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PROBLEMS AT THE INTERNAL REVENUE SERVICE: CLOSING THE TAX GAP AND PREVENTING IDENTITY THEFT

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT ORGANIZATION, EFFICIENCY AND FINANCIAL MANAGEMENT

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

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PROBLEMS AT THE INTERNAL REVENUE SERVICE: CLOSING THE TAX GAP AND PREVENTING IDENTITY THEFT

THURSDAY, APRIL 19, 2012,

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT ORGANIZATION,
EFFICIENCY AND FINANCIAL MANAGEMENT,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:007 a.m. in room 2154, Rayburn House Office Building, the Honorable Todd Russell Platts [chairman of the subcommittee], presiding.

Present: Representatives Platts, Towns and Connolly.

Staff Present: Michael R. Bebeau, Majority Assistant Clerk; Adam P. Fromm, Majority Director of Member Services and Committee Operations; Mark D. Marin, Majority Director of Oversight; Tegan Millspaw, Majority Research Analyst; Staff Member; Jaron Bourke, Minority Director of Administration; Beverly Britton Fraser, Minority Counsel; Devon Hill, Minority Staff Assistant; Jennifer Hoffman, Minority Press Secretary.

Mr. PLATTS. Today's hearing of the Subcommittee on Government Organization, Efficiency and Financial Management will come to order.

I certainly thank everyone for being here today, both witnesses and guests, and my Ranking Member, Mr. Towns from New York.

Our hearing today focuses on two key issues at the Internal Revenue Service. First, our hearing will address the tax gap between what people owe in Federal taxes and what the IRS ultimately collects. Second, the hearing will review the increasing problem of identity theft related to tax fraud.

Federal taxes make up about 96 percent of the Government's total revenues each year. Because of this, it is very important that the IRS is able to effectively collect taxes and enforce Federal policy. The majority of Americans pay their taxes voluntarily and on time. But every year, there is a gap between the amount of Federal taxes owed and the amount the IRS collects.

Earlier this year, the IRS released its most recent analysis on the tax gap using data from the 2006 tax year. That data shows a $450 billion gap between taxes owed and taxes voluntarily paid. IRS recovered approximately $65 billion of this amount, making the net tax gap $385 billion.

According to the National Taxpayer Advocate, the average household must pay approximately $3,400 or more for the Government

to raise the same revenue it would have collected if everyone paid their taxes in full.

There are many causes of the tax gap, including intentional under-reporting, failing to file taxes or math errors on those taxes that are filed. Because of this, we need a multi-faceted approach to achieve an effective and appropriate response, and to close the tax gap. Using third party information to verify tax returns could increase voluntary compliance. The Treasury Department has recommended increasing penalties for people who purposely do not comply with Federal tax law, especially egregiously, and maybe more so, repeatedly failing to comply.

Simplifying the Federal tax code could also help by making it easier to file taxes and reducing the opportunity to commit willful tax evasion. We will hear more from our witness today about solutions on how to close the tax gap and better serve all of our taxpayers.

This hearing will also address identity theft-related tax fraud. Identity theft affects thousands, as we are learning more and more, hundreds of thousands of taxpayers each year, and has a significant impact on its victims. Identity thieves often steal personal information from taxpayers, including names, social security numbers and addresses. With this information, the thieves can file fraudulent tax returns with the IRS and receive the refunds that are owed to the legitimate taxpayer. Victims may not even know they have had their identity and tax returns stolen until they go to file their own returns and the IRS notifies them that somebody has already fraudulently filed on their behalf.

It can often take months for IRS to resolve these cases and issue refunds to the legitimate taxpayer, the victim of the crime. Identity theft-related tax fraud is a serious and rapidly growing problem that has been the focus of two prior hearings of this Subcommittee. While significant work is being done to address this problem, and I certainly commend the IRS for their efforts, we must do more to protect taxpayers from criminals who steal their identities and their refunds and do harm to not just that individual victim, but also to America and the hard-earned tax dollars of lawful citizens.

Just this week, authorities reported that a man working for a health care non-profit stole the identities of more than 50 brain injured patients to steal funds from the American people through fraudulent returns. The American people deserve a government that protects the taxes they pay and fairly and equitably enforces the law. We need solutions to ensure that honest taxpayers are not unduly burdened because others do not pay their share. We must also work to reduce identity theft and prevent it before payments are issued to criminals.

Today we are joined by four experts regarding these issues, who have extensive knowledge about the problems that exist within the Federal tax systems. I look froward to the testimony of our witnesses and to continuing to work with each of them and all our partners, including here within the Subcommittee, to better prevent tax fraud and fairly administer the tax code.

With that, I yield to the previous chairman of the full Committee and the Ranking Member of the Subcommittee, and previous chair-

man of the Subcommittee, my good friend and colleague from New York, Mr. Towns, for the purpose of an opening statement.

Mr. TOWNS. Thank you very much, Mr. Chairman. Let me thank the witnesses as well. I think this is a very timely hearing.

This is the third hearing in a series held by this Committee to examine how the IRS handles the growing problem of identity theft and tax fraud. As of March 3rd, 2012, the IRS had already identified over 440,000 tax returns with $2.7 billion claims in fraudulent refunds. Fortunately, IRS screening prevented 97 percent of those fraudulent claims from being paid.

Today the IRS is doing a better job of protecting the taxpayer and the Treasury from criminals than ever before, and we salute you for that. But more is required of us to stay ahead of the criminals and to help the victims. One of the first priorities we must address is the quality of assistance given to taxpayers victimized by employment or tax refund fraud. The Inspector General does not paint a pretty picture of how the IRS will be able to handle this problem going forward.

It seems as if taxpayers will have fewer walk-in help centers, with shorter business hours, and longer hold time on the phone with IRS agents. Budget cuts are the primary reason, but I hope we can find alternate solutions to these issues.

Today we will also focus on the $450 billion tax gap. This tax gap equals nearly 20 percent of our forecasted deficit for this fiscal year. We simply cannot afford to look the other way and just not do anything.

Part of the tax gap is a result of tax cheats who simply refuse to comply with the law, which increases burden on the rest of us. But a portion is due to taxpayers' confusion and unintentional errors as well. I am sure that we can all agree that the tax code is extremely complex. This complexity makes it hard for taxpayers who honestly want to pay their taxes to figure out what they actually owe. And as a result, they can accidentally overpay or underpay.

We must do more to understand the sources of the tax gap and compliance burdens, so we can make progress in uncovering new, creative solutions. We cannot close the tax gap by enforcement against the average American who is doing their best to comply with the tax laws. We all have to share the burden and do more. And let us work to reform our tax code in a way that will help us collect more of the taxes that are owed but not paid. And let us continue our work to make the tax code more fair and simple. In order to do that, we must work together.

I thank our witnesses today, Inspector General Miller, Mr. White, Ms. Olson, for your appearance here today, Mr. George, I thank all of you for being here. I look forward to the testimony with great anticipation. We need to make certain that people are protected, and that is our obligation and responsibility to do it. I think that working together, we can do a lot better than what we are doing. This is not a Committee here to blame you and you blame us, this is a Committee to come up with some solutions.

Thank you so much, Mr. Chairman.

Mr. PLATTS. I thank the gentleman and would echo your final comment there as well, that we are about working with you and

all to solve problems, not to pay gotcha. And all the more, we appreciate our witnesses being here with us today.

We will keep the record open for seven days for any additional statements or extraneous materials to be submitted for the record.

We are now glad to move to our witnesses and we are honored to have four very dedicated public servants who day in and day out seek to serve the American people with great distinction and honor, and who bring great expertise to the benefit of the Subcommittee today. So we thank each of you for being here.

We are honored to have Mr. Steven Miller, Deputy Commissioner of Service and Enforcement at the Internal Revenue Service, Ms. Nina Olson, National Taxpayer Advocate, the Honorable J. Russell George, Treasury Inspector General for Tax Administration, and Mr. James White, Director of Strategic Issues at the United States Government Accountability Office.

Again, we thank each of you for being here. We have had a chance to review your written testimony and appreciate your submitting that ahead of time. That allows me to go through, and I am famous for my blue marker and making notes in things I want to try to get to in the time we will have. But we do appreciate having that in advance and welcome your testimony today. If we can try to stay to about the five-minute window, and hopefully that will allow us again to go through all of your opening statements before running to the Floor for votes and then coming back for questions.

Commissioner Miller, if you would like to begin. I apologize, if I could ask all four of you to stand. Pursuant to our Committee rules, I need to swear you in. If you could stand and raise your right hand.

Do you solemnly swear or affirm that the testimony you are about to give this Committee will be the truth, the whole truth and nothing but the truth?

[Witnesses respond in the affirmative.]

Mr. PLATTS. Thank you, you may be seated. Let the record reflect that all four witnesses affirmed the oath.

We will now begin with Commissioner Miller. You are recognized.

STATEMENTS OF WITNESSES

STATEMENT OF STEVEN T. MILLER

Mr. MILLER. Chairman Platts, Ranking Member Towns, my name is Steve Miller, as you have mentioned, Deputy Commissioner of the Internal Revenue Service. I appreciate the opportunity to testify on the tax gap today and also to update the Subcommittee on our identity theft work this filing season.

The tax gap is the difference between the amount of tax owed by taxpayers for a given year and the amount that is paid voluntarily and on time. The amount includes the complete spectrum of behavior from confusion to fraud. The tax gap analysis itself is best seen as a directional tool to provide insights into areas where non-compliance exists and the means by which we can impact compliance.

