

**HEARING BEFORE THE  
COMMITTEE ON APPROPRIATIONS  
SUBCOMMITTEE ON FINANCIAL SERVICES  
AND GENERAL GOVERNMENT  
UNITED STATES SENATE**

“Review of the President’s Fiscal Year 2015 Funding  
Request for the Department of the Treasury and the  
Internal Revenue Service”



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

**April 30, 2014**

**Washington, D.C.**

TESTIMONY  
OF  
THE HONORABLE J. RUSSELL GEORGE  
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION  
*before the*  
COMMITTEE ON APPROPRIATIONS, SUBCOMMITTEE ON  
FINANCIAL SERVICES AND GENERAL GOVERNMENT  
UNITED STATES SENATE

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Chairman Udall, Ranking Member Johanns, and Members of the Subcommittee, thank you for the opportunity to testify on the Internal Revenue Service’s (IRS) Fiscal Year (FY)<sup>1</sup> 2015 budget request, our recent work related to the most significant challenges currently facing the IRS, and the Treasury Inspector General for Tax Administration’s (TIGTA) FY 2015 budget request.

The Treasury Inspector General for Tax Administration, also known as “TIGTA,” is a nationwide organization. We are statutorily mandated to provide independent audit and investigative services necessary to improve the economy, efficiency, and effectiveness of IRS operations, including the oversight of the IRS Chief Counsel and the IRS Oversight Board. TIGTA’s oversight activities are designed to identify high-risk systemic inefficiencies in IRS operations and to investigate exploited weaknesses in tax administration. TIGTA’s role is critical in that we provide the American taxpayer with assurance that the approximately 95,000<sup>2</sup> IRS employees who collected over \$2.9 trillion in tax revenue, processed over 241 million tax returns, and issued \$364 billion in tax refunds during FY 2013,<sup>3</sup> do so in an effective and efficient manner while minimizing the risks of waste, fraud, or abuse.

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

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<sup>1</sup> The Federal Government’s fiscal year begins on October 1 and ends on September 30.

<sup>2</sup> Total IRS staffing as of April 5, 2014. Included in the total are approximately 19,000 seasonal employees.

<sup>3</sup> IRS, *Management’s Discussion & Analysis, Fiscal Year 2013*.

by the IRS Restructuring and Reform Act of 1998 (RRA 98),<sup>4</sup> the American Recovery and Reinvestment Act of 2009,<sup>5</sup> and other laws, as well as areas of concern raised by Congress, the Secretary of the Treasury, the Commissioner of Internal Revenue, and other key stakeholders. The OA has examined specific high-risk issues such as identity theft, refund fraud, improper payments, information technology, security vulnerabilities, complex modernized computer systems, tax collections and revenue, and waste and abuse in IRS operations.

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

TIGTA's Office of Inspections and Evaluations (I&E) provides responsive, timely, and cost-effective inspections and evaluations of challenging areas within the IRS, providing TIGTA with additional flexibility and capability to produce value-added products and services to improve tax administration. Inspections and Evaluations' work is not a substitute for audits and investigations. In fact, its findings may result in subsequent audits and/or investigations. Inspections are intended to monitor compliance, assess the effectiveness and efficiency of programs and operations, and inquire into allegations of waste, fraud, abuse, and mismanagement; evaluations are intended to provide in-depth reviews of specific management issues, policies, or programs. In the last year, I&E has reviewed the IRS's implementation of the Telework Enhancement Act of 2010, assessed the costs and frequency of IRS executives' temporary duty travel and the associated travel taxability, and determined that the IRS needs to improve the comprehensiveness, accuracy, reliability, and timeliness of the Tax Gap estimate.

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<sup>4</sup> Pub. L. No. 105-206, 112 Stat. 685 (1998) (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

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

## OVERVIEW OF THE IRS'S FY 2015 BUDGET REQUEST

The IRS is the largest component of the Department of the Treasury and has primary responsibility for administering the Federal tax system. The IRS's budget request supports the Department of the Treasury's Strategic Plan and agency priority goal of focusing on expanding the availability and improving the quality of customer service options. The IRS's Strategic Plan goals are to: 1) Deliver high quality and timely service to reduce taxpayer burden and encourage voluntary compliance and 2) Effectively enforce the law to ensure compliance with tax responsibilities and combat fraud. The IRS's role is unique within the Federal Government in that it collects the revenue that funds the Government and administers the Nation's tax laws. It also works to protect Federal revenue by detecting and preventing the growing risk of fraudulent tax refunds and other improper payments.

To achieve these goals, the proposed FY 2015 IRS budget requests appropriated resources of approximately \$12.5 billion.<sup>6</sup> The total appropriations amount is an increase of \$1.2 billion, or approximately 11 percent more than the FY 2014 enacted level of approximately \$11.3 billion. This increase is illustrated in Table 1. The budget request includes a net staffing increase of 6,998 full-time equivalents (FTE)<sup>7</sup> for a total of approximately 91,187 appropriated FTEs.

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<sup>6</sup> The FY 2015 budget request also includes approximately \$101 million from reimbursable programs, \$27 million from non-reimbursable programs, \$396 million from user fees, \$265 million in available unobligated funds from prior years, and a transfer of \$5 million to the Alcohol and Tobacco Tax and Trade Bureau for a total amount of \$13.3 billion in available resources.

<sup>7</sup> A measure of labor hours in which one FTE is equal to eight hours multiplied by the number of compensable days in a particular fiscal year.

**TABLE 1**

**IRS Fiscal Year 2015 Budget Request Increase  
Over FY 2014 Enacted Budget  
(in Thousands)**

<b>Appropriations Account</b>	<b>FY 2014 Enacted<sup>8</sup></b>	<b>FY 2015 Request</b>	<b>\$ Change</b>	<b>% Change</b>
Taxpayer Services	\$2,156,554	\$2,317,633	\$161,079	7.5%
Enforcement	\$5,022,178	\$5,371,826	\$349,648	7.0%
Operations Support	\$3,798,942	\$4,456,858	\$657,916	17.3%
Business Systems Modernization	\$312,938	\$330,210	\$17,272	5.5%
<b>Total Appropriated Resources</b>	<b>\$11,290,612</b>	<b>\$12,476,527</b>	<b>\$1,185,915</b>	<b>10.5%</b>

*Source: TIGTA analysis of the IRS's FY 2015 Budget Request, Operating Level Tables.*

The three largest appropriation accounts are Taxpayer Services, Enforcement, and Operations Support. The Taxpayer Services account provides funding for programs that focus on helping taxpayers understand and meet their tax obligations, while the Enforcement account supports the IRS's examination and collection efforts. The Operations Support account provides funding for functions that are essential to the

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<sup>8</sup> Fiscal Year 2014 enacted includes \$92 million in funding (\$34 million in Taxpayer Services and \$58 million in Operations Support). The \$92 million was a nonrecurring appropriation increase in the Consolidated Appropriations Act 2014. The additional funds were granted to improve the delivery of services to taxpayers, improve the identification and prevention of refund fraud and identity theft, and address international and offshore compliance issues.

overall operation of the IRS, such as infrastructure and information services. Finally, the Business Systems Modernization account provides funding for the development of new tax administration systems and investments in electronic filing.

As a result of the Balanced Budget and Emergency Deficit Control Act, as amended,<sup>9</sup> the IRS was required to reduce planned spending from its appropriations by \$594 million for FY 2013 as a result of sequestration.<sup>10</sup> The IRS was also required in FY 2013 to reduce planned spending from its appropriations by \$24 million as the result of an across-the-board rescission.<sup>11</sup> These funding reductions represented a total decrease of \$618 million to the IRS's budget of \$11.8 billion, resulting in a revised annual budget for FY 2013 of \$11.2 billion.

