through December 2011 to 340,659 for the same period in 2012. In Processing Year 2013, the number of ITIN filers claiming the ACTC decreased to 1.8 million ITIN filers claiming \$3.9 billion in ACTC.

We are currently conducting an audit to assess the IRS's efforts to identify and address the causes of EITC and ACTC improper payments, and to evaluate the IRS's efforts to identify alternative processes to address improper EITC refunds in response to our recommendation. We plan to issue a report later in Fiscal Year 2014.<sup>35</sup>

**American Opportunity Tax Credit** – The Recovery Act amended the Hope Scholarship Credit<sup>36</sup> to allow a refundable tax credit — called the American Opportunity Tax Credit (AOTC). The AOTC allowed individuals to receive a credit for higher education expenses up to \$2,500 per student per year for TYs 2009 and 2010, with up to \$1,000 being refundable. The American Taxpayer Relief Act of 2012<sup>37</sup> subsequently extended the AOTC through December 31, 2017.

As part of our Recovery Act oversight, we reported in September 2011<sup>38</sup> that the IRS lacked effective processes to identify taxpayers who claim erroneous education credits. As a result, 2.1 million taxpayers received a total of \$3.2 billion in education credits (\$1.6 billion in refundable credits and \$1.6 billion in nonrefundable credits) that appeared to be erroneous. Each of these taxpayers claimed students for whom there was no associated Form 1098-T, *Tuition Statement*,<sup>39</sup> in IRS files to substantiate the student's attendance at an educational institution. We have recently initiated a

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<sup>34</sup> TIGTA, Ref. No. 2013-40-052, *Review and Verification of Individual Taxpayer Identification Number Applications Has Improved, However, Additional Processes and Procedures Are Still Needed* (May 2013).

<sup>35</sup> TIGTA, Audit No. 201340031, *Efforts to Reduce Erroneous Refundable Child-Based Tax Credit Payments*, report planned for March 2014.

<sup>36</sup> The Hope Scholarship Credit was established to assist middle-class families with the costs associated with a college degree.

<sup>37</sup> Pub. L. No. 112-240, 126 Stat. 2319 (2013).

<sup>38</sup> TIGTA, Ref. No. 2011-41-083, *Billions of Dollars in Education Credits Appear to Be Erroneous* (Sep. 2011).

<sup>39</sup> Institutions of higher education are required to provide each student with a Form 1098-T, *Tuition Statement*, that reports payments received or amounts billed for qualified tuition and related expenses, scholarships and grants given, adjustments made for a prior year, and the name and location of the institution. Educational institutions are required to provide a Form 1098-T to students who attend their institution and a duplicate copy to the IRS.

follow-up review to assess the IRS's efforts to improve the detection and prevention of erroneous Education Credit claims.<sup>40</sup>

**Premium Tax Credit** – The Affordable Care Act provides for a refundable tax credit to offset an individual's health insurance expenses. Beginning in TY 2014, some low to moderate income individuals eligible to obtain health insurance through one of the State Exchanges or the Federal Exchange (collectively referred to as the Exchanges)<sup>41</sup> may be eligible for a refundable credit to assist them in paying monthly insurance premiums. The amount of the credit is determined by an individual's income in relation to the Federal poverty level, among other factors. In October 2013, the IRS began working with the Exchanges to provide a computation of individuals' estimated maximum monthly Premium Tax Credit.<sup>42</sup> Individuals can elect the amount of credit they want advanced. Qualified individuals can elect to either: 1) have the monthly credit sent directly to their insurance provider as an advanced payment (Advanced Premium Tax Credit)<sup>43</sup> to lower the amount of monthly premiums they would pay out-of-pocket; or 2) wait to receive the credit when they file their TY 2014 tax return. The Congressional Budget Office estimates that six million individuals will receive Premium Tax Credits totaling \$16 billion in Calendar Year (CY) 2014.<sup>44</sup>

Like other refundable credits, there is a risk for improper payments with the Premium Tax Credit. For example, Advanced Premium Tax Credits are computed using a number of factors, including an individual's projected 2014 income, family size, etc. The Exchanges rely on information provided by individuals during the application process as well as information provided by third-parties, including the IRS, to estimate an individual's eligibility to receive the credit. However, it is not until the individual files his or her TY 2014 tax return during CY 2015 that the IRS will know the individual's actual income for 2014 and the amount of the tax credit the individual is entitled to receive.

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<sup>40</sup> TIGTA, Audit No. 201440015, *Efforts to Identify and Prevent Erroneous Education Credits – Follow-up*, report planned for June 2014.

<sup>41</sup> Exchanges are intended to allow eligible individuals to obtain health insurance, and all Exchanges, whether State-based or established and operated by the Federal Government, will be required to perform certain functions.

<sup>42</sup> A refundable tax credit to assist individuals and families in purchasing health insurance coverage through an Exchange.

<sup>43</sup> An Advanced Premium Tax Credit is paid in advance to a taxpayer's insurance company to help cover the cost of premiums.

<sup>44</sup> Congressional Budget Office data tables, *Effects on Health Insurance and the Federal Budget for the Insurance Coverage Provisions in the Affordable Care Act—May 2013 Baseline*, published May 14, 2013.

Individuals who receive an Advanced Premium Tax Credit will reconcile the amount received to the amount of Premium Tax Credit they are eligible to receive based on their actual 2014 income and family size when they file their 2014 tax return. Individuals who are eligible to receive the Premium Tax Credit but did not receive an advanced credit can claim the credit on their 2014 tax return. Individuals who received more than they were entitled to in the form of an Advanced Premium Tax Credit will be responsible for repaying all or part of the credit paid. The IRS will assess the additional credit on the taxpayer's account and attempt to collect it.

We have developed a multi-audit strategy to evaluate the IRS's implementation of the Premium Tax Credit. To date, we have completed evaluations of the IRS's development of needed information systems and the adequacy of the IRS's plans to provide customer service to individuals seeking assistance with the Premium Tax Credit. In September 2013, we reported that a fraud mitigation strategy is not in place to guide Affordable Care Act systems development, testing, initial deployment, and long-term operations.<sup>45</sup> The IRS informed us that two new systems are under development that will address Affordable Care Act tax refund fraud risk. However, until these new systems are successfully developed and tested, TIGTA remains concerned that the IRS's existing fraud detection system may not be capable of identifying Affordable Care Act refund fraud or schemes prior to the issuance of tax refunds.

Currently, we are in the process of evaluating the accuracy of the IRS's computation of the maximum monthly Premium Tax Credit for use by the Exchanges.<sup>46</sup> Future reviews will evaluate the adequacy of the IRS's controls to verify the accuracy of Premium Tax Credit claims and will also assess the impact that delayed employer health insurance reporting will have on the IRS's ability to verify these claims when tax returns are processed.

**Fuel Tax Credit** – Individual taxpayers may claim credits for Federal excise taxes paid on fuels used for tax-exempt purposes, such as farming and off-highway businesses. During Processing Year 2011, approximately \$176 million in fuel tax credits were claimed by individual taxpayers. For the past several years, the IRS has listed Fuel Tax Credit fraud scams as an example of one of the “Dirty Dozen” tax scams. In an ongoing audit, we analyzed Form 1040 tax return data and determined that over 20 percent of tax returns claiming a Fuel Tax Credit of \$100 or more had questionable characteristics, such as little or no reported income from self-employment

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<sup>45</sup> TIGTA, Ref. No. 2013-23-119, *Affordable Care Act: Improvements Are Needed to Strengthen Systems Development Controls for the Premium Tax Credit Project* (Sep. 2013).

<sup>46</sup> TIGTA, Audit No. 201340335, *Affordable Care Act: Accuracy of the Income and Family Size Verification and Advanced Premium Tax Credit Calculation*, report planned for May 2014.

or farming.<sup>47</sup> We provided IRS management with listings of questionable Processing Year 2011 and 2012 tax returns claiming the fuel tax credit. As of February 2014, the IRS has included over 3,600 tax returns in the correspondence examination stream.