As better explained in my written testimony, our work shows that compliance is most prevalent where there is withholding and/or third party reporting.

The IRS recently received an updated tax gap study covering the tax year 2006, which shows that the Nation's compliance rate for that year is a little over 83 percent. This is essentially unchanged from the last review covering tax year 2001. The report also showed that the net tax gap in dollars for 2006 was $385 billion.

The tax gap is comprised of three components: under-reporting, non-filing and under-payment, of which under-reporting is by far the largest. As indicated, the largest parts of the under-reporting category are where there is little withholding or third party reporting.

In our view, any discussion on how to reduce the tax gap must consider three guiding principles. First, both unintentional taxpayer error and intentional taxpayer evasion must be addressed. Thus, both enforcement and service are necessary.

Second, different sources of non-compliance require different approaches. And third, any major attempt to address the tax gap by legislation, regulation or through increased enforcement must be considered within a context that fully recognizes taxpayer burden and taxpayer rights.

In keeping with these principles, our strategy involves not only increasing enforcement activities but also educating taxpayers about their tax obligations, improving customer service in order to make it easier for individuals and businesses to get the help they need to meet their filing requirements, reducing opportunities for tax evasion, expanding compliance research and improving information technology.

With respect to enforcement, the IRS is making significant headway in increasing tax compliance. Over the last decade, tax collections have gone up significantly and audit rates have risen. But some of these gains are deteriorating as our budget atrophies. Thus, we would ask for your support for our 2013 budget. We believe the best way to impact the tax gap is through a combination of responsible discussions on legislative change and responsible investments in the IRS.

Turning now to identity theft. In November I testified before the Subcommittee and described our ongoing work. In my written testimony today I provided an update on IRS actions. What you will see is that we have implemented the many initiatives we outlined in November.

As before, our approach is two-pronged. First, we need to stop false refunds before they get out. Second, we need to help those who have been victimized. We are in fact stopping much more refund fraud generally and identity theft specifically. We have put various new identity theft screening filters in place to improve our ability to spot false returns before they are processed and before a refund is issued. The numbers are in my testimony and I am obviously more than willing to discuss any questions that you have in a particular area.

On our work with victims, we have trained 35,000 of our employees to recognize and be sensitive to identity theft. We have also expanded a program for identity protection personal identification numbers, or IP PINS. For the 2012 filing season, we issued IP PINS to over 250,000 i.d. theft victims, which will allow unfettered filing for 2012 for those individuals. We continue to increase staff-

ing to assist identity theft victims and we are revising and streamlining our process to determine who the real taxpayer is when duplicate filings occur.

Again, I will say that we are not done, but we have made real progress in the area.

Mr. Chairman, this concludes my oral testimony. I would be more than happy to answer any questions.

[Prepared statement of Mr. Miller follows:]

WRITTEN TESTIMONY OF
STEVEN T. MILLER
DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT
INTERNAL REVENUE SERVICE
BEFORE THE
HOUSE COMMITTEE ON OVERISIGHT AND GOVERNMENT REFORM
SUBCOMMITTEE ON GOVERNMENT ORGANIZATION, EFFICIENCY AND FINANCIAL MANAGEMENT
ON THE TAX GAP AND IDENTITY THEFT
APRIL 19, 2012

INTRODUCTION AND SUMMARY

Chairman Platts, Ranking Member Towns and Members of the Subcommittee on Government Organization, Efficiency and Financial Management, my name is Steven Miller and I am the Deputy Commissioner for Services and Enforcement at the Internal Revenue Service. I appreciate the opportunity to testify on the important issue of the tax gap, and discuss actions that the IRS is taking to improve voluntary compliance with our nation's tax laws. I will also provide the Subcommittee with an update on our identity theft initiatives during the current filing season.

The tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws. While no system can ever achieve 100 percent compliance, the IRS has been and remains committed to finding ways to increase compliance.

The IRS recently released an updated tax gap study covering the tax year 2006 which shows that the nation's compliance rate for that year of 83.1 percent is essentially unchanged from the last review covering tax year 2001. The report also showed that the net tax gap in dollars for 2006 was $385 billion. (More detailed information on the 2006 tax gap is included in an appendix at the end of this testimony.)

In terms of what makes up the tax gap, the underreporting of business income by individual taxpayers – income of sole proprietors, farmers and those earning rental, royalty, partnership and S Corporation income – is the largest contributor, accounting for $122 billion of the total in 2006. That is because this income, for which little or no reporting is required for income tax purposes, is the least adequately reported.

We at the IRS are often asked what actions we are taking to close the tax gap. I include in my testimony a number of initiatives, from providing taxpayer services to individuals and businesses grappling with a complex tax code, to running targeted compliance and enforcement programs to address a wide variety of compliance issues. But it is important to understand that while the tax gap is a helpful guide to the scale of tax

compliance in the economy, it greatly overstates the amount of deficit reduction that could be achieved through IRS enforcement alone. In other words, it is unrealistic to imagine that IRS enforcement revenues, which stood at $55.2 billion for FY 2011, could grow to a level that would close the net tax gap ($385 billion). Further, major attempts to close the gap must be considered within a context that considers taxpayer burden and taxpayer rights.

At the same time, targeted investments in IRS enforcement such as those included in the Administration's FY 2013 budget request have a high return on investment and serve to improve overall compliance. Steady increases in enforcement resources applied to well-founded examination and collection programs, coupled with increases in selected third-party reporting requirements, are proven cost-effective means of reducing the tax gap.

We also should not lose sight of the fact that failures to comply with tax law often involve unintentional mistakes that are the result of not fully understanding what has come to be an extremely complex tax code. For that reason, a truly comprehensive strategy to increase tax compliance must also include programs to educate taxpayers in their tax obligations and efforts at improving customer service, to make it easier for individuals and businesses to fulfill filing requirements.

In its efforts to address the tax gap and improve tax compliance, the IRS follows four guiding principles:

- Both unintentional taxpayer errors and intentional taxpayer evasion should be addressed;
- Sources of noncompliance should be targeted with specificity;
- Enforcement activities should be combined with a commitment to taxpayer service; and
- Policy positions and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.

Achieving greater voluntary compliance and shrinking the tax gap involves a comprehensive, integrated multi-year strategy. Along with increased enforcement activities, components of this strategy also include: reducing opportunities for tax evasion, expanding compliance research, improving information technology, enhancing taxpayer service, reforming and simplifying the tax law and coordinating with partners and stakeholders, such as states and foreign governments, to share compliance strategies.

The IRS has made considerable progress in these efforts and will continue taking reasonable steps toward this goal as I will detail later in my testimony.

MEASURING THE TAX GAP

The tax gap statistic is a helpful guide to the scale of tax compliance and to the persisting sources of low compliance but it is not an adequate guide to year-to-year changes. The statistic is also useful in providing the big picture of the relationship between tax liability on the books and tax receipts available to support Federal Government activity, but it should be viewed in the context of a broad range of compliance studies, some of which analyze specific initiatives designed to increase tax compliance.

The tax gap can be viewed in two different ways. There is the gross tax gap, which is simply the amount of true tax liability faced by taxpayers that is not paid on time. For 2006 it is estimated to be $450 billion. The net tax gap of $385 billion represents the amount of true tax liability that is not only not paid on time but is also not collected subsequently, either voluntarily or as the result of enforcement activities. Thus, the net tax gap represents the amount of tax liability that is never paid.

The gross and net tax gap estimates provide only a small portion of the information produced under the tax gap rubric at the IRS. Component tax gap estimates, distinguishing unpaid tax liability by mode of compliance, by tax source and by income source, provide a "map" of where noncompliance is concentrated. Further breakouts, some for specific tax return line items, add additional information.

Components of the Tax Gap

When looked at by mode of compliance, the tax gap can be divided into three components: Nonfiling, or not filing required returns on time; underreporting, or not reporting one's full tax liability when the return is filed on time; and underpayment, or not paying by the due date the full amount of tax reported on a timely filed return. Underreporting constitutes 84 percent of the tax gap for 2006, while underpayment constitutes 10 percent and nonfiling 6 percent.

The underpayment gap is calculated directly from IRS administrative records for the individual income tax, the corporate income tax, employment taxes, the estate tax and excise taxes. Taxpayers who have filed returns indicating taxes owed but who have not paid the full amounts on time are identified upon filing. The difference between taxes owed as reported on returns and the amounts paid on time is the underpayment gap.

The other two components of the tax gap – nonfiling and underreporting – present vastly greater estimation challenges because they measure activity that is either not revealed to the IRS at all (e.g. failure to file a return) or is reported in understated or otherwise mischaracterized fashion. Estimating those components of the tax gap entails two logical steps: estimating how many taxpayers engage in noncompliant activity and estimating the tax liabilities that they incur but do not report. Those two steps are combined in different ways to estimate the nonfiling and the underreporting gaps.

For example, the figure for the individual income tax nonfiling gap in 2006 was developed using IRS administrative data to identify taxpayers who appeared on a return filed late and taxpayers who did not appear on a return at all. The estimate associated with late returns began with the balance due reported on those returns, but also took into account additional income reported on third-party information documents. The tax on those updated returns was then estimated using a tax calculator. The estimate associated with people who did not file any return followed a similar procedure that also relied on income and withholding reported on third-party information documents.