The IRS achieved these budgetary savings by cuts in key spending areas such as personnel compensation (\$276 million), including not issuing bargaining unit employee awards during FY 2013 and furloughing employees for three days, travel (\$92 million), and equipment (\$50 million). We are currently assessing the IRS's steps to plan for and implement the reductions in its FY 2013 budget due to sequestration.<sup>12</sup>

Implementation of the sequestration mandated cuts, coupled with a trend of lower budgets, reduced staffing, and the loss of supplementary funding for the implementation of the Patient Protection and Affordable Care Act of 2010 (hereinafter referred to as the ACA or Affordable Care Act),<sup>13</sup> impacted the IRS's ability to effectively deliver its priority program areas, including enforcement activities. For example, examinations of individual tax returns declined from 1,481,966 in FY 2012 to 1,404,931 in FY 2013, an approximate 5 percent decrease. Further, collection activities initiated by the IRS, such as taxpayer liens, levies, and property seizures declined from 3,669,663 in FY 2012 to 2,457,647 in FY 2013, an approximately 33 percent decrease.

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<sup>9</sup> Pub. L. No. 112-25, 125 Stat. 240 (2011).

<sup>10</sup> Sequestration involves automatic spending cuts of approximately \$1 trillion across the Federal Government that took effect on March 1, 2013.

<sup>11</sup> A rescission cancels part of an agency's discretionary budget authority and is usually established as a percentage reduction to the budget authority.

<sup>12</sup> TIGTA, Audit No. 201310030, *Implementation of Fiscal Year 2013 Sequestration Budget Reductions*, report planned for May 2014.

<sup>13</sup> Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered titles of the U.S.C.).

## **KEY CHALLENGES FACING THE IRS**

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

### **TAXPAYER SERVICE**

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

Overall, the IRS's FY 2013 enacted budget was over \$1 billion less than its FY 2010 enacted budget as a result of the FY 2013 sequestration and rescission and declines in its FY 2011 and FY 2012 budgets. These budget constraints continue to result in the IRS cutting service to taxpayers which make it difficult for the IRS to effectively assist taxpayers. As demand for taxpayer services continues to increase, resources devoted to customer service have decreased, thereby affecting the quality of customer service that the IRS is able to provide. I would like to provide you with some specific examples.

First, the IRS continues to struggle in providing high-quality customer service over the phone. These struggles result in long customer wait times, customers abandoning calls, and customers redialing the IRS toll-free telephone lines<sup>14</sup> for service. Despite other available options, most taxpayers continue to use the telephone as the primary method to make contact with the IRS. For the 2014 Filing Season as of March 8, 2014, approximately 46.3 million taxpayers contacted the IRS by calling the various customer service toll-free telephone assistance lines seeking help to understand the tax laws and meet their tax obligations. IRS assistors have answered 6 million calls and have achieved a 74.7 percent Level of Service<sup>15</sup> with an 11.7 minute Average

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<sup>14</sup> The IRS refers to the suite of 29 telephone lines to which taxpayers can make calls as "Customer Account Services Toll-Free."

<sup>15</sup> The primary measure of service to taxpayers. It is the relative success rate of taxpayers who call for live assistance on the IRS's toll-free telephone lines.

Speed of Answer.<sup>16</sup> The Level of Service for the 2013 Filing Season was 67.9 percent. The IRS forecasted a 70.2 percent Level of Service for the 2014 Filing Season.

Although the IRS is reporting an increase in the Level of Service, IRS numbers continue to show a decline in the total number of taxpayers who contact the IRS who are actually assisted. As of March 8, 2014, the number of taxpayers actually assisted has dropped from 56.1 percent to 51.6 percent as of the same time last year.<sup>17</sup> We previously reported that the Level of Service measure does not accurately reflect total call demand (*i.e.*, total number of taxpayers attempting to call the IRS).<sup>18</sup> The Level of Service only measures the percentage of calls in the queue waiting to be answered by an assistor that are actually answered. The Level of Service does not measure the success of taxpayers attempting to call the IRS to use the IRS's automated services. The IRS can manage the Level of Service by increasing or decreasing the number of calls it allows into the assistor queue.<sup>19</sup>

Second, the IRS's ability to process taxpayer correspondence in a timely manner has also declined. The over-age correspondence inventory rose from approximately 181,000 at the end of Processing Year 2010 to almost 1.2 million at the end of Processing Year 2013, representing an increase of 556 percent.<sup>20</sup> IRS management indicated that the continued increase in the over-age correspondence inventory is the result of reduced resources. The allocation of limited resources requires difficult decisions with the focus on maximizing taxpayer assistance on the toll-free telephone lines during filing season while concentrating any remaining resources toward various priority programs such as identity theft and aged work.<sup>21</sup>

Third, the number of taxpayers assisted by Taxpayer Assistance Centers (TACs) will decrease this fiscal year. The IRS assisted more than 6.5 million taxpayers in FY 2013 and plans to assist 5.6 million taxpayers in FY 2014, which is 14 percent fewer than in FY 2013. The IRS indicated that budget cuts and its strategy of not offering services at TACs that can be obtained through other service channels, such as the

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<sup>16</sup> The average amount of time for an assistor to answer the call after the call is routed to a call center staff.

<sup>17</sup> Using automation or live assistance, the IRS answered 31.6 million of the 56.3 million calls received as of March 8, 2013 (56.1 percent) and 23.9 million of the 46.3 million calls received as of March 8, 2014 (51.6 percent).

<sup>18</sup> TIGTA, Ref. No. 2009-40-127, *Higher Than Planned Call Demand Reduced Toll-Free Telephone Access for the 2009 Filing Season* (Sept. 2009).

<sup>19</sup> TIGTA, Ref. No. 2014-40-029, *Interim Results of the 2014 Filing Season* (Mar. 2014).

<sup>20</sup> Numbers have been rounded. The percentage of change is based on the actual inventory volumes as of the end of Processing Years 2010 and 2013.

<sup>21</sup> TIGTA, Ref. No. 2014-40-029, *Interim Results of the 2014 Filing Season* (Mar. 2014).



IRS's website, result in the reduction of the number of taxpayers the IRS plans to assist at the TACs.

In FY 2014, the IRS eliminated or reduced services at TACs. Currently, TACs are not preparing tax returns. Instead, taxpayers seeking this assistance will be referred to Volunteer Income Tax Assistance sites or other free preparation options. TAC assistors will only answer basic tax law questions during the filing season and will not answer any tax law questions after April 15, 2014. After April 15, 2014, the IRS will direct all tax law inquiries to alternative services such as IRS.gov, TeleTax, commercial software packages, or a tax professional. In addition, TACs will no longer answer taxpayers' tax refund inquiries unless the taxpayer has waited more than 21 days for the refund. Taxpayers with refund inquiries will be referred to the "Where's My Refund?" application on IRS.gov. Finally, the TACs are transitioning to no longer provide transcripts upon request without extenuating circumstances. For the 2014 Filing Season, TACs will still provide transcripts but are encouraging taxpayers to obtain them through other sources.<sup>22</sup>

The reduction in services was implemented without completing the required taxpayer burden risk evaluation for the taxpayers most likely to visit a Taxpayer Assistance Center, such as low-income, elderly, and limited-English-proficient taxpayers. The purpose of such an evaluation is to assess the burden that service changes can have on taxpayers.