## **IDENTITY THEFT AND TAX REFUND FRAUD**

While refundable tax credits increase the risk of potentially fraudulent tax refunds, other issues concerning tax administration can also pose a significant risk for improper payments. For example, the IRS does not have third-party information to effectively verify income and withholding when tax returns are processed. The IRS is also challenged with the rapidly growing problem of identity theft tax refund fraud, including the use of Social Security Numbers of and by prisoners to file false tax returns, and tax fraud related to the use of stolen Employer Identification Numbers (EIN).<sup>48</sup>

### Identity Theft

The IRS has described identity theft as the number one tax scam for 2014.<sup>49</sup> The IRS has made this issue one of its top priorities and has made some progress; however, significant improvements are still needed.

As of September 28, 2013, the IRS had identified more than 2.5 million incidents of identity theft in CY 2013. As of December 31, 2013, the IRS reported that during the 2013 Filing Season it stopped the issuance of more than \$10.7 billion in potentially fraudulent tax refunds associated with over 1.8 million tax returns classified as involving identity theft.

In September 2013, TIGTA reported that the impact of identity theft on tax administration continues to be significantly greater than the amount the IRS detects and prevents.<sup>50</sup> Using the characteristics of tax returns that the IRS has confirmed as involving identity theft and income and withholding information the IRS received in 2012 late in the filing season and in early 2013, we analyzed TY 2011 tax returns processed

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<sup>47</sup> TIGTA, Audit No. 201230024, *Fuel Tax Credits*, report planned for July 2014.

<sup>48</sup> An EIN is a Federal Tax Identification Number used to identify a taxpayer's business account. The EIN is used by employers, sole proprietors, corporations, partnerships, nonprofit associations, trusts and estates, government agencies, certain individuals, and other types of businesses.

<sup>49</sup> IRS Press Release, IR-2014-16 (February 19, 2014), available at <http://www.irs.gov/uac/Newsroom/IRS-Releases-the-“Dirty-Dozen”-Tax-Scams-for-2014;-Identity-Theft,-Phone-Scams-Lead-List>.

<sup>50</sup> TIGTA, Ref. No. 2013-40-122, *Detection Has Improved; However, Identity Theft Continues to Result in Billions of Dollars in Potentially Fraudulent Tax Refunds* (Sep. 2013).

during the 2012 Filing Season and identified approximately 1.1 million undetected tax returns where the primary Taxpayer Identification Number on the tax return was a Social Security Number. The undetected tax returns have potentially fraudulent tax refunds totaling approximately \$3.6 billion, which is a decrease of \$1.6 billion compared to the \$5.2 billion we reported for TY 2010.<sup>51</sup>

In addition, we expanded our TY 2011 analysis to include tax returns where the primary Taxpayer Identification Number on the tax return is an ITIN. We identified more than 141,000 TY 2011 tax returns filed with an ITIN that have the same characteristics as IRS-confirmed identity theft tax returns. Potentially fraudulent tax refunds issued for these undetected tax returns totaled approximately \$385 million, which is in addition to the approximately \$3.6 billion referred to earlier. In total, the IRS could issue potentially fraudulent refunds of approximately \$4 billion annually as a result of identity theft tax refund fraud.

A common characteristic of tax returns filed by identity thieves is the reporting of false income and withholding to generate a fraudulent tax refund. Another aspect to this problem is that many individuals who are victims of identity theft may be unaware that their identity has been stolen and used to file fraudulent tax returns. These individuals are typically those who are not required to file a tax return.<sup>52</sup>

The IRS continues to expand its efforts to identify fraudulent tax returns and prevent the payment of tax refunds by processing all individual tax returns through identity theft screening filters. These filters look for known characteristics of identity theft cases to detect fraudulent tax returns before they are processed and before any tax refunds are issued. In Processing Year 2012, there were 11 filters that identified approximately 325,000 tax returns and prevented approximately \$2.2 billion in fraudulent refunds from being issued. In Processing Year 2013, the number of filters increased to approximately 80, which has enhanced the IRS's ability to identify identity theft tax refund fraud. As of September 30, 2013, the IRS indicated that it had identified 561,033 tax returns and prevented approximately \$2.5 billion in fraudulent tax refunds from being issued. This represents a 157 percent increase over the number that the IRS identified for the same period in Processing Year 2012.<sup>53</sup>

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<sup>51</sup> TIGTA, Ref. No. 2012-42-080, *There Are Billions of Dollars in Undetected Tax Refund Fraud Resulting From Identity Theft* (July 2012).

<sup>52</sup> Individuals who generally are not required to file a tax return include children, deceased individuals, elderly, and individuals who earn less than their standard deduction or earn non-taxable income such as some Social Security benefits.

<sup>53</sup> The IRS indicated that it had identified 218,156 tax returns and prevented approximately \$1.5 billion in fraudulent tax refunds from being issued as of September 30, 2012.



Tax returns detected by the various expanded filters are held during processing until the IRS can verify the taxpayers' identities. IRS employees attempt to contact these individuals and request information to verify that the individual filing the tax return is the legitimate taxpayer. If the IRS cannot confirm the filer's identity, it suspends processing of the tax return to prevent the issuance of a fraudulent refund.

In January 2012, the IRS created the Identity Theft Clearinghouse (the Clearinghouse) within its Criminal Investigation division. The Clearinghouse was created to accept tax fraud-related identity theft leads from the IRS's Criminal Investigation field offices. The Clearinghouse performs research, develops each lead for the field offices, and provides support for ongoing criminal investigations involving identity theft. As of September 30, 2013, the Clearinghouse had received 3,962 identity theft leads that have resulted in the development of 485 investigations.

Finally, the IRS has significantly expanded the number of tax accounts that it locks by placing an indicator on the individual's tax account.<sup>54</sup> In Processing Year 2011, the IRS began locking taxpayers' accounts where the IRS Master File<sup>55</sup> and Social Security Administration data showed a date of death. The IRS places a unique identity-theft indicator to lock the individual's tax account if he or she is deceased. Electronically filed tax returns using the Social Security Number of a locked account will be rejected (the IRS will not accept the tax return for processing). Paper tax returns will be processed; however, the tax returns will not post to the taxpayer's account due to the account lock, and a refund will not be issued.

Between January 2011 and September 2013, the IRS had locked approximately 11 million deceased taxpayer accounts, which will assist the IRS in preventing future identity theft fraudulent tax refunds from being issued. As of September 30, 2013, the IRS had rejected 404,490 e-filed tax returns during the 2013 Filing Season. Additionally, the IRS has prevented the issuance of approximately \$10 million in fraudulent tax refunds since the inception of the lock on paper tax returns. In November 2013, the Chairman of the Senate Finance Committee proposed restricting access to the Social Security Administration's public Death Master File, which would help the IRS's efforts to reduce tax fraud via the use of a deceased individual's Social Security Number.

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<sup>54</sup> When an account is locked, tax refunds are not processed.

<sup>55</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

Despite these improvements, the IRS could continue to expand the use of characteristics of confirmed identity theft cases to improve its ability to detect and prevent the issuance of fraudulent tax refunds. As we reported in July 2008,<sup>56</sup> July 2012, and again in September 2013, the IRS is not in compliance with direct-deposit regulations that require tax refunds to be deposited into an account only in the name of the individual listed on the tax return. Direct deposit, which now includes debit cards, provides the ability to receive fraudulent tax refunds quickly, without the difficulty of having to negotiate a tax refund paper check. The majority of the TY 2011 tax returns we identified with indicators of identity theft (84 percent) involved the use of direct deposit to obtain tax refunds totaling approximately \$3.5 billion. There are indications that abusive practices are still ongoing. For example, one bank account received 446 direct deposits totaling over \$591,000.<sup>57</sup>

To improve the IRS's conformance with direct-deposit regulations and to help minimize fraud, TIGTA recommended that the IRS limit the number of tax refunds being sent to the same direct-deposit account. By limiting the number of tax refunds that can be deposited into the same account, the IRS could minimize losses associated with fraud. As of December 2013, the IRS is still considering this recommendation, but the IRS did develop new filters for the 2013 Filing Season to identify and stop tax returns with similar direct deposit and address characteristics. As of September 26, 2013, the IRS indicated that it had identified 267,838 tax returns using these filters and prevented approximately \$817 million tax refunds from being issued. We will be initiating a follow-up review to assess the IRS's efforts to identify and stop tax returns in the 2013 Filing Season with similar direct deposit and address characteristics.<sup>58</sup>

In addition, in January 2013, the IRS implemented a pilot program with the Department of the Treasury Fiscal Service<sup>59</sup> designed to allow financial institutions to reject direct deposit tax refunds based on mismatches between the account name and the name on the tax return. Once the refund is identified by the institution, it is sent back to the Fiscal Service to be routed back to the IRS. As of September 30, 2013, there have been 20,051 refunds returned from financial institutions totaling more than \$66 million. This is a promising first step in recovering fraudulent tax refunds issued via direct deposit.