The predominant method used to calculate the underreporting gap involves auditing a statistically selected sample of taxpayers. Research audits are time consuming, but they constitute the only viable method for estimating the underreporting gap for the individual income tax. This program, called the National Research Program (NRP), has been in place since 2000. The information gleaned from these audits helps examiners more effectively select the types of cases to audit, and offers other detailed insights about noncompliant behavior used throughout the IRS to better target service and enforcement work.

The NRP uses random audits for the underreporting gap and compiles data for the underpayment gap, which is tabulated from the Master File. The NRP office is also involved in nonfiling estimation efforts.

Importance of Information Reporting

One of the key findings from our research on the tax gap has been that tax compliance is far higher when reported amounts are subject to information reporting and, more so, when subject to withholding as well. For 2006, the net misreporting percentage (NMP) – taking the net amount that was misreported and expressing it as a ratio of the true amount – is 1 percent for amounts subject to substantial information reporting and withholding, and 8 percent for amounts subject to substantial information reporting without withholding. But the NMP jumps to 56 percent for amounts, such as business income, that are subject to little or no information reporting or withholding.

These statistics provide further confirmation that "visibility" of income sources and financial transactions is the main factor in high compliance rates, and information reporting is one of the few means of sizably increasing the compliance rate. Therefore, it is significant to note that the predominant source of the tax gap is business income reported on 1040s, which is a much lower "visibility" income source that is not subject to the same information reporting and withholding requirements that exist for salary and wage income.

IRS ACTIONS TO IMPROVE TAX COMPLIANCE

Since 2001, IRS tax collections have increased significantly, audit rates have improved across all taxpayer segments, and the IRS has expanded its service options. But much work remains to be done, which is why the Administration has called for an increase in funding for the IRS for FY 2013.

The IRS has been and remains committed to improving voluntary compliance, which is the cornerstone of our tax system. The importance of voluntary compliance cannot be overstated: An additional percentage point of voluntary compliance brings in about $25 billion in tax receipts. Therefore, loss of public confidence in the proficiency and fairness of the IRS would come at a high cost, and the effects of a reduction in compliance would take a long time to reverse.

At the same time, the IRS recognizes that increased enforcement alone is not the answer. Put another way, we cannot simply audit our way out of the tax gap. The burden on taxpayers and on IRS resources would be too great. That is why the IRS continues to combine efforts against tax evasion with other measures, such as enhanced research techniques, improvements in information technology, and partnering with stakeholders such as states and foreign governments that also have a vested interest in increased taxpayer compliance.

Following is a description of some of our major initiatives:

- **Return preparers**. The IRS initiated a comprehensive review of the tax return preparation industry in 2009. A multifaceted return preparer strategy was launched in 2010 to ensure top-notch, professional and ethical service to taxpayers. Prior to this initiative, only CPAs, attorneys and Enrolled Agents were subject to professional credentialing, which together represented an estimated 39 percent of paid preparers. As a result of this compliance strategy, which is being phased in over several years; all paid return preparers will be registered with the IRS and identified on the returns they prepare. In addition, all paid preparers who are not CPAs, attorneys or Enrolled Agents will have to pass a competency exam and complete annual continuing education requirements related to tax law and professional conduct. This compliance strategy will cut down on inaccurate and fraudulent returns, help the IRS catch unscrupulous return preparers and improve service to taxpayers so that they are better able to comply with filing requirements.

- **Business taxes**. A major initiative in this area involves business tax audits. In recent years, the IRS has improved its focus in business audits more toward issues with the highest compliance risk. Risk-based audit selection leads to a more efficient use of limited resources and a higher return on investment. The IRS continues to improve its exam selection procedures to focus on the most-pressing issues.

- **Employment taxes**. One of the major ongoing issues the IRS faces in the employment tax area involves companies that misclassify their workers as independent contractors instead of employees, and fail to withhold and remit employment tax on these workers. Last fall the IRS announced a new voluntary worker classification settlement program, which allows companies to voluntarily reclassify workers who have been misclassified. Participating companies get substantial relief from federal payroll taxes they may have owed if they prospectively treat workers as employees. Participants must make a minimal payment covering past payroll tax obligations, but they will not be charged interest or penalties.

- **Basis reporting**. As stated above, third-party reporting and transparency are crucial to a high voluntary compliance rate among individual taxpayers. Basis reporting associated with the buying and selling of securities was an area that was in need of third-party reporting based on previous studies that showed low levels of compliance. The IRS issued proposed regulations in 2009 and final regulations in 2010 under a new law that requires reporting of basis and other information by stockbrokers and mutual fund companies for most stock purchased in 2011 and all stock purchased in 2012 and later years. The reporting will be made to investors and to the IRS.

- **Credit card reporting.** Another major initiative in the area of third-party reporting and transparency involves new merchant card reporting requirements, which were established for the 2011 tax year. They provide third-party reporting data on business receipts for the first time, making it easier for the IRS to identify businesses that are either under-reporting receipts or not reporting at all. In general, these requirements apply to government entities and private businesses, as well as most types of payment cards, such as credit and debit cards. To help ease the transition to this new reporting system, the IRS provided penalty relief to filers for one year, through 2012.

- **Offshore tax avoidance**. Stopping offshore tax cheating and getting these taxpayers, especially high-net-worth individuals, back into the tax system has been a top priority of the IRS. A special offshore voluntary disclosure program was made available in 2009 and again in 2011, and these programs have encouraged more than 33,000 taxpayers to get right with the U.S. tax system while generating billions of dollars in back taxes, interest and penalties. In January, we reopened the special offshore voluntary disclosure program, which will allow us to bring still more taxpayers with offshore accounts into compliance. Offshore tax avoidance is also being addressed through actions against foreign banks that have helped U.S. taxpayers hide their assets. A landmark enforcement victory against a Swiss bank in 2009 has led to the erosion of Swiss bank secrecy, and work by the IRS and the Justice Department continues in this area. There are other international efforts, including the creation of the Global High Wealth unit in November 2009, which was formed to better cope with the growing complexity of income and assets of the high-wealth population.

- **Uncertain tax positions**. In 2011, certain large corporations were required to start making so-called uncertain tax position (UTP) disclosures on their 2010 tax returns. The IRS issued the final UTP Schedule and instructions in September 2010. Reporting of uncertain tax positions fosters compliance by speeding up the time it takes to find issues and complete exams. It also helps the IRS work through corporate returns more efficiently and see where further guidance is needed to reduce uncertainty. An uncertain tax position is generally defined as a stance on a tax return where the corporation sets aside a reserve to either pay the higher amount of tax later or litigate the matter in the future.

- **Real time tax system**. The IRS has started exploring how to implement a series of long-term changes to the tax system which would result in higher levels of tax compliance. Under this concept of a "real time" tax system, the IRS would move away from the traditional "look-back" model of compliance, and instead perform substantially more upfront information return matching with tax returns when they are first filed with the IRS. The goal of this initiative is to improve the tax filing process by reducing burden for taxpayers and improving overall compliance.

- **Refund fraud**. Over the past few years the IRS has seen a significant increase in refund fraud schemes in general and schemes involving identity theft in particular. Overall, the IRS identified and prevented the issuance of more than $14 billion in fraudulent refunds in 2011. Our work in the area of refund fraud is a major endeavor and involves a multifaceted strategy. Our efforts to combat refund fraud related to identity theft are a subset of this program, and further details of what we are doing in this area are outlined below.

- **Earned Income Tax Credit (EITC).** Reducing improper payments in the EITC program is a top priority for the IRS. We have taken a two-pronged approach to dealing with this problem. We perform outreach to help people understand the eligibility requirements before they file a claim. We also have a robust enforcement program that uses a variety of traditional and nontraditional methods. The EITC improper payment rate dropped from 26.3 percent in FY 2010 to 23.5 percent in FY 2011. This corresponds to a reduction in improper payments from $16.9 billion in FY 2010 to $15.2 billion in FY 2011.

- **Nonfilers and underreporters**. Over the last several years, the IRS has enhanced its technology capabilities, including software programs and document matching, to improve our ability to identify cases where taxpayers have failed to file a return or failed to report the correct amount of income. In FY 2011, the IRS closed 4.7 million document matching cases in our Automated Underreporter (AUR) program, up 47 percent from FY 2006. We also closed 1.4 million cases in our nonfiler program, known as Automated Substitute for Return (ASFR) in FY 2011, up 69 percent from FY 2006.

- **Assisting taxpayers**. Along with robust enforcement, a key component of the IRS efforts to shrink the tax gap involves easing burdens on taxpayers to make it easier for them to understand and to pay the taxes they owe. For example, under our Fresh Start initiative, in 2011 and again this year, we added new flexibilities to our collection program. Among other things, these flexibilities give more taxpayers the chance to set up installment agreements or apply for Offers in Compromise (OIC), which in turn allows the IRS to capture more in back taxes than we otherwise would have been able to collect.

- **Improvements in compliance research**. Keeping track of noncompliance in the presence of changing tax law and changing economic conditions, and conducting research on ways to increase compliance, are top priorities at the IRS. Research that is produced out of the NRP directly informs the models and algorithms that the IRS uses to target resources to the areas of highest compliance risk.

IDENTITY THEFT UPDATE: 2012 FILING SEASON

As I stated above, the IRS has seen a significant increase in refund fraud schemes in general and schemes involving identity theft in particular. The IRS has a comprehensive identity theft strategy that comprises a dual effort, focusing both on fraud prevention and victim assistance. Following up on my testimony to the Subcommittee in November on identity theft, I would like to provide the Subcommittee with an update on IRS actions taken recently to improve our efforts against identity theft for the 2012 filing season and beyond.

