

WRITTEN STATEMENT OF

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INTERNAL REVENUE SERVICE OVERSIGHT

BEFORE THE

SUBCOMMITTEE ON FINANCIAL SERVICES AND GENERAL GOVERNMENT

COMMITTEE ON APPROPRIATIONS

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TABLE OF CONTENTS

I.	Need for a Taxpayer Bill of Rights	5
II.	Taxpayer Services and IRS Funding	8
III.	Update on Exempt Organization Concerns	11
IV.	Identity Theft and Refund Fraud	16
V.	Affordable Care Act	22
VI.	Accelerated Receipt and Use of Third-Party Information Reports	28
VII.	Improper Payments of the Earned Income Tax Credit and Other Refundable Credits	30
VIII.	Conclusion.....	47

Chairman Crenshaw, Ranking Member Serrano, and distinguished Members of this Subcommittee:

Thank you for inviting me to appear today to present my perspective on the key challenges facing the Internal Revenue Service.¹

The year 2013 was, to say the least, a very challenging one for the IRS. Among other things:

- The IRS's budget was cut for the third year in a row, and because of sequestration, the cuts last year were the most substantial to date. Because of these resource reductions, the IRS's ability to meet the service needs of the taxpaying public was severely impaired, and the agency has made unprecedented and disturbing changes to its delivery of taxpayer service.
- The Treasury Inspector General for Tax Administration (TIGTA) reported that the Exempt Organizations unit had used a "Be on the Lookout" (or "BOLO") list to select applicants with the words "tea party" and other political-sounding names for further review. The IRS initially maintained that such lists were a workload management tool to help identify organizations that were disproportionately likely to engage "primarily" in political activity and therefore be ineligible for exempt status. However, the IRS eventually acknowledged that BOLO lists were a bad idea and banned their use. As a result of this incident, public trust in the fairness and impartiality of the IRS was called into question, and multiple investigations are still underway.
- The 16-day government shutdown affected the IRS's ability to prepare for the tax filing season. As a result, the agency delayed the start of the filing season by 10 days, requiring early filers to wait additional time to receive their tax refunds. During the shutdown, moreover, thousands of taxpayers were exposed to IRS enforcement actions but had no ability to contact IRS employees, including the Taxpayer Advocate Service, all of whose employees were furloughed and unable to assist taxpayers who experienced emergencies caused by ongoing enforcement.²

¹ The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

² During the shutdown from October 1 through October 16, 2013, taxpayers were subject to the following compliance and enforcement actions: 3,902 levies on Social Security benefits; 5,455 levies on financial or other accounts; 7,025 wage levies; 4,099 Notices of Federal Tax Lien issued; 180,095 Automated Underreporter Statutory Notices of Deficiency; and 102,231 Collection Due Process Levy Hearing Notices

Getting the IRS back on track requires not merely strong leadership within the agency, but helpful oversight and support from Congress and other key stakeholders. For that reason, I appreciate your holding today's hearing.

In my view, the IRS is often so focused on resolving immediate crises that it is not able to devote sufficient time to setting long-term goals and developing approaches to achieve those goals. In the preface to my most recent annual report to Congress, I attempted to provide my vision of what a 21st century tax administration system should look like.³ In my testimony today, I will elaborate on the following key issues:

1. **Need for a Taxpayer Bill of Rights.** Congress should enact a thematic, principle-based Taxpayer Bill of Rights.⁴ Taxpayers have rights on the service side (e.g., the right to be told what they need to do to comply with the tax laws and the right to have their questions answered) and on the enforcement side (e.g., the right to challenge the IRS's position, the right to designate a representative, and the right to appeal an adverse IRS decision in an independent forum). I have made this recommendation in past reports, and I am very pleased the House of Representatives passed my proposal verbatim last year, with bipartisan support, on a voice vote.⁵ Many of the excesses that led up to the IRS Restructuring and Reform Act of 1998 and, as I describe more fully below, many of the IRS actions in dealing with organizations seeking tax-exempt status under IRC § 501(c)(4) in recent years violated the proposed rights. If a Taxpayer Bill of Rights were in place, some of these problems would have been prevented or at least identified and resolved sooner. While I believe a Taxpayer Bill of Rights should have the force of law, and therefore hope the Senate passes this legislation, the IRS has the authority to adopt a Taxpayer Bill of Rights on its own. I have been working with the IRS leadership to try to get agreement to do so.

issued by the Automated Collection System. Preliminary information from IRS Office of Taxpayer Correspondence, Individual Master File (IMF), and Automated Lien System.

³ National Taxpayer Advocate 2013 Annual Report to Congress [hereinafter "NTA 2013 Annual Report"], at x.

⁴ See NTA 2013 Annual Report 5-19 (Most Serious Problem: *Taxpayer Rights: The IRS Should Adopt a Taxpayer Bill of Rights as a Framework for Effective Tax Administration*); NTA 2011 Annual Report 493-518 (Legislative Recommendation: *Enact the Recommendations of the National Taxpayer Advocate to Protect Taxpayer Rights*); NTA 2007 Annual Report 478-489 (Legislative Recommendation: *Taxpayer Bill of Rights and De Minimis "Apology" Payments*).

⁵ Taxpayer Bill of Rights Act, H.R. 2768, 113th Cong. (2013). In my 2013 report, I suggested some wording modifications, and as discussed below, the Office of the Taxpayer Advocate recently tested our proposed modifications with focus groups of taxpayers and preparers to assess whether the language accurately conveys the gist of the rights we have identified. Based on input from the focus groups, we are currently tweaking the language of a few provisions.

2. **Taxpayer Services and IRS Funding.** The IRS is failing badly at meeting taxpayer needs because it lacks resources.⁶ Last year, the IRS received some 109 million telephone calls on its customer service lines. The IRS could answer only 60.5 percent of calls seeking to reach a customer service representative (CSR) – and those taxpayers who got through had to wait an average of 17.6 minutes on hold. Initial statistics for fiscal year (FY) 2014 indicate service has declined even more, with taxpayers waiting an average of more than 20 minutes and tax practitioners kept on hold for more than half an hour.⁷ The tax collector is rarely the government's most popular agency, and the revelations that the IRS had used BOLO lists to screen applicants for exempt status further undermined support for the agency. But at the end of the day, IRS funding reductions do not punish the IRS nearly as much as they punish the nearly 150 million individual taxpayers and more than 10 million business entity taxpayers who are trying to comply with the tax laws and not receiving the help they need. When the IRS receives 109 million telephone calls, there is no substitute for the funding to hire enough CSRs to answer them. If the IRS does not receive more funding, the IRS will be unable to assist millions of taxpayers seeking assistance from their government to comply with the tax laws.

3. **Update on Exempt Organization Concerns.** The Commissioner should review and implement my recommendations to expand both taxpayer and employee awareness of TAS and taxpayer rights. Shortly after TIGTA issued its report on the BOLO lists, I published a special report that examined systemic factors contributing to the use of questionable screening criteria and processing delays in connection with exempt organization applicants, and offered 16 preliminary recommendations to address them.⁸ Subsequently, Acting Commissioner Danny Werfel asked me to provide recommendations specifically to improve taxpayer and employee awareness of TAS, as the IRS function designed to assist taxpayers with IRS problems, and of taxpayer rights generally. I submitted one report on each topic with specific recommendations,⁹ but I have not received a

⁶ See NTA 2013 Annual Report 20-38 (Most Serious Problem: *IRS Budget: The IRS Desperately Needs More Funding to Serve Taxpayers and Increase Voluntary Compliance*).

⁷ IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot and Product Line Detail* reports (week ending Feb. 1, 2014) (showing results for the first four months of FY 2014).

⁸ National Taxpayer Advocate, *Special Report: Political Activity and the Rights of Applicants for Tax-Exempt Status* (June 2013), at www.taxpayeradvocate.irs.gov/userfiles/file/FullReport/Special-Report.pdf.

⁹ See National Taxpayer Advocate, *Report in Response to the Acting Commissioner's 30-Day Report: Analysis and Recommendations to Raise Taxpayer and Employee Awareness of the Taxpayer Advocate and Taxpayer Rights* (Aug. 19, 2013), at www.taxpayeradvocate.irs.gov/userfiles/file/2013FullReport/Analysis-and-Recommendations-to-Raise-Taxpayer-and-Employee-Awareness-of-the-Taxpayer-Advocate-Service-and-Taxpayer-Rights.pdf; National Taxpayer Advocate, *Toward a More Perfect Tax System: A Taxpayer Bill of Rights as a Framework for Effective Tax Administration; Recommendations to Raise Taxpayer and Employee Awareness of Taxpayer Rights* (Nov. 4, 2013), at www.taxpayeradvocate.irs.gov/userfiles/file/2013FullReport/Toward-a-More-Perfect-Tax-System-A-Taxpayer-Bill-of-Rights-as-a-Framework-for-Effective-Tax-Administration.pdf.

response from the IRS. Further, on November 29, 2013, the Treasury Department and the IRS requested public comment on a proposed regulation that provides guidance to tax-exempt social welfare organizations on political activities related to candidates that will not be considered to promote social welfare. Neither the IRS nor Treasury shared this proposed regulation with me, my office, or my counsel for comment prior to submitting it to the Federal Register for publication, nor was I consulted during the drafting process. Therefore, I had no opportunity to influence the content of the regulations prior to publication.

4. **Identity Theft and Refund Fraud.** The IRS should establish a meaningful single point of contact for taxpayers who become victims of identity theft. Today, 21 separate units handle different aspects of identity theft, and although the IRS says it has adopted a single point of contact, no employee has the authority to coordinate the entirety of the taxpayer/victim's case if, as is common, more than one of the 21 units is involved. Thus, taxpayers traumatized by the crime of identity theft are forced to navigate the IRS by themselves, increasing their frustration and despair.¹⁰ The IRS also takes much too long to resolve ID theft cases and issue refunds to legitimate taxpayers. The Taxpayer Advocate Service's experience with identity theft cases demonstrates the soundness of our recommendation that the IRS assign one employee to work with the victim from the beginning, and help coordinate resolution of the case (not merely monitor it) when it requires work by multiple units.

5. **Affordable Care Act.** As part of the Affordable Care Act (ACA), the IRS is implementing complicated health care tax provisions. I believe the IRS has acquitted itself well in meeting its initial responsibilities under the ACA. I have concerns about the IRS's approach to addressing taxpayer questions and adequately training employees on the new provisions. In particular, the IRS is not doing enough to educate taxpayers about the importance of updating their information throughout the year with the Exchange if they are receiving a credit. Our office will continue to work with the IRS to ensure that taxpayers are treated properly and fairly in the implementation of the new law. Within TAS, we are also training our employees about taxpayer concerns they are likely to see next year, such as the impact of premium tax credit reconciliation and under- and overpayments, so they will be properly prepared to assist taxpayers.¹¹

¹⁰ See NTA 2013 Annual Report 75-83 (Most Serious Problem: *Identity Theft: The IRS Should Adopt a New Approach to Identity Theft Victim Assistance that Minimizes Burden and Anxiety for Such Taxpayers*).

¹¹ See generally National Taxpayer Advocate Fiscal Year 2014 Objectives Report to Congress 29 (*TAS Prepares for Implementation of Health Care Provisions*); *IRS: Enforcing Obamacare's New Rules and Taxes: Hearing Before the House Comm. on Oversight & Gov't Reform, 112th Cong. (2012)* (statement of Nina E. Olson, National Taxpayer Advocate).

6. **Accelerated Receipt and Use of Third-Party Information Reports.** Congress should direct the IRS to develop a plan to enable it to match information return data against tax return data before paying out refunds.¹² If the IRS could match Forms 1040 against Forms W-2 in a pre-refund environment, it could dramatically reduce improper payments to identity thieves and other perpetrators of refund fraud, including some improper Earned Income Tax Credit claimants. At the same time, it could make the data available to taxpayers and thereby help them prepare their returns more accurately and easily.

7. **Improper Payments in the Earned Income Tax Credit and Other Refundable Credits.** The IRS must perform a delicate balancing act in administering social benefit programs – seeking simultaneously to maximize participation among the eligible population and to minimize improper payments to persons who are not eligible.¹³ While the EITC enjoys a higher participation rate than other benefit programs, it also suffers from significant overclaims. The low income taxpayers who claim the credit must navigate complicated eligibility requirements, often while dealing with changing circumstances in their lives. Since 2001, we have made a number of proposals designed to reduce overclaims without deterring participation by eligible taxpayers. These include changes in EITC audit procedures, regulating tax preparers to improve return accuracy and protect taxpayers, imposing penalties on preparers who fail to comply with due diligence requirements, using a third-party affidavit form to verify the residence of a qualified child in EITC audits, and accelerating the use of third-party information reports so the IRS can verify employee income data before paying out refunds (as discussed in more detail above).

I. Need for a Taxpayer Bill of Rights

Taxpayer rights are central to our tax system and to tax compliance. If taxpayers believe they are treated, or can be treated, in an arbitrary and capricious manner, they will mistrust the system and be less likely to comply voluntarily. If taxpayers have confidence in the fairness and integrity of the tax system, they will be more likely to comply.

¹² See NTA 2013 Annual Report, vol. 2, 67-96 (Analysis: *Fundamental Changes to Return Filing and Processing Will Assist Taxpayers in Return Preparation and Decrease Improper Payments*). The National Taxpayer Advocate has been recommending this approach since 2009. See National Taxpayer Advocate 2009 Annual Report to Congress 338-345 (Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reverse the “Pay Refunds First, Verify Eligibility Later” Approach to Tax Return Processing*).

¹³ See Improper Payments in the Administration of Refundable Tax Credits: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means, 112th Cong. (2011) (statement of Nina E. Olson, National Taxpayer Advocate), at www.irs.gov/pub/irs-utl/testimony-written-wm_oversight-improper_payments-5-25-2011.pdf.

The good news on this front is that the Internal Revenue Code provides dozens of taxpayer rights. The bad news is that most taxpayers have no idea what their rights are and therefore often cannot take advantage of them. That is because taxpayer rights are scattered throughout the code and are not presented in a coherent way. Not surprisingly, in response to a taxpayer survey conducted for our office in 2012, less than half of all U.S. taxpayers said they believed they have rights before the IRS, and only 11 percent said they knew what those rights are.¹⁴

We can and must do a better job of making taxpayers aware of their rights and enabling them to assert them. Since 2007, I have repeatedly recommended adoption of a Taxpayer Bill of Rights that takes the multiple existing rights embedded in the code and groups them into ten broad categories, modeled on the U.S. Constitution's Bill of Rights.¹⁵ Just as the Constitution's Bill of Rights sets out the relationship between the federal government and U.S. citizens and imposes limits on the federal government's power, I believe a thematic, principle-based list of core taxpayer rights would provide a foundational framework for taxpayers and IRS employees alike that would promote effective tax administration. As the National Taxpayer Advocate, I find it wholly unacceptable and deeply concerning that less than half of our taxpayers believe they have rights and only about one out of ten believes they know what their rights are.

The rights we recommend are as follows:

Ten Taxpayer Rights

1. The Right to Be Informed
2. The Right to Quality Service
3. The Right to Pay No More than the Correct Amount of Tax
4. The Right to Challenge the IRS's Position and Be Heard
5. The Right to Appeal an IRS Decision in an Independent Forum
6. The Right to Finality
7. The Right to Privacy

¹⁴ Forrester Research Inc., *The TAS Omnibus Analysis*, from North American Technographics Omnibus Mail Survey, Q2/Q3 2012 19-20 (Sept. 2012).

¹⁵ Congress has passed several pieces of legislation with "Taxpayer Bill of Rights" in the title. See Technical and Miscellaneous Revenue Act, Pub. L. No. 100-647, § 6226, 102 Stat. 3342, 3730 (1988) (containing the "Omnibus Taxpayer Bill of Rights," also known as TBOR 1); Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996) (also known as TBOR 2); Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105-206, 112 Stat. 685 (1998) (Title III is known as "Taxpayer Bill of Rights III" or TBOR 3). These laws create specific rights in certain instances, but they do not create a thematic, principle-based list of overarching taxpayer rights.