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<sup>56</sup> TIGTA, Ref. No. 2008-40-182, *Processes Are Not Sufficient to Minimize Fraud and Ensure the Accuracy of Tax Refund Direct Deposits* (Sep. 2008).

<sup>57</sup> TIGTA, Ref. No. 2013-40-122, *Detection Has Improved; However, Identity Theft Continues to Result in Billions of Dollars in Potentially Fraudulent Tax Refunds* (Sep. 2013).

<sup>58</sup> TIGTA, Audit No. 201440001, *Detection and Prevention of Identity Theft on Individual Tax Accounts – Follow-Up*.

<sup>59</sup> Formerly, the Department of the Treasury Financial Management Service.

Identifying potential identity theft tax fraud is the first step. Once the IRS identifies a potential identity theft tax return, it must verify the identity of the individual filing the return. However, verifying whether the returns are fraudulent will require additional resources. Using IRS estimates, it would cost approximately \$22 million to screen and verify the more than 1.2 million tax returns that we identified as not having third-party information on income and withholding. In August 2013, the IRS Principal Deputy Commissioner testified that more than 3,000 IRS employees are currently working on identity theft – more than double the number at the start of the previous filing season.

Without the necessary resources, it is unlikely that the IRS will be able to work the entire inventory of potentially fraudulent tax returns it identifies. The IRS selects only those tax returns for which it can verify the identity of the taxpayer and/or the income based on available resources. If the IRS does not have the resources to work the remainder of the potentially fraudulent tax returns it identifies, the refunds for those returns will be issued. The net cost of failing to provide the necessary resources is substantial, given that the potential revenue loss to the Federal Government of these tax fraud-related identity theft cases is billions of dollars annually.

#### TIGTA Criminal Investigations of Identity Theft and Impersonation Scams

Identity theft has a negative impact on the economy, and the damage it causes to its victims can be personally, professionally, and financially devastating. When individuals steal identities and file fraudulent tax returns to obtain fraudulent refunds before the legitimate taxpayers file, the crime is tax fraud, which falls within the programmatic responsibility of IRS Criminal Investigation. TIGTA's Office of Investigations focuses its limited resources on investigating identity theft characterized by any type of IRS employee involvement, the misuse of client information by tax preparers, or the impersonation of the IRS through phishing<sup>60</sup> schemes and other means. Where there is overlapping jurisdiction, TIGTA and IRS Criminal Investigation will work together to bring identity thieves to justice.

Tax fraud-related identity theft extends beyond the borders of the United States and its possessions. A notable instance of foreign-based identity theft occurred in 2007 when individuals created a phishing site that mimicked the legitimate IRS Free File

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<sup>60</sup> Phishing is an attempt by an individual or group to solicit personal and financial information from unsuspecting users in an electronic communication by masquerading as trustworthy entities such as government agencies, popular social websites, auction sites, online payment processors, or information technology administrators.

Alliance site.<sup>61</sup> The perpetrator, a Belarusian national, along with his co-conspirators, collected taxpayer data, altered the tax returns, and caused approximately \$200,000 in stolen refunds to be deposited into bank accounts he controlled.<sup>62</sup>

Currently, TIGTA is investigating several cases that involve international identity theft potentially impacting nearly 30,000 victims with estimated fraudulent tax refund claims of between \$73 million and \$148 million. A recent example of this activity involved TIGTA's arrest, when he returned to the United States, of a Nigerian foreign national for aggravated identity theft, wire fraud, and conspiracy charges relating to fraudulent tax returns. During a subsequent plea agreement, he admitted to using victim identities to e-file more than 80 fraudulent tax returns requesting more than \$400,000.<sup>63</sup> In another example, TIGTA Office of Investigations arrested two subjects in July 2013 who were involved in a conspiracy to steal patient identities from a Virginia-based health care facility where they were employed.<sup>64</sup> The subjects filed fraudulent Federal tax returns in the victims' names attempting to collect more than \$400,000 in fraudulent returns, and "a substantial part of the scheme was committed from outside the United States and the offense involved sophisticated means."<sup>65</sup> One of the subjects was sentenced to 57 months of imprisonment and the other sentenced to 81 months of imprisonment.<sup>66</sup> Each subject was ordered to make restitution to the IRS in the amount of \$116,404.<sup>67</sup>

IRS employees are entrusted with the sensitive personal and financial information of taxpayers. Using this information to perpetrate a criminal scheme for personal gain negatively impacts our Nation's voluntary tax system and it can generate widespread distrust of the IRS. TIGTA aggressively investigates IRS employees involved in identity theft-related tax refund fraud and refers these investigations to the Department of Justice for prosecution. Many of these employees face significant prison sentences as well as the loss of their jobs if convicted. The following cases highlight TIGTA's work in this area.

In November 2013, TIGTA special agents arrested an IRS Tax Examining Technician for aggravated identity theft and conspiracy.<sup>68</sup> The IRS employee conspired

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<sup>61</sup> The Free File Alliance is a nonprofit coalition of industry-leading tax software companies that partnered with the IRS to help millions of Americans prepare and e-file their Federal tax returns for free.

<sup>62</sup> D. Mass. Plea Agr. filed Jan. 19, 2011; D. Mass. Indict. filed June 23, 2010.

<sup>63</sup> N.D.N.Y. Plea Agr. filed July 11, 2012.

<sup>64</sup> E.D. Va. Arrest Warrant returned July 11, 2013.

<sup>65</sup> E.D. Va. Indict. filed Aug. 7, 2013; E.D. Va. Statement of Facts filed Oct. 11, 2013.

<sup>66</sup> E.D. Va. Judgment filed Jan. 13, 2014 and E.D. Va. Judgment filed Jan. 27, 2014.

<sup>67</sup> E.D. Va. Restitution Order filed Jan. 10, 2014 and E.D. Va. Restitution Order filed Jan. 24, 2014.

<sup>68</sup> N.D. Ga. Executed Arrest Warrant dated Nov. 26, 2013.

with another individual to divert a tax refund belonging to another taxpayer by changing the taxpayer's mailing address without the taxpayer's permission, causing a refund of \$595,901 to be mailed to her co-conspirator.<sup>69</sup> Further criminal action is pending.

TIGTA investigated an IRS employee who accessed a family member's tax return information that was stored in an IRS database and used that information to file a false amended tax return. She directed the tax refund generated from the false tax return to her own address. The IRS employee pled guilty in July 2013 to a criminal information<sup>70</sup> charging her with knowingly and willingly disclosing tax return and return information collected by the Department of the Treasury to an unauthorized party.<sup>71</sup>

In another case, a former IRS employee was indicted for wire fraud and aggravated identity theft in October 2013. From at least 2008 through March 2011, the subject, while an IRS employee, obtained the personal identifiers of individuals without their consent or knowledge and completed individual Federal tax returns and State tax returns.<sup>72</sup> Using a false identity, the subject of this investigation established an account with an Internet service provider, an e-mail address in order to submit the false returns to the IRS and the State of Missouri, and generated fraudulent refunds. She opened bank accounts with at least six financial institutions in five different States and used the routing number, account number, and debit card number on the fraudulent returns to direct payment or credit to accounts she controlled. Through her scheme, the subject unlawfully acquired approximately \$326,260 (\$211,474 from the IRS and \$114,786 from the State of Missouri) in fraudulent tax refunds.<sup>73</sup>

TIGTA also investigates tax preparers who misuse their clients' information to commit identity theft-related refund fraud. For example, TIGTA investigated a tax preparer who stole the personal identifiers of her clients and filed numerous fraudulent tax returns without their permission or knowledge. The tax preparer, who was indicted in April 2013 on charges of aggravated identity theft, wire fraud, mail fraud and false claims, prepared and filed more than 200 fraudulent tax returns and defrauded the U.S. Government of more than \$1 million in tax refunds. She used the proceeds from the fraudulently obtained tax returns to purchase 20 real properties in Arizona.<sup>74</sup>

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<sup>69</sup> N.D. Ga. Crim. Compl. dated Nov. 25, 2013.