Preventing Fraud from Identity Theft

Since 2008, the IRS has marked the accounts of more than 460,000 taxpayers who appear to have had their identities stolen outside the tax system. These are taxpayers who have filing requirements and who are or may be impacted by the theft. With respect to these taxpayers, in calendar year 2011, the IRS protected $1.4 billion in refunds from being erroneously sent to identity thieves. This does not include identity theft of those without a filing requirement (though that value is also included in the figure cited above of $14 billion in fraudulent refunds prevented in 2011).

The IRS is committed to improving its approaches to blocking these fraudulent refund claims. To that end, we strive to process returns in such a way that potentially false returns are screened out at the earliest possible stage. For example:

- Various new identity theft screening filters have been put in place to improve our ability to spot false returns before they are processed and before a refund is issued. For example, new filters were designed and launched that flag returns if certain changes in taxpayer circumstances are detected. As of March 9, 2012, we have stopped 215,000 questionable returns with $1.15 billion in claimed refunds from filters specifically targeting refund fraud.

- Moreover, this filing season we have expanded our work on several fraud filters which catch not only identity but other fraud. In this area we have stopped roughly as much so far this filing season as we stopped last calendar year. Until we work these cases we will not have a solid answer as to how much of this work is fraud but not identity fraud, but we suspect a great deal may fall into the latter category.

- We have implemented new procedures for handling returns that we suspect were filed by identity thieves. Once a return has been flagged, we will correspond with the sender before continuing to process the returns.

- We have accelerated the availability of information returns in order to identify mismatches earlier, further enhancing our ability to spot fraudulent tax returns before they are processed.

- We are leveraging mechanisms to stop the growing trend of fraudulent tax returns being filed under deceased taxpayers' identities. We have coded accounts of decedent taxpayers whose Social Security numbers were previously misused by identity thieves to prevent future abuse. We are also identifying returns of recently deceased taxpayers to determine if it is the taxpayer's final return, and then marking accounts of deceased taxpayers who have no future filing requirement. So far this filing season, 66,000 returns have been stopped for this review.

- We expanded the use of our list of prisoners to better utilize the list to stop problematic returns. We have stopped 135,000 questionable returns this filing season. For the fiscal year, we have prevented almost $800 million in refunds. This represents an 80% increase in refunds stopped over the same period last year.

Criminal Investigation Work

The investigative work done by our Criminal Investigation (CI) division is another major component in our efforts to combat tax-related identity theft. Recent actions taken by CI in the identity theft area include the following:

- We established the Identity Theft Clearinghouse (ITC), a specialized unit that became operational in January, to work on identity theft leads. The ITC receives all refund-fraud-related identity theft leads from IRS-CI offices. The ITC's primary responsibility is to develop and refer identity theft schemes to the field offices, facilitate discussions between field offices with multi-jurisdictional issues, and provide support for ongoing criminal investigations involving identity theft.

- We have continued to increase investigations of tax fraud related to identity theft. Already in Fiscal Year 2012, CI has initiated 258 cases and recommended 150

cases for prosecution. Indictments in identity theft cases total 167, with 49 individuals sentenced and average time to be served at 45 months. The direct investigative time spent on identity theft in FY 2011 was 225,000 hours, and CI is on pace to double this in FY 2012.

- We conducted a coordinated identity theft enforcement sweep, which occurred during the week of January 23. It was an outstanding success. Working with the Justice Department's Tax Division and local U.S. Attorneys' offices, the nationwide effort targeted 105 people in 23 states. The coast-to-coast effort that took place included indictments, arrests and the execution of search warrants involving the potential theft of thousands of identities. In all, 939 criminal charges were included in the 69 indictments and informations related to identity theft. That same week, IRS auditors and investigators conducted extensive compliance visits to money service businesses in nine locations across the country. The approximately 150 visits occurred to help ensure that these check-cashing businesses aren't facilitating fraud and identity theft.

Assisting Taxpayers Victimized by Identity Theft

Along with prevention, the other key component of the IRS' efforts to combat identity theft involves providing assistance to taxpayers whose personal information has been stolen and used by a perpetrator in the tax filing process. We are implementing new procedures designed to resolve cases faster and minimize the disruption to innocent taxpayers. We increased staffing last year and this year, and have plans to dedicate additional resources following the current filing season. By the end of the fiscal year, staffing dedicated to identity theft will be almost 2,500 employees.

In 2011 we launched a pilot program for Identity Protection Personal Identification Numbers (IP PIN). The IP PIN is a unique identifier that establishes that a particular taxpayer is the rightful filer of the return. Under this pilot, we issued IP PINs to more than 50,000 taxpayers who were identity theft victims. We have expanded the program for the new filing season, and have issued IP PINs to approximately 250,000 taxpayers who have suffered identity theft in the past.

To ensure that we provide high quality, courteous service to taxpayers who have been victims of identity theft, last year we conducted a thorough review of the training we provide our employees. We wanted to make sure that they have the tools and the sensitivity they need to respond in an appropriate manner to taxpayers in these situations. Out of this review, we did two things:

- We updated the training course for our telephone assistors in order to ensure that our assistors maintain the proper level of sensitivity when dealing with identity theft victims and understand the serious financial problems that identity theft poses for these taxpayers. We conducted this training at the beginning of the 2012 filing season.

- We broadened the scope of our training to cover those IRS employees who are not telephone assistors but who nonetheless interact with taxpayers or work identity theft cases. We developed a new course for these employees, which includes not only sensitivity training but also ensures that employees who process identity theft cases have the proper tools and techniques to do so. This course was provided to all employees who might come into contact with an identity theft victim. In all, 35,000 IRS employees received this training.

CONCLUSION

Mr. Chairman, thank you again for the opportunity to appear before the Subcommittee to discuss the tax gap and to provide you with an update on IRS actions taken in the area of identity theft. The IRS remains committed to finding ways to increase compliance and thus reduce the tax gap, while minimizing burden on the vast majority of taxpayers who pay their taxes fully and on time. On the issue of identity theft, our work here for filing season 2012 is a solid start but not the end of our efforts. I cannot tell you that we will beat this problem in one year. I can tell you we have committed our talents and resources to prevent the issuance of fraudulent refunds and have developed processes to minimize the pain felt by those who have been victimized. We are committed to continuing to look for new and innovative ways to improve our processes and techniques. I would be happy to answer any questions you may have.

Mr. PLATTS. Thank you, Commissioner Miller.
Ms. Olson?

STATEMENT OF NINA OLSON

Ms. OLSON. Chairman Platts, Ranking Member Towns and members of the Subcommittee, thank you for inviting me to testify today about the subjects of the tax gap and tax-related identity theft. Both of these issues present challenges to tax administration.

Regarding the tax gap, the IRS recently released an updated net tax gap estimate of $385 billion in 2006. And the size of this estimate has understandably attracted considerable attention.

There are many causes of non-compliance, including difficulty understanding and complying with the law, inability to pay due to financial hardships, and deliberate understatements of tax. I believe the complexity of the tax code is responsible for a considerable portion of non-compliance, and I have repeatedly recommended in my reports to Congress that you all simplify the code.

While you are working on that, and I am ever the optimist in that regard, that there are other steps that can be taken. First, the IRS should be given the resources to substantially improve its taxpayer services. The percentage of calls the IRS answers, known as the level of service, has been declining in recent years. For the year to date, about one out of every three calls seeking to reach an IRS representative hasn't gotten through. When taxpayers have managed to get through, taxpayers have waited an average of about 14 minutes on hold.

The IRS is also behind in timely processing taxpayer correspondence, with the percentage of letters classified as over age at nearly half of all correspondence by the end of fiscal year 2011. There is no doubt in my mind but that some taxpayers give up in frustration or in anger when the find nobody is home and simply don't file or pay. This state of affairs may cause the tax gap to increase by converting formerly compliant taxpayers into non-compliant ones, simply because the IRS doesn't timely pick up the phone or look at its mail.

Second, while the IRS will never be the Government's most popular agency, I believe its funding levels should be substantially increased. Overall, the IRS is an extraordinary investment. On a budget of $12.1 billion, it collected $2.4 trillion in tax revenue last year, bringing in about $200 for every dollar invested. Yet the Congressional budget rules generally require that the IRS be funded like all other spending programs, with no direct credit given for the funds the IRS brings in. That makes little sense.

In my view, simplifying the tax code, improving taxpayer service and giving the IRS sufficient funds to expand its enforcement programs in the proper way would go a long way toward maximizing the tax compliance.

Regarding tax-related identity theft, the IRS has made significant progress in this area in recent years, including adopting many of my office's recommendations. Notwithstanding these efforts, it is clear that combating identity theft continues to pose significant challenges for the IRS.

Three points deserve particular emphasis. First, the IRS should continue to work with the Social Security Administration to restrict

public access to the Death Master File. Second, I am aware that some State and local law enforcement agencies would like access to taxpayer return information to help combat identity theft. I have significant concerns about loosening taxpayer privacy protections and believe this is an area where we need to tread carefully.

But as I describe in my written statement, the IRS is developing a procedure that would enable taxpayers to consent to the release of their returns in appropriate circumstances. In my view, giving taxpayers a choice strikes the appropriate balance.