## **IMPROPER PAYMENTS**

The Improper Payments Information Act of 2002<sup>23</sup> requires Federal agencies, including the IRS, to estimate the amount of improper payments made each year and to describe the steps taken to ensure that managers are held accountable for reducing these payments. Agencies must also report to Congress on the causes of and the steps taken to reduce improper payments and address whether they have the information systems and other infrastructure needed to reduce improper payments. The Improper Payments Elimination and Recovery Act of 2010<sup>24</sup> (IPERA) amended the Improper Payments Information Act of 2002 by redefining the definition of improper payments and strengthening agency reporting requirements. TIGTA is required to review annually the IRS's compliance with the Act's reporting requirements.

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<sup>22</sup> TIGTA, Ref. No. 2014-40-029, *Interim Results of the 2014 Filing Season* (Mar. 2014).

<sup>23</sup> Pub. L. No. 107-300, 116 Stat. 2350.

<sup>24</sup> Pub. L. No. 111-204, 124 Stat. 2224.

The Office of Management and Budget has declared the Earned Income Tax Credit (EITC) Program a high-risk program that is subject to reporting in the Department of the Treasury's Agency Financial Report. The IRS estimates that 22 to 26 percent of EITC payments were issued improperly in FY 2013. The dollar value of these improper payments was estimated to be between \$13.3 billion and \$15.6 billion.

In March 2014,<sup>25</sup> we reported that the IRS continued to not provide all required IPERA information to the Department of the Treasury for inclusion in the Department of the Treasury's Agency Financial Report for FY 2013. For the third consecutive year, the IRS did not publish annual reduction targets or report an improper payment rate of less than 10 percent for the EITC. IRS management indicated that on March 20, 2014, the Office of Management and Budget approved the establishment of supplemental measures for use in evaluating the incremental reduction in EITC improper payments. The IRS is in the process of developing these supplemental measures.

Finally, although risk assessments were performed for each of the programs that the Department of the Treasury required the IRS to assess, the risk assessment process still may not provide a valid assessment of improper payments in tax administration. As such, the EITC remains the only area considered at high risk for improper payments. There continues to be no effective process to address the continued risks associated with improper tax refund payments resulting from other refundable tax credits<sup>26</sup> and tax refund fraud. Improper payments due to identity theft are the most significant example of a category that is not estimated by the IRS. As such, we believe the IRS's identification of EITC as the only program of high risk of improper payments may significantly underestimate the risk of improper payments to tax administration. IRS management indicated that on March 20, 2014, the Office of Management and Budget provided guidance exempting improper refunds made without relation to any refundable tax credit program from improper payment requirements. We plan to evaluate the impact of the Office of Management and Budget guidance in an upcoming review.

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

While refundable tax credits increase the risk of potentially fraudulent tax refunds, other issues concerning tax administration can also pose a significant risk for

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<sup>25</sup> TIGTA, Ref, No. 2014-40-027, *The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply With the Improper Payments Elimination and Recovery Act* (Mar. 2014).

<sup>26</sup> A refundable credit is not limited to the amount of an individual's tax liability and can result in a Federal tax refund that is larger than the amount of a person's Federal income tax withholding for that year.

improper payments. The IRS continues to be challenged with the rapidly growing problem of identity-theft tax refund fraud, including tax fraud related to the use of stolen Employer Identification Numbers (EIN).<sup>27</sup> Efforts to identify and detect tax returns with these characteristics are hampered by the IRS's lack of third-party information to effectively verify income and withholding when tax returns are processed.

### Identity Theft

The IRS has described identity theft as the number one tax scam for 2014.<sup>28</sup> The IRS has made this issue one of its top priorities and has made some progress; however, significant improvements are still needed.

As of December 28, 2013, the IRS had identified more than 2.9 million incidents of identity theft in Calendar Year (CY) 2013. As of December 31, 2013, the IRS reported that during the 2013 Filing Season it stopped the issuance of more than \$10.7 billion in potentially fraudulent tax refunds associated with over 1.8 million tax returns classified as involving identity theft.

In September 2013, TIGTA reported that the impact of identity theft on tax administration continues to be significantly greater than the amount the IRS detects and prevents.<sup>29</sup> Using the characteristics of tax returns that the IRS has confirmed as involving identity theft and income and withholding information the IRS received in 2012 late in the filing season and in early 2013, we analyzed Tax Year (TY) 2011 tax returns processed during the 2012 Filing Season and identified approximately 1.1 million undetected tax returns where the primary Taxpayer Identification Number on the tax return was a Social Security Number. The undetected tax returns have potentially fraudulent tax refunds totaling approximately \$3.6 billion, which is a decrease of \$1.6 billion compared to the \$5.2 billion we reported for TY 2010.<sup>30</sup>

In addition, we expanded our TY 2011 analysis to include tax returns where the primary Taxpayer Identification Number on the tax return is an Individual Taxpayer

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<sup>27</sup> An EIN is a Federal Tax Identification Number used to identify a taxpayer's business account. The EIN is used by employers, sole proprietors, corporations, partnerships, nonprofit associations, trusts and estates, government agencies, certain individuals, and other types of businesses.

<sup>28</sup> IRS Press Release, IR-2014-16 (Feb. 19, 2014), available at <http://www.irs.gov/uac/Newsroom/IRS-Releases-the-Dirty-Dozen-Tax-Scams-for-2014-Identity-Theft-Phone-Scams-Lead-List>.

<sup>29</sup> TIGTA, Ref. No. 2013-40-122, *Detection Has Improved; However, Identity Theft Continues to Result in Billions of Dollars in Potentially Fraudulent Tax Refunds* (Sept. 2013).

<sup>30</sup> TIGTA, Ref. No. 2012-42-080, *There Are Billions of Dollars in Undetected Tax Refund Fraud Resulting From Identity Theft* (July 2012).

Identification Number (ITIN).<sup>31</sup> We identified more than 141,000 TY 2011 tax returns filed with an ITIN that have the same characteristics as IRS-confirmed identity-theft tax returns. Potentially fraudulent tax refunds issued for these undetected tax returns totaled approximately \$385 million, which is in addition to the approximately \$3.6 billion referred to earlier. In total, the IRS could issue potentially fraudulent refunds of approximately \$4 billion annually as a result of identity-theft tax refund fraud.

A common characteristic of tax returns filed by identity thieves is the reporting of false income and withholding to generate a fraudulent tax refund. Another aspect to this problem is that many individuals who are victims of identity theft may be unaware that their identity has been stolen and used to file fraudulent tax returns. These individuals are typically those who are not required to file a tax return.<sup>32</sup>

The IRS continues to expand the number of identity-theft filters it uses to identify potentially fraudulent tax returns and prevent the issuance of fraudulent tax refunds from 80 filters during Processing Year 2013 to 114 filters during Processing Year 2014. The identity-theft filters incorporate criteria based on characteristics of confirmed identity-theft tax returns. These characteristics include amounts claimed for income and withholding, filing requirements, prisoner status, taxpayer age, and filing history.

Tax returns identified by these filters are held during processing until the IRS can verify the taxpayer's identity. The IRS attempts to contact the individual who filed the tax return and, if this individual's identity cannot be confirmed, the IRS removes the tax return from processing. This prevents the issuance of many fraudulent tax refunds. For Processing Year 2014 as of February 28, 2014, the IRS reported that it identified and confirmed 28,076 fraudulent tax returns and prevented the issuance of nearly \$143 million in fraudulent tax refunds as a result of the identity-theft filters.<sup>33</sup>

In January 2012, IRS Criminal Investigation created the Identity Theft Clearinghouse (the Clearinghouse). The Clearinghouse was created to accept tax fraud-related identity-theft leads from the IRS's Criminal Investigation field offices. The Clearinghouse performs research, develops each lead for the field offices, and provides support for ongoing criminal investigations involving identity theft. Since its inception,

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<sup>31</sup> An ITIN is available to individuals who are required to have a taxpayer identification number for tax purposes, but do not have and are not eligible to obtain a Social Security Number because they are not authorized to work in the United States.