<sup>70</sup> N.D. Ga. Plea Agr. filed July 11, 2013.

<sup>71</sup> N.D. Ga. Crim. Info. filed June 10, 2013.

<sup>72</sup> W.D. Mo. Indict. filed Oct. 2, 2013.

<sup>73</sup> *Id.*

<sup>74</sup> S.D. Cal. Indict. filed Apr. 13, 2013.

In another case, TIGTA investigated a tax preparer who stole the personal identifiers of several individuals and unlawfully disclosed the information to others to fraudulently obtain tax refunds. According to the indictment, the subject of the investigation worked as a tax preparer from January 2002 to June 2008. In 2010, he used the personal identifiers of other individuals to file false income tax returns and obtain refunds from the IRS. The preparer obtained most of the personal identifiers in the course of his prior employment as a tax preparer and from other employment positions he held. He disclosed this information to co-conspirators so they could also file false income tax returns and obtain refunds from the IRS. The subject and his co-conspirators ultimately defrauded or attempted to defraud the IRS of at least \$560,000 in tax refunds.<sup>75</sup> The subject was sentenced to 15 years in prison and ordered to pay restitution in the amount of \$515,257.75.<sup>76</sup>

In addition to these TIGTA investigations, the IRS announced in February 2013 the results of a nationwide effort with the Department of Justice and local U.S. Attorneys' offices focusing on identity theft suspects in 32 States and Puerto Rico, which involved 215 cities and surrounding areas. This joint effort involved 734 enforcement actions related to identity theft and refund fraud, including indictments, informations, complaints, and arrests.

Criminals have been impersonating the IRS for years. While the fraud schemes may change, the motive remains the same: to bilk honest taxpayers out of their hard-earned money. Scammers and thieves often prey on immigrants and the elderly and sometimes even resort to threats. For example, in the summer of 2013, TIGTA began receiving numerous complaints from around the country about suspicious callers claiming to be IRS employees collecting taxes from recent IRS audits. The callers demanded that the tax payments be made to pre-paid credit cards and threatened arrest, suspension of business or driver's licenses, and even deportation if the callers' demands were not met. In many cases, the callers became hostile and insulting. Investigative information indicates that the calls originated from outside the United States and are likely part of an organized criminal enterprise. To date, the TIGTA Hotline has received over 15,000 calls related to this scam and it is estimated that the scheme has resulted in \$945,000 in payments made by the victims. TIGTA special agents are actively investigating these crimes against taxpayers.

Identity theft and other fraud schemes targeting senior citizens continue to be on the rise. Sweepstakes and lottery scams, e-mail and phishing scams, and investment

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<sup>75</sup> S.D. Cal. Superseding Indict. filed June 19, 2012.

<sup>76</sup> S.D. Cal. Judgment dated May 22, 2013.

scams are among the top ten fraud schemes used by criminals to target seniors.<sup>77</sup> TIGTA's Office of Investigations investigated an individual who, along with his co-conspirators, engaged in a fraud scheme that specifically targeted senior citizens. As part of the scheme, a co-conspirator sent e-mails to victims representing that he was an attorney or foreign government official who was responsible for distributing an inheritance. The e-mails sent to the unsuspecting victims falsely informed them that they owed additional taxes to the IRS, or had inherited millions of dollars but needed to pay processing fees to release the funds. When the victims responded to the e-mails, the subject of the investigation, or one of his co-conspirators, contacted them by telephone and e-mail pretending to be someone who could assist them in obtaining the promised inheritance. The victims were led to believe that these contacts were from legitimate business people, and were deceived into paying fees in advance of receiving the inheritance. However, the funds were never used to pay any fees, nor were any inheritance payments made to the victims. The subject of this investigation was sentenced to 10 years in prison<sup>78</sup> after pleading guilty to an indictment charging him with 15 counts of wire fraud.<sup>79</sup>

## Tax Refund Fraud

### *Verification of Income and Withholding*

Access to third-party income and withholding information at the time tax returns are processed is the most important tool the IRS could use to detect and prevent tax fraud resulting from the reporting of false income and withholding. While the IRS has increased its detection of fraudulent tax returns at the time tax returns are processed and has prevented the issuance of billions of dollars in fraudulent tax refunds, it still does not have timely access to third-party income and withholding information needed to make any substantial improvements in its detection efforts.

Expanded access to the National Directory of New Hires could immediately provide the IRS with this type of information that could help prevent tax fraud. Currently, the IRS's use of this information is limited by law to just those tax returns that include a claim for the EITC. The IRS has included a legislative proposal for expanded access to this information in its annual budget submissions for FYs 2010 through 2013

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<sup>77</sup> *Top Ten Scams Targeting Seniors*, National Council on Aging, <http://www.ncoa.org/enhance-economic-security/economic-security-Initiative/savvy-saving-seniors/top-10-scams-targeting.html> (last visited Apr. 4, 2013).

<sup>78</sup> C.D. Cal. Judgment and Probation/Commitment Order filed Oct. 21, 2013.

<sup>79</sup> C.D. Cal. Opposition to Defendant's Ex Parte Application to Continuance of Trial Date filed June 6, 2012; C.D. Cal. Indict. filed Oct. 21, 2009; C.D. Cal. Crim. Complaint filed Aug. 3, 2009; C.D. Cal. Crim. Minutes Change of Plea filed July 31, 2012.

and has once again included this proposal in its FY 2014 budget submission. In an effort to combat identity theft, the Chairman of the Senate Finance Committee proposed in November 2013 granting the IRS authority to use the Department of Health and Human Services (HHS) National Directory of New Hires to verify employment data.

Improvements can also be made to the income and verification processes when tax returns are identified by the IRS as potentially fraudulent. In August 2013, we reported<sup>80</sup> that ineffective income and withholding verification processes are resulting in the issuance of potentially fraudulent tax refunds. Our review of a random sample of 272 tax returns sent for verification found that ineffective verification processes resulted in the issuance of the potentially fraudulent tax refunds associated with these tax returns.

### *Prisoner Fraud*

Refund fraud associated with the use of Social Security Numbers of and by prisoners to file false tax returns remains a significant problem for tax administration. The IRS informed us that the number of fraudulent tax returns identified by the IRS as filed using a prisoner SSN has increased from more than 18,000 tax returns in CY 2004 to more than 186,000 tax returns in CY 2011. The refunds claimed on these tax returns increased from \$68 million to \$3.7 billion.

In December 2010, we reported<sup>81</sup> that significant problems exist with the IRS's efforts to identify the use of Social Security Numbers of and by prisoners to file false tax returns to commit tax refund fraud. The Inmate Tax Fraud Prevention Act of 2008<sup>82</sup> provided the IRS with the authority to disclose prisoner tax information to the Federal Bureau of Prisons. The Homebuyer Assistance and Improvement Act of 2010<sup>83</sup> expanded that authority to include State Departments of Corrections in July 2010. However, as of October 2010, the IRS had not completed the necessary agreements to share prisoner information. As a result, no information had been disclosed to either the Federal Bureau of Prisons or State Departments of Corrections at that time. In January 2013, the American Taxpayer Relief Act of 2012<sup>84</sup> provided the IRS with the permanent

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<sup>80</sup> TIGTA, Ref. No. 2013-40-083, *Income and Withholding Verification Processes are Resulting in the Issuance of Potentially Fraudulent Tax Refunds* (Aug. 2013).