Lastly, I note that even as the IRS is being urged to do much more to combat identity theft, taxpayers are clamoring for the IRS to process returns and issue refunds more quickly. While there is still room for the IRS to make improvements in both areas, the two goals are fundamentally at odds. If our overriding goal is to process tax returns and deliver tax refunds as quickly as possible for the vast majority of persons who file legitimate tax returns, it is inevitable that some identity thieves will get away with refund fraud and some honest taxpayers will be harmed.

On the other hand, if we decide to place a greater value on protecting taxpayers against identity theft and the Treasury against fraudulent refund claims, the IRS will need more time to review returns and the roughly 110 million taxpayers who receive refunds will have to wait longer to get them, perhaps considerably longer.

Alternatively, the IRS will require a considerably larger staff to enable it to review questionable returns more quickly. There is no way around these tradeoffs.

I appreciate the opportunity to testify today and would be happy to answer your questions.

[Prepared statement of Ms. Olson follows:]

Chairman Platts, Ranking Member Towns, and distinguished Members of the Subcommittee:

Thank you for inviting me to testify today about the subjects of the tax gap and tax-related identity theft.[1] Both of these issues present challenges to tax administration, and in this testimony, I will describe some approaches to mitigate them. However, as with most problems, minimizing both the tax gap and identity theft will require a balancing act. For example, even as we allocate resources toward "closing the tax gap" by going after those trying to evade their responsibilities, we must not inadvertently increase the tax gap by alienating taxpayers who are trying to comply. We may alienate them if we treat them like tax cheats, sidestep taxpayer rights, or fail to provide reasonable taxpayer services. Similarly, even as we implement procedures to protect federal revenue against identity theft and other schemes, we must take care not to harm taxpayers whose legitimate refunds are delayed by those procedures.

In addressing the tax gap, the following points should be kept in mind:

1. Enhanced information reporting can help minimize the tax gap, but must not impose undue reporting burdens.

2. Making it easier for taxpayers to make estimated tax payments could help minimize the tax gap.

3. Funding balanced enforcement initiatives that include a service component could help minimize the tax gap.

4. Funding the IRS at a level that allows it to promptly communicate with taxpayers could help minimize the tax gap. The IRS has increased automated enforcement, which can sidestep taxpayer rights and unduly burden taxpayers. This may reduce voluntary compliance, particularly if the IRS cannot answer calls or letters timely. Thus, the IRS may need to contact taxpayers by phone or at least answer their calls and letters promptly to prevent the tax gap from increasing.

In addressing identity theft, the following points should be kept in mind:

1. The IRS should continue working with the Social Security Administration to restrict access to the Death Master File.

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[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. Congress should take into account that new exceptions to taxpayer privacy protections pose risks and should be approached carefully, if at all.

3. The IRS's taxpayer protection unit needs significantly more staffing to increase its level of service.

4. At the same time that it is trying to curtail identity theft, the IRS is doing its best to process tax returns and provide prompt refunds to the nearly 145 million taxpayers who file legitimate returns, and measures likely to make a major dent in the identity theft problem are likely to burden these legitimate taxpayers.

I. The Tax Gap

According to the IRS's most recent estimate, the net tax gap – the difference between the taxes people owe and the amount they pay – stood at $385 billion in 2006,[2] when there were about 114 million U.S. households.[3] This means the average household paid a "noncompliance surtax" of nearly $3,400 to enable the federal government to raise the same revenue it would have collected if all taxpayers had reported their income and paid their taxes in full. For this reason, minimizing the tax gap is a matter of fairness to all taxpayers.

The largest portion of the gross tax gap is due to underreporting ($376 billion), with smaller amounts attributable to underpayment ($46 billion) and nonfiling ($28 billion).[4] Tax credits, which are often discussed as a major problem, are included in the underreporting gap, but they constitute a relatively small portion of the gross tax gap ($28 billion, or about six percent).[5] The largest portion of the underreporting gap is due to underreporting of business income by individuals ($122 billion).[6] The percentage of income that goes unreported (or the net misreporting percentage) is lowest (at one percent) for income subject to information reporting and withholding,

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[2] *See* IRS, IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged From Previous Study* (Jan. 6, 2012), http://www.irs.gov/newsroom/article/0,,id=252038,00.html. The IRS computes the net tax gap by subtracting the $65 billion that the IRS estimates it will eventually collect through enforcement and late payments from the $450 billion gross tax gap – the difference between the taxes people owed and the amount they voluntarily and timely paid. *Id.*

[3] U.S. Census Bureau, *America's Families and Living Arrangements: 2006, Table AVG1* (2007), http://www.census.gov/population/www/socdemo/hh-fam/cps2006.html.

[4] *See* IRS, IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged from Previous Study* (Jan. 6, 2012) (accompanying charts).

[5] *See id.*

[6] *See id.*

such as wages, and highest (at 56 percent) for income subject to little or no information reporting, such as cash receipts earned by sole proprietors.[7]

A. Enhanced Information Reporting Could Help Minimize the Tax Gap if It Does Not Create Excessive Burden.

The tax gap data (above) suggest that we could reduce the tax gap through increased information reporting (or even withholding) on taxable payments, particularly payments to small businesses. I have offered recommendations in this area, many of which have been adopted.[8] For example, pursuant to legislation enacted in 2008, brokers are required to report tax basis to customers and the IRS.[9] Similarly, credit card companies are required to report receipts to businesses and the IRS.[10]

However, the benefit of increased compliance and revenue must be balanced against the burden of information reporting and withholding. Overly burdensome requirements are not practical. One example: The Patient Protection and Affordable Care Act (PPACA), signed into law on March 23, 2010, included an overly burdensome expansion of information reporting that Congress chose to repeal before it even took effect.[11]

I had previously recommended that Congress require service recipients to issue Forms 1099-MISC to incorporated service providers, which are exempt from the requirement, applicable to unincorporated businesses. The PPACA reflected this recommendation, eliminating a reporting exemption for payments to corporate providers of property and services.[12] However, the PPACA also contained a

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[7] *See* IRS, IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged from Previous Study* (Jan. 6, 2012) (accompanying charts).

[8] For a list of proposals to expand information reporting and withholding, see National Taxpayer Advocate 2011 Annual Report to Congress 469-471, 485-486 (legislative proposals to reduce the tax gap). The Taxpayer Advocacy and Government Accountability Promotion Act of 2011 (also known as the "TAX GAP Act") includes several of the National Taxpayer Advocate's recommendations. S. 1289, 112th Cong. (2011).

[9] *See* Energy Improvement and Extension Act of 2008, Pub. L. No. 110-343, Div. B, § 403, 122 Stat. 3765, 3854 (2008). The National Taxpayer Advocate made a similar recommendation in 2005. National Taxpayer Advocate 2005 Annual Report to Congress 433-441 (Legislative Recommendation: *Requiring Brokers to Track and Report Cost Basis for Stocks and Mutual Funds*).

[10] *See* Housing Assistance Tax Act of 2008, Pub. L. No. 110-289, Div. C, § 3091, 122 Stat. 2654, 2908 (2008) (codified at IRC § 6050W). The National Taxpayer Advocate made a similar recommendation in 2007. National Taxpayer Advocate 2007 Annual Report to Congress 500-501 (Legislative Recommendation: *Require Information Reporting by Financial Institutions on Credit and Other "Payment Card" Receipts*).

[11] Pub. L. No. 111-148, Title IX, Subtitle A, § 9006 (2010) (codified at IRC § 6041), *repealed by* The Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011, Pub. L. No. 112-9, 125 Stat. 36 (2011).

[12] *Id.*

reporting requirement for goods sold, which I opposed because of the enormous burden it would place on businesses.[13] After I highlighted the burden such reporting would impose in the National Taxpayer Advocate's Fiscal Year (FY) 2011 Objectives report, Congress repealed it.[14]

Nonetheless, there are still some ways that Congress could expand information reporting without imposing excessive taxpayer burden. For example, Congress could close the loophole that allows incorporated businesses to avoid information reporting on income from services.

Congress could also expand information reporting applicable to bank accounts, which are currently only subject to information reporting if they pay more than $10 in interest per year.[15] Tracking cash flows through a taxpayer's financial institutions is a common method of identifying underreporting. While it is possible to avoid using a bank account when operating on a purely cash basis, this option is not practical for many businesses. Taxpayers may be less likely to underreport income if they know that the financial institution in which the income is deposited must provide information about their accounts to the IRS. Moreover, IRS auditors would be more likely to uncover underreporting if they could request account statements using specific names of financial institutions and account numbers.

Recommendations: ☐Eliminate the $10 threshold on interest reporting by financial institutions so that non-interest bearing accounts receive more transparency without significantly increasing the burden to taxpayers; and close the loophole that allows small businesses to avoid information reporting on payments for services by incorporating.[16]

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[13] *See* National Taxpayer Advocate 2010 Annual Report to Congress 373-376.

[14] *See* National Taxpayer Advocate FY 2011 Objectives Report 9-13 (describing the magnitude of the burden the requirement would impose and pointing out that it would affect 26 million non-farm sole proprietorships, four million S corporations, two million C corporations, three million partnerships, two million farming businesses, one million charities and other tax-exempt organizations, and probably more than 100,000 federal, state, and local government entities). The requirement was repealed by The Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011, at an estimated 10-year cost of about $22 billion. Pub. L. No. 112-9, 125 Stat. 36 (2011); Joint Committee on Taxation (JCT), JCX-12-11, *Estimated Revenue Effects of the Chairman's Amendment in the Nature of a Substitute to H.R. 4* (Feb. 15, 2011), http://www.jct.gov/publications.html?func=startdown&id=3736. The Act also repealed Section 2101 of the 2010 Small Business Jobs Act (P.L. 111-240), which would have required information reporting by landlords on Form 1099 of certain rental property expense payments of $600 or more in conjunction with their rental properties, at an estimated 10-year cost of nearly $3 billion. *Id.*

[15] IRC § 6049.