<sup>32</sup> Individuals who generally are not required to file a tax return include children, deceased individuals, the elderly, and individuals who earn less than their standard deduction or earn non-taxable income such as some Social Security benefits.

<sup>33</sup> TIGTA, Ref. No. 2014-40-029, *Interim Results of the 2014 Filing Season* (Mar. 2014).

the Clearinghouse has received 5,287 identity-theft leads that have resulted in the development of 568 investigations.

Finally, the IRS has significantly expanded the number of tax accounts that it locks by placing an indicator on the individual's tax account.<sup>34</sup> In Processing Year 2011, the IRS began locking taxpayers' accounts where the IRS Master File<sup>35</sup> and Social Security Administration data showed a date of death. The IRS places a unique identity-theft indicator to lock the individual's tax account if he or she is deceased. Electronically filed tax returns using the Social Security Number of a locked account will be rejected (the IRS will not accept the tax return for processing). Paper tax returns will be processed; however, the tax returns will not post to the taxpayer's account due to the account lock, and a refund will not be issued.

Between January 2011 and September 2013, the IRS had locked approximately 11 million deceased taxpayer accounts, which will assist the IRS in preventing future identity-theft fraudulent tax refunds from being issued. For Processing Year 2014 as of February 28, 2014, the IRS had rejected 67,079 e-filed tax returns. As of September 30, 2013, the IRS had prevented the issuance of approximately \$10 million in fraudulent tax refunds since the inception of the lock on paper tax returns. In November 2013, the Chairman of the Senate Finance Committee proposed restricting access to the Social Security Administration's public death data – the Death Master File, which would help the IRS's efforts to reduce tax fraud via the use of a deceased individual's Social Security Number.

Despite these improvements, the IRS could continue to expand the use of characteristics of confirmed identity-theft cases to improve its ability to detect and prevent the issuance of fraudulent tax refunds. As we reported in July 2008,<sup>36</sup> July 2012, and again in September 2013, the IRS is not in compliance with direct-deposit regulations that require tax refunds to be deposited into an account only in the name of the individual listed on the tax return. Direct deposit, which now includes debit cards, provides the ability to receive fraudulent tax refunds quickly, without the difficulty of having to negotiate a tax refund paper check. The majority of the TY 2011 tax returns we identified with indicators of identity theft (84 percent) involved the use of direct deposit to obtain tax refunds totaling approximately \$3.5 billion. There are indications

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<sup>34</sup> When an account is locked, tax refunds are not processed.

<sup>35</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

<sup>36</sup> TIGTA, Ref. No. 2008-40-182, *Processes Are Not Sufficient to Minimize Fraud and Ensure the Accuracy of Tax Refund Direct Deposits* (Sep. 2008).

that abusive practices are ongoing. For example, one bank account received 446 direct deposits totaling over \$591,000.<sup>37</sup>

To improve the IRS's conformance with direct-deposit regulations and to help minimize fraud, TIGTA recommended that the IRS limit the number of tax refunds being sent to the same direct-deposit account. As of December 2013, the IRS is still considering this recommendation, but the IRS did develop new filters for the 2013 Filing Season to identify and stop tax returns with similar direct-deposit and address characteristics. As of March 3, 2014, the IRS indicated that it had identified 395,468 tax returns using these filters and prevented approximately \$1.3 billion in tax refunds from being issued.<sup>38</sup> Recently, the IRS indicated it is developing a systemic restriction to limit to three the number of deposits to a single bank account. After three deposits to a single account, including situations where refunds are split, the entire refund amount will be sent by paper check to the taxpayer at the address of record.

In addition, the IRS implemented a pilot program in January 2013 with the Department of the Treasury's Bureau of Fiscal Service<sup>39</sup> designed to allow financial institutions to reject direct-deposit tax refunds based on mismatches between the account name and the name on the tax return. Once the refund is identified by the institution, it is sent back to the Bureau of Fiscal Service to be routed back to the IRS. As of the end of CY 2013, there have been 20,898 refunds returned from financial institutions totaling more than \$67 million. This is a promising first step in recovering fraudulent tax refunds issued via direct deposit.

Identifying potential identity-theft tax fraud is the first step. Once the IRS identifies a potential identity-theft tax return, it must verify the identity of the individual filing the return. However, verifying whether the returns are fraudulent will require additional resources. Using IRS estimates, it would cost approximately \$22 million to screen and verify the more than 1.2 million tax returns that we identified as not having third-party information on income and withholding. Without the necessary resources, it is unlikely that the IRS will be able to work the entire inventory of potentially fraudulent tax returns it identifies. The net cost of failing to provide the necessary resources is substantial, given that the potential revenue loss to the Federal Government of these tax fraud-related identity theft cases is in the billions of dollars annually.

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<sup>37</sup> TIGTA, Ref. No. 2013-40-122, *Detection Has Improved; However, Identity Theft Continues to Result in Billions of Dollars in Potentially Fraudulent Tax Refunds* (Sep. 2013).

<sup>38</sup> Statistical information provided by the IRS Wage and Investment Division Return Integrity and Correspondence Services.

<sup>39</sup> Formerly the Department of the Treasury Financial Management Service.

## TIGTA Criminal Investigations of Identity Theft and Impersonation Scams

Identity theft has a negative impact on the economy, and the damage it causes to its victims can be personally, professionally, and financially devastating. When individuals steal identities and file fraudulent tax returns to obtain fraudulent refunds before the legitimate taxpayers file, the crime is tax fraud, which falls within the programmatic responsibility of IRS Criminal Investigation. TIGTA's Office of Investigations focuses its limited resources on investigating identity theft characterized by any type of IRS employee involvement, the misuse of client information by tax preparers, or the impersonation of the IRS through phishing<sup>40</sup> schemes and other means. Where there is overlapping jurisdiction, TIGTA OI and IRS Criminal Investigation will work together to bring identity thieves to justice.

Currently, TIGTA is investigating several cases that involve identity theft. A recent example of this activity involved two hospital employees who conspired with each other to defraud the United States by filing false Federal income tax returns using the personal identifiers of patients at the hospital where they were employed and directing more than \$400,000 in tax refunds to be deposited into bank accounts they controlled, or accounts linked to prepaid debit or gift cards.<sup>41</sup> One individual was sentenced to a total of 81 months of imprisonment for his role in the conspiracy and aggravated identity theft.<sup>42</sup> The other individual was sentenced to 57 months of imprisonment for his role in the conspiracy.<sup>43</sup> Both were ordered to pay restitution to the IRS in the amount of \$116,404.<sup>44</sup>

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

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<sup>40</sup> Phishing is an attempt by an individual or group to solicit personal and financial information from unsuspecting users in an electronic communication by masquerading as trustworthy entities such as government agencies, popular social websites, auction sites, online payment processors, or information technology administrators.

<sup>41</sup> E.D. Va. Indictment dated Aug. 7, 2013.

<sup>42</sup> E.D. Va. Judgment dated Jan. 13, 2014.

<sup>43</sup> E.D. Va. Judgment dated Jan. 24, 2014.

<sup>44</sup> E.D. Va. Restitution Orders dated Jan. 10, 2014, and Jan.24, 2014.