8. The Right to Confidentiality

9. The Right to Retain Representation

10. The Right to a Fair and Just Tax System, Including Access to the Taxpayer Advocate Service

In my view, the value of a Taxpayer Bill of Rights can scarcely be overstated. The IRS is largely an enforcement agency, and from time to time, it inevitably will overreach. In the mid-1990s, the IRS employed aggressive collection practices, and in response to numerous taxpayer complaints, Congress passed the IRS Restructuring and Reform Act of 1998 to place significant new limits on collection practices. Many of those practices would have violated the Bill of Rights I have proposed.

Similarly, many of the IRS's recent actions in screening tax exemption applications from "tea party" and other groups violated the rights I have proposed. In my preface to the National Taxpayer Advocate's Fiscal Year 2014 Objectives Report to Congress, I analyzed the IRS's processing of applications for tax-exempt status and showed that the IRS had violated eight of my proposed ten rights.

A Taxpayer Bill of Rights is not a panacea that will prevent all problems or errors in judgment. However, a Taxpayer Bill of Rights would serve as an organizing principle for tax administrators in establishing agency goals and performance measures, provide foundational principles to guide IRS employees in their dealings with taxpayers, and provide information to taxpayers to assist them in their dealings with the IRS.

I am very pleased the House of Representatives passed an earlier version of my Taxpayer Bill of Rights proposal last year with bipartisan support.¹⁶ I believe a TBOR should have the force of law and therefore hope the Senate passes this legislation.

If Congress does not pass this legislation, however, I believe the IRS has the authority to adopt a Taxpayer Bill of Rights on its own. Therefore, I have been working with the IRS leadership to get agreement to do so. I have encountered very few concerns about this proposal. That is because it does not aim to create new rights or remedies – only to group existing rights into categories that are easier for taxpayers and IRS employees to understand and remember. If Congress does not codify a Taxpayer Bill of Rights, I am hopeful the IRS will decide to adopt one in the near future.

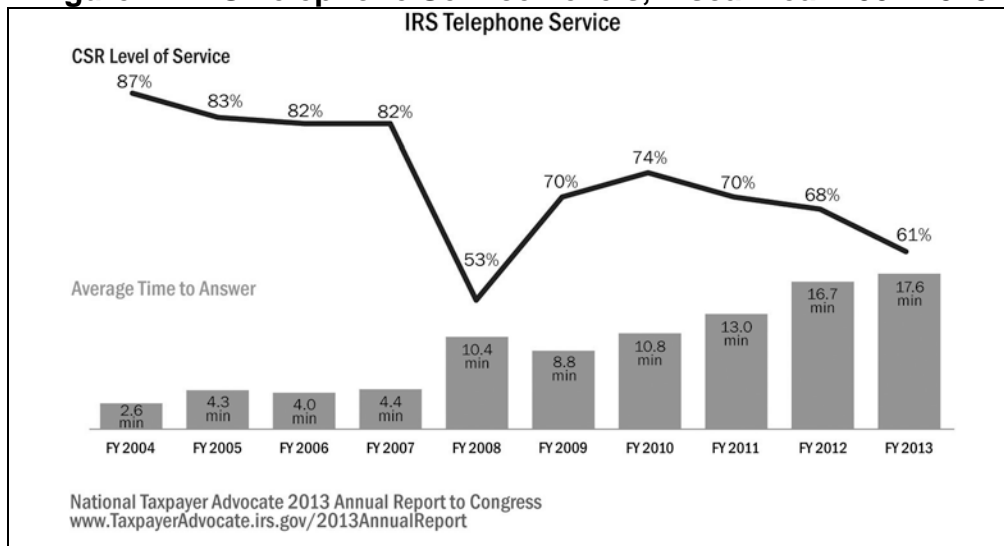
¹⁶ Taxpayer Bill of Rights Act, H.R. 2768, 113th Cong. (2013). In my 2013 report, I suggested some wording modifications, and as discussed below, the Office of the Taxpayer Advocate recently tested our proposed modifications with focus groups of taxpayers and preparers to assess whether the language accurately conveys the gist of the rights we have identified. Based on input from the focus groups, we are currently tweaking the language of a few provisions.

II. Taxpayer Services and IRS Funding

The requirement to pay taxes is generally the most significant burden a government imposes on its citizens. For that reason, I believe the government has a practical and moral obligation to make compliance as simple and painless as possible. Yet the IRS is increasingly unable to meet the service needs of our taxpayers by phone, in person, and by mail. Consider the following:

- Despite the greater availability of information on IRS.gov, the number of telephone calls the IRS receives from taxpayers on its customer service lines has been rising steadily over the past decade – from 71 million calls in FY 2004 to 109 million calls in FY 2013, an increase of 53 percent.¹⁷
- The IRS lacks the staffing to answer these calls. In FY 2004, the IRS answered 87 percent of calls from taxpayers seeking to speak with a CSR (which, in IRS parlance, is referred to as the “Level of Service” or “LOS”). In FY 2013, the IRS answered only 61 percent of such calls, a reduction of 26 percentage points, or 30 percent, in the LOS. Among those taxpayers lucky enough to get through, hold time increased from 2.6 minutes to 17.6 minutes, a nearly six-fold rise.¹⁸

Figure 1: IRS Telephone Service Levels, Fiscal Year 2004-2013



- The IRS historically has prepared tax returns for low income, elderly, and disabled taxpayers seeking assistance at its walk-in sites (known as “Taxpayer Assistance Centers,” or “TACs”). In FY 2004, the IRS prepared 476,000

¹⁷ IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (final week of FY 2013 and FY 2004).

¹⁸ IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (final week of each fiscal year for FY 2004 through FY 2013).

returns.¹⁹ Since that time, the IRS has imposed increasing limits on return preparation, and by FY 2013, the number of returns it prepared during the filing season had declined by 59 percent as compared with FY 2004.²⁰

- The IRS's ability to timely process taxpayer correspondence has also taken a hit. When the IRS sends a taxpayer a notice proposing to increase his or her tax liability, it gives the taxpayer an opportunity to present an explanation or documentation supporting the position taken on the return. Each year, the IRS typically receives around ten million taxpayer responses, known collectively as the "adjustments inventory."²¹ The IRS has established timeframes for processing taxpayer correspondence, generally 45 days. During the final week of FY 2004, the IRS failed to process 12 percent of its adjustments correspondence within its timeframes. By contrast, during the final week of FY 2013, the IRS was unable to process 53 percent of adjustments correspondence within these timeframes.²²

As compared with FY 2013, the IRS's ability to assist taxpayers has suffered further declines in FY 2014:

- For the first four months of FY 2014, the LOS on the phones was 62.5 percent, down from 73.7 percent during the first four months of FY 2013. Among taxpayers who got through, hold time rose from 12.8 minutes to 20.3 minutes. For practitioners calling the Practitioner Priority Service line, the decline was even steeper. The LOS dropped from 81.5 percent to 68 percent, while hold time rose from 12.2 minutes to 32.5 minutes.²³

¹⁹ This data was provided to TAS by the IRS Wage & Investment Division in connection with the National Taxpayer Advocate's 2007 Annual Report to Congress 162-182 (Most Serious Problem: *Service at Taxpayer Assistance Centers*).

²⁰ GAO, GAO-14-133, *2013 Tax Filing Season: IRS Needs to Do More to Address the Growing Imbalance between the Demand for Services and Resources* 26 (Dec. 2013); GAO, GAO-11-111, *2010 Tax Filing Season: IRS's Performance Improved in Some Key Areas, but Efficiency Gains Are Possible in Others* 45 (Dec. 2010); GAO, GAO-07-27, *Tax Administration: Most Filing Season Services Continue to Improve, but Opportunities Exist for Additional Savings* 29 (Nov. 2006) (supplemented with IRS data provided to TAS for 2004 through 2006).

²¹ In FY 2013, receipts in the Adjustments Inventory were about 8.4 million, as compared with 10.4 million in FY 2012. We are not certain why the number declined. The Adjustments Inventory is one component of the Accounts Management function's overall Paper Inventory. In FY 2013, receipts in the Paper Inventory were about 20.8 million, and the percentage classified as overage at year-end was 47 percent. IRS, Joint Operations Center, *Account Management Information Report (AMIR) – National Summary* (week ending Sept. 28, 2013).

²² IRS, Joint Operations Center, *Adjustments Inventory Reports: July-September Fiscal Year Comparison (FY 2004 through FY 2013)*.

²³ IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot and Product Line Detail* reports (week ending Feb. 1, 2014). IRS data for the first four months of the fiscal year (October through January) generally does not include the tax-return filing season, which this year started on January 31.

- In an effort to answer more calls, the IRS posted an announcement on IRS.gov in December that said it will answer only “basic” tax-law questions on its phone lines and in its walk-in sites during the filing season (January through mid-April).²⁴ It will not answer any questions that are “more detailed” than “basic” during the filing season. Moreover, it will not answer any tax-law questions after mid-April, including “basic” questions from the millions of taxpayers who obtain filing extensions and prepare their returns later in the year.
- Also to conserve resources, the IRS announced that it will no longer prepare any tax returns at its walk-in sites, even for low income, elderly, or disabled taxpayers.²⁵

At the risk of vast understatement, it is a sad state of affairs when the government writes tax laws as complex as ours – and then can answer nothing beyond “basic” questions from baffled citizens who are doing their best to comply.

I realize the subject of IRS funding is somewhat controversial for a number of reasons, including the way the IRS screened tax-exemption applications, inappropriate conference spending, and the “Star Trek” parody video. I personally have concerns about IRS performance, and in fact, I am required by statute to be an “IRS critic” by identifying at least 20 of the most serious problems facing taxpayers in my annual reports to Congress.²⁶ But I must tell you that I do not see any way the agency can begin to meet the service needs of the taxpaying public without substantially more funding. Most notably, almost twenty million phone calls from taxpayers seeking to speak with a customer service representative went unanswered last year. With phone calls up about 17 percent and IRS funding down 8 percent since FY 2010, there is no way the IRS can answer all these calls without more employees.

In part because of mistakes made in the past, the agency has undergone significant leadership changes in recent months. Many policy changes have been made in response to congressional concerns, and the FY 2014 appropriations act contains new directives. If Members have continuing concerns, I encourage you to use the oversight process to try to address them. But I personally believe it is a mistake to cut the IRS’s budget and thereby preclude the agency from providing basic service to tens of millions of taxpayers who seek help each year. When we ask our taxpayers to turn over a significant portion of their incomes to the government, we owe it to them – the constituents you represent, and the taxpayers for whom I advocate – to ensure we have the infrastructure in place to help them comply with the requirements Congress has imposed by law.

²⁴ IRS, e-News for Tax Professionals – Issue Number 2013-49, Item 4, *Some IRS Assistance and Taxpayer Services Shift to Automated Resources* (Dec. 20, 2013), at <http://www.irs.gov/uac/Some-IRS-Assistance-and-Taxpayer-Services-Shift-to-Automated-Resources>.

²⁵ *Id.*

²⁶ See IRC § 7803(c)(2)(B)(ii)(III).

III. Update on Exempt Organization Concerns

Last June, in a Special Report that accompanied my Fiscal Year 2014 Objectives Report to Congress, I described the management and other failures in the Exempt Organizations (EO) function that led to violations of taxpayers' rights and to the inappropriate activity reported by TIGTA in May of 2013.²⁷ These failures, affecting taxpayers seeking recognition of exempt status under IRC § 501(c)(4), brought to light both procedural issues (lengthy delays, excessive questioning and document production) and substantive issues (such as the degree to which an entity may engage in political activity and still qualify as an exempt social organization under IRC § 501(c)(4)). As discussed extensively in the Special Report, a number of factors led to the inappropriate handling of these cases, including EO's unfamiliarity with TAS's role and TAS's authority under IRC § 7811. With respect to 19 affected cases in which the taxpayers sought help from TAS, EO was not forthright in explaining why their applications for recognition of exempt status were being delayed.

The Special Report contained recommendations to help prevent the problem from recurring and to restore trust with the taxpaying public. I noted that although IRC § 501(c)(4) allows an exemption to an organization "operated *exclusively* for the promotion of social welfare," the Supreme Court in 1945 held only that a non-exempt purpose, "if *substantial in nature*, will destroy the exemption (emphasis added)."²⁸ Treasury regulations reflect this distinction, and as I noted, "the prevailing legal standard is that an organization formed under IRC § 501(c)(4) may participate in political campaigns as long as it is 'primarily' engaged in social welfare."²⁹

The determination as to the sufficiency of an organization's exempt (as opposed to political) purpose is inherently subjective. Because these decisions affect political speech and action, placing the tax agency – which must be apolitical – into the position of making this determination is fraught with risk. To that end, we recommended that Congress clarify the level of political activity that exempt organizations may conduct, and establish an objective test to identify when an organization exceeds that level.³⁰ On

²⁷ National Taxpayer Advocate Special Report to Congress: *Political Activity and the Rights of Applicants for Tax-Exempt Status* (June 30, 2013) [hereinafter the Special Report]; TIGTA, Ref. No. 2013-10-053, *Inappropriate Criteria Were Used to Identify Tax-Exempt Applications for Review* (May 14, 2013).

²⁸ *Better Business Bureau of Washington, D.C. v. U.S.*, 326 U.S. 279, 283 (1945).

²⁹ Treas. Reg. § 1.501(c)(4)-1(a)(2)(i) (stating that an "organization is operated *exclusively* for the promotion of social welfare if it is *primarily* engaged in promoting in some way the common good and general welfare of the people of the community (emphasis added);" National Taxpayer Advocate Special Report, at 8.

³⁰ National Taxpayer Advocate Special Report at 15. Noting that "it may be advisable to separate political determinations from the function of revenue collection," and that the IRS already relies on substantive non-tax determinations from an agency in other situations (see, e.g., IRC § 47 (relating to historic rehabilitation credits certified by the Secretary of the Interior and IRC § 48C (relating to energy credits for which the IRS must consult with the Secretary of Energy regarding certifications)), we also recommended that Congress "[e]xplore the feasibility of requiring the Federal Election Commission or another specialized agency to certify to the IRS that political activity proposed by an applicant for

November 29, 2013, the Treasury Department and the IRS requested public comment on a proposed regulation that provides guidance to tax-exempt social welfare organizations on political activities related to candidates that will not be considered to promote social welfare.³¹ Neither the IRS nor Treasury shared this proposed regulation with me, my office, or my counsel for comment prior to submitting it to the Federal Register for publication, nor was I consulted during the drafting process. Therefore, I had no opportunity to influence the content of the regulations prior to publication. I am preparing comments on the proposed guidance, and my staff and I will review comments from others, which are due by February 27, 2014. Additionally, I intend to update my Special Report in June of 2014, providing a follow up on the issues identified in the report and the status of the report's recommendations.

As I noted in the Special Report, other important issues involving exempt organizations have received much less public attention. For example, EO has struggled for years with an inventory backlog of applications for exempt status.³² The problem has been aggravated by the manner in which EO implemented the provisions in the Pension Protection Act of 2006, which mandated automatic revocation of exempt status for organizations that do not file a return or e-Postcard for three consecutive years.³³ EO required revoked organizations to apply for reinstatement using the same cumbersome Form 1023 used by first-time applicants, and these reinstatement applications added more than 50,000 cases to EO's workload over the past three years.³⁴

EO's understaffed Determinations Unit, which processes both first-time and reinstatement applications, now has an inventory backlog of about 66,000 cases, more

exemption under IRC § 501(c)(4) is not excessive." National Taxpayer Advocate Special Report, 16-17. An example of such an independent regulatory body is the United Kingdom's Charity Commission for England and Wales (<http://www.charitycommission.gov.uk/>).

³¹ Notice of Proposed Rulemaking, 78 Fed. Reg. 71535 (Nov. 29, 2013).