[16] For additional proposals, see National Taxpayer Advocate 2011 Annual Report to Congress 469-471, 485-486 (legislative proposals to reduce the tax gap). In addition, in response to repeated recommendations by the National Taxpayer Advocate, the IRS recently added two checkboxes to Form 1040, Schedule C – the form used by sole proprietors. They ask: "Did you make any payments in 2011 that would require you to file Form(s) 1099?" and "[I]f 'Yes,' did you or will you file all required Forms 1099?" This should help improve information reporting compliance. However, the IRS has not

B. Making It Easier for Taxpayers to Make Estimated Tax Payments Could Help Minimize the Tax Gap.

Taxpayers sometimes inadvertently fall behind on their estimated tax payments, which are due on four oddly-spaced dates: April 15, June 15, September 15, and January 15.[17] Taxpayers who owe a balance upon filing a return are more likely to understate their tax liability than other taxpayers.[18] Moreover, more than 20 percent of such taxpayers with a balance due fail to pay it in full.[19] Thus, if the IRS could reduce estimated tax payment shortfalls, it could increase both reporting and payment compliance. The Electronic Federal Tax Payment System (EFTPS) allows a taxpayer to have tax payments electronically debited from a bank account.

Current law requires the IRS to use an electronic system such as EFTPS to collect at least 94 percent of depository taxes (*i.e.*, withheld income taxes and employment taxes), but no similar goal exists for estimated tax payments.[20] A similar goal could motivate the IRS and the Financial Management Service to do more to actively promote EFTPS for estimated tax payments, provide incentives for using it (*e.g.,* penalty waivers), make the system easier to use, and allocate adequate funding for any necessary enhancements and advertising.

Similarly, expressly authorizing voluntary withholding agreements could make it easier for some contractors to pay estimated taxes. Even though withholding is not required on payments to independent contractors (payees), some contractors may wish to have customers (payors) withhold taxes for them, just as they do for employees. Such withholding would help contractors avoid the burdens of making timely quarterly estimated tax payments. Some payors, such as hair salon operators or travel agencies, may be willing to do this as a convenience to the contractors they pay, particularly if they already withhold and remit employment taxes for employees. It is unclear, however, whether statutory authority to enter into such agreements currently exists.[21]

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adopted the National Taxpayer Advocate's related recommendation to add a line to Schedule C so that taxpayers separately report (1) the amount of income reported on Forms 1099, *U.S. Information Return,* and (2) other income not reported on Forms 1099. Accordingly, Congress could require the IRS to do so.

[17] IRC § 6654(c)(2); IRS, Pub. 505, *Tax Withholding and Estimated Tax Payments*, 22 (Feb. 2007).

[18] Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 7 (Jan. 16, 2004).

[19] *Id.* at 1.

[20] *See* IRC § 6302(h)(2)(C). By "employment taxes" we mean Federal Insurance Contribution Act (FICA) taxes, and Federal Unemployment Tax Act (FUTA) taxes.

[21] IRC § 3402(p)(1) provides for voluntary withholding on certain federal payments (such as Social Security benefits). IRC § 3402(p)(2) provides for voluntary withholding on unemployment compensation payments. IRC § 3402(p)(3) provides for "other voluntary withholding" agreements and

Recommendations: Require the IRS to promote the use of EFTPS to make estimated tax payments and establish a goal of collecting more estimated taxes electronically; and expressly authorize voluntary withholding agreements, which would make it easier for some contractors to make sufficient estimated tax payments.[22]

C. Funding Balanced Enforcement Initiatives that Include a Service Component Could Help Minimize the Tax Gap.

As I have discussed in detail in testimony and reports, I believe we can increase voluntary compliance by simplifying the tax code, making tax compliance easier, and offering services to help the vast majority of taxpayers who want to pay what they owe, while reserving enforcement for the small minority who do not.[23]

The most recent tax gap data, which reflect tax year 2006 returns, confirm that the IRS collects most taxes by promoting voluntary compliance, not through direct enforcement efforts. The data show that taxpayers paid about 83.1 percent of their taxes voluntarily and timely ($2.210 trillion of the $2.660 trillion due), and the IRS eventually collected another two percent through late payments or enforcement ($65 billion out of $2.660 trillion).[24] In other words, taxpayers voluntarily and timely paid about 34 times as much as the IRS collects through enforcement and voluntary late payments.[25] Similarly, of the $2.4 trillion in tax revenue received by the IRS in FY 2011, direct enforcement revenue accounted for only $55.2 billion, or about

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authorizes the Secretary, by regulation, to provide for withholding from (1) payments from employer to employee that do not constitute wages, and (2) "any other type of payment with respect to which the Secretary finds that withholding would be appropriate under the provisions of [IRC chapter 24, Collection of Income Tax at Source]." No such regulations have been issued and the Secretary's authority to issue regulations that would permit such voluntary withholding agreements has been questioned. *See* National Taxpayer Advocate 2005 Annual Report to Congress 381, 393 (discussing IRS concerns about issuing regulations without additional statutory authorization).

[22] The legislation should also make clear that the agreement would not be taken into account in determining whether the service provider is an employee (rather than an independent contractor) for tax purposes.

[23] For a discussion of suggestions for reforming the current tax code to reduce burden and promote compliance, *see, e.g., Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due: Hearing Before the S. Comm. on Finance* (June 28, 2011) (statement of Nina E. Olson, National Taxpayer Advocate).

[24] IRS, IR-2012-4, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged from Previous Study* (Jan. 6, 2012) (accompanying charts).

[25] For example, if the IRS could collect one percent more through a collection strategy that would reduce voluntary compliance by one percent, overall revenues would decline by 34 times as much as collections increased. However, because the IRS does not measure the impact of its activities on voluntary compliance, IRS metrics would not alert anyone to a problem.

two percent.[26] The remaining 98 percent resulted from voluntary compliance. Accordingly, trying to reduce the tax gap by increasing the two percent of revenue that results from enforcement, while ignoring the 98 percent that results from voluntary compliance, would be a bit like letting the tail wag the dog.

Overall, the IRS is an extraordinary investment. On a FY 2011 budget of $12.1 billion, it collected $2.4 trillion in tax revenue, bringing in about $200 for every dollar invested.[27] As shown by the tax gap data above, it collects most of this revenue by promoting voluntary compliance through a balanced combination of service and enforcement, rather than through direct enforcement actions. Yet in recent years, the IRS budget has utilized a mechanism that makes it easier for Congress to fund the IRS Enforcement account than its Taxpayer Services account.

Under this mechanism, known as a "program integrity allocation adjustment," new funding appropriated for IRS enforcement programs generally does not count against otherwise applicable spending ceilings provided that

> (1) the IRS's existing enforcement base is fully funded, and
>
> (2) a determination is made that the proposed additional expenditures will generate a return-on-investment (ROI) of greater than 1:1 (*i.e.*, the additional expenditures will reduce the deficit on a net basis).

These conditions reflect the fact that the IRS is able to project the direct ROI of its enforcement activities – it can measure to the dollar the amounts collected by its Examination, Collection, and document-matching functions – but it faces a much harder task in measuring the ROI of taxpayer services.

It seems intuitively clear that the ROI of taxpayer service activities is greater than 1:1, and services – such as timely answering the phone and opening the mail – are an essential component of the IRS's increasingly automated enforcement procedures, which prompt taxpayers to contact the IRS, as described below. Basic services like publishing tax forms, providing guidance, and answering taxpayer questions are also essential for enabling taxpayers to file returns and enabling the IRS to collect revenue. Yet because the IRS cannot quantify either the overall ROI of taxpayer service spending or the ROI of specific taxpayer service initiatives, Taxpayer Services spending is not currently considered eligible for program integrity allocation adjustments.

As a consequence, allocations for the Enforcement account have *decreased by one percent* while spending for the Taxpayer Services account has *decreased by*

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[26] Government Accountability Office (GAO), GAO-12-165, *IRS's Fiscal Years 2011 and 2010 Financial Statements* 23 (Nov. 2011), http://cfo.fin.irs.gov/4all_docs/docs/gao_reports/financial_audits/gao12165.pdf.

[27] *Id.*

eight percent between FY 2006 and FY 2012 on an inflation-adjusted basis.[28] Further, if the Administration's proposed FY 2013 budget is adopted without change, spending for the Enforcement account will have *increased by six percent* while spending for the Taxpayer Services account will have *decreased by eight percent* since FY 2006 on an inflation adjusted basis.[29]

I am deeply concerned about the widening resource gap between the IRS's taxpayer service and enforcement programs. First, I think the distinction between service and enforcement can be highly artificial and arbitrary. To substantially increase funding to any program that gets classified as "enforcement" while reducing or holding flat spending for any program that gets classified as "taxpayer service" will not result in a balanced agency and may even encourage the IRS to engage in game-playing to classify priority programs as enforcement. The classification of a program as "enforcement" rather than "service" also has significant implications for the way the IRS treats taxpayers.

Second, it is widely acknowledged that taxpayer service contributes significantly to compliance. In some cases, service may contribute even more than enforcement to improved compliance. As noted, however, because the IRS is unable to compute an ROI for service activities, service activities by themselves do not qualify for allocation adjustments.