<sup>81</sup> TIGTA, Ref. No. 2011-40-009, *Significant Problems Still Exist With Internal Revenue Service Efforts to Identify Prisoner Tax Refund Fraud* (Dec. 2010).

<sup>82</sup> Pub. L. No. 110-428, 122 Stat. 4839.

<sup>83</sup> Pub. L. No. 111-198, 124 Stat. 1356.

<sup>84</sup> Pub. L. No. 112-240, 126 Stat. 2319 (2013).



authority to share information with the Federal Bureau of Prisons or State Departments of Corrections. As of January 2014, there are still no agreements in place.

We also found that the review process used by the IRS to compile the 2009 prisoner data file<sup>85</sup> lacked managerial oversight to ensure the accuracy and reliability of this file. This omission is critical because the Prisoner File is used by the IRS to identify potentially fraudulent prisoner tax returns at the time a tax return is filed and prior to issuance of the refund. In December 2012, we reported<sup>86</sup> the results of a follow-up review assessing the reliability of the IRS's Prisoner File. We determined that despite increased efforts by the IRS to improve the accuracy of the Prisoner File, there were inaccuracies in the prisoner information, the file contained incomplete records, and not all prisons reported prisoners. As such, the controls used to ensure that the IRS identifies fraudulent refunds on tax returns prepared by prisoners were not fully effective. Most of these issues we identified are beyond the control of the IRS because the IRS has to rely on information provided by the prisons to identify prisoner-filed tax returns. Nonetheless, the IRS can do more to ensure that the Prisoner File is accurate and complete by taking further steps to improve its validation and verification processes. IRS management agreed to continue to assess the effectiveness of the validation activities performed on the Prisoner File. We recently initiated a follow-up review<sup>87</sup> to evaluate the effectiveness of the IRS's corrective actions in response to our prior report to identify and reduce prisoner fraud.<sup>88</sup>

#### *Stolen or Falsely Obtained Employer Identification Numbers*

Individuals attempting to commit tax refund fraud commonly steal or falsely obtain an EIN to file tax returns reporting false income and withholding. A valid EIN for the employer must be provided in support of wages and withholding reported on individual tax returns. Individuals who report wages and withholding on a tax return must attach a Form W-2, *Wage and Tax Statement*,<sup>89</sup> to a paper-filed tax return to support the income and withholding reported. For an e-filed tax return, the filer must input the information from the Form W-2 into the e-filed tax return.

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<sup>85</sup> The IRS annually compiles a list of prisoners (Prisoner Data File) from the Federal Bureau of Prisons and State Departments of Corrections. Various IRS offices and functions use the Prisoner File to prevent and detect fraud committed by prisoners, including the filing of fraudulent tax returns.

<sup>86</sup> TIGTA, Ref. No. 2013-40-011, *Further Efforts Are Needed to Ensure the Internal Revenue Service Prisoner File is Accurate and Complete* (Dec. 2012).

<sup>87</sup> TIGTA, Audit No. 201340016, *Prisoner Fraud – Follow-Up*, report planned for May 2014.

<sup>88</sup> TIGTA, Ref. No. 2011-40-009, *Significant Problems Still Exist With Internal Revenue Service Efforts to Identify Prisoner Tax Refund Fraud* (Dec. 2010).

<sup>89</sup> The IRS requires employers to report wage and salary information for employees on a Form W-2. The Form W-2 also reports the amount of Federal, State, and other taxes withheld from an employee's paycheck.

TIGTA identified 767,071 TY 2011 e-filed individual tax returns with refunds based on falsely reported income and withholding using a stolen or falsely obtained EIN.<sup>90</sup> TIGTA estimates that the IRS could issue almost \$2.3 billion annually in potentially fraudulent tax refunds based on these EINs. There were 285,670 EINs used on these tax returns:

- 277,624 were stolen EINs used to report false income and withholding on 752,656 tax returns with potentially fraudulent refunds issued totaling more than \$2.2 billion.
- 8,046 were falsely obtained EINs used to report false income and withholding on 14,415 tax returns with potentially fraudulent refunds issued totaling more than \$50 million.

These 767,071 returns with potentially fraudulent refunds issued is in addition to the approximately 1.2 million undetected TY 2011 tax returns we identified as having characteristics of an identity theft tax return discussed earlier in our testimony.

The IRS has developed a number of processes to prevent fraudulent refunds claimed using stolen and falsely obtained EINs. As previously noted, third-party information is not available to effectively detect the reporting of false income and withholding at the time tax returns are processed. Nonetheless, the IRS has both tax information and other data that can be used to proactively identify tax returns with income reported using a stolen or falsely obtained EIN. Using these data, the IRS could have identified 53,169 tax returns with refunds issued totaling almost \$154 million that had income reported with a stolen or falsely obtained EIN. IRS management agreed with our recommendation to update fraud filters using the tax information and other data we identified.

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<sup>90</sup> TIGTA, Ref. No. 2013-40-120, *Stolen and Falsely Obtained Employer Identification Numbers Are Used to Report False Income and Withholding* (Sep. 2013).

## IMPLEMENTATION OF THE AFFORDABLE CARE ACT

The Patient Protection and Affordable Care Act<sup>91</sup> and the Health Care and Education Reconciliation Act of 2010 (Affordable Care Act) contains an extensive array of tax law changes that will present many challenges for the IRS in the coming years. The ACA provisions provide incentives and tax breaks to individuals and small businesses to offset health care expenses. They also impose penalties, administered through the tax code, for individuals and businesses that do not obtain health care coverage for themselves or their employees. The ACA represents the largest set of tax law changes in more than 20 years and represents a significant challenge to the IRS.

### *ACA-related Customer Service*

In December 2013, we issued a report on the IRS's ACA customer service strategy,<sup>92</sup> which is a collaborative and coordinated effort between the IRS and multiple Federal and State agencies. The Department of Health and Human Services will serve as the "public face" for customer service at the Exchanges<sup>93</sup> until Calendar Year 2015. Individuals who contact the IRS for ACA assistance will be referred to the HHS's public website (Healthcare.gov) and toll-free telephone assistance lines. The IRS will also refer individuals to its own recorded telephone messages and self-assistance tools. In CY 2015, the IRS will take the lead in providing customer service when individuals begin filing their 2014 tax returns. The IRS's customer service strategy includes sufficient plans to: 1) perform outreach and education; 2) update or develop tax forms, instructions, and publications; and 3) provide employee training to assist individuals in understanding the requirement to maintain minimum essential coverage and the tax implications of obtaining the Premium Tax Credit.

However, changes in the implementation of ACA tax provisions may result in increased demand for customer service assistance resulting in more contacts with the IRS. Depending on the nature of any changes made to ACA tax provisions, the IRS's strategy and plans to provide adequate customer service could be affected. In an attempt to mitigate the effect that implementation changes may have on its ability to provide adequate customer service, the IRS has developed oversight and monitoring

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<sup>91</sup> Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of U.S. Code), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.

<sup>92</sup> TIGTA, Ref. No. 2014-43-006, *Affordable Care Act: The Customer Service Strategy Sufficiently Addresses Tax Provisions; However, Changes in Implementation Will Create Challenges* (Dec. 2013).

<sup>93</sup> Exchanges are intended to allow eligible individuals to obtain health insurance, and all Exchanges, whether State-based or established and operated by the Federal government, will be required to perform certain functions.

processes and procedures to alert management at the earliest possible time of actions that may affect its operations.

### *Security Over Federal Tax Data*

The information technology and security challenges for the ACA are considerable and include implementation of interdependent projects in a short span of time, evolving requirements, coordination with internal and external stakeholders, cross-agency system integration, and testing. ACA implementation will have a significant impact on existing systems, so there must be bandwidth to support all provisions. Finally, projects must be staffed with personnel who have the required knowledge and skills to efficiently deploy new technologies. To manage these challenges, the IRS created a Project Management Office for the ACA within the Information Technology program area.

The Exchanges will request income and family size information for each applicant and their family members who are qualified to apply for health insurance and will forward the request to the IRS. The Department of Health and Human Services Data Services Hub provides the connections for the Exchanges and all other Federal agencies, including the IRS.