For example, in November 2013, TIGTA special agents arrested an IRS Tax Examining Technician for aggravated identity theft and conspiracy.<sup>45</sup> The IRS employee conspired with another individual to divert a tax refund belonging to another taxpayer by changing the taxpayer's mailing address without the taxpayer's permission, causing a refund of \$595,901 to be mailed to her co-conspirator.<sup>46</sup> Further criminal action is pending.

TIGTA also investigates tax preparers who misuse their clients' information to commit identity theft-related refund fraud. For example, TIGTA investigated a tax preparer who stole the personal identifiers of her clients and filed numerous fraudulent tax returns without their permission or knowledge. The tax preparer, who was indicted in April 2013 on charges of aggravated identity theft, wire fraud, mail fraud and false claims, prepared and filed more than 200 fraudulent tax returns and defrauded the U.S. Government of more than \$1 million in tax refunds. She used the proceeds from the fraudulently obtained tax returns to purchase 20 real properties in Arizona.<sup>47</sup>

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

Criminals have been impersonating the IRS for years. While the fraud schemes may change, the motive remains the same: to bilk honest taxpayers out of their hard-earned money. Scammers and thieves often prey on immigrants and the elderly and sometimes even resort to threats. For example, in the late summer of 2013, TIGTA began noticing numerous complaints from around the country about suspicious callers claiming to be IRS employees collecting taxes from recent IRS audits. The callers demanded that the tax payments be made to pre-paid debit cards and threatened arrest, suspension of business or driver's licenses, and even deportation if the callers' demands were not met. In many cases, the callers became hostile and insulting. As of April 2014, the TIGTA Hotline has received tens of thousands of reports related to this scam, and it is estimated that the scheme has resulted in over \$2 million in payments made by the victims. TIGTA special agents are actively reviewing these complaints.

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<sup>45</sup> N.D. Ga. Executed Arrest Warrant dated Nov. 26, 2013.

<sup>46</sup> N.D. Ga. Crim. Compl. dated Nov. 25, 2013.

<sup>47</sup> S.D. Cal. Indict. filed Apr. 13, 2013.



## Tax Refund Fraud

### *Verification of Income and Withholding*

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

Expanded access to the National Directory of New Hires could immediately provide the IRS with this type of information that could help prevent tax fraud. Currently, the IRS's use of this information is limited by law to just those tax returns that include a claim for the EITC. The IRS has included a legislative proposal for expanded access to this information in its annual budget submissions for FYs 2010 through 2014 and has once again included this proposal in its FY 2015 budget submission. In an effort to combat identity theft, the Chairman of the Senate Finance Committee proposed in November 2013 granting the IRS authority to use the Department of Health and Human Services (HHS) National Directory of New Hires to verify employment data.

Improvements can also be made to the income and verification processes when tax returns are identified by the IRS as potentially fraudulent. In August 2013, we reported<sup>48</sup> that ineffective income and withholding verification processes are resulting in the issuance of potentially fraudulent tax refunds. Our review of a random sample of 272 tax returns sent for verification found that ineffective verification processes resulted in the issuance of the potentially fraudulent tax refunds associated with these tax returns.

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

Individuals attempting to commit tax refund fraud commonly steal or falsely obtain an EIN to file tax returns reporting false income and withholding. A valid EIN for the employer must be provided in support of wages and withholding reported on individual tax returns. Individuals who report wages and withholding on a tax return

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<sup>48</sup> TIGTA, Ref. No. 2013-40-083, *Income and Withholding Verification Processes are Resulting in the Issuance of Potentially Fraudulent Tax Refunds* (Aug. 2013).

must attach a Form W-2, *Wage and Tax Statement*,<sup>49</sup> to a paper-filed tax return to support the income and withholding reported. For an e-filed tax return, the filer must input the information from the Form W-2 into the e-filed tax return.

TIGTA identified 767,071 TY 2011 e-filed individual tax returns with refunds based on falsely reported income and withholding using a stolen or falsely obtained EIN.<sup>50</sup> TIGTA estimates that the IRS could issue almost \$2.3 billion annually in potentially fraudulent tax refunds based on these EINs. There were 285,670 EINs used on these tax returns. Of these:

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

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

The IRS has developed a number of processes to prevent fraudulent refunds claimed using stolen and falsely obtained EINs. As previously noted, third-party information is not available to effectively detect the reporting of false income and withholding at the time tax returns are processed. Nonetheless, the IRS has both tax information and other data that can be used to proactively identify tax returns with income reported using a stolen or falsely obtained EIN. Using these data, the IRS could have identified 53,169 tax returns with refunds issued totaling almost \$154 million that had income reported with a stolen or falsely obtained EIN. IRS management agreed with our recommendation to update fraud filters using the tax information and other data we identified such as the Suspicious EIN Listing.<sup>51</sup>

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<sup>49</sup> The IRS requires employers to report wage and salary information for employees on a Form W-2. The Form W-2 also reports the amount of Federal, State, and other taxes withheld from an employee's paycheck.

<sup>50</sup> TIGTA, Ref. No. 2013-40-120, *Stolen and Falsely Obtained Employer Identification Numbers Are Used to Report False Income and Withholding* (Sep. 2013).

<sup>51</sup> The Suspicious EIN Listing is a cumulative listing of EINs that the IRS has confirmed as suspicious. The IRS has confirmed 6,333 EINs as suspicious since January 2003.

## IMPLEMENTATION OF THE AFFORDABLE CARE ACT

The Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010<sup>52</sup> contain an extensive array of tax law changes that will present many challenges for the IRS in the coming years. The ACA provisions provide incentives and tax breaks to individuals and small businesses to offset health care expenses. They also impose penalties, administered through the tax code, for individuals and businesses that do not obtain health care coverage for themselves or their employees. The ACA represents the largest set of tax law changes in more than 20 years and represents a significant challenge to the IRS.

### *ACA-related Customer Service*

In December 2013, we issued a report on the IRS's ACA customer service strategy,<sup>53</sup> which is a collaborative and coordinated effort between the IRS and multiple Federal and State agencies. The Department of Health and Human Services (HHS) will serve as the "public face" for customer service at the Exchanges<sup>54</sup> until CY 2015. Individuals who contact the IRS for ACA assistance will be referred to the HHS's public website (Healthcare.gov) and toll-free telephone assistance lines. The IRS will also refer individuals to its own recorded telephone messages and self-assistance tools. In CY 2015, the IRS will take the lead in providing customer service when individuals begin filing their TY 2014 tax returns. The IRS's customer service strategy includes sufficient plans to: 1) perform outreach and education; 2) update or develop tax forms, instructions, and publications; and 3) provide employee training to assist individuals in understanding the requirement to maintain minimum essential coverage and the tax implications of obtaining the Premium Tax Credit.

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

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<sup>52</sup> Pub. L. No. 111-152, 124 Stat. 1029 (codified in scattered titles of the U.S.C.).

<sup>53</sup> TIGTA, Ref. No. 2014-43-006, *Affordable Care Act: The Customer Service Strategy Sufficiently Addresses Tax Provisions; However, Changes in Implementation Will Create Challenges* (Dec. 2013).

<sup>54</sup> Exchanges are intended to allow eligible individuals to obtain health insurance, and all Exchanges, whether State-based or established and operated by the Federal government, will be required to perform certain functions.

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

### *Security of Federal Tax Data*

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

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

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

TIGTA issued a report on the IRS Income and Family Size Verification Project and found that the project was on schedule and the IRS was managing known information technology risks at the time the audit was conducted.<sup>55</sup> TIGTA recommended that the IRS: 1) improve the management of ACA changes to requirements; and 2) use an integrated suite of automated tools to manage ACA requirements and application test cases.