³² I have been reporting on these backlogs and explaining how they burden taxpayers since 2004 (see National Taxpayer Advocate 2004 Annual Report to Congress 193, 203 (Most Serious Problem: *Application and Filing Burdens on Small Tax-Exempt Organizations*). I identified the delay in processing applications for exempt status as among the Most Serious Problems in four of my past seven Annual Reports to Congress, including the most recent (see NTA 2013 Annual Report 165 (Most Serious Problem: *Exempt Organizations: The IRS Continues to Struggle with Revocation Processes and Erroneous Revocations of Exempt Status*); National Taxpayer Advocate 2012 Annual Report to Congress 192 (Most Serious Problem: *Overextended IRS Resources and IRS Errors in the Automatic Revocation and Reinstatement Process Are Burdening Tax-Exempt Organizations*); National Taxpayer Advocate 2011 Annual Report to Congress 442 (Most Serious Problem: *The IRS Makes Reinstatement of an Organization's Exempt Status Following Revocation Unnecessarily Burdensome*); National Taxpayer Advocate 2007 Annual Report to Congress 210 (Most Serious Problem: *Determination Letter Process*).

³³ Section 1223 of the Pension Protection Act of 2006 (Pub. L. No. 109-280, 120 Stat. 780 (2006)) amended IRC § 6033 to impose a new annual reporting requirement, Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt EOs Not Required to File Form 990 or 990-EZ, on small exempt organizations and mandated automatic revocation of tax-exempt status of organizations that fail to file required returns or e-Postcards for three consecutive years.

³⁴ NTA 2013 Annual Report 165 (Most Serious Problem: *Exempt Organizations: The IRS Continues to Struggle with Revocation Processes and Erroneous Revocations of Exempt Status*).

than the number of first-time applications it usually receives in an entire year, four times the 2010 level, and more than triple the 2011 level.³⁵ Organizations consulting the “Where’s My Exemption Application?” page on IRS.gov on February 14, 2014 learned “the average date of pending applications is April 2013,”³⁶ *i.e.*, the IRS is just now getting around to applications submitted last April. Past EO executives exacerbated the problem by resisting TAS’s authority to order expedited processing of applications and isolating EO from TAS.³⁷

EO has adopted measures intended to reduce its backlog, especially for applications more than a year old.³⁸ As a result of these efforts, the timeframe for assignment of applications has been reduced from 18 months in December 2013 to ten months.³⁹ For example, the IRS suspended processing of new applications for a 60-day period beginning January 6, 2014, in order to devote more resources to working backlogged applications.⁴⁰ However, employees were instructed that “Applications requiring expedited treatment (including referrals from the Taxpayer Advocate Service where it has been determined the taxpayer is suffering or is about to suffer a significant hardship within the meaning of IRC § 7811) will continue to be processed under existing procedures.”⁴¹

As a first step toward addressing the problems I identified in my Special Report, I met in Cincinnati on August 7, 2013 with managers and employees in the EO Determinations

³⁵ National Taxpayer Advocate 2013 Annual Report to Congress 165 (Most Serious Problem: *Exempt Organizations: The IRS Continues to Struggle with Revocation Processes and Erroneous Revocations of Exempt Status*).

³⁶ Where Is My Exemption Application?, available at <http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Where's-My-Application>, with last update of Feb. 11, 2014 (informing taxpayers, as of Feb. 14, 2014, that it would take EO about 14 days to acknowledge receipt of the application, up to an additional 90 days to either approve the application or request additional information, and, if the application needed to be assigned to an agent for development, up to an additional 180 days to be assigned. The average date of pending applications is April 2013.).

³⁷ National Taxpayer Advocate Special Report, at 28.

³⁸ *The State of the IRS*, Hearing before the H. Comm. on Ways and Means, Subcomm. on Oversight, 113th Cong. 2nd Sess. (Feb. 5, 2014) (written testimony of John A. Koskinen, Commissioner, Internal Revenue Service, 9-10), available at <http://waysandmeans.house.gov/calendar/eventsingle.aspx?EventID=368226>. Additionally, on Jan. 2, 2014, the IRS published a revenue procedure that provides for streamlined procedures for reinstating the tax-exempt status of organizations whose status had been automatically revoked. See Rev. Proc. 2014-11, 2014-3 I.R.B.411.

³⁹ See NTA 2013 Annual Report 165 (Most Serious Problem: *Exempt Organizations: The IRS Continues to Struggle with Revocation Processes and Erroneous Revocations of Exempt Status*), noting that as of Nov. 14, 2013, organizations consulting the “Where is My Exemption Application?” page on IRS.gov were informed that applications requiring review by an EO specialist would take a year and a half just to be assigned.

⁴⁰ Memorandum from Acting Director, Exempt Organizations Rulings and Agreements, *Suspension of Initial Classification of Applications for 60 days* (Dec. 27, 2013).

⁴¹ *Id.*

Unit.⁴² By the end of August 2013, under instructions from newly-appointed EO leadership, EO employees routinely accepted TAS requests for expedited processing where TAS determined that the taxpayer was suffering or about to suffer significant hardship within the meaning of IRC § 7811, and no longer insisted on applying only EO expedite criteria.⁴³ In December of 2013, my staff and I developed training courses on the requirements for obtaining exempt status under IRC § 501(c)(3) and (c)(4), and on how EO processes applications for exempt status.⁴⁴ All TAS case advocacy employees will be required to complete the training by March 14.⁴⁵ I expect that with this training, our employees will be better able to assist taxpayers when the delays associated with their applications are causing significant hardship to the organizations or their beneficiaries.

The training instructs TAS employees how to advocate for taxpayers in light of EO's processes and procedures and will be supplemented with written guidance with case studies. Additionally, TAS and EO are collaborating to develop training for EO employees about TAS and our statutory advocacy function, which is expected to be available by this June. I expect this training to help EO employees understand TAS's role, statutory authority, and operating procedures, and to recognize when they should refer cases to TAS.

EO's new leadership team, upon taking office in June of 2013, immediately responded to overtures from TAS and signaled that it would depart from the previous practice of noncooperation described in my Special Report.⁴⁶ TAS and EO managers and executives now meet regularly to discuss general procedures as well as specific cases, and the Special Counsel to the National Taxpayer Advocate has begun monthly meetings with Chief Counsel Tax Exempt and Government Entities (TE/GE) executives to discuss EO and other TE/GE issues. Through the regular meetings with EO managers and executives, TAS is assisting EO to manage its inventory backlog and improve customer service. For example, organizations seeking exempt status sometimes approach EO through more than one channel. They may contact EO directly, they may contact TAS directly, they may contact their representative in Congress who in turn directs them to TAS, or they may adopt a combination of these

⁴² The visit was reported in TE/GE's internal newsletter, TE/GE Connect, *National Taxpayer Advocate Meets with Cincinnati Employees*, IRS intranet, <http://tege.web.irs.gov/my-news/2013/08/tas-employees.asp> (last visited Feb. 14, 2014).

⁴³ Email from Acting Director, EO Rulings and Agreements, to front-line managers (Aug. 13, 2013).

⁴⁴ As described below, two videos were recorded on DVDs, designated as C01 and C02, and accompanying written training materials were prepared, designated with course numbers of 55250-102 (student guide) and 55250-103 (facilitator guide).

⁴⁵ See National Taxpayer Advocate Special Report, at 28-34 (describing my commitment to provide this training).

⁴⁶ Notes of meeting between the Acting Director of Exempt Organizations and TAS's Executive Director of Systemic Advocacy (June 4, 2013), on file with TAS; see National Taxpayer Advocate Special Report, at 28, for a description of EO's cultural difficulty with TAS.

approaches. Consequently, EO may create and assign more than one case for the same organization.

To help identify duplicate cases, TAS now reports weekly to EO on cases for which it has issued Operations Assistance Requests (OARs).⁴⁷ TAS also provided instructions to other IRS offices that receive inquiries from organizations seeking exempt status on how to recognize from researching IRS databases when an organization has already requested assistance from TAS.⁴⁸ EO is exploring several ways to improve customer service and TAS has assisted in building the business case for one of its initiatives.⁴⁹ We have offered EO our assistance in developing a system for tracking employee requests for guidance (the lack of which contributed to the problems TIGTA identified in its May 2013 report). In the first six months or so following publication of the TIGTA report, TE/GE sent TAS 75 items of proposed procedures or correspondence for review, compared to 52 for the same June to December period in 2012, an increase of over 40 percent.⁵⁰ We continue to assist thousands of organizations with exempt organization issues.

- For FY 2013, TAS had 3,258 case receipts with this issue, 58 percent of which were Congressional referrals. We closed 2,621 cases, with a relief rate of 83 percent.
- In FY 2014 to date, we have received 1,501 cases with exempt organization issues, 65 percent of which were Congressional referrals. We have closed 1,331 cases, with a relief rate of 84 percent.

My employees also continue to advocate for EO taxpayers through the Taxpayer Assistance Order (TAO), issuing 53 TAOs to EO from June of 2013 through February 13, 2014, five of which involved applications under IRC § 501(c)(4).⁵¹ EO complied with 49 of the 53 TAOs, three are still open, and one was rescinded.

⁴⁷ TAS uses an Operations Assistance Request (OAR) to request action on a taxpayer account by the responsible IRS function.

⁴⁸ Email from TAS Director of Technical Analysis & Guidance to cross-functional TE/GE Correspondence Assistance team that includes TAS (Nov. 6, 2013), on file with TAS.

⁴⁹ EO, while working with the IRS Office of Online Services to revise the "Where is My Exemption Application?" webpage, solicited data about the volume of inquiries to TAS about determination status and the resources this consumes to help bolster its position that a better online tool is needed. TAS provided submissions on the TAS Systemic Advocacy Management System (SAMS) that related to this issue.

⁵⁰ From May 31, 2012 to Dec. 10, 2012, TAS received 52 Internal Revenue Manual (IRM) chapters from TE/GE for review. From May 31, 2013 to Dec. 10, 2013, TAS received 57 IRM chapters from TE/GE for review, as well as 13 interim guidance memoranda and five draft letters or notices to taxpayers for a total of 75 items. TAS IMD SPOC. Seventy-five is an increase of 44 percent over 52.

⁵¹ Under IRC § 7811, the National Taxpayer Advocate (or her delegate) can issue a Taxpayer Assistance Order (TAO) to order the IRS to take certain actions, cease certain actions, or refrain from taking certain actions (e.g., to release a levy). A TAO may also be issued to order the IRS to expedite consideration of a taxpayer's case, reconsider its determination in a case, or review the case at a higher level. Treas.

IV. Identity Theft and Refund Fraud

As I have written in nearly every Annual Report I have delivered to Congress since 2004, tax-related identity theft is a serious problem – for its victims, for the IRS and, when Treasury funds are improperly paid to the perpetrators, for all taxpayers.⁵² In general, tax-related identity theft occurs when an individual intentionally uses the Social Security number of another person to file a false tax return to obtain an unauthorized refund.⁵³

Within my organization, the Taxpayer Advocate Service (TAS), identity theft receipts increased sharply over the past decade, accounting for approximately one out of four cases in our inventory in recent years.

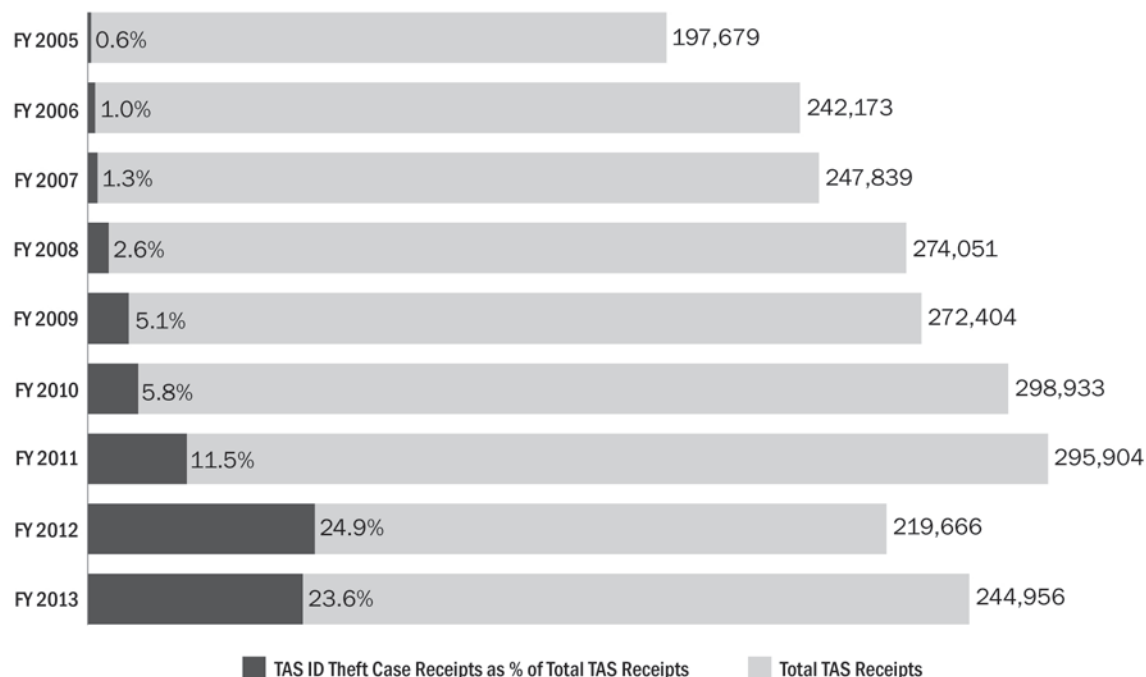
Reg. § 301.7811-1(c). Once a TAO is issued, the IRS can comply with the action ordered or appeal the issue for resolution at a higher level. IRM 13.1.20.5(2) (Dec. 15, 2007).

⁵² See National Taxpayer Advocate 2013 Annual Report to Congress 75-83 (Most Serious Problem: *The IRS Should Adopt a New Approach to Identity Theft Victim Assistance that Minimizes Burden and Anxiety for Such Taxpayers*); National Taxpayer Advocate 2012 Annual Report to Congress 42-67 (Most Serious Problem: *The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft*); National Taxpayer Advocate 2011 Annual Report to Congress 48-73 (Most Serious Problem: *Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS*); National Taxpayer Advocate 2009 Annual Report to Congress 307-317 (Status Update: *IRS's Identity Theft Procedures Require Fine-Tuning*); National Taxpayer Advocate 2008 Annual Report to Congress 79-94 (Most Serious Problem: *IRS Process Improvements to Assist Victims of Identity Theft*); National Taxpayer Advocate 2007 Annual Report to Congress 96-115 (Most Serious Problem: *Identity Theft Procedures*); National Taxpayer Advocate 2005 Annual Report to Congress 180-191 (Most Serious Problem: *Identity Theft*); National Taxpayer Advocate 2004 Annual Report to Congress 133-136 (Most Serious Problem: *Inconsistence Campus Procedures*).

⁵³ The IRS refers to this type of tax-related identity theft as “refund-related” identity theft. In “employment-related” identity theft, an individual files a tax return using his or her own taxpayer identifying number (usually an Individual Taxpayer Identification Number or ITIN), but uses someone else’s SSN to obtain employment. Consequently, the wages are reported to the IRS under the SSN of the victim, potentially prompting the IRS to pursue the victim for additional tax on the apparent income. See IRM 10.5.3.2(4), *Identity Protection Program Servicewide Identity Theft Guidance* (Feb. 27, 2013). Unlike in 1993, when I first represented a client in an identity theft case, the IRS now has procedures in place to minimize the tax administration impact to the victim in these employment-related identity theft situations. Accordingly, I will focus on refund-related identity theft in this testimony.