The IRS, using Federal tax data, will determine the applicant's historical household income, family size, filing status, adjusted gross income, taxable Social Security benefits, and other requested information. The IRS will then transmit the Federal tax data to the HHS Data Services Hub for delivery to the appropriate Exchange. The Exchanges will compare the IRS information with the information provided by the applicant and other available data.

TIGTA issued a report on the IRS Income and Family Size Verification Project and found that the project was on schedule and the IRS was managing known information technology risks at the time the audit was conducted.<sup>94</sup> TIGTA recommended that the IRS: 1) improve the management of ACA changes to requirements; and 2) use an integrated suite of automated tools to manage ACA requirements and application test cases.

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<sup>94</sup> TIGTA, Ref. No. 2013-23-034, *Affordable Care Act: The Income and Family Size Verification Project: Improvements Could Strengthen the Internal Revenue Service's New Systems Development Process* (Mar. 2013).

TIGTA remains concerned about the protection of confidential taxpayer data that will be provided to the Exchanges. The Federal tax data provided to HHS and the Exchanges will be protected through the IRS's Safeguard Review Program. TIGTA is currently conducting an audit of the IRS's Safeguard Review Program and will issue a report on its operations in Fiscal Year 2014.<sup>95</sup> TIGTA has concerns that the Safeguard Review Program may lack sufficient staffing or funding to adequately expand its operations to include the addition of the Federal and State Exchanges.

### *Protection Against Fraudulent ACA Claims on Tax Returns*

The Exchanges will use the income and family size information received from the IRS as well as information provided by the applicant and other data sources in finalizing the income amounts and family size. TIGTA is currently evaluating the accuracy of the data that the IRS provides to the HHS for use in enrolling individuals and calculating the Advanced Premium Tax Credit, and plans to issue a report this year.<sup>96</sup> We plan to assess the protection of Federal tax data provided by the Program in the future.<sup>97</sup>

There could be many reasons why the Credit originally claimed by the taxpayer is different when the tax return is filed. For example, the taxpayer's income could have changed from the prior year when he or she applied for health coverage, or the taxpayer's family size may have increased or decreased from the prior year.

TIGTA is concerned that the potential for refund fraud and related schemes could increase as a result of processing ACA Premium Tax Credits unless the IRS builds, implements, updates, and embeds ACA predictive analytical fraud models into its tax filing process.

The IRS has developed a plan to prevent, detect, and resolve fraud and abuse during ACA tax return processing. The plan, when fully developed and implemented, is designed to leverage third-party reporting from the Exchanges and new computer analytical capability built into the Return Review Program.<sup>98</sup> The plan calls for the

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<sup>95</sup> TIGTA, Audit No. 201320029, *Review of the Internal Revenue Service's Office of Safeguards*, report planned for April 2014.

<sup>96</sup> TIGTA, Audit No. 201340335, *Affordable Care Act: Accuracy of the Income and Family Size Verification and Advanced Premium Tax Credit Calculation*, report planned for May 2014.

<sup>97</sup> TIGTA, Audit No. 201420302, *Security Over Federal Tax Data at Health Insurance Exchanges*, report planned for August 2014.

<sup>98</sup> The Return Review Program is the key automated component of the IRS's pre-refund initiative and will implement the IRS's new business model for a coordinated criminal and civil tax noncompliance approach to prevent, detect, and resolve tax refund fraud, including refundable ACA premium tax credits.

development of the ACA Validation Service which will be used to identify improper ACA-related refunds. The ACA Validation Service will be designed to perform screening for improper refunds and will also identify fraudulent schemes that include multiple returns. The IRS plans to rely on the Electronic Fraud Detection System and/or the new Return Review Program to provide the systems to identify and prevent ACA-related refund fraud.

The applications for processing electronic and paper tax returns will need to be modified before January 2015 in order to be able to use the new ACA Validation Service to determine if a taxpayer claiming the Premium Tax Credit also purchased insurance through the Exchanges or received an Advanced Premium Tax Credit in 2014, and if any math errors exist.

TIGTA performed a system development audit of the Return Review Program<sup>99</sup> and determined that roles for program-level governance were not yet established for the Return Review Program, and that the key role of system integrator was not documented or clearly communicated. As a result, there is limited assurance that Return Review Program systems development activities will achieve expected benefits or meet time-sensitive business and information technology requirements for addressing the IRS's evolving tax refund fraud risks.

#### *ACA Provisions Impacting the Current 2014 Filing Season*

Several ACA tax-related provisions became effective for CY 2013 that affect individuals with high incomes including the creation of a new net investment income tax,<sup>100</sup> and an increase in the employee-share of the Medicare tax (i.e., Hospital tax).<sup>101</sup> The ACA also increased the income limit for qualifying medical and dental expenses taken as an itemized deduction. In prior years, individuals could take an itemized deduction for qualified medical and dental expenses that exceeded 7.5 percent of their Adjusted Gross Income. Beginning in Calendar Year 2013, the qualifying expenses must exceed 10 percent of Adjusted Gross Income.

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<sup>99</sup> TIGTA, Ref No. 2013-20-063, *Improvements Are Needed to Ensure Successful Development and System Integration for the Return Review Program* (July 2013).

<sup>100</sup> The ACA created a new tax that is equal to 3.8 percent of an individual's net investment income for the tax year or the excess of the individual's Modified Adjusted Gross Income over \$200,000 (\$250,000 for married individuals filing jointly).

<sup>101</sup> The ACA increased the employee-share of the Medicare tax to 0.9 percent of an individual's covered wages in excess of \$200,000 (\$250,000 for married individuals filing jointly). The ACA also increased the Medicare tax on self-employment income to 0.9 percent of an individual's self-employment income over \$200,000 (\$250,000 for married individuals filing jointly).

Taxpayers will begin filing tax returns with these tax changes during the 2014 Filing Season. In addition to reprogramming its computer systems to properly reflect these changes, the IRS had to issue guidance to taxpayers and tax return preparers explaining each of these provisions and revise or develop new tax forms, instructions and publications to reflect the tax law changes. We have a review ongoing to determine if the IRS has correctly implemented these provisions, which includes analyzing tax returns to ensure that they are accurately processed.<sup>102</sup>

## **IRS TAX GAP**

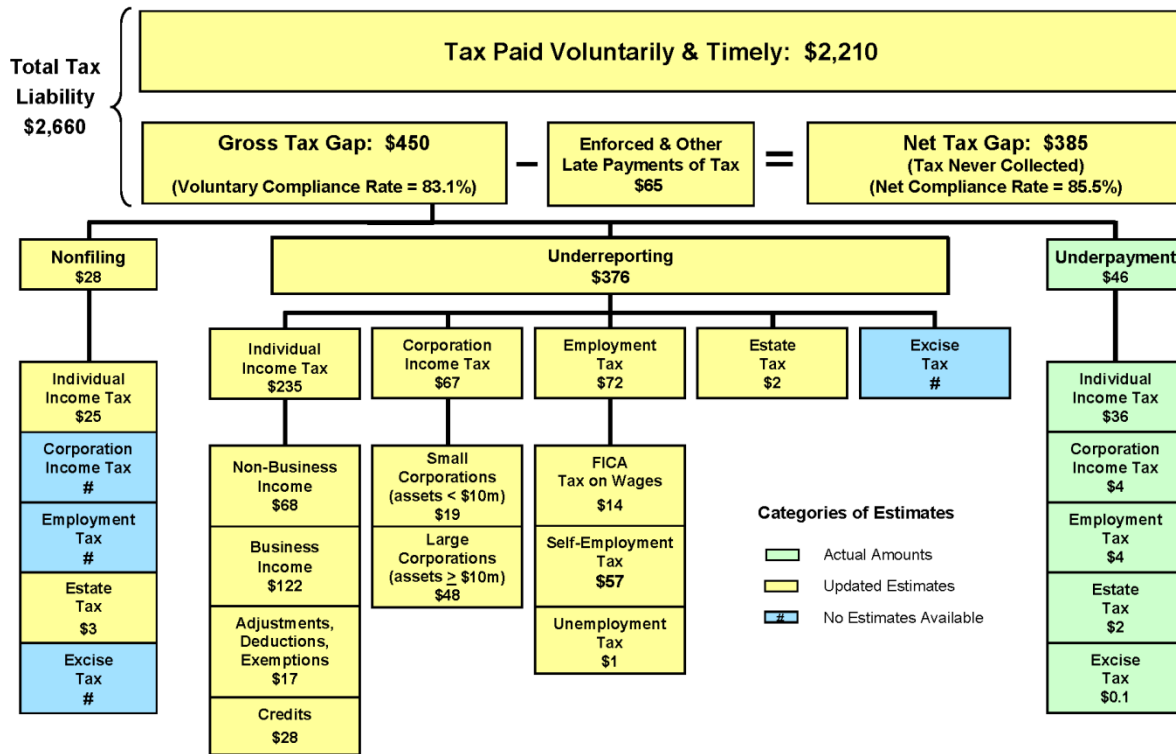
A serious challenge confronting the IRS is the Tax Gap, which is defined as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year. The most recent gross Tax Gap estimate developed by the IRS was \$450 billion for TY 2006, which is an increase from the prior estimate of \$345 billion for TY 2001. The voluntary compliance rate<sup>103</sup> decreased slightly from 83.7 percent in 2001 to 83.1 percent in 2006. Figure 1 shows the IRS's latest Tax Gap Map illustrating the various components of the Tax Gap.