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<sup>55</sup> TIGTA, Ref. No. 2013-23-034, *Affordable Care Act: The Income and Family Size Verification Project: Improvements Could Strengthen the Internal Revenue Service's New Systems Development Process* (Mar. 2013).

TIGTA remains concerned about the protection of confidential taxpayer data that will be provided to the Exchanges. The Federal tax data provided to HHS and the Exchanges will be protected through the IRS's Safeguard Review Program. TIGTA is currently conducting an audit of the IRS's Safeguard Review Program and will issue a report on its operations in FY 2014.<sup>56</sup> TIGTA has concerns that the Safeguard Review Program may lack sufficient staffing or funding to adequately expand its operations to include the addition of the Federal and State Exchanges.

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

The Affordable Care Act provides for a refundable tax credit to offset an individual's health insurance expenses. Beginning in TY 2014, some low to moderate income individuals eligible to obtain health insurance through one of the State Exchanges or the Federal Exchange may be eligible for a refundable credit to assist them in paying monthly insurance premiums. The amount of the credit is determined by an individual's income in relation to the Federal poverty level, among other factors. In October 2013, the IRS began working with the Exchanges to provide a computation of individuals' estimated maximum monthly Premium Tax Credit.<sup>57</sup> Individuals can elect the amount of credit they want advanced up to the maximum credit for which the Exchange has approved them to receive. Qualified individuals can elect to either: 1) have the monthly credit sent directly to their insurance provider as an advance payment (Advance Premium Tax Credit)<sup>58</sup> to lower the amount of monthly premiums they would pay out-of-pocket; or 2) wait to receive the credit when they file their TY 2014 tax return. As of March 31, 2014, the Department of Health and Human Services reported that more than \$1.4 billion in Advance Premium Tax Credits have been paid to insurers.

Like other refundable credits, there is a risk for improper payments with the Premium Tax Credit. For example, Advance Premium Tax Credits are computed using a number of factors, including an individual's projected 2014 income, family size, etc. The Exchanges will use income and family size information received from the IRS, as well as information provided by the applicant and other data sources, to project the income and family size amounts used to determine eligibility for the credit. The Exchanges also rely on the IRS's computation of the maximum available credit based

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<sup>56</sup> TIGTA, Audit No. 201320029, *Review of the Internal Revenue Service's Office of Safeguards*, report planned for July 2014.

<sup>57</sup> A Premium Tax Credit is a refundable tax credit to assist individuals and families in purchasing health insurance coverage through an Exchange.

<sup>58</sup> An Advance Premium Tax Credit is paid in advance to a taxpayer's insurance company to help cover the cost of premiums.

on the projected income and family size when assisting applicants in choosing a health insurance plan. TIGTA is currently evaluating the accuracy of the data that the IRS provides to the HHS for use in enrolling individuals and calculating the Advance Premium Tax Credit, and plans to issue a report this year.<sup>59</sup> We plan to assess the protection of Federal tax data provided by the IRS in the future.<sup>60</sup>

It is not until the individual files his or her TY 2014 tax return during CY 2015 that the IRS will know the individual's actual income for 2014 and the amount of the tax credit the individual is entitled to receive. Individuals who receive an Advance Premium Tax Credit will reconcile the amount received to the amount of Premium Tax Credit they are eligible to receive based on their actual 2014 income and family size when they file their TY 2014 tax return.

Individuals who are eligible to receive the Premium Tax Credit but did not receive a credit in advance can claim the credit on their TY 2014 tax return. Individuals who received more than they were entitled in the form of an Advance Premium Tax Credit will be responsible for repaying all or part of the advanced credit received. The IRS will assess the additional credit on the taxpayer's account and attempt to collect it.

TIGTA is concerned that the potential for refund fraud and related schemes could increase as a result of processing ACA Premium Tax Credits unless the IRS builds, implements, updates, and embeds ACA predictive analytical fraud models into its tax filing process. The IRS has developed a plan to prevent, detect, and resolve fraud and abuse during ACA tax return processing. The plan, when fully developed and implemented, is designed to leverage third-party reporting from the Exchanges and new computer analytical capability built into the Return Review Program.<sup>61</sup> The plan calls for the development of the ACA Validation Service, which will be used to identify improper ACA-related refunds. The ACA Validation Service will be designed to perform screening for improper refunds and will also identify fraudulent schemes that include multiple returns. The IRS plans to rely on the Electronic Fraud Detection System and/or the new Return Review Program to provide the systems to identify and prevent ACA-related refund fraud.

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<sup>59</sup> TIGTA, Audit No. 201340335, *Affordable Care Act: Accuracy of the Income and Family Size Verification and Advanced Premium Tax Credit Calculation*, report planned for May 2014.

<sup>60</sup> TIGTA, Audit No. 201420302, *Security Over Federal Tax Data at Health Insurance Exchanges*, report planned for September 2014.

<sup>61</sup> The Return Review Program is the key automated component of the IRS's pre-refund initiative and will implement the IRS's new business model for a coordinated criminal and civil tax noncompliance approach to prevent, detect, and resolve tax refund fraud, including refundable ACA premium tax credits.

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

We have developed a multi-audit strategy to evaluate the IRS's implementation of the Premium Tax Credit. To date, we have completed evaluations of the IRS's development of needed information systems and the adequacy of the IRS's plans to provide customer service to individuals seeking assistance with the Premium Tax Credit. In September 2013, we reported that a fraud mitigation strategy is not in place to guide ACA systems development, testing, initial deployment, and long-term operations.<sup>62</sup> The IRS informed us that two new systems are under development that will address Affordable Care Act tax refund fraud risk. However, until these new systems are successfully developed and tested, TIGTA remains concerned that the IRS's existing fraud detection system may not be capable of identifying Affordable Care Act refund fraud or schemes prior to the issuance of tax refunds.

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

Several ACA tax-related provisions became effective for CY 2013 that affect individuals with high incomes including the creation of a new net investment income tax,<sup>63</sup> and an increase in the employee-share of the Medicare tax (i.e., Hospital tax).<sup>64</sup> The ACA also increased the income limit for qualifying medical and dental expenses taken as an itemized deduction. In prior years, individuals could take an itemized deduction for qualified medical and dental expenses that exceeded 7.5 percent of their Adjusted Gross Income. Beginning in CY 2013, the qualifying expenses must exceed 10 percent of Adjusted Gross Income.

Taxpayers began filing tax returns with these tax changes on January 31, 2014. In addition to reprogramming its computer systems to properly reflect these changes, the IRS had to issue guidance to taxpayers and tax return preparers explaining each of

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<sup>62</sup> TIGTA, Ref. No. 2013-23-119, *Affordable Care Act: Improvements Are Needed to Strengthen Systems Development Controls for the Premium Tax Credit Project* (Sep. 2013).

<sup>63</sup> The ACA created a new tax that is equal to 3.8 percent of an individual's net investment income for the tax year or the excess of the individual's Modified Adjusted Gross Income over \$200,000 (\$250,000 for married individuals filing jointly).