Figure 2: Taxpayer Advocate Service ID Theft Cases⁵⁴

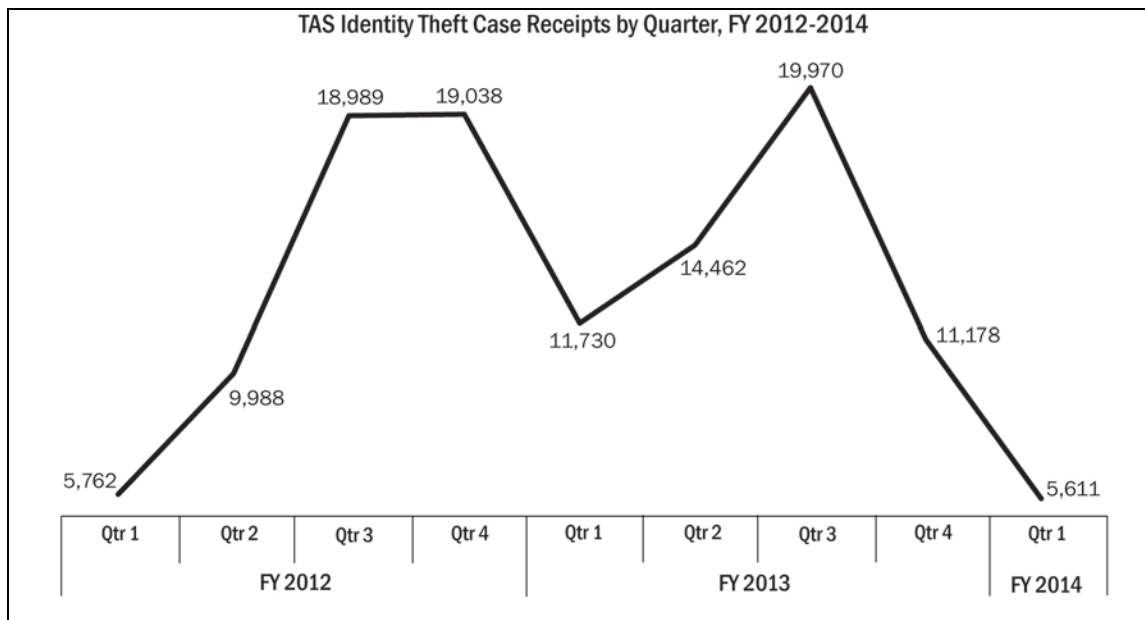
TAS Identity Theft Case Receipts, FY 2005-FY 2013



Identity theft receipts in TAS have finally started to decline in the past two quarters (although it is too early to tell whether this decline represents an actual decline in identity theft cases or is simply a result of cyclical variance). I believe this is because, in part, the IRS has done a better job of developing automated filters that flag suspicious returns and delay the payout of refunds while the refund claims are scrutinized. The IRS has also improved some of its victim assistance procedures and has been able to reduce its backlog of identity theft cases.

⁵⁴ Case receipt data obtained from the Taxpayer Advocate Management Information System (TAMIS) on February 13, 2014.

Figure 3: TAS ID Theft Cases by Quarter⁵⁵



When we first started writing about tax-related identity theft in 2004, the IRS had no procedures for its employees to follow when a taxpayer claimed to be a victim of ID theft. Since then, the IRS has established a program office to develop victim assistance procedures and has adopted many of the recommendations we have made over the years.

⁵⁵ Case receipt data obtained from TAMIS on February 13, 2014.

Figure 4: TAS Recommendations Adopted by IRS to Assist ID Theft Victims

MSP Year	Rec. #	TAS Recommendation	Year First Recommended	Year IRS Adopted
2004	9-A2	Revise the IRM to provide that scrambled procedures be used only after phone contact is attempted with the SSN users and only in those cases where available information clearly supports use of the SSN by both taxpayers.	2004	2009
2004	9-A3	Standardize procedures for information required from taxpayers.	2004	2009
2005	9-1	Conduct appropriate training for employees who determine whether to send cases to the SSA.	2005	2009
2005	9-2	Integrate awareness of identity theft into various training modules throughout the operating divisions and functions, so all employees are sensitive to this issue and can refer taxpayers to the appropriate IRS function.	2005	2011
2005	9-3	Use an electronic indicator on its master files to mark the accounts of taxpayers who have verified that they have been victims of identity theft.	2005	2008
2007	6-2	Develop a form that taxpayers can file when they believe they have been victims of identity theft. The instructions on the form should explain which steps the IRS will take and which steps the taxpayer should take (e.g., obtaining an FTC affidavit) to restore the integrity of the taxpayer's account.	2007	2009
2007	6-7	Create a prefix for IRS numbers (IRSNs) or some other system so that it does not deny tax benefits to the rightful owner of the Social Security number (SSN). While assignment of IRSNs may be the only way to isolate the fraud taking place under an SSN, it is inequitable to assign the IRSN to identity theft victims and then deny tax benefits that depend on the SSN.	2007	2012

Yet, the IRS still has much room for improvement in how it addresses identity theft. For starters, it must recognize that the consequences for victims can be significant. Being victimized by an identity thief is a traumatic life event; when someone steals and uses your identity, it is an invasion of your person. On top of that, the victim must spend time and energy having to prove his or her identity to the IRS and must endure months of aggravation and frustration before receiving his or her tax refund. The IRS's current approach in many ways treats the victim as someone experiencing a minor inconvenience, instead of a frightening personal disaster.

In acknowledging that identity theft is a traumatic life event, the IRS should set up a centralized identity theft unit similar to the innocent spouse unit that assists taxpayers who are seeking relief from joint and several liability. It is important to have a centralized unit with specially trained employees who can remain on the case as a single point of contact with the victim from the beginning to full case resolution. Otherwise, the IRS would be guilty of contributing to the problem and perpetuating the trauma to the victim. When I visited the IRS Identity Protection Specialized Unit (IPSU) unit last summer, I met with front-line employees, many of whom expressed frustration about not truly "owning" a case and having to wait for other functions to take actions on these cases that the IPSU could have easily completed.

In my latest report to Congress, I recommended that the IRS designate the IPSU as the centralized function that assigns a single employee to work with ID theft victims until all related issues are resolved. In my meetings with the new IRS leadership, they have

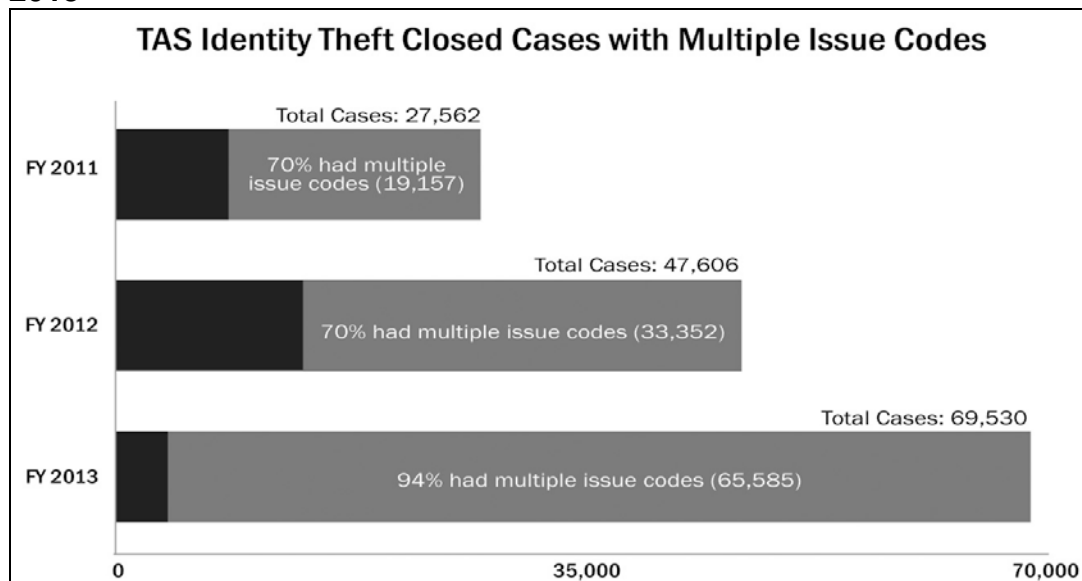
expressed willingness to revisit whether the current decentralized approach is the right one. I have offered to collaborate with the Wage and Investment division to test the effectiveness of creating a meaningful single point of contact for victims of identity theft with cases that require the involvement of multiple IRS functions (for example, where the taxpayer is not only trying to get a current year's return refund but also seeking abatement of an assessment attributable to a prior year's identity theft return).

The IRS takes much too long to resolve ID theft cases and issue refunds to the legitimate taxpayers, particularly where the case moves back and forth among IRS functions. A 2013 TIGTA report found the IRS took an average of 312 days to work the 100 ID theft cases in their sample.⁵⁶ This included 277 days of inactivity. In other words, though the cases lingered in various IRS units for approximately ten months, the average case in TIGTA's sample was resolved with just 35 days of direct contact.

The IRS's current approach of using more than 20 specialized units to handle discrete aspects of an identity theft victim's case is simply not working. As far as the victims are concerned, there should be *one* IRS employee who interacts with the taxpayer. That one employee should maintain control of the taxpayer's case, including all peripheral issues stemming from the identity theft. Because identity theft cases are often very complex, and can involve multiple issues spanning multiple years, too many victims fall between the cracks of the IRS bureaucracy.

⁵⁶ See TIGTA, Ref. No. 2013-40-129, *Case Processing Delays and Tax Account Errors Increased Hardship for Victims of Identity Theft* (Sept. 26, 2013).

Figure 5: Percent of TAS ID Theft Cases with Multiple Issue Codes, FY 2011 - 2013⁵⁷



The Taxpayer Advocate Service’s experience with working identity theft cases demonstrates the soundness of our recommendation that the IRS should assign one employee to work with the victim from the beginning, and oversee the case when it requires coordination among different units. Instead of taking 312 days to work an identity theft case, TAS case advocates resolve them in 87 days.⁵⁸ And even though identity theft cases are complex (with over 94 percent of our identity theft cases closed in FY 2013 involving more than one issue code), TAS case advocates have achieved a relief rate of 87 percent.⁵⁹ Furthermore, an overwhelming 94 percent of identity theft victims who came to TAS in fiscal year 2013 have expressed satisfaction with our assistance.⁶⁰

The IRS also needs to do a better job of tracking identity theft case data. The IRS cannot even provide a reliable figure for the number of identity theft victims it has assisted, partly because the various specialized units use different systems to track cases. Moreover, while some IRS functions track the length of time a case is in their

⁵⁷ The IRS does not track the number of issues in a given identity theft case because, unlike TAS, it treats each module (year/tax/issue) as a different case. Accordingly, we can provide TAS data only. This chart is meant to illustrate that the vast majority of TAS identity theft cases involve multiple issue codes. The increase in the percentage of cases with multiple issue codes from FY 2011 to FY 2013 may be due to better coding by TAS case advocates to record secondary issue codes; it does not necessarily mean that TAS identity theft cases have become more complex in recent years.

⁵⁸ Analysis conducted by TAS Technical Analysis and Guidance of data obtained from TAMIS (Oct. 1, 2013).

⁵⁹ *Id.*

⁶⁰ Analysis conducted by TAS Business Assessment of customer satisfaction scores reported for FY 2013 (through June 2013); data obtained from TAMIS (Oct. 1, 2013).

inventory, the IRS still cannot provide an overall cycle time from the taxpayer's perspective. For example, specialized units generally measure cycle time from the date that particular unit received the case; it does not reflect the time elapsed since the taxpayer attempted to file the initial return, or all of the prior interactions the victim may have had with the IRS. In my 2013 Annual Report to Congress, I recommended that the IRS develop a method of tracking cycle time *from the perspective of the victim*.

V. Affordable Care Act

As part of the Affordable Care Act (ACA), the IRS is implementing complicated health care tax provisions that require new technology and significant rule-making.⁶¹ These provisions would present a serious administrative challenge to any agency, but for one such as the IRS, with its annual and continuing tax administration duties, the added work is daunting. To date, I believe the IRS has acquitted itself well in meeting its initial responsibilities under the ACA. Specifically, the IRS has done an impressive job of updating information technology (IT) systems, issuing guidance, and attempting to collaborate with other federal agencies. The IRS's actions with regard to ACA implementation demonstrate what the IRS can do when it has sufficient lead time to plan and implement a complex social benefit delivered through the tax system.

While the opening of the Health Insurance Marketplaces⁶² on October 1, 2013, was riddled with problems, the one aspect that went better than anticipated was the role of the IRS in providing information to the Marketplace on household income and family size. Originally, the IRS agreed that queries from the Marketplace would have an average response time of less than five seconds. However the IRS has been providing an average response time of less than one second.⁶³ The IRS is to be commended on its ability to surpass expectations thus far.

In order to ensure that ACA design and implementation treat taxpayers – both individuals and businesses – appropriately and fairly, the Taxpayer Advocate Service has been actively involved with the IRS roll-out of the Affordable Care Act tax provisions. I personally sit on the ACA Executive Steering Committee and have staff throughout TAS on the ACA Joint Implementation Teams to ensure the provisions are implemented in a fair and equitable manner and that taxpayer rights are protected.⁶⁴

⁶¹ See Patient Protection & Affordable Care Act of 2009, Pub. L. No. 111-148, 124 Stat. 119 (Mar. 23, 2010), as amended by the Health Care & Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (Mar. 30, 2010).

⁶² <https://www.healthcare.gov/marketplace/individual>.

⁶³ This is due, in part, to a lower than anticipated volume of inquiries. Data provided verbally at ACA Executive Steering Committee on Nov. 13, 2013.

⁶⁴ The Joint Implementation Teams TAS is represented on are: Customer Service Operations, Tax Return Processing, Information Return Receipt and Processing, ACA Notices and Correspondence, Compliance – Individuals, Compliance – Business, and Collection.

ACA Taxpayer Service and Training Raise Concerns

The true test for the IRS will be in 2015, when taxpayers begin filing their 2014 tax returns. This will be the first year taxpayers will have to provide information regarding their health insurance coverage (or pay a penalty excise tax⁶⁵) and many taxpayers will have to reconcile the Premium Tax Credit amounts they are currently receiving with the amounts to which they are entitled, based on their actual (as opposed to projected) 2014 income.⁶⁶ Although the IRS has been successful in many aspects of ACA implementation, it is lagging in one of the most critical areas – addressing taxpayer questions and adequately training employees on the new provisions. The IRS has adopted a “Web First” assistance and education strategy that directs taxpayers to various web pages for additional information.

While other agencies have telephone or web chat options, the IRS’s web-first strategy acts more as a “web-only” strategy that limits taxpayers’ access to in-person assistance with *tax-related* health care questions.⁶⁷ The IRS has specifically advised its assistors “the best service to the customer is to provide the web URLs. This is known as the ‘Web First’ strategy.”⁶⁸ In comparison, Healthcare.gov has telephone assistors trained to answer questions, as well as a live web chat option.⁶⁹

⁶⁵ IRC § 5000A is in Subtitle D, *Misc. Excise Taxes*, of Title 26, U.S.C. At the same time, this excise tax is what ACA “describes as a ‘penalty’.” *Nat’l Fed’n of Ind. Business v. Sebelius*, 132 S Ct. 2566, 2580 (2012). There are exceptions for individuals who: have religious objections documented in a certificate issued by an Exchange to members of a recognized sect who adhere to established religious tenets; are not lawfully present in the U.S.; are incarcerated for at least one day of the applicable month in a jail, prison, or similar penal institution or correctional facility after the disposition of charges; have income below the tax filing threshold; lack coverage for fewer than three months; cannot afford coverage where the required contribution exceeds eight percent of household income for 2014; are members of federally recognized Indian tribes; or have suffered hardship as certified by an Exchange with respect to the capability to obtain minimum essential coverage (including, among others, patients of the federal Indian Health Service not enrolled in a recognized tribe). On affordability, “if an employee with a family is offered self-only coverage costing five percent of income and family coverage costing ten percent of income, the employee is not eligible for the tax credit in the Exchange because self-only coverage costs less than 9.5 percent of household income. The employee is not exempt from the individual responsibility penalty on the grounds of an affordability exemption because the self-only plan costs less than eight percent of income.” Jt. Comm. on Tax’n, *Technical Explanation of the Revenue Provisions of the “Reconciliation Act of 2010,” as Amended, in Combination with the “Patient Protection and Affordable Care Act”*, JCX-18-10, p. 33, n. 70 (Mar. 21, 2010).