Third, Congress has given the IRS an increasing number of social and economic benefits programs to administer, and as I will discuss below, both of these types of benefits programs typically require more service.

Thus, if we are not careful and do not adopt a more balanced approach to IRS funding, we may end up increasing the tax gap by not providing necessary services and assistance to taxpayers. As a result of the failure to provide services, we may convert formerly compliant taxpayers into noncompliant ones. And because these taxpayers have lost faith in the tax agency, it will be very difficult to convert them back to compliant taxpayers.

The use of program integrity allocation adjustments has enabled the IRS to receive more funding than it would otherwise, and I think that is positive. But I strongly encourage the IRS and Congress to consider ways to modify the way allocation adjustments are used so that the IRS meets taxpayer needs and remains a balanced

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[28] Compare U.S. Department of the Treasury, 2008 *Budget in Brief, Internal Revenue Service, available at http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/FY_2008_BIB_IRS.pdf with* U.S. Department of the Treasury, *2013 Budget in Brief, Internal Revenue Service, available at http://www.irs.gov/pub/newsroom/budget-in-brief-fy2013.pdf.* Inflation adjustments were made using the Bureau of Labor Statistics inflation calculator, *available at* http://data.bls.gov/cgi-bin/cpicalc.pl.

[29] *Id.* Because we do not know the inflation rate for 2013, we converted the 2006 dollars to 2012 dollars using the inflation calculator, and then compared the result with the administration's unadjusted proposal for 2013.

agency. One possibility is to define new compliance initiatives more broadly, so that they include both enforcement and service components. Because the projected ROI of some types of enforcement initiatives is high, a more broadly constructed initiative could still produce a provable ROI of greater than 1:1 (*i.e.*, the service components would piggyback on the high-ROI enforcement activity). That could satisfy the requirements for an allocation adjustment while giving the agency more flexibility to meet taxpayer needs and improve compliance in obvious yet currently immeasurable ways.

Example of a Broader Compliance Initiative

Assume the IRS is planning a new enforcement initiative to improve compliance among small business taxpayers. The initiative will cost $50 million and is projected to produce an ROI of 6:1 (or $300 million in additional revenue). The IRS intends to request $50 million for this initiative as a program integrity allocation adjustment (*i.e.*, not counting against otherwise applicable spending ceilings). Assume further that the IRS has identified taxpayer service activities that would also improve small business compliance, such as new or additional types of outreach and education. The cost of the service initiative would be $25 million, but the IRS cannot quantify the ROI.

If the IRS defines new compliance initiatives more broadly to include service activities, it could package the enforcement measures with the outreach and education measures and request $75 million for the combined initiative as an allocation adjustment. The ROI would still be positive (the $75 million cost and projected revenue of $300 million would produce an ROI of 4:1). Most important, the IRS would be operating a more integrated, effective, and balanced compliance program.

If the IRS cannot obtain $25 million for services in this compliance initiative without exceeding the prescribed spending levels, it will be forced to take the funding from other service programs, thus undermining compliance for one group of taxpayers while trying to increase compliance among others.
If it chooses to not fund the $25 million for new taxpayer service initiatives at all, the IRS will be following an unbalanced, less effective enforcement strategy that may harm taxpayers and violate their rights.

Recommendation: ☐I recommend that the IRS and Congress consider ways to broaden the use of program integrity allocation adjustments so that compliance initiatives include taxpayer service components, which work in tandem with enforcement to increase voluntary compliance and reduce the tax gap more effectively, as described below.

D. Funding the IRS at a Level that Allows It to Promptly Communicate with Taxpayers Could Help Minimize the Tax Gap.

IRS funding is declining. The agency's budget was reduced slightly from FY 2010 to FY 2011,[30] and has been cut by an additional 2.5 percent for FY 2012.[31] While these cuts may not seem very deep, they come as the IRS faces increasing responsibilities.

In recent years, Congress has expanded the IRS's traditional role as tax collector to include that of benefits administrator, which requires the IRS to serve an increasingly diverse population.[32] Historically, the Earned Income Tax Credit (EITC) was the main significant refundable credit.[33] But Congress recently has enacted the First-Time Homebuyer Credit,[34] the Making Work Pay credit,[35] the American Opportunity tax credit,[36] and the health care premium tax credit.[37] It has also made the adoption tax credit fully refundable,[38] and the child tax credit partially refundable.[39]

For the 2011 filing season, 75 percent of all individual income tax returns claimed refunds, and the average refund was $2,913.[40] Because so many people file just to

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[30] Department of Defense and Full-Year Continuing Appropriations Act, 2011, Pub. L. No. 112-10, § 1119, 1125 Stat. 38, 107 (2011).

[31] Consolidated Appropriations Act, 2012, Pub. L. No. 112-74, Div. C, Title I, 125 Stat. 786, 884 (2011).

[32] See National Taxpayer Advocate 2011 Annual Report to Congress vol. 2 1-62 (*From Tax Collector To Fiscal Automaton: Demographic History of Federal Income Tax Administration, 1913-2011*); National Taxpayer Advocate 2011 Annual Report to Congress 273-323 (*Introduction to Diversity Issues: The IRS Should Do More to Accommodate Changing Taxpayer Demographics,* and related Most Serious Problems).

[33] IRC § 32. The EITC is effectively a wage supplement for low income workers.

[34] IRC § 36. The First-Time Homebuyer credit, as modified, most recently provided up to $8,000 to certain first-time homeowners ($6,500 for long-time residents) for qualifying 2010 purchases.

[35] IRC § 36A. The Making Work Pay credit expired on Dec. 31, 2010.

[36] IRC § 25A(i). The American Opportunity tax credit is partially refundable and may be used to offset the costs of college tuition, course materials, and certain fees. *See* IRC § 25A(i)(6).

[37] IRC § 36B. The health care premium tax credit is designed to help low income individuals purchase coverage under a qualified health plan beginning in 2014. Congress also recently added the Small Business Health Care Tax Credit, a credit for small business employee health insurance expenses, which may be partially refunded to certain tax-exempt entities. Pub. L. No. 111-148, § 1421, 124 Stat. 119, 237 (2010) (codified at IRC § 45R).

[38] IRC § 36C (applicable to tax years (TY) 2010 and 2011). The adoption credit, which offsets the costs of adoptions, is non-refundable for TY 2012 unless Congress extends its refundable status. *See* IRC § 23.

[39] IRC § 24(d). The refundable portion is known as the Additional Child Tax Credit, and eligibility is dependent on earnings.

[40] IRS, *2011 and Prior Year, Filing Season Statistics, Cumulative through the weeks ending 12/31/10 and 12/31/11* (Jan. 9, 2012), http://www.irs.gov/newsroom/article/0,,id=252176,00.html (indicating (109,337,000 out of 145,320,000 received refunds).

receive government benefits, the IRS has had to devote resources to performing its role of payment disburser and benefits administrator while serving new and more diverse segments of the population, preventing fraudulent refund claims, addressing tax-related identity theft, and juggling constant (and sometimes retroactive) tax law changes and increasing responsibilities in other areas.

For example, as noted above, Congress has enacted several new third-party information reporting requirements in recent years, which the IRS must implement. Most notably, credit card issuers generally must report the aggregate amount of reportable payments they process for businesses,[41] and brokerage firms generally must report the cost basis (as well as gross proceeds) of stock, bond, and mutual fund sales.[42]

1. The IRS Has Increased Automated Enforcement, Which Can Sidestep Taxpayer Rights and Unduly Burden Taxpayers, Particularly if the IRS Does Not Timely Answer Calls or Letters.

Faced with a deluge of new third-party data, new responsibility for distributing tax credits, the responsibility of paying only valid refund claims, and shrinking resources, the IRS has increasingly been turning to automation to achieve greater efficiencies. But these efficiencies often come at the expense of taxpayer rights or adequate service.

i. The IRS Increasingly Uses "Unreal" Audits.

With 140,837,499 individual income tax returns filed in the 2010 calendar year, the IRS conducted and closed a total of 1,564,690 audits in FY 2011, for a "coverage" rate of 1.11 percent, which is in line with historic rates.[43] However, the IRS is increasingly relying on unexplained data mismatches to adjust a person's liability and to deny or delay refunds using a variety of procedures. I have characterized these procedures as "unreal" audits because they do not provide the same taxpayer rights as "real" examinations. For example, while the IRS generally will not audit a return twice, it may examine a return that was already subject to an "unreal" audit.

To get a sense of how many taxpayers are affected by IRS adjustments, our research staff compiled a breakdown of FY 2010 "real" and "unreal" audits by income level. To do that, they used the IRS Compliance Data Warehouse, an internal IRS research database that houses taxpayer account information by tax year. The numbers in our breakdown do not exactly mesh with what the IRS reports in its Statistics of Income Data Book. In part, this is because we counted each taxpayer

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[41] IRC § 6050W.

[42] IRC § 6045(g).