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<sup>102</sup> TIGTA, Audit No. 201440014, *2014 Filing Season Implementation*, report planned for September 2014.

<sup>103</sup> The voluntary compliance rate is an estimate of the amount of tax for a given year that is paid voluntarily and timely.

**Figure 1**  
**Tax Gap “Map”**  
**Tax Year 2006 (\$ billions)**



Internal Revenue Service, December 2011

The largest component (approximately 84 percent) of the Tax Gap is based on taxpayers’ underreporting taxes due. The IRS addresses this gap by attempting to identify questionable tax returns when they are received and processed and by conducting examinations of tax returns filed to determine if there are any adjustments needed to the information reported on the tax returns. Additional taxes are assessed and collected.

The next component (10 percent) of the Tax Gap is based on taxpayers underpaying taxes due. The IRS addresses this gap by issuing notices and contacting taxpayers to collect the delinquent taxes. The IRS is authorized to take enforcement action, such as filing liens and seizing assets, to collect the taxes.

The smallest component (6 percent) of the Tax Gap is based on taxpayers who do not file tax returns when they are due. This component also may not have taxes withheld or make estimated taxes. The IRS analyzes data from third parties (such as Forms W-2 or Forms 1099) to identify taxpayers who should have filed a tax return, and either prepares a substitute tax return or contacts the taxpayer to obtain the delinquent



tax return.

The scope, complexity, and magnitude of the international financial system also presents significant enforcement challenges for the IRS. At the end of CY 2012, foreign business holdings and investments in the United States were \$25.5 trillion, an increase of nearly \$135 billion over CY 2011, while U.S. business and investments abroad grew to over \$21.6 trillion, an increase of nearly \$1.5 billion during the same period. The numbers of taxpayers conducting international business transactions continues to grow as technological advances provide opportunities for offshore investments that were once only possible for large corporations and wealthy individuals.

As advancing technology continues to allow more cross-border transactions, the IRS is increasingly challenged by a lack of information reporting on many of them. In addition, the varying legal requirements imposed by different jurisdictions lead to the creation of complex business structures that are not easy to understand, making the determination of the full scope and effect of cross-border transactions extremely difficult.

As this global economic activity increases, so do concerns regarding the International Tax Gap.<sup>104</sup> While the IRS has not developed an accurate and reliable estimate of the International Tax Gap, non-IRS sources estimate it to be between \$40 billion and \$133 billion annually. To address the International Tax Gap, the IRS developed an international tax strategy plan with two major goals: (1) to enforce the law to ensure that all taxpayers meet their obligations and (2) to improve service to make voluntary compliance less burdensome.

The IRS also currently faces the challenge of implementing the *Foreign Account Tax Compliance Act (FATCA)*.<sup>105</sup> FATCA was enacted to combat tax evasion by U.S. persons holding investments in offshore accounts. Under this Act, a U.S. taxpayer with financial assets outside the United States will be required to report those assets to the IRS. In addition, foreign financial institutions will be required to report to the IRS certain information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. The IRS is developing a new international system, the Foreign Financial Institution Registration System, to support the requirements of FATCA. This system is intended to register foreign financial institutions to assist in achieving the primary objective of FATCA which is the disclosure of U.S. taxpayer foreign accounts. TIGTA reviewed the development of this

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<sup>104</sup> Taxes owed but not collected on time from a U.S. person or foreign person whose cross-border transactions are subject to U.S. taxation.

<sup>105</sup> Pub. L. No. 111-147, Subtitle A, 124 Stat 71, \*96-116 (2010) (codified in scattered sections of 26 U.S.C.).

system and reported that the program management control processes did not timely identify or communicate system design changes to ensure its successful deployment.<sup>106</sup>

Concerns about the International Tax Gap have also led to increased enforcement efforts on international information reporting requirements and increased assessments of related penalties. For example, the IRS has automated the penalty-setting process for the Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, which has resulted in a total of \$215.4 million in late-filed Form 5471 penalty assessments during FYs 2009 through 2012.<sup>107</sup>

In addition, the IRS established the International Campus Compliance Unit to expand its audit coverage of tax returns with international aspects and to increase compliance among international individual taxpayers. For FY 2011 through March 13, 2013, the Campus Compliance Unit conducted almost 18,000 audits and assessed approximately \$36 million in additional tax. Despite its accomplishments, TIGTA found that the Campus Compliance Unit has no specific performance measures for its operations.<sup>108</sup>

We reviewed enforcement revenue trends and noted that in FY 2007, the IRS collected over \$59 billion in taxes, penalties and interest, but the dollars collected dropped over the next two years before increasing again in FY 2010. Subsequently, dollars collected decreased to slightly more than \$50 billion in FY 2012. While the IRS did not track the reason for the increase in FY 2010, it did receive additional funds to hire over 1,500 revenue officers from June 2009 to February 2010.

One enforcement program whose resources have been significantly reduced is the Automated Collection System (ACS). The ACS function attempts to collect taxes through telephone contact with taxpayers before cases are assigned to revenue officers who make in-person visits to collect delinquent taxes. The ACS has 16 call sites in the Small Business and Self Employed Division and Wage and Investment Division. However, ACS staff was reduced from 2,824 contact representatives in FY 2010 to 2,140 (24 percent) contact representatives in FY 2013. In addition, three call sites were taken off-line in February 2013 to work Accounts Management inventory (other than identity theft cases) because Accounts Management began devoting more of its

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<sup>106</sup> TIGTA Ref. No. 2013-20-118, *Foreign Account Tax Compliance Act: Improvements Are Needed to Strengthen Systems Development for the Foreign Financial Institution Registration System* (Sept. 2013).

<sup>107</sup> TIGTA, Ref. No. 2013-30-111, *Systemic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement* (Sept. 2013).

<sup>108</sup> TIGTA, Ref. No. 2013-30-113, *The International Campus Compliance Unit Is Improving Individual Tax Compliance* (Sept. 2013).

resources to work the growing inventory of identity theft cases. This shift in resources to Accounts Management was originally scheduled to continue for three months but was subsequently extended through the end of FY 2013 and was still ongoing as of February 2014. As a result of these combined reductions, the number of ACS contact representatives in FY 2013 was 41 percent less than in FY 2010.