⁶⁶ The Premium Tax Credit is a refundable, advanceable tax credit available to help low and middle income taxpayer purchase health insurance through a Marketplace. IRC § 36B.

⁶⁷ See Health Insurance Market Place, *Help-Center*, <https://www.healthcare.gov/help-center/> (last visited Aug. 12, 2013).

⁶⁸ IRS, *Affordable Care Act Web First Strategy: Addressing Health Care Law Inquiries*, http://win.web.irs.gov/field/fadocs/ACA_Web_First_Strat.pdf (last visited Apr. 30, 2013).

⁶⁹ See Health Insurance Market Place, *Help-Center*, <https://www.healthcare.gov/help-center/> (last visited Aug. 12, 2013).

Websites alone may not meet the needs of taxpayers dealing with complicated new provisions for the first time.⁷⁰ Moreover, those who are eligible for the Premium Tax Credit may not have the necessary language or computer literacy skills,⁷¹ and those who lack Internet access still need IRS assistance through other channels. Obtaining health care is an inherently complicated and personal decision that can have a major impact on a taxpayer's life and finances. If the IRS cannot answer tax-related questions, taxpayers may unknowingly make health care choices that carry significant tax implications.

The IRS Is Not Adequately Training Assistors to Respond to Taxpayer Questions on Health Care Issues.

As discussed above, due to resource constraints the IRS already cannot answer millions of telephone calls or respond timely to volumes correspondence from taxpayers.⁷² The new work caused by the ACA will compound this backlog. The IRS estimates it needs almost 2,000 new employees to handle the numerous additional calls and letters that may arrive once applicable provisions take effect.⁷³ Absent additional employees dedicated to the ACA, the IRS must ensure that the employees it does have – particularly in taxpayer-facing roles – are properly trained to respond to taxpayer inquiries.

The IRS has provided some general ACA information to employees but has not yet engaged in substantive training. The IRS says it is developing training for 2014, but TAS has yet to see or review its training plan. In contrast, TAS has been providing training to its employees on the Affordable Care Act since 2010, to give them time to digest and develop a basic understanding of the new provisions. TAS plans to continue this training through 2014, adding more in-depth sessions and specific case studies. It

⁷⁰ Existing IRS functions, such as Stakeholder Partnership, Education & Communication (SPEC), Stakeholder Liaison, and Taxpayer Assistance Centers may receive questions and even visits from taxpayers who want to know about the ACA. See SPEC *Outreach Summary* (Filing Season Jan.-Apr. 2013) (containing 3-pg. ACA Overview); IRS Pub. 5093, *Healthcare Law Online Resources* (1 pg. listing a half-dozen URLs for individuals & employers).

⁷¹ Adults “living in households earning at least \$50,000 per year are more likely to have home broadband than those at lower income levels.” Pew Res. Ctr., *Home Broadband 2013*, available at <http://pewinternet.org/Reports/2013/Broadband.aspx> (last visited Sept. 17, 2013). As of 2011, only “75.6 percent of households reported having a computer,” which means almost a quarter of the nation's households may be unable to get the information they need from the IRS's web strategy. U.S. Census Bureau, *Computer and Internet Use in the United States*, P20-569 (May 2013) 1. See also National Taxpayer Advocate 2011 Annual Report to Congress 273, 279 (Introduction to Diversity Issues: *The IRS Should Do More to Accommodate Changing Taxpayer Demographics*) (“low income, less educated, minority, elderly, disabled, or rural populations are less likely than others to use the Internet”).

⁷² See NTA 2013 Annual Report 20 (*Most Serious Problem: IRS Budget Cuts Diminish Taxpayer Service*); National Taxpayer Advocate 2012 Annual Report to Congress 34 (*Most Serious Problem: The IRS Is Significantly Underfunded to Serve Taxpayers and Collect Tax*); IRS Joint Operation Center (JOC) Snapshot Report for fiscal year 2013 (Sept. 30, 2013) and JOC Accounts Management Inventory Reports for fiscal year 2013 (Oct. 6, 2012 – Sept. 28, 2013).

⁷³ See IRS FY 2014 President's Budget, Table 4.9 at 169.

is my understanding that one of the ACA Implementation Teams is reviewing the ACA training TAS offered this year to see if it meets the needs of the ACA overview all IRS employees should receive. I encourage the IRS to use TAS's training and ensure that all IRS employees receive basic training on the new health care provisions.

IRS Outreach Does Not Alert Taxpayers to the Issues Surrounding a Change in Circumstances.

The IRS has made strides in its ACA outreach efforts. It has issued several user-friendly publications for taxpayers regarding the Premium Tax Credit, and we understand it plans similar publications for the employer provisions and Shared Responsibility Payment.⁷⁴ Additionally, the IRS has made efforts to improve the ACA pages on IRS.gov, including a new page specifically on the Premium Tax Credit⁷⁵ as well as updated Q&As and legal guidance.⁷⁶ The IRS also plans to create a page on the 5000A Individual Shared Responsibility Payment. TAS will continue to work with the IRS on its outreach efforts.

However, we remain concerned that the IRS is not being proactive and educating taxpayers as early as possible on a critical issue: the importance of updating their information throughout the year with the Exchange if they are receiving a credit.⁷⁷ To avoid receiving an excess credit, taxpayers must update their information with the marketplace if their income or other relevant circumstances change.⁷⁸ This is also

⁷⁴ Thus far, the IRS has issued several electronic publications, including Pub. 5093, *Health Care Law Online Resources* (July 2013), Pub. 5120, *Facts About the Premium Tax Credit* (flyer) (Sept. 2013), and Pub. 5121, *Facts About the Premium Tax Credit* (brochure) (Dec. 2013). We understand that Spanish versions of the publications are in progress.

⁷⁵ The ACA homepage is located at <http://www.irs.gov/aca>. The Premium Tax Credit page is located at <http://www.irs.gov/uac/The-Premium-Tax-Credit>.

⁷⁶ <http://www.irs.gov/uac/Newsroom/Affordable-Care-Act-Tax-Provisions-Questions-and-Answers>.

⁷⁷ To apply for a premium assistance credit, an individual goes to an Exchange, which will attempt to verify household income with the IRS. In general, applicable taxpayers seeking health insurance and a premium tax credit through an Exchange will supply names, Social Security numbers, and income data for themselves and their dependents to the Exchange. See ACA § 1411(b), 124 Stat. 119, 224 (2010). The Exchange can verify data with HHS, which has authority under the ACA to obtain IRS data, and then disclose any inconsistency to the Exchange. See IRC § 6103(l)(21). If IRS information is inaccurate or outdated, the individual may need to present updated documentation or other evidence to HHS to establish eligibility for a premium tax credit. If a taxpayer's household status at year's end is other than anticipated – due either to a change in income or family size – the premium tax credit may be more or less than the amount advanced. Consequently, the IRS may recover the excess as a tax (below a ceiling for low income taxpayers), or owe the taxpayer a refund. Section “36B(f)(2)(B) places a graduated set of caps on the additional tax liability for taxpayers with household income under 400 percent of the F[ederal] P[overty] Level]. The repayment limitation amounts range from \$600 to \$2,500 (one-half that amount for single taxpayers) depending on FPL, and are adjusted to reflect changes in the cost of living beginning in 2015.” 76 Fed. Reg. 50931, 50933-934 (Aug. 17, 2011).

⁷⁸ Income may change after submission of an application, which reflects the amount on the last tax return, *i.e.*, the one filed in the current year relating to the year that just ended. Thus, a couple of years' worth of life changes may transpire by the time of reconciliation between the advance and ultimate credit amounts.

important for taxpayers who may be eligible for a larger credit due to a reduction in pay or an increase in family size (such as having or adopting a child). Educating taxpayers early and repeatedly about this requirement will help prevent them from owing money to the IRS (or reducing their refunds) or receiving an additional credit amount at the end of the year.

Healthcare.gov now has a “Report Life Change” button that allows individuals to modify their health insurance plans (once they are enrolled) if they have experienced a change such as family size, moving, etc.⁷⁹ Assuming this option will also allow for a recalculation of the Premium Tax Credit based on these changes, the IRS can easily tie its messages about changing circumstances into this new option.

TAS worked with the IRS to prominently place language in the 2013 Form 1040, *U.S. Individual Income Tax Return*, instructions to alert taxpayers of the importance of updating their information with the marketplaces. However, the IRS still needs to be more proactive. While almost 80 percent of individual returns are refund returns and thus may offset some or all of the reconciliation amount, the IRS should be doing all it can to ensure that as few taxpayers as possible have excessive advanced premium tax credit payments and instead receive the correct amount throughout the year.⁸⁰ In addition to preventing taxpayers from owing money, this approach will reduce future costs to the IRS for collection activities.⁸¹

I have additional concerns that other taxpayers will have their returns delayed because they claim a larger Premium Tax Credit than what they received during the year due to a change in circumstances. If the IRS flags these returns as potentially fraudulent, it may hold up legitimate refunds. TAS has seen these issues previously, especially when large dollar amounts are at stake.⁸²

By the same token, certain changed circumstances, such as the birth of a child or a reduction in pay, may increase the credit.

⁷⁹ Amy Goldstein, *Administration will allow people to switch health-care plan to a limited degree*, Washington Post (Feb. 7, 2014) available at http://www.washingtonpost.com/national/health-science/administration-will-allow-people-to-switch-obamacare-plans-to-a-limited-degree/2014/02/07/56c8bfd2-9015-11e3-b227-12a45d109e03_story.html (last visited Feb. 18, 2014).

⁸⁰ IRS Compliance Data Warehouse, Individual Returns Transaction File Tax Year 2012 (Feb. 2014).

⁸¹ TAS looks forward to working with RAS to try to identify the areas and populations of taxpayers most likely to have experienced a change in circumstances. This information can be used by the IRS's SPEC organization, TAS Local Taxpayer Advocates (LTAs), Low Income Taxpayer Clinics (LITCs), and other stakeholders to conduct outreach to these specific populations.

⁸² National Taxpayer Advocate 2012 Annual Report to Congress 111-133 (Most Serious Problem: *The IRS's Compliance Strategy for the Expanded Adoption Credit Has Significantly and Unnecessarily Harmed Vulnerable Taxpayers, Has Increased Costs for the IRS, and Does Not Bode Well for Future Credit Administration*); National Taxpayer Advocate Fiscal Year 2012 Objectives Report to Congress 28-32; National Taxpayer Advocate 2011 Annual Report to Congress 687-689 (Case Advocacy: *Policymakers Can Learn from the Implementation of the FTHBC*); National Taxpayer Advocate Fiscal Year 2011 Objectives Report to Congress 3, 37-43; National Taxpayer Advocate 2010 Annual Report to Congress 15 (Most Serious Problem: *The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*) (Case Advocacy: *TAS Assists the*

While there will always be persons trying to game the tax system, I believe the risk of fraud with respect to the PTC is much less than with many other refundable credits. With respect to the Advanced Premium Tax Credit, the credit will be paid to established insurance companies when a policy is actually in place. When a taxpayer claims the PTC on his or her income tax return, it is a *reimbursement* of amounts already paid; the taxpayer will have to provide proof of a qualified health insurance plan, which the IRS will be able to verify through third-party information reporting. This design minimizes the opportunities for fraud.

TAS is in the final stages of developing an estimator for the Premium Tax Credit that will help taxpayers and practitioners understand how changes in circumstances will impact their credit amounts. TAS hopes to have this tool online and available to the public in the next few months. We have had success with a similar estimator for the Small Business Health Care Tax Credit (SBHCTC), which we launched on the TAS Tax Toolkit in November 2012.⁸³ The homepage for the estimator received 5,000 page views for October 2013 and over 13,000 page views for October – December 2013.⁸⁴

Delays in Information Matching Show Need for Real-Time Tax System

Last year, the Treasury Department delayed the requirement for certain employers with 100 or more employees to provide coverage to their employees.⁸⁵ Due to the delay in implementation, employers will not have to provide information reporting to the IRS regarding the employees they cover.⁸⁶ This information reporting will help identify which taxpayers have coverage and which do not (and therefore have to pay a penalty). We do not yet know how the IRS plans to address this lack of information during the 2015 filing season. TAS members on the relevant Joint Implementation Team have been told it will be discussed later.

IRS with the Administration of the First-Time Homebuyer Credit); National Taxpayer Advocate 2009 Annual Report to Congress 506-509; *Hearing on Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due*, Hearing Before the S. Comm. on Finance, 112th Cong. (statement of Nina E. Olson, National Taxpayer Advocate) (June 28, 2011); *Filing Season Update: Current IRS Issues: Hearing Before the S. Comm. on Finance*, 111th Cong. (2010) (statement of Nina E. Olson, National Taxpayer Advocate) (Apr. 15, 2010); *The National Taxpayer Advocate's 2009 Report on the Most Serious Problems Encountered by Taxpayers: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 111th Cong. (2010) (statement of Nina E. Olson, National Taxpayer Advocate) (Mar. 16, 2010).

⁸³ <http://www.taxpayeradvocate.irs.gov/Businesses/Small-Business-Health-Care-Tax-Credit-Estimator> (last visited Feb. 19, 2014). According to Weber Shandwick, which tracks statistics for the estimator, the SBHCTC estimator has received over 23,500 page views since its launch in 2012.

⁸⁴ Taxpayer Advocate Service, FY 2014 1st Quarter Business Performance Review.

⁸⁵ Continuing to Implement the ACA in a Careful, Thoughtful Manner, Treasury Notes, (July 2, 2013), available at <http://www.treasury.gov/connect/blog/Pages/Continuing-to-Implement-the-ACA-in-a-Careful-Thoughtful-Manner-.aspx> (last visited Feb. 13, 2014). The requirement was further delayed until 2016 for employers with between 50 to 99 employees. Shared Responsibility for Employers Regarding Health Coverage, 79 Fed. Reg. 8543 (Feb. 12, 2014).

⁸⁶ Transition Relief for 2014 Under §§ 6055 (§ 6055 Information Reporting), 6056 (§ 6056 Information Reporting) and 4980H (Employer Shared Responsibility Provisions), Notice 2013-45.

Without this information, the IRS's job is increasingly difficult. This further strengthens my position on the need for a real-time tax system, discussed below.

VI. Accelerated Receipt and Use of Third-Party Information Reports

Accelerated Third-Party Information Report Processing and Upfront Document Matching Will Protect Revenue, Reduce Fraud, and Improve Taxpayer Service.

Whether in the context of Premium Tax Credit reconciliation, eligibility for the Earned Income Tax Credit, or returns filed by identity thieves, the IRS faces pressure to satisfy two competing demands: protect the public fisc from erroneous refund claims and meet taxpayer expectations by issuing refunds quickly. Although the IRS has instituted many business rules and filters to identify questionable refunds, it generally matches third-party information reports with tax return data long after it has released any associated income tax refunds.⁸⁷

In 2009, I recommended that Congress establish a timeframe for the IRS to develop a strategy and timeline for accelerating third-party information report processing and providing taxpayers with electronic access to such data.⁸⁸ Most recently, a study in my 2013 Annual Report provides a strategic framework and preliminary recommendations to better structure the filing season to reduce fraud and protect the interests of both the government and taxpayers.⁸⁹ This is a key component of 21st century tax administration.

The government benefits from the revenue protection aspect of accelerated third-party information report processing and upfront document matching. Third-party information reporting is a crucial element in maximizing tax compliance.⁹⁰ By enabling the IRS to match third-party data to tax return information before issuing refunds, the IRS could identify and resolve inaccurate income reporting soon after the return is filed and

⁸⁷ For a more detailed discussion of the IRS's processes to review refund returns, see Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 2013 TNT 92-131, Tax Notes Tax Analysts Tax Notes Today (May 13, 2013).