[43] IRS, *Fiscal Year 2011 Enforcement and Service Results* (2011), http://www.irs.gov/pub/newsroom/fy_2011_enforcement_results_table.pdf

only once. So, for example, the IRS conducted 1.6 million individual audits in FY 2010, but the audits affected only 1.4 million taxpayers; some taxpayers may have been audited for more than one year. Similarly, if a taxpayer was touched by more than one program, we count him or her in just one of the programs, with the order of preference for counting purposes as Examination, Automated Substitute for Return, Automated Underreporter, and Math Error (I'll explain these terms below).[44]

The data show that in addition to conducting "real" audits of 1.4 million individual taxpayers in FY 2010, the IRS conducted "unreal" audits of 9.2 million individual taxpayers as follows:

- 3,911,005 Automated Underreporter (AUR) cases, in which the IRS matches income reported by the taxpayer on his or her return with income reported to the IRS by third-party payers;
- 4,740,909 math error notices, in which the IRS corrects mathematical or other inconsistent entries on a return and assesses tax before the taxpayer has a chance to contest the change; and
- 563,927 Automated Substitute for Returns (ASFRs), in which the IRS creates a substitute return for a nonfiler based on third-party payer information.

As the table below indicates, the combined impact of "real" and "unreal" audits in terms of coverage by income segment is very different from that of "real" audits alone.

[44] Two more notes on the data: First, for the discussion and table in the text below, we excluded 4.6 million math error notices that the IRS says related to the Making Work Pay credit. The IRS says these notices advised taxpayers who had failed to claim the credit that they were entitled to it. Although we have not verified this statement, we agree that if it is true, giving taxpayers a refund would not feel like an audit to the taxpayer and therefore should not be included in our totals. Second, our income breakdown in the chart below is based on each taxpayer's self-reported Adjusted Gross Income (AGI). Because the ASFR program generates returns for taxpayers who have not filed returns on their own, we do not have an AGI breakdown for ASFRs. Therefore, ASFR amounts are listed only in the "Total" row at the bottom and are not included in the column labeled "Combined" or in the percentages in the final column (except for the grand total).

Table 1: "Real" and "Unreal" Audit Coverage by Adjusted Gross Income

Adjusted Gross Income Category	Exams	Exam Coverage %	ASFR	AUR	Math Error	Combined	Returns Filed in Calendar Year 2009	Combined Coverage %
No adjusted gross income	158,194	5.2%		29,216	110,540	297,950	3,040,573	9.8%
$1 under $25,000	633,380	1.1%		1,124,251	1,904,185	3,661,816	57,093,609	6.4%
$25,000 under $50,000	232,781	0.7%		1,150,382	1,178,156	2,561,319	34,527,079	7.4%
$50,000 under $75,000	138,287	0.7%		572,762	665,300	1,376,349	19,324,212	7.1%
$75,000 under $100,000	69,385	0.6%		345,479	365,531	780,395	11,830,856	6.6%
Subtotal - under $100,000	1,232,027	1.0%		3,222,090	4,223,712	8,677,829	125,816,329	6.9%
$100,000 under $200,000	85,796	0.6%		498,665	435,114	1,019,575	13,891,529	7.3%
$200,000 under $500,000	59,480	1.7%		145,713	65,435	270,628	3,472,882	7.8%
$500,000 under $1,000,000	17,253	2.9%		28,273	9,964	55,490	590,822	9.4%
$1,000,000 under $5,000,000	16,046	5.6%		14,411	5,649	36,106	288,206	12.5%
$5,000,000 under $10,000,000	2,175	15.1%		1,137	556	3,868	14,410	26.8%
$10,000,000 or more	1,887	13.1%		716	479	3,082	14,410	21.4%
Total	1,414,664	1.0%	563,927	3,911,005	4,740,909	10,630,505	144,088,590	7.4%

Although the "real" audit coverage rate for individual taxpayers with incomes below $100,000 is about one percent, the combined coverage rate balloons to 6.9 percent, an increase of over 600 percent, when we include "unreal" audits in the mix. For individual taxpayers reporting incomes between $100,000 and $200,000, the FY 2010 "real" audit coverage rate is 0.6 percent, but when we include the "unreal" audit contacts, the coverage rate rises to 7.3 percent – an increase of about 1,100 percent. Including "unreal" audits also increases the coverage rate of the wealthiest taxpayers – those reporting incomes over $10 million – from 13.1 percent to 21.4 percent. (And these totals understate the total number of "unreal" audits because the percentages within income categories do not include ASFRs and because we have not addressed a few additional programs that adjust taxpayer liabilities, including some flagged by the Electronic Fraud Detection System.)

The bottom line: The overwhelming majority of IRS notices proposing to increase a taxpayer's liability are not deemed to be "audits" and therefore do not give taxpayers some of the protections provided in the context of audits.

ii. The IRS Increasingly Uses Automated Collection Tools.

After a delinquency is assessed – sometimes as a result of an unreal audit that did not include any communication with the taxpayer – IRS computers send collection notices and begin offsetting refunds. In FY 2011, 3.7 million cases remained unresolved after this initial stage and moved to the Automated Collection System (ACS),[45] where the IRS traditionally spends only about three percent of its direct time

[45] In FY 2011, the IRS collected nearly $9.5 billion on nearly 2.7 million taxpayer accounts through the notice stream, but the Automated Collection System (ACS) received 3,706,183 taxpayer cases. IRS, Collection Activity Report NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2011); IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011).

making outgoing calls.[46] According to recent data, 60 percent of the cases in ACS have been there six months or longer.[47] The collection industry estimates that the probability of collecting unpaid accounts falls to 70 percent after three months, 52 percent after six months, and 23 percent after a year.[48] Thus, the IRS is probably losing money every day that it fails to call these taxpayers, especially given that tax delinquencies continue to accrue penalties and interest, making them more difficult to resolve.

Rather than calling or visiting taxpayers, the IRS either moves these accounts to the "queue" where they age until a revenue officer can work them or it files a Notice of Federal Tax Lien (NFTL) or levies assets.[49] The dollar value of cases assigned to the queue has doubled in the last six years – to over $56.2 billion at the end of FY 2011.[50] In FY 2010, ACS received approximately 3.7 million taxpayer cases, and issued over 2.9 million levies – an average of nearly four levies for every five cases it received.[51] In FY 2011, the IRS filed over one million NFTLs[52] and issued 3.7 million levies.[53] The obvious result of placing an account in the queue is that it becomes less collectable. But liens, levies and even refund offsets may also be problematic, particularly before any meaningful communication with the taxpayer takes place.

Using automated enforcement tools to prompt taxpayers to communicate with the IRS may result in rework when taxpayers do not owe the liability. For example, ACS might issue a levy, seizing all available funds in a taxpayer's bank account before anyone talks to the taxpayer. When the taxpayer learns he no longer has access to the money, he may call ACS and explain why he does not owe the tax balance. ACS might research the issue, determine the taxpayer is correct, release the levy, and

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[46] Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2010-30-046, *More Management Information is Needed to Improve Oversight of Automated Collection System Outbound Calls* 6 (Apr. 28, 2010).

[47] At the conclusion of FY 2011, 2,454,770 ACS modules were in ACS less than six months, out of a total inventory of 6,080,835. IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011).

[48] BANXQUOTE Rx, Business Debt Restructuring Solutions, www.banx.com/rx/ (last visited Apr. 16, 2012) (citing collectability statistics based on a survey conducted by the Commercial Collection Agency Association among its members, who collectively handle about eighty percent of all commercial debt claims placed for collection in the United States).

[49] The IRS generally moves taxpayer cases to the queue after ACS makes some attempt to resolve the accounts (usually by lien or levy).

[50] IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2011). A Taxpayer Delinquent Account (TDA) represents a balance due account for a specific taxpayer, tax return, and period.

[51] National Taxpayer Advocate 2010 Annual Report to Congress vol. 2 53 n.48 (citing IRS, Collection Activity Report NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2010); IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 2010)).

[52] IRS, Collection Activity Report NO-5000-C23, *Collection Workload Indicators* (Oct. 2011).

[53] *Id.*

prepare paperwork to adjust the balance. If ACS had phoned the taxpayer first in this example, the levy and subsequent release might have been avoided, saving both the taxpayer and the IRS time and money.[54]

IRS rework also occurs in the Automated Substitute for Return program, where IRS computers prepare a return for the taxpayer based on third-party information reporting documents.[55] Because the IRS does not have access to information about all of the taxpayer's deductions or expenses, the taxpayer usually ends up owing more on the IRS-prepared return. Once the taxpayer files a return, the IRS must adjust the tax balance, penalty, and interest to correct the assessment.[56] Based on this approach, the IRS spends excess time processing accounts, when a simple phone call early in the delinquency could resolve the problem faster and more efficiently, at least in many cases.

Since 2004, the National Taxpayer Advocate has urged the IRS to adopt collection policies that emphasize early personal contact, both by telephone and face-to-face.[57] In fact, an IRS pilot program that incorporates personal taxpayer contacts has resolved 40 percent more cases within six months than cases handled under the IRS's standard procedures.[58] The IRS declined to adopt our recommendations

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[54] Even when the IRS releases a levy, the taxpayer may still incur bank fees (*e.g.*, for overdraft protection or insufficient funds in an account).

[55] IRC § 6020(b); IRM 5.1.11.6.3.1 (Jan. 15, 2010). *See also* National Taxpayer Advocate 2011 Annual Report to Congress 93-108 (Most Serious Problem: *Automated "Enforcement Assessments" Gone Wild: IRS Efforts to Address the Non-Filer Population Have Produced Questionable Business Results for the IRS, While Creating Serious Burden for Many Taxpayers).*

[56] *See* National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 40-70 (TAS Research Study: *An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*); *see also* National Taxpayer Advocate 2011 Annual Report to Congress 93-108 (Most Serious Problem: *Automated "Enforcement Assessments" Gone Wild: IRS