<sup>64</sup> The ACA increased the employee-share of the Medicare tax to 0.9 percent of an individual's covered wages in excess of \$200,000 (\$250,000 for married individuals filing jointly). The ACA also increased the Medicare tax on self-employment income to 0.9 percent of an individual's self-employment income over \$200,000 (\$250,000 for married individuals filing jointly).

these provisions and revise or develop new tax forms, instructions and publications to reflect the tax law changes. In an ongoing review, we will determine whether the IRS has correctly implemented these provisions, which includes analyzing tax returns to ensure that they are accurately processed.<sup>65</sup>

## **IRS TAX GAP**

A serious challenge confronting the IRS is the Tax Gap, which is defined as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year. The most recent gross Tax Gap estimate developed by the IRS was \$450 billion for TY 2006, which is an increase from the prior estimate of \$345 billion for TY 2001. The voluntary compliance rate<sup>66</sup> decreased slightly from 83.7 percent in 2001 to 83.1 percent in 2006.

The largest component (\$376 billion or approximately 84 percent) of the Tax Gap is based on taxpayers' underreporting their taxes due. The IRS addresses this gap by attempting to identify questionable tax returns when they are received and processed and by conducting examinations of tax returns filed to determine if there are any adjustments needed to the information reported on the tax returns. Additional taxes are assessed and collected.

The next component (\$46 billion or 10 percent) of the Tax Gap is based on taxpayers underpayment of taxes due. The IRS addresses this gap by issuing notices and contacting taxpayers to collect the delinquent taxes. The IRS is authorized to take enforcement action, such as filing liens and seizing assets, to collect the taxes.

The smallest component (\$28 billion or 6 percent) of the Tax Gap is based on taxpayers who do not file tax returns when they are due. These taxpayers also may not have taxes withheld or make estimated taxes. The IRS analyzes data from third parties (such as Forms W-2 or Forms 1099) to identify taxpayers who should have filed a tax return, and either prepares a substitute tax return or contacts the taxpayer to obtain the delinquent tax return.

The scope, complexity, and magnitude of the international financial system also present significant enforcement challenges for the IRS. At the end of CY 2012, foreign business holdings and investments in the United States were \$25.5 trillion, an increase

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<sup>65</sup> TIGTA, Audit No. 201440014, *2014 Filing Season Implementation*, report planned for September 2014.

<sup>66</sup> The voluntary compliance rate is an estimate of the amount of tax for a given year that is paid voluntarily and timely.



of nearly \$135 billion over CY 2011, while U.S. business and investments abroad grew to over \$21.6 trillion, an increase of nearly \$1.5 billion during the same period. The numbers of taxpayers conducting international business transactions continues to grow as technological advances provide opportunities for offshore investments that were once only possible for large corporations and wealthy individuals.

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

As this global economic activity increases, so do concerns regarding the International Tax Gap.<sup>67</sup> While the IRS has not developed an accurate and reliable estimate of the International Tax Gap, non-IRS sources estimate it to be between \$40 billion and \$133 billion annually. To address the International Tax Gap, the IRS developed an international tax strategy plan with two major goals: (1) to enforce the law to ensure that all taxpayers meet their obligations and (2) to improve service to make voluntary compliance less burdensome.

The IRS also currently faces the challenge of implementing the *Foreign Account Tax Compliance Act* (FATCA).<sup>68</sup> FATCA was enacted to combat tax evasion by U.S. persons holding investments in offshore accounts. Under FATCA, a United States taxpayer with financial assets outside the United States will be required to report those assets to the IRS. In addition, foreign financial institutions will be required to report to the IRS certain information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. The IRS is developing a new international system, the Foreign Financial Institution Registration System, to support the requirements of FATCA. This system is intended to register foreign financial institutions to assist in achieving the primary objective of FATCA which is the disclosure of U.S. taxpayer foreign accounts. TIGTA reviewed the development of this system and reported that the program management control processes did not timely identify or communicate system design changes to ensure its successful deployment.<sup>69</sup>

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<sup>67</sup> The International Tax Gap is the taxes owed but not collected on time from a U.S. person or foreign person whose cross-border transactions are subject to U.S. taxation.

<sup>68</sup> Pub. L. No. 111-147, §§ 501-541, 124 Stat 71 \*96-116 (2010) (codified in scattered sections of 26 U.S.C.).

<sup>69</sup> TIGTA Ref. No. 2013-20-118, *Foreign Account Tax Compliance Act: Improvements Are Needed to Strengthen Systems Development for the Foreign Financial Institution Registration System* (Sept. 2013).

Concerns about the International Tax Gap have also led to increased enforcement efforts on international information reporting requirements and increased assessments of related penalties. For example, the IRS has automated the penalty-setting process for the Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, which has resulted in a total of \$215.4 million in late-filed Form 5471 penalty assessments during FYs 2009 through 2012.<sup>70</sup>

In addition, the IRS established the International Campus Compliance Unit to expand its audit coverage of tax returns with international aspects and to increase compliance among international individual taxpayers. For FY 2011 through March 13, 2013, the International Campus Compliance Unit conducted almost 18,000 audits and assessed approximately \$36 million in additional tax. Despite its accomplishments, TIGTA found that the International Campus Compliance Unit has no specific performance measures for its operations.<sup>71</sup>

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

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

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<sup>70</sup> TIGTA, Ref. No. 2013-30-111, *Systemic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement* (Sept. 2013).

<sup>71</sup> TIGTA, Ref. No. 2013-30-113, *The International Campus Compliance Unit Is Improving Individual Tax Compliance* (Sept. 2013).

February 2014. As a result of these combined reductions, the number of ACS contact representatives in FY 2013 was 41 percent fewer than in FY 2010.

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

- New inventory is outpacing closures, so the inventory is growing.
- Inventory is taking longer to close, and the cases are older.
- When cases are closed, more are closed as currently not collectible.
- Fewer enforcement actions are taken.
- More, and older, cases are being transferred to the growing inventory of cases available to be assigned to Collection Field personnel.<sup>72</sup>

Leveraging external resources, such as whistleblowers, can help improve tax compliance. The IRS Whistleblower Program also plays an important role in reducing the Tax Gap and maintaining the integrity of a voluntary tax compliance system. However, TIGTA reported that the program continued to have internal control weaknesses with respect to processing whistleblower claims. For example, information captured from multiple systems and entered into a single inventory control system was potentially erroneous, and the quality review process for the new inventory system was not sufficient to ensure that claims were accurately controlled. Additionally, TIGTA determined that timeliness standards for processing claims were not sufficient. Without adequate oversight of the Whistleblower Program, the IRS is not as effective as it could be in responding timely to tax noncompliance issues.<sup>73</sup>

Modernizing information systems could potentially allow the IRS to post more comprehensive tax return information to its computer systems, which could facilitate the examination process and expedite taxpayer contacts for faster resolution. The IRS considers the Customer Account Data Engine 2 (CADE 2) program to be critical to its mission and it is the IRS's most important information technology investment. TIGTA

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<sup>72</sup> TIGTA, Audit No. 201330017, *Review of the Automated Collection System Inventory Management*, report planned for August 2014.

<sup>73</sup> TIGTA, Ref. No. 2012-30-045, *Improved Oversight Is Needed to Effectively Process Whistleblower Claims* (Apr. 2012).

reported that the implementation of CADE 2 daily processing allowed the IRS to process tax returns for individual taxpayers more quickly by replacing existing weekly processing.<sup>74</sup> The CADE 2 system also provides for a centralized database of individual taxpayer accounts, which will allow IRS employees to view tax data online and provide timely responses to taxpayers once it is implemented. The IRS's modernization efforts also include developing computer programs to conduct predictive analytics to reduce refund fraud.<sup>75</sup> The successful implementation of the IRS's modernization program should significantly improve service to taxpayers and enhance Federal tax administration.