⁸⁸ National Taxpayer Advocate 2009 Annual Report to Congress 338-345; National Taxpayer Advocate 2011 Annual Report to Congress 284-295; National Taxpayer Advocate 2012 Annual Report to Congress 180-191.

⁸⁹ NTA 2013 Annual Report vol. 2, 67-96.

⁹⁰ Tax gap data show the importance of information reporting compliance, and how third-party reporting is essential to encourage voluntary compliance; specifically, when taxpayers have a choice about reporting their income, tax compliance rates are remarkably low. For example, workers who are classified as employees have little opportunity to underreport their earned income because it is subject to both information reporting on Forms W-2 and tax withholding. In fact, IRS data show that taxpayers report about 99 percent of their wages and salaries. IRS, *Tax Gap for Tax Year 2006 Overview*, Chart 1 (Jan. 6, 2012).

prevent the release of erroneous refunds. This system would deter tax fraud and identity theft by stopping the refund associated with a mismatch.

In addition, accelerated information report processing and upfront matching would substantially improve taxpayer service and reduce taxpayer burden by:

- Providing taxpayers with direct electronic access to the third-party information report data to assist in tax preparation and reduce inadvertent errors;⁹¹
- Improving taxpayers' ability to answer questions about an underlying economic transaction if the IRS identifies the mismatch within months rather than a year or more after the fact;
- Avoiding IRS collection actions long after taxpayers have spent the refunds;
- Avoiding the long-term accrual of penalties and interest on unintentionally omitted or under-reported items; and
- Reducing vulnerability to identity-theft related refund fraud.⁹²

While the IRS has acknowledged the benefits of accelerated third-party information report processing and upfront matching, it has not made any recent progress in developing a long-term plan for such a system.⁹³ The IRS's lack of progress only delays the significant benefits we outlined throughout the study. Thus, we reiterated our 2009 Legislative Recommendation that Congress require the IRS and Treasury, in consultation with the Taxpayer Advocate Service, to prepare a plan and timeline to achieve an accelerated third-party report processing system.

⁹¹ Taxpayers will not realize the full benefits of accelerated third-party information reporting unless the IRS provides taxpayers and their preparers with the ability to access and download their third party data from an online account. To address inadvertent omissions, the IRS should provide access to real-time transcripts of third-party data to aid in return preparation. Taxpayers and preparers could refer to the transcripts to ensure they do not accidentally omit income. One step above the transcript would be to provide a platform from which taxpayers and preparers could download third-party data submitted to the IRS or the Social Security Administration directly into a commercial tax software package or even an improved version of the IRS's Free File Fillable Forms (FFFF). This second option would eliminate transcription errors and provide a one-stop-service to taxpayers who would not need to download the data separately from each third party. In addition, the government would enjoy the benefits experienced by other tax administrations through pre-filled returns, but would still encourage competition in the tax software industry. For more information on the benefits of electronic access to third-party data and the experience of international tax administrations, see National Taxpayer Advocate 2013 Annual Report to Congress vol. 2, 67-96.

⁹² William Hoffman, *IRS Oversight Board Brainstorms Real-Time Tax System, ID Theft Initiatives*, Tax Notes Today (May 2, 2013); IRS, PowerPoint, *Real Time Tax System Initiative, Public Meeting 1* (Dec. 8, 2011), available at http://www.irs.gov/file_source/pub/irs-utl/rtts_deck.pdf. For more information on identity-theft refund fraud, see National Taxpayer Advocate 2013 Annual Report to Congress 75-83 (Most Serious Problem: *The IRS Should Adopt a New Approach to Identity Theft Victim Assistance that Minimizes Burden to Such Taxpayers*); National Taxpayer Advocate 2012 Annual Report to Congress 42-67 (Most Serious Problem: *The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft*).

⁹³ For written and oral statements of panelists at the two IRS Real Time Tax System Initiative public meetings, see <http://www.irs.gov/Tax-Professionals/Real-Time-Tax-Initiative> (last visited Feb. 13, 2013).

In addition, to stimulate serious consideration and discussion of the issue, we offered the following administrative and legislative recommendations to achieve a system that allows the IRS to perform upfront matching to protect government revenue and improve taxpayer service:

- Provide taxpayers with electronic access to real-time transcripts of third-party information reporting data to aid in return preparation.
- Provide a platform from which taxpayers and preparers could download third-party data directly into commercial tax return preparation software.
- To accelerate the processing of Form W-2 data, develop and implement a one-year pilot to determine if the IRS can screen Form W-2 data as effectively as the Social Security Administration.
- Because almost 98 percent of all information reports are already e-filed, eliminate the March 31 deadline for e-filed information reports.⁹⁴ Thus, all information reports, whether e-filed or filed on paper, would be due at the end of February.
- Create a \$50 *de minimis* threshold for corrections, which would eliminate the need to file an amended or corrected third-party information report for any adjustments to income below \$50.
- Further increase electronic filing by reducing the 250 report threshold in IRC § 6011(e) to 50 reports and offer 2D bar code technology for those who cannot e-file.
- Issue direct deposit and other electronic refunds by April 30 and paper checks by May 31.

The proposals included in the 2013 study are meant to serve as a “conversation starter” and are based on research conducted by the Taxpayer Advocate Service, including discussions with impacted stakeholder groups and a review of international tax systems. We attempted to address all identified concerns and risks, but we acknowledge that there will be unexpected challenges and risks before a proposal along these lines is implemented. We recognize that the changes necessary to accomplish an accelerated third-party reporting system require a great deal of forethought, analysis, and stakeholder engagement.

VII. Improper Payments of the Earned Income Tax Credit and Other Refundable Credits

One area of tax administration that has both warranted and received a great deal of attention over the years is refundable credits, particularly the Earned Income Tax Credit

⁹⁴ IRS Pub. 6961, *2013 Update: Calendar Year Projections of Information and Withholding Documents for the United States and Campuses*, Tables 2-4 (Of the 2,288,516,144 information reports received in calendar year 2012, 2,240,335,726 were received electronically).

(EITC).⁹⁵ Most credits merely reduce the amount a taxpayer owes, but in the case of *refundable* tax credits, the IRS may end up paying a taxpayer more than the taxpayer paid in tax, resulting in a “negative” tax. Refundable credits may have become familiar in the context of benefits to low income taxpayers and therefore may be viewed as a form of “welfare.” Nevertheless, these credits are no longer limited to this population but are now available to middle-income taxpayers and businesses as well.⁹⁶

The EITC, enacted as a work incentive in the Tax Reduction Act of 1975, has become the government’s largest means-tested anti-poverty program.⁹⁷ Unlike traditional anti-poverty and welfare programs, the EITC was designed to have an easy “application” process by allowing an individual to claim the benefit on his or her tax return. This approach dramatically lowered administrative costs, since it did not require an infrastructure of case workers and local agencies. The Treasury Inspector General for Tax Administration has noted as follows:

Current administration costs are less than 1% of benefits delivered. This is quite different from other non-tax benefits programs in which administrative costs related to determining eligibility can range as high as 20% of program expenditures.⁹⁸

The IRS reports that it paid \$60.3 billion in EITC claims for tax year 2013. If this amount had been paid by another agency that spent 20 percent of program expenditures verifying eligibility, the administrative costs to the government would have been \$12.1 billion – more than 90 percent of the amount of improper payments that the IRS estimates were made.⁹⁹

However, ease of application and the absence of eligibility interviews result in greater overclaims for the EITC than traditional anti-poverty programs. In other words, the front-end administrative costs of traditional anti-poverty programs have shifted to the post-claim compliance costs of the EITC.

A significant positive difference is the EITC has far higher participation rates than other anti-poverty programs (*i.e.*, the percentage of eligible individuals and families who

⁹⁵ For a comprehensive discussion of the challenges in administering the EITC, see *Improper Payments in the Administration of Refundable Credits, Hearing Before the H. Comm. on Ways and Means*, 112th Cong. (2011) (statement of Nina E. Olson, National Taxpayer Advocate).

⁹⁶ See *e.g.*, the adoption credit (IRC § 36C) and the American Opportunity Tax Credit (IRC § 25A) for low and moderate income taxpayers and the fuel tax credit for purchasers of gasoline used on farms or local buses or of fuels for certain other purposes (IRC §§ 34, 4081(a)(2)(A), 6420, 6421, 6427).

⁹⁷ See Pub. L. No. 94-12, § 204, 89 Stat. 26 (1975).

⁹⁸ See TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year* 1 (2011) (IRS response).

⁹⁹ Department of the Treasury, *Fiscal Year 2013 Agency Financial Report* 210 (Dec. 13, 2013). The lower bound estimate of improper EITC payments in FY 2013 is \$13.3 billion.

receive the benefit is much greater, at 79 percent).¹⁰⁰ Assuming we want the intended beneficiaries to receive the benefits enacted by Congress, the EITC is a highly effective method of delivery.

Overall, EITC noncompliance is a relatively small portion of the tax gap.¹⁰¹ EITC overclaims account for six percent of the gross individual income tax noncompliance while business income underreported by individuals accounts for 51.9 percent.¹⁰² Nevertheless, EITC post-claim compliance costs are high and cannot be ignored.

The most familiar estimate of EITC compliance is the Improper Payment (IP) rate.¹⁰³ The IP rate for FY 2012 attributable to EITC is 22.8 percent (or \$12.6 billion).¹⁰⁴ This is based on estimates of dollars ultimately misspent (*i.e.*, the amount of taxpayer overclaims *net* of amounts the IRS prevents or recovers).¹⁰⁵ TIGTA has described the EITC IP rate as equal to the total (gross) EITC overclaims less total EITC claims protected/recovered, divided by total EITC claims.

¹⁰⁰ IRS, *EITC Participation Rate by States*, at <http://www.eitc.irs.gov/EITC-Central/Participation-Rate>.

¹⁰¹ The tax gap is defined as the amount of tax liability faced by taxpayers that is not paid on time. The tax gap can be divided into three components: non-filing, underreporting and underpayment. See IRS, IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged from Previous Study* (Jan. 6, 2012).

¹⁰² IRS, IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged from Previous Study* (Jan. 6, 2012). The IRS estimates \$235 billion in individual income tax underreporting for tax year (TY) 2006 with \$122 billion of this amount attributable to business income underreported by individuals as sole proprietors on Schedule C (Profit or Loss from Business) or as farmers on Schedule F (Profit or Loss from Farming). The IRS estimates about \$14.1 billion in EITC overclaims from the NRP from TYs 2006-2008. We determined the EITC overclaim amount by multiplying the overclaim rate by the amount of EITC claims (0.285 lower bound EITC overclaim rate multiplied by \$49.3 billion). IRS, RAS, *Compliance Estimates and Sources of Errors for the Earned Income Tax Credit Claimed on 2006-2008 Returns* (Feb. 12, 2014) (unpublished).

¹⁰³ Improper payments include “any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements” as well as “any payment to an ineligible recipient, any payment for an ineligible service, any duplicate payment, payments for services not received, and any payment that does not account for credit for applicable discounts.” Improper Payments Information Act of 2002, Pub. L. No. 107-300 § 2351, 116 Stat. 2350 (2002). See also GAO, GAO-09-628T, *Improper Payments: Progress Made but Challenges Remain in Estimating and Reducing Improper Payments*, App. I, at 20 (Apr. 22, 2009) (identifying EITC as the Treasury improper payment).

¹⁰⁴ Fiscal Year 2013 Agency Financial Report – Department of the Treasury 210 (Dec. 13, 2013). The \$12.6 billion amount is the midpoint between Treasury’s lower and upper estimate.

¹⁰⁵ IRS, RAS, *Compliance Estimates and Sources of Errors for the Earned Income Tax Credit Claimed on 2006-2008 Returns* 6 (Feb. 12, 2014) (unpublished).

Figure 6:
Improper EITC Payment Rate Formula

$\frac{\text{Total Overclaims} - \text{Total Claims Protected/Recovered}}{\text{Total EITC Claims}}$
Total Overclaims <i>The difference between the amount of the EITC claimed by the taxpayer on his or her tax return and the amount the taxpayer should have claimed.</i>
Total Claims Protected/Recovered <i>The amount of EITC overclaims that the IRS prevents from being paid through activities such as math error processing and prerefund examinations or recovers after being paid through Automated Underreporter document matching and post-refund examinations.</i>
Total EITC Claims <i>The amount of the EITC claimed on all tax returns.</i>

Source: TIGTA analysis of the IRS's Fiscal Year 2012 Executive Order 13520 report

The 2006-2008 NRP Study Provides a Roadmap for Understanding and Addressing EITC Noncompliance

While the Improper Payment rate provides us with a consistent net measure of improper EITC payments (*i.e.*, improper payments actually made), it is important to understand the sources of error for total (gross) EITC overclaims in order to develop targeted strategies to reduce the Improper Payment rate. The most recent IRS National Research Program (NRP) EITC results are useful in this regard, because they provide a statistically representative sample from which to draw observations of taxpayer behavior and better understand the sources of EITC noncompliance.¹⁰⁶ Specifically, the IRS Tax Year 2006 – 2008 NRP Compliance Study (hereafter, NRP Compliance Study) data show the impact on compliance of the complex eligibility criteria and the characteristics of the EITC beneficiary population. These findings should drive the IRS's EITC education, compliance, and enforcement initiatives.¹⁰⁷

¹⁰⁶ The IRS created the National Research Program (NRP) in 2000 to “develop and monitor strategic measures of taxpayer compliance.” National Research Program, at [http://www.irs.gov/uac/National-Research-Program-\(NRP\)](http://www.irs.gov/uac/National-Research-Program-(NRP)) (last visited on Feb. 19, 2014). NRP is a comprehensive effort by the IRS to measure payment, filing, and reporting compliance for different types of taxes and various sets of taxpayers and to deliver the data to the Business Operation Divisions to meet a wide range of needs including support for the development of strategic plans and improvements in workload identification. Internal Revenue Manual (IRM) 4.22.1.3 (Apr. 25, 2008).

¹⁰⁷ The NRP Compliance Study estimated the total (gross) dollar overclaim percentage at 28.5 percent or \$14.1 billion (Lower Bound Estimate or LBE). IRS, RAS, Compliance Estimates and Sources of Errors for the Earned Income Tax Credit Claimed on 2006-2008 Returns 7 (Feb. 12, 2014) (unpublished). Lower-bound estimates assume audit non-participants have similar compliance behavior to audit participants with similar characteristics (*i.e.*, in same sampling strata). Upper-bound estimates assume audit non-participants are noncompliant (*i.e.*, exam conclusion is correct). IRS, RAS, Compliance Estimates and

I should point out that the NRP data does not necessarily present a complete picture of the sources of EITC noncompliance because some taxpayers do not participate in the NRP audits for a variety of reasons. However, the NRP audit results are more reliable than typical EITC audits. Unlike the IRS's typical EITC audits, which are conducted via correspondence with a population that has limited literacy and high transiency and thus has a very high no-response rate, 95 percent of NRP EITC audits are conducted in a face-to-face environment in the office or the field.¹⁰⁸ Field and office audits generally have a higher response rate and agreement rate than correspondence audits and thus provide a better opportunity to identify the sources of error.¹⁰⁹ Still, the NRP Compliance Study distinguishes between "known errors" and "unknown errors." It estimates that 30 percent of total possible overclaim returns and 41 percent of total possible overclaim dollars stem from unknown errors (*i.e.*, cases where compliance and errors are unknown mostly because of audit non-participation). Nevertheless, based on audit participants, the IRS believes it can reliably project 8.4 million overclaim returns and \$11.4 billion overclaim dollars to the EITC population.¹¹⁰

These findings from the NRP Compliance Study demonstrate that the sources of known EITC errors are numerous, and imply that a one-size-fits-all solution will not work:

- As a threshold matter, many EITC overclaims are less than \$500 (44 percent LBE), and relatively few overclaims are above \$3,000 (11 percent LBE).
- Income misreporting is by far the most common type of error:
-- 65 percent of overclaim returns show some income misreporting, and it is the

Sources of Errors for the Earned Income Tax Credit Claimed on 2006-2008 Returns 4 (Feb. 12, 2014) (unpublished). TAS research studies suggest the Lower Bound Estimate more accurately reflects the EITC dollar overclaim rate. A 2004 Taxpayer Advocate Service study of a representative sample of the EITC Audit Reconsideration population found that 43 percent of taxpayers who in the original audit did not respond to IRS contacts, or whose response was received after the IRS deadline and thus was not considered in the audit, had favorable outcomes from the audit reconsideration process (meaning they received more EITC from the reconsideration than from the initial audit itself). This percentage is about the same as the favorable outcome rate for *all* taxpayers in the audit reconsideration sample. Moreover, the non- and late-responders received about 96 percent of the total EITC claimed on the original return. "*This suggests that taxpayers who fail to respond to the audit, or who have a late response, may in fact be eligible for the EITC.*" (Emphasis in original.) See National Taxpayer Advocate 2004 Annual Report to Congress, vol. 2, at 29 (Earned Income Tax Credit (EITC) Audit Reconsideration Study). Accordingly, we use the LBE rate throughout this discussion.