Another impact on the ACS program is how resources are applied to its growing workload. In FY 2013, the ACS prioritized answering telephone phone calls from taxpayers over working delinquent accounts, which resulted in the ACS spending only 24 percent of its resources on working inventory and 76 percent on answering taxpayers' questions. The shift from working inventory has had consequences on the ACS's core mission of collecting delinquent taxes. In an ongoing audit, we reviewed ACS business results from FY 2010 through FY 2013 and determined:

- New inventory is outpacing closures, so the inventory is growing.
- Inventory is taking longer to close, and the cases are older.
- When cases are closed, more are closed as currently not collectible.
- Fewer enforcement actions are taken.
- More, and older, cases are being transferred to the growing inventory of cases available to be assigned Collection Field personnel.<sup>109</sup>

Leveraging external resources, such as whistleblowers, can help improve tax compliance. The IRS Whistleblower Program also plays an important role in reducing the Tax Gap and maintaining the integrity of a voluntary tax compliance system. However, TIGTA reported that the program continued to have internal control weaknesses when processing whistleblower claims. For example, information captured from multiple systems and entered into a single inventory control system was potentially inaccurate, and the quality review process for the new inventory system was not sufficient to ensure that claims were accurately controlled. Additionally, TIGTA determined that timeliness standards for processing claims were not sufficient. Without adequate oversight of the Whistleblower Program, the IRS is not as effective as it could be in responding timely to tax noncompliance issues.<sup>110</sup>

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<sup>109</sup> TIGTA, Audit No. 201330017, *Review of the Automated Collection System Inventory Management*, report planned for May 2014.

<sup>110</sup> TIGTA, Ref. No. 2012-30-045, *Improved Oversight Is Needed to Effectively Process Whistleblower Claims* (Apr. 2012).

Modernizing information systems could potentially allow the IRS to post more comprehensive tax return information to its computer systems, which could facilitate the examination process and expedite taxpayer contacts for faster resolution.

The IRS considers the Customer Account Data Engine 2 (CADE 2) program to be critical to its mission and it is the IRS's most important information technology investment. TIGTA reported that the implementation of CADE 2 daily processing allowed the IRS to process tax returns for individual taxpayers more quickly by replacing existing weekly processing.<sup>111</sup> The CADE 2 system also provides for a centralized database of individual taxpayer accounts, which will allow IRS employees to view tax data online and provide timely responses to taxpayers once it is implemented. The IRS's modernization efforts also include developing computer programs to conduct predictive analytics to reduce refund fraud.<sup>112</sup> The successful implementation of the IRS's modernization program should significantly improve service to taxpayers and enhance Federal tax administration.

Simplifying the tax code could help taxpayers understand and voluntarily comply with their tax obligations and limit opportunities for tax evasion.

Finally, penalties are an important tool because they discourage taxpayer behavior that contributes to the Tax Gap. Congress provided numerous penalty provisions in the Internal Revenue Code that the IRS can use to help remedy the noncompliance that contributes to the Tax Gap. The IRS can assess accuracy-related penalties for negligence, substantial understatement of income tax, or substantial valuation misstatement. The IRS estimated that the underreporting of tax contributed \$376 billion (84 percent) of the \$450 billion total gross Tax Gap, including \$235 billion from individual income taxes. To deter this type of behavior, the IRS reported during FY 2011 it assessed over 500,000 accuracy-related penalties, involving over \$1 billion against individuals.

## **MANAGEMENT ACTIONS IN RESPONSE TO PRIOR REPORTED ISSUES**

TIGTA follows up regularly on management actions in response to recommendations in our reports. Two notable examples that we are currently following up on are the reports on Exempt Organizations and IRS spending on conferences.

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<sup>111</sup> TIGTA, Ref. No. 2012-20-122, *Customer Account Data Engine 2 System Requirements and Testing Processes Need Improvements* (Sep. 2012).

<sup>112</sup> Computer models that analyze extremely large quantities of data to seek out data patterns and relationships that could indicate potential tax fraud schemes.

TIGTA previously reported<sup>113</sup> that the IRS used inappropriate criteria for selecting and reviewing applications for tax-exempt status. This resulted in substantial delays in processing certain applications and unnecessary information requests being issued to certain organizations.

The IRS Commissioner reported in January 2014 that the IRS completed action on all nine recommendations contained in our May 2013 report. TIGTA is currently assessing the actions the IRS has taken in response to our recommendations.<sup>114</sup>

In its response to our report on conference spending,<sup>115</sup> IRS management agreed with all of our recommendations. Since the issuance of our report, the IRS has addressed many of our recommendations with interim guidance that it plans to formalize through updates to the Internal Revenue Manual.<sup>116</sup> Once the IRS finalizes its guidance, TIGTA plans to conduct a follow-up audit to determine if controls implemented by the IRS address the recommendations we made.

We at TIGTA take seriously our mandate to provide independent oversight of the IRS in its administration of our Nation's tax system. As such, we plan to provide continuing audit coverage of the IRS's efforts to operate efficiently and effectively and investigate any instances of IRS employee misconduct. I hope my discussion of some of the major challenges facing the IRS assists Congress in ensuring accountability over the IRS.

Chairman Crenshaw, Ranking Member Serrano, and Members of the Subcommittee, thank you for the opportunity to share my views.

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<sup>113</sup> TIGTA, Ref. No. 2013-10-053, *Inappropriate Criteria Were Used to Identify Tax-Exempt Applications for Review* (May 2013).

<sup>114</sup> TIGTA, Audit No. 201410009, *Status of Actions to Improve Identification and Processing of Applications for Tax-Exempt Status – Follow-Up*.

<sup>115</sup> TIGTA, Ref. No. 2013-10-037, *Review of the August 2010 Small Business/Self-Employed Division's Conference in Anaheim, California* (May 2013).

<sup>116</sup> The Internal Revenue Manual is the primary official source of IRS instructions to staff that relate to the administration and operation of the IRS.



## **J. Russell George**

### **Treasury Inspector General for Tax Administration**

Following his nomination by President George W. Bush, the United States Senate confirmed J. Russell George in November 2004, as the Treasury Inspector General for Tax Administration. Prior to assuming this role, Mr. George served as the Inspector General of the Corporation for National and Community Service, having been nominated to that position by President Bush and confirmed by the Senate

in 2002.

A native of New York City, where he attended public schools, including Brooklyn Technical High School, Mr. George received his Bachelor of Arts degree from Howard University in Washington, DC, and his Doctorate of Jurisprudence from Harvard University's School of Law in Cambridge, MA. After receiving his law degree, he returned to New York and served as a prosecutor in the Queens County District Attorney's Office.

Following his work as a prosecutor, Mr. George joined the Counsel's Office in the White House Office of Management and Budget where he was Assistant General Counsel. In that capacity, he provided legal guidance on issues concerning presidential and executive branch authority. He was next invited to join the White House Staff as the Associate Director for Policy in the Office of National Service. It was there that he implemented the legislation establishing the Commission for National and Community Service, the precursor to the Corporation for National and Community Service. He then returned to New York and practiced law at Kramer, Levin, Naftalis, Nessen, Kamin & Frankel.

In 1995, Mr. George returned to Washington and joined the staff of the Committee on Government Reform and Oversight and served as the Staff Director and Chief Counsel of the Government Management, Information and Technology subcommittee (later renamed the Subcommittee on Government Efficiency, Financial Management and Intergovernmental Relations), chaired by Representative Stephen Horn. There he directed a staff that conducted over 200 hearings on legislative and oversight issues pertaining to Federal Government management practices, including procurement policies, the disposition of government-controlled information, the performance of chief financial officers and inspectors general, and the Government's use of technology. He continued in that position until his appointment by President Bush in 2002.

In addition to his duties as the Inspector General for Tax Administration, Mr. George serves as a member of the Recovery Accountability and Transparency Board, a non-partisan, non-political agency created by the American Recovery and Reinvestment Act of 2009 to provide unprecedented transparency and to detect and prevent fraud, waste, and mismanagement of Recovery funds. There, he serves as chairman of the Recovery.gov committee, which oversees the dissemination of accurate and timely data about Recovery funds.

Mr. George also serves as a member of the Integrity Committee of the Council of Inspectors General for Integrity and Efficiency (CIGIE). CIGIE is an independent entity within the executive branch statutorily established by the Inspector General Act, as amended, to address integrity, economy, and effectiveness issues that transcend individual Government agencies; and increase the professionalism and effectiveness of personnel by developing policies, standards, and approaches to aid in the establishment of a well-trained and highly skilled workforce in the offices of the Inspectors General. The CIGIE Integrity Committee serves as an independent review and investigative mechanism for allegations of wrongdoing brought against Inspectors General.