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

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

TIGTA follows up regularly on management actions in response to recommendations in our reports. One notable example that we are currently following up on is the report on Exempt Organizations. TIGTA previously reported<sup>76</sup> that the IRS used inappropriate criteria for selecting and reviewing applications for tax-exempt status. This resulted in substantial delays in processing certain applications and the issuance of unnecessary information requests being issued to certain organizations.

The IRS Commissioner reported in January 2014 that the IRS completed action on all nine recommendations contained in our May 2013 report. TIGTA is currently

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<sup>74</sup> TIGTA, Ref. No. 2012-20-122, *Customer Account Data Engine 2 System Requirements and Testing Processes Need Improvements* (Sep. 2012).

<sup>75</sup> These are computer models that analyze extremely large quantities of data to seek out data patterns and relationships that could indicate potential tax fraud schemes.

<sup>76</sup> TIGTA, Ref. No. 2013-10-053, *Inappropriate Criteria Were Used to Identify Tax-Exempt Applications for Review* (May 2013).

assessing the actions the IRS has taken in response to our recommendations.<sup>77</sup>

## **TIGTA BUDGET REQUEST FOR FY 2015**

As requested by the Subcommittee, I will now provide information on our budget request for FY 2015.

TIGTA's FY 2015 proposed budget requests appropriated resources of \$157,419,000, an increase of 0.67 percent from the FY 2014 enacted budget. TIGTA will continue to focus on its mission of ensuring an effective and efficient tax administration system in this lean budget environment. The FY 2015 budget resources include funding to support TIGTA's critical audit, investigative, and inspection and evaluation priorities, while still maintaining a culture that continually seeks to identify opportunities to achieve efficiencies and cost savings.

During FY 2013, TIGTA's combined audit and investigative efforts have recovered, protected, and identified monetary benefits totaling \$16.6 billion<sup>78</sup>, including cost savings, increased revenue, revenue protection<sup>79</sup>, and court-ordered settlements in criminal investigations, and affected approximately 3.9 million taxpayer accounts. Based on TIGTA's FY 2013 budget of \$143.8 million, this represents a Return on Investment of \$116-to-\$1.

In FY 2014, TIGTA received approximately \$7 million above its requested amount of \$149.4 million. This additional funding will enable TIGTA to 1) restore staffing to pre-sequestration levels; 2) increase training expenditures for auditors and special agents to meet required standards; and 3) upgrade and improve our technology infrastructure. The additional funding will allow TIGTA to continue to support critical audit, investigative, and inspection and evaluation priorities. The additional funds have also enabled the Office of Audit to immediately initiate audits that require travel to various IRS locations – travel that had previously been placed on hold due to budget constraints. In addition, the Office of Audit has been able to immediately initiate audits in critical areas such as international tax compliance and identity theft. As additional

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<sup>77</sup> TIGTA, Audit No. 201410009, *Status of Actions to Improve Identification and Processing of Applications for Tax-Exempt Status – Follow-Up*.

<sup>78</sup> This figure includes dollars potentially compromised by bribery; dollar amount of tax liability for taxpayers who threaten and/or assault IRS employees; dollar value of IRS and resources protected against malicious loss; dollar amount of embezzlement or taxpayer remittance theft; dollar value of Government property recovered; dollar value of court ordered criminal and civil penalties, fines, and restitution; and dollar value of seizures, forfeitures, and recoveries from contract fraud.

<sup>79</sup> Recommendations made by TIGTA to ensure the accuracy of the total tax, penalties, and interest paid to the Federal Government.

law enforcement staff is hired, the Office of Investigations will be able to conduct more proactive initiatives to uncover fraud in IRS operations and identify threats to IRS employees and infrastructure. In addition, the Office of Investigations will be able to investigate more complaints of IRS employee misconduct, fraud, waste, and abuse.

### *IRS Implementation of the ACA*

Several key ACA provisions will become effective in FY 2014, and the IRS must ensure that the taxpayer system is able to fully implement these provisions. TIGTA's oversight requires close coordination among the Audit, Investigations, and Inspections and Evaluations functions. Each program office brings unique skills and experience, but TIGTA's overall success depends greatly upon these offices' close collaboration. As such, TIGTA has implemented a multi-year oversight strategy that includes audits, evaluations, and investigative resources to assess and to proactively deter efforts to impede the IRS's implementation of the ACA. This strategy includes coordination with other agencies, including the Department of Health and Human Services Office of Inspector General.

For example, TIGTA is conducting or planning to initiate 10 ACA-related audits during FY 2014 and FY 2015. For TIGTA's investigators, our experience has shown that the IRS's expanded role under the ACA may spark a new wave of animosity directed toward IRS employees that could result in threats of violence, or the actual assault of IRS employees and attacks on IRS facilities. For example, TIGTA has investigated threats made by taxpayers to IRS employees as a result of the IRS offsetting their Federal tax refunds for the repayment of student loans or court-ordered child support payments. As ACA provisions start to take effect, additional resources will be dedicated to investigating related threats.

Shortly after the Supreme Court upheld the constitutionality of the ACA, the media reported that criminals impersonated a Federal agency in an attempt to fraudulently obtain personally identifiable information from unsuspecting taxpayers to further their identity theft schemes and other crimes under the guise that the sensitive information was required for ACA compliance. Based upon our experience investigating this type of criminal activity, TIGTA anticipates a significant increase in the number of ACA-related impersonation attempts as the IRS begins its role in ACA compliance activity.

### *TIGTA's Audit Priorities*

TIGTA's audit priorities include mitigating risks associated with tax refund fraud and identity theft, monitoring the IRS's implementation of the Affordable Care Act and other tax law changes, and assessing the IRS's ability to provide quality taxpayer service and address the Tax Gap.

Recent audit work has shown that the IRS could develop or improve processes that will increase its ability to detect and prevent the issuance of fraudulent tax refunds resulting from identity theft. In addition, TIGTA has concerns over the security of tax data provided to the Exchanges and is also concerned that the potential for refund fraud and related schemes could increase as a result of processing ACA Premium Tax Credits.

### *TIGTA's Investigative Priorities*

TIGTA's investigative priorities include investigating allegations of serious misconduct and criminal activity by IRS employees; ensuring IRS employees are safe and IRS facilities, data and infrastructure are secure and not impeded by threats of violence; and protecting the IRS against external attempts to corrupt or otherwise interfere with tax administration.

IRS employees are entrusted with the sensitive personal and financial information of taxpayers. It is particularly troubling when IRS employees misuse their positions in furtherance of identity theft and other fraud schemes. TIGTA will continue to proactively review the activities of IRS employees who access taxpayer accounts for any indication of unauthorized accesses that may be part of a larger fraud scheme and conduct investigations into suspected wrongdoing.

Between FYs 2010 and 2013, TIGTA processed over 11,391 threat-related complaints and conducted over 5,500 investigations of threats made against IRS employees. TIGTA will continue to aggressively investigate individuals who threaten the safety and security of the IRS and its employees.

As mentioned earlier, the TIGTA Hotline has received over 30,000 reports from taxpayers victimized by individuals impersonating IRS employees in an effort to defraud them. To date, thousands of victims have paid over \$2 million to the scammers. TIGTA will continue to investigate these crimes against taxpayers and alert the public to this scam to ensure that innocent taxpayers are not harmed by these criminals.

We at TIGTA take seriously our mandate to provide independent oversight of the IRS in its administration of our Nation's tax system. As such, we plan to provide continuing audit coverage of the IRS's efforts to operate efficiently and effectively and investigate any instances of IRS employee misconduct.

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





## **J. Russell George**

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

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

in 2002.

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

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

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

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

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