¹⁰⁸ The combined no response and undeliverable rate for non-NRP correspondence examinations is 53 percent. An additional 15 percent of taxpayers stopped responding. IRS, Audit Information, Closed Case Database, TY 2012.

¹⁰⁹ TAS, *IRS Correspondence Examinations: Are they really as effective as the IRS thinks?*, National Taxpayer Advocate's Blog: Taxpayer Rights and Taxpayer Burden, <http://www.taxpayeradvocate.irs.gov/Blog/irs-correspondence-examinations-are-they-really-as-effective-as-the-irs-thinks>.

¹¹⁰ IRS, RAS, *Compliance Estimates and Sources of Errors for the Earned Income Tax Credit Claimed on 2006-2008 Returns* 9 (Feb. 12, 2014) (unpublished).

only error on 50 percent of overclaim returns.

-- The average overclaim on income-error-only returns is \$658.

- Qualifying child (QC) errors occur less than half as often and they are less likely to be the only error:
 - 29 percent of overclaim returns show a qualifying child error, and it is the *only* error on 15 percent of overclaim returns.
 - The average overclaim on QC-error-only returns is \$2,299.
- 8 percent of overclaim returns have *both* QC errors and income misreporting.
- 14 percent of overclaim returns have *neither* QC nor income errors.

Figure 7 shows the five *most costly* error types and their percentages of total overclaim dollars.

Figure 7:

Five Most Costly Error Types

Error Type	Lower-bound estimate
Qualifying child errors	40%
Self-employment income misreporting	13%
Filing status errors	9%
Income reporting of investment income and AGI (excluding earned income)	5%
Wage income misreporting	2%

Figure 8 below shows the five *least costly* error types and their percentages of total overclaim dollars. Note that “tiebreaker” errors – where more than one eligible person claims a qualifying child – are now trivial, compared with the 1999 Compliance Study, when tiebreaker errors accounted for 17 percent or more of overclaim dollars.¹¹¹ The tiebreaker rules were significantly modified and clarified in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA);¹¹² the NRP Compliance Study data show the positive impact legislative clarification can have on compliance.

¹¹¹ See IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (Feb. 28, 2002).

¹¹² Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16, § 303, 115 Stat. 38 (2001). Tiebreaker rules under EGTRRA stipulate that if a child is claimed by more than one eligible person, the credit would first go to the biological parent. If there are two claims between non-parental family members, the credit will go to the family member with the highest adjust gross income. If two parents do not file a joint return, the credit will go to the parent with whom the child resided for the longest

Figure 8:

Five Least Costly Error Types

Error Type	Lower-bound estimate
Rules for all taxpayers claiming EITC <i>Having a valid SSN, being a U.S. citizen or resident alien all year, not filing Form 2555 or Form 2555-EZ, not being a qualifying child of another person</i>	1%
Tiebreaker errors	1%
Errors corrected in processing <i>Includes math errors and other adjustments made prior to NRP exam</i>	1%
Rules for taxpayers claiming EITC without children <i>Being age 25-64, not a dependent of another taxpayer, and having a home in the U.S. for more than half the year</i>	0%

The Interaction of Complex Eligibility Requirements and the Characteristics of the EITC Population Accounts for Many EITC Errors

Generally, the amount of the EITC increases with earned income, creating an incentive to work.¹¹³ The EITC amount also increases if a worker has one, two, or three qualifying children, but is disallowed if the worker has more than \$3,300 of investment income.¹¹⁴ The EITC phases out at an income ceiling of \$51,567 (for a married couple

time. If residency was split equally between two parents, the credit will go to the parent with the highest adjusted gross income.

¹¹³ See Stacy Dickert, Scott Houser & John Karl Scholz, *The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation*, Tax Policy and the Economy, vol. 9, ed. James M. Poterba (MIT Press, 1995); Janet Holtzblatt, *Trade-offs Between Targeting and Simplicity: Lessons from the U.S. and British Experiences with Refundable Tax Credits* (Dept. of the Treasury, 2004) 13 (citing Dickert, Houser & Scholz among academic economists who “estimated that expansions of the EITC between 1993 and 1996 would induce more than half a million families to move from welfare to work”).

¹¹⁴ See generally IRC § 32(i); Rev. Proc. 2013-15, § 2.05, 2013-5 I.R.B. 444; Instructions for Form 1040, *U.S. Individual Tax Return 51* (2013).

filing jointly with three or more qualifying children).¹¹⁵ Detailed requirements govern eligibility and computation.¹¹⁶

For purposes of EITC, the definition of a qualifying child has three main components: age, relationship, and residence. The IRS can systematically verify age with federal databases (such as the Social Security Numident database). However, relationship and residence are factual circumstances that often require intrusive inquiries into taxpayers' personal circumstances and are hence more difficult to establish.

- Under the *relationship* requirement, the taxpayer generally may claim the EITC only with respect to a child who is his or her son, daughter, stepchild, foster child, or a descendant of any of them (e.g., a grandchild), or a child who is a sibling, stepsibling, or half-sibling of the taxpayer, or a descendant of any of them (e.g., a nephew or grandnephew).¹¹⁷
- Under the residence requirement, a taxpayer generally may claim the credit only with respect to a child who lives with the taxpayer for more than half the calendar year (i.e., six months plus one day).¹¹⁸

As a practical matter, low income taxpayers have considerable difficulty documenting relationship and residence,¹¹⁹ because of a lack of clarity from the IRS as well as their

¹¹⁵ IRC § 32(b); Rev. Proc. 2013-15, § 2.05, 2013-5 I.R.B. 444; Instructions for Form 1040, *U.S. Individual Tax Return* 51 (2013).

¹¹⁶ A 2009 House committee report provided the following description:

Eligibility for the EITC is based on earned income, adjusted gross income, investment income, filing status, and immigration and work status in the United States. The amount of the EITC is based on the presence and number of qualifying children in the worker's family, as well as on adjusted gross income and earned income.

The EITC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range. For taxpayers with earned income (or adjusted gross income (AGI), if greater) in excess of the beginning of the phaseout range, the maximum EITC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

An individual is not eligible for the EITC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds \$3,100 (for 2009). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income (if greater than zero) that is not self-employment income.

H.R. Rept. No. 111-16, at 519 (2009).

¹¹⁷ See IRC § 152(c)(2).

¹¹⁸ See IRC § 152(c)(1)(B).

personal circumstances. In the past, TAS has reported that the “two main problems are inconsistency as to which documents the IRS will accept (a document is accepted in one office, but not in another) and inflexibility in accepting proof (failure to accept other types of documents where the taxpayer cannot provide standard documentation).”¹²⁰ On the low income taxpayers’ part, one of the biggest issues is “their tendency to be transient or even temporarily homeless” coupled with literacy challenges.¹²¹ This combination of byzantine requirements with the lack of a home in which to store documents, not to mention the skills needed to read or retain them, frequently results in a lack of documentation.

Given the inherently personal and fluid nature of household living arrangements, a child’s relationship and residence with respect to a low income taxpayer must be validated on a case-by-case basis. Moreover, about one-third of EITC claimants cycle in and out of eligibility each year.¹²² Thus, the learning curve for understanding how complex EITC eligibility rules apply to one’s (changing) household situation is very steep.

Despite these challenges, the NRP Compliance Study found that *about 87 percent (LBE) of the qualifying children claimed for EITC are claimed correctly.*¹²³ That is a credit to the IRS’s outreach and education efforts, and the IRS’s partnership with external stakeholders who work with the EITC population. Of the 13 percent of “knowable” QC errors,¹²⁴

- 76 percent were attributable to the residency test;
- 20 percent were attributable to the relationship test;

¹¹⁹ See Leslie Book, *EITC Noncompliance: What We Don’t Know Can Hurt Them*, Tax Notes (June 23, 2003) 1821; Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kans. L. Rev. 1145 (2003), at http://works.bepress.com/leslie_book/8; National Taxpayer Advocate 2002 Annual Report to Congress 50 (Most Serious Problem: *EITC Eligibility Determinations Can Be Made Less Burdensome*).

¹²⁰ National Taxpayer Advocate 2005 Annual Report to Congress 106-07 (Most Serious Problem: *Earned Income Tax Credit Exam Issues*).

¹²¹ Leslie Book, *The IRS’s EITC Compliance Regime: Taxpayers Caught in the Net*, 81 Ore. L. Rev. 351, 393 (2002).

¹²² See *IRS EITC Fact Facts* at <http://www.eitc.irs.gov/Partner-Toolkit/basicmaterials/ff> (last viewed February 20, 2014). See also Phyllis Jeroslow, *The Earned Income Tax Credit as an Anti-Poverty Programme: Palliative or Cure?* at 31, 25th Annual Social Policy Review, The Policy Press, Bristol, UK (2013).

¹²³ The 87 percent estimate was computed using the lower-bound estimate methodology, which assumes audit non-participants have similar compliance behavior to audit participants with similar characteristics (*i.e.*, in the same sampling strata). Upper-bound estimates assume audit non-participants are noncompliant (*i.e.*, exam exclusion is correct). IRS, RAS, *Compliance Estimates and Sources of Errors for the Earned Income Tax Credit Claimed on 2006-2008 Returns 4* ((Feb. 12, 2014) (unpublished).

¹²⁴ IRS, RAS, *Compliance Estimates and Sources of Errors for the Earned Income Tax Credit Claimed on 2006-2008 Returns 13* ((Feb. 12, 2014) (unpublished).

- 7 to 9 percent were each attributable to the age test, an error corrected in processing, an invalid SSN, and the tiebreaker rules;
- 1 percent to a married child; and
- 10 percent to unknown errors (*i.e.*, the taxpayer acknowledged the error but gave no detail, or it was an “operational exam.”)¹²⁵

Return Preparers Are an Important Factor in EITC Compliance.

Return preparers play a significant role in EITC compliance, and can facilitate either compliant or noncompliant taxpayer behavior.¹²⁶ Congress has recognized this role by imposing on paid return preparers a Due Diligence penalty if they fail to comply with due diligence requirements imposed by the IRS.¹²⁷ As Figure 9 shows, paid preparers prepared over half of all returns claiming various refundable credits in recent years.

Figure 9: Taxpayers Claiming Refundable Credits, Claim Amounts, and Preparer Usage, Tax Years 2010-2011¹²⁸

Tax Credit	Tax Year	Number of Taxpayers	Average Claim (dollars)	Total Claims (dollars in thousands)	Preparer Returns (percentage)
Earned Income Tax Credit	2011	27,362,193	\$2,270	\$62,119,975	59.3%
Additional Child Tax Credit	2011	20,616,435	\$1,347	\$27,771,740	65.0%
First-Time Homebuyer Credit	2010	373,880	\$6,893	\$2,577,155	53.8%
Adoption Credit	2011	55,794	\$13,474	\$760,365	60.1%
Making Work Pay Credit	2010	106,381,764	\$514	\$54,784,234	53.6%
American Opportunity Tax Credit	2011	12,525,776	\$899	\$11,266,488	55.9%

Unenrolled preparers – those who are neither attorneys, certified public accountants, nor enrolled agents – account for more than three-fourths of EITC returns that are prepared by a paid preparer. This figure is conservative, given significant anecdotal evidence that some paid preparers do not sign the returns they prepare (despite a statutory requirement to do so) and thus are not visible to the IRS.

¹²⁵ Note that the total equals more than 100 percent due to multiple errors per child. “Operational exam” is defined as a standard non-NRP exam. Some of the cases selected into the NRP sample end up being worked by regular IRS examination procedures (because during processing some cases are “frozen” and claimed by regular exam processes before NRP can claim them). About one percent of the NRP sample is worked by standard “operational” exams.

¹²⁶ National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2, 74-116 44-74 (Leslie Book, *The Need to Increase Preparer Responsibility, Visibility, and Competence*); National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2, 44-74 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*).

¹²⁷ IRC § 6695(g). This duty also extends to determining the correct amount of credit allowed. *Id.*

¹²⁸ IRS Compliance Data Warehouse (CDW), Individual Returns Transaction File and Individual Master File, TY 2010 and 2011 (through Mar. 2013).

Figure 10: Preparation of EITC Claims by Unenrolled Preparers in TY 2010-2012¹²⁹

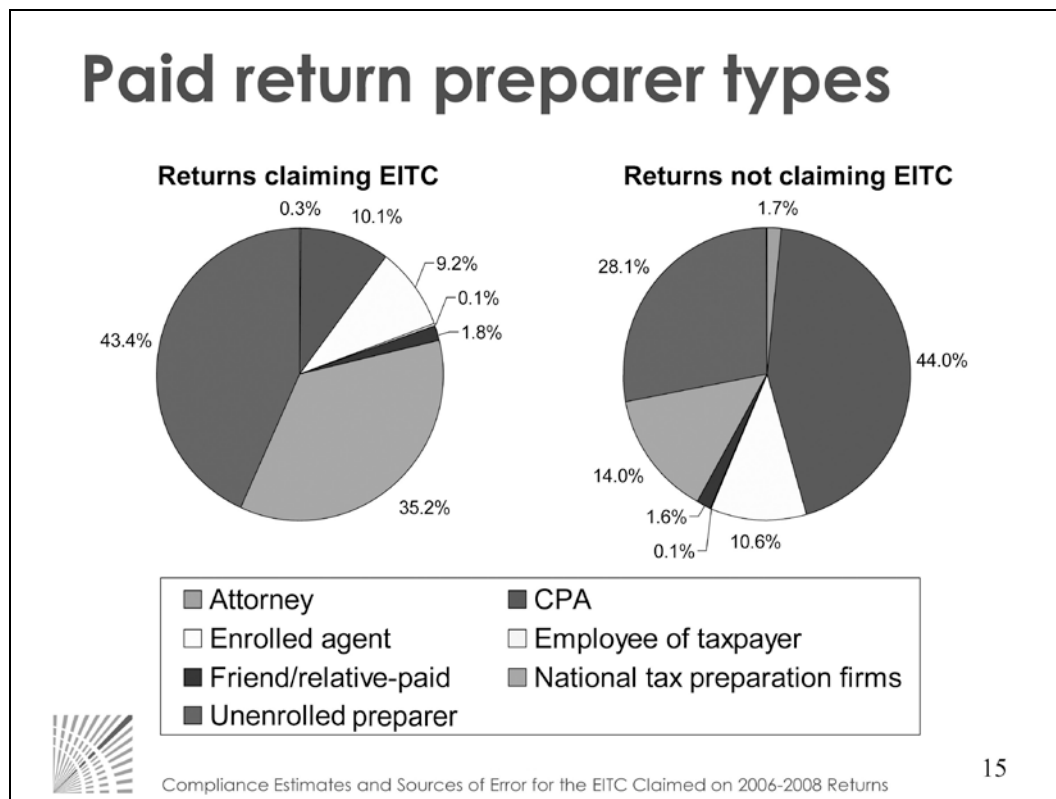
Tax Year	EITC Paid	Count	Total Preparers	Unenrolled Preparers	Percent Unenrolled
2010	\$58,573,186,452	27,627,852	16,464,493	12,430,967	75.5%
2011	\$61,109,934,146	27,816,576	16,549,166	12,198,085	73.7%
2012	\$62,981,818,983	27,081,228	15,132,562	11,523,814	76.2%

The NRP Compliance Study found that 68 percent of returns claiming the EITC showed the involvement of a paid preparer, compared to 55 percent of individual returns not claiming the EITC. (VITA, Tax Counseling for the Elderly, and IRS-prepared returns only accounted for three percent of EITC returns and two percent of non-EITC individual returns.)

EITC returns also differ from non-EITC individual returns in terms of type of preparer. As the chart below shows, unaffiliated unenrolled preparers and preparers in national tax preparation firms are disproportionately active with EITC returns, in contrast with non-EITC returns.

Figure 11: Types of Preparers Handling EITC and Non-EITC Returns

¹²⁹ IRS, Compliance Data Warehouse Individual Returns Transaction File; IRS, Individual Master File (net of transactions 764, 765, and 768); IRS, Return Preparer and Provider Database (through Nov. 2013) (note that the amounts paid out by the IRS may have been subsequently disallowed in post-refund audits).



Interestingly, the NRP Compliance Study found no statistically significant difference between all self-prepared returns and all paid-preparer returns in terms of the likelihood or magnitude of EITC error. However, variation does exist within preparer types. Unaffiliated unenrolled preparers (*i.e.*, unenrolled preparers who are not affiliated with a national tax preparation firm) are most prone to error, and the difference is statistically significant in some comparisons. Specifically, 49 percent of the EITC returns prepared by unaffiliated unenrolled preparers contain overclaims averaging 33 percent of the amount claimed.

Preliminary Recommendations to Improve EITC Compliance

In summary, the most recent NRP Compliance Study found that:

- High audit non-participation makes it difficult to fully discern the sources of EITC error and the movement in overall compliance.
- Income misreporting is the most common error, although individual errors are relatively low-dollar, and self-employment income misreporting is the most costly component of this type of error.
- Qualifying child errors, especially failure to meet the residency test, are the largest contributor to overclaim dollars, although 87 percent of qualifying children

are claimed correctly.¹³⁰

- Taxpayer-prepared and preparer-prepared returns show similar error rates, but unenrolled preparers have the highest error rates among preparers.

Each of these points leads to specific actions the IRS can take to improve both its understanding of the causes of compliance and taxpayers' compliance behavior. The following recommendations will improve the administration of refundable credits, particularly the EITC, and reduce improper payments without unduly burdening taxpayers or impairing their rights.

Increasing the EITC Audit Response Rate is Key to Improving Compliance.

The IRS should focus on how to improve the EITC audit participation rate. Audits are not just about correcting a specific year's tax liability, as every audit provides an opportunity for the IRS to educate the taxpayer about errors on the return so he or she becomes and remains compliant.

TAS research studies have shown correspondence audits have a disproportionately negative effect on the EITC taxpayer outcomes, particularly on the no-response rate. For example, in 2007, TAS reported on a study confirming the discrepancy between actual ineligibility and "flunking" an IRS audit. The study concluded:

Overall, more than one-quarter of taxpayers receiving an [EITC] audit notice did not understand that the IRS was auditing their return. An even larger percentage, almost 40 percent, of the respondents did not understand what the IRS was questioning about their [EITC] claim. Similarly, only about half of the respondents felt that they knew what they needed to do in response to the audit letter.¹³¹

TAS recently conducted another study in collaboration with the Wage and Investment and Small Business/Self Employed divisions' correspondence exam units.¹³² In the study, a test group of about 900 taxpayers underwent EITC audits that involved two or more outbound call attempts. A control group of about 2,500 taxpayers underwent

¹³⁰ The 87 percent estimate was computed using the lower-bound estimate methodology, which assumes audit non-participants have similar compliance behavior to audit participants with similar characteristics (*i.e.*, in the same sampling strata). Upper-bound estimates assume audit non-participants are noncompliant (*i.e.*, exam exclusion is correct). IRS, RAS, *Compliance Estimates and Sources of Errors for the Earned Income Tax Credit Claimed on 2006-2008 Returns* 4 ((Feb. 12, 2014) (unpublished).

¹³¹ National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 100, 103-104 (relating to a survey sample designed to achieve an overall accuracy of plus or minus five percent at the 95 percent confidence level).

¹³² Taxpayer Advocate Service, *Enhanced EITC Communication Project* (Nov. 2013) (unpublished report, on file with the Taxpayer Advocate Service). See also National Taxpayer Advocate 2011 Annual Report to Congress, vol. 2, 63-90 (*Research Study: An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*).

traditional correspondence examination processing, which is primarily automated and generally involves no outbound call attempts.¹³³ When the audit resulted in disallowance of all or part of the EITC claimed on the original returns and when the taxpayer did not agree with the audit findings, a Taxpayer Advocate Service Case Advocate contacted the taxpayer and offered assistance.¹³⁴

Significant findings from the first phase of the study (IRS test and control group audits) include:

- Using internal IRS databases, Exam found a contact number associated with the test group taxpayer in 63 percent (565) of the cases. Nevertheless, Exam successfully contacted the taxpayer in only 24 percent of the test group cases.
- Overall, taxpayers in the test group participated in the audit (rather than defaulting or “dropping out”) somewhat more frequently than those in the control group. The response rate for these taxpayers was 47 percent compared to 43 percent for the control group. (The results are statistically significant at the 93 percent level.)
- Taxpayers in the test group who were successfully contacted participated in the audit much more frequently than taxpayers in the control group (who received no outbound calls). The response rate for these taxpayers was 61 percent compared to 43 percent for the control group. (This difference is statistically significant at the 93 percent confidence level.)

In the second phase of the study, Exam forwarded to TAS 686 cases that had been closed other than as a “no-change” or “agreed” for additional attempts at taxpayer contact and assistance. The significant findings from this phase of the study are:

- To better identify contact telephone numbers, TAS used additional external databases (such as Accurint) and Internet searches that Exam did not use, as well as information from the return filed in the tax year following the audit. TAS successfully contacted 37 percent (243) of its study cases, including 28 percent (186) of the taxpayers that Exam was unable to contact.
- Of the taxpayers TAS successfully contacted, in 44 percent of the cases (87), the taxpayers indicated they were ineligible for the EITC, but only two taxpayers indicated that they understood they were ineligible for EITC prior to TAS contact.

¹³³ IRM 4.19.20.1 (May 21, 2013).

¹³⁴ Taxpayer Advocate Service, Enhanced EITC Communication Project (Nov. 2013) (unpublished report, on file with the Taxpayer Advocate Service).

- TAS successfully advocated for eight taxpayers to receive EITC for one or more children, usually substantiating the claim with conventional documentation.
- TAS assisted an additional 32 taxpayers with receiving the childless-worker EITC. TAS reviewers discovered that Exam either was not discussing the childless-worker EITC with taxpayers or did not always process the necessary paperwork to obtain the credit.

This study shows that the IRS's current correspondence exam-based EITC audit strategy squanders an important educational opportunity and in some cases actually misstates the dollar amount of overclaims by not making contact with the taxpayer or by not determining whether the taxpayer is eligible for the childless-worker portion of the EITC.

The IRS Needs to Change its EITC Audit Procedures

Given the literacy and transiency challenges facing the low income population, and the fact that about a third of the EITC population annually churns, the IRS should revamp its EITC audit procedures.¹³⁵ Specifically, it should take the following steps:

- Expand its address and telephone contact research;
- Incorporate outbound calls into its examination process;
- Require its auditors to determine the taxpayer's eligibility for the childless worker EITC;
- Require its auditors to explain and educate taxpayers, orally and in writing, in language the low income population can understand, the reasons for the disallowance;
- Enable taxpayers to have virtual face-to-face audit appointments via encrypted videoconference software; and
- When the taxpayer has responded to an audit notice, assign the case to a specific exam employee who will work it to completion.

Matching Third-Party Information Reports with EITC Returns During the Filing Season Can Address the Most Common EITC Errors

As discussed above, if the IRS could receive third party information reports of income during the filing season, it could identify income misreporting designed to maximize EITC benefits and EITC claims attributable to identity theft. Once taxpayers know the IRS is using this information during the filing season, they will adjust their behavior accordingly. Moreover, if taxpayers or their preparers can download this information, inadvertent omissions of income (e.g., nonreceipt of a 1099 or W-2 form attributable to a taxpayer's change of address) would be minimal. In addition, the advent of payment

¹³⁵ IRS EITC Fact Facts at <http://www.eitc.irs.gov/Partner-Toolkit/basicmaterials/ff> (last visited February 20, 2014).

card information reporting may provide the IRS with better selection of Sole Proprietorship returns for audit, which account for the largest component of income-error EITC dollars.

The IRS and Treasury should prepare a report, in consultation with the National Taxpayer Advocate, which provides a plan and timeline to achieve an accelerated third-party information reporting system, including the ability of taxpayers to access and download, print, or export their information reports.

Focusing on the Qualifying Child Residency Test Will Improve the Area of Highest Dollar Noncompliance

Failure to meet the residency test for a qualifying child accounts for the largest volume of overclaim dollars. Given the fact-based nature of the determination of where a child resides for the majority of the year, the IRS should make this issue a key component of its outreach strategy. EITC auditors should be required to pay particular attention to this issue and make significant efforts to explain to the taxpayer how they determine residency and why the taxpayer did not meet the requirement.

The IRS should also immediately use the Form 8836, *Qualifying Children Residency Statement*, which it developed and tested in a TY 2003 initiative to use affidavits to document the residency of qualifying children of low income taxpayers. At that time, the IRS found affidavits more reliable than traditional documentation:

Affidavits were believed to be easier for taxpayers to obtain than official documents or letters. *The results show that affidavits had a higher acceptance rate than the other two types of documents. In each of the tests, about one-half of the records and statements or letters were accepted compared to approximately three-quarters of the affidavits.*¹³⁶ (Emphasis added.)

The form walks the taxpayer through the requirements for meeting the residency test and overcomes the difficulties associated with obtaining documentary evidence that low income taxpayers otherwise face. Taxpayers could utilize this form in audits in conjunction with current procedures that allow either official records or letters on official letterhead to document the residency requirement.¹³⁷ In appropriate instances, the form could be incorporated into the Due Diligence Preparer requirements (discussed below).

¹³⁶ See IRS, *Earned Income Tax Credit Initiatives: Report on Qualifying Child Residency Certification, Filing Status, and Automated Underreporter Tests*, at 14 (2008).

¹³⁷ Form 886-H-EIC-2013, *Documents You Need to Prove You Can Claim an Earned Income Credit on the Basis of a Qualifying Child or Children*, requires “photocopies of school (no report cards), medical, childcare provider (provider can't be a relative) or social service records” or “a letter on official letterhead from a school, a health care provider, a social service agency, placement agency official, employer, Indian tribal official, landlord or property manager, or a place of worship that shows the name of your child's parent or guardian, your child's address and the dates that they lived with you.”

Regulation, Testing, Continuing Education, and Oversight of Unenrolled Preparers Are the Most Powerful Tools for Increasing EITC Compliance and Reducing Overclaims.

Simply stated, unenrolled preparers are the make-and-break point for all EITC compliance strategies. Preparers account for the majority of EITC claims submitted to the IRS, and unenrolled preparers account for three-quarters of preparer EITC returns. Unenrolled preparers have the highest error rate of all types of preparers. If a single unenrolled preparer plays fast and loose with EITC eligibility rules, tens if not hundreds of taxpayers' returns could be in error.

The recently strengthened regulations and increased EITC due diligence penalty under IRC § 6695(g), coupled with a robust preparer compliance initiative and vigorous preparer prosecutions, should shift some preparer compliance behavior. But so long as anyone can purchase off-the-shelf software and hang out a shingle declaring him or herself a return preparer, without any demonstration of competency or any set of ethical rules to adhere to, we will not bring about significant change in EITC compliance.

The low income population is vulnerable to unskilled and unethical preparers. The size of the refund is attractive to payday lenders and others interested only in what fees they can charge, not to mention criminal opportunists. Preparers in this category have no professional responsibility to the tax system. Yet, as numerous studies have shown, they operate in the areas and communities where low income persons reside.¹³⁸

The single most useful step Congress can take to improve EITC compliance and reduce Improper Payments is to enact a regulatory regime that requires unenrolled preparers who prepare returns for a fee to demonstrate minimum levels of competency by passing an initial test and then taking annual continuing education courses (including ethics).¹³⁹ The IRS cannot audit this EITC noncompliance out of existence – audits occur after the noncompliance has occurred and, in many instances, after the dollars have already gone out the door. Preparer regulation is prophylactic and efficient.

More specifically, I believe Congress should explicitly authorize the IRS to require unenrolled return preparers to take a competency test and fulfill annual continuing

¹³⁸ For a chilling inventory of studies showing the predatory practices and abuses in this area, see Brief of Amici Curiae, National Consumer Law Center and National Community Tax Coalition in Support of Defendants-Appellants, *Loving v. Internal Revenue Service*, No. 13-5061 (D.C. Cir. 2014.)

¹³⁹ Support for preparer regulation as a means both to protect consumers and to improve return accuracy has been broad and bipartisan. The Senate Finance Committee has twice approved legislation to authorize preparer regulation – once under former Chairman Grassley (during Republican control) and once under former Chairman Baucus (during Democratic control). On the House side, the Ways and Means Committee has not considered preparer regulation, but its Oversight Subcommittee held a hearing in 2005 at which numerous preparer groups testified in support of such regulation. In 2010, the IRS began to implement preparer regulation on its own, but the Court of Appeals for the District of Columbia recently invalidated the regulation as exceeding the agency's authority in the absence of authorizing legislation. See *Loving v. IRS*, 2014 U.S. App. LEXIS 2512 (D.C. Cir. 2014). Authorizing legislation would allow the IRS to resume the program that was already underway.

education requirements as a condition of preparing tax returns for compensation. In the meantime, the IRS should offer the testing and continuing education certification on a voluntary basis and condition limited representation of the taxpayer on completion of these competency requirements. The IRS should also continue to develop its EITC preparer strategy, including audits and application of the EITC due diligence penalty, as appropriate. The due diligence form should be updated periodically to reflect current preparer errors and abuses.¹⁴⁰

VIII. Conclusion

In my 2013 Annual Report, I stated that the short-term crises of the past year masked the major problem facing the IRS today – unstable and chronic underfunding that puts at risk the IRS's ability to meet its current responsibilities, much less articulate and achieve the necessary transformation to an effective, modern tax agency. The issues I have discussed today clearly illustrate this situation. In this and every filing season, the IRS must carry out its core mission of collecting revenue and helping taxpayers comply with their obligations. At the same time, it must deal with threats such as identity theft, improve its administration of longstanding programs like the EITC, and prepare for the new challenges presented by the ACA.

I am hopeful that the new leadership of the IRS, with continued oversight and support from Congress and the involvement of the Office of the Taxpayer Advocate, can meet these goals. I strongly believe that the IRS can improve tax administration and the fundamental fairness of the system by embracing the Taxpayer Bill of Rights I have outlined here today. Thank you for the opportunity to deliver this testimony.

¹⁴⁰ For a more detailed discussion of regulation of return preparers, see National Taxpayer Advocate 2013 Annual Report to Congress 61-75 (Most Serious Problem: *Taxpayers and Tax Administration Remain Vulnerable to Incompetent and Unscrupulous Return Preparers While the IRS Is Enjoined from Continuing its Efforts to Effectively Regulate Return Preparers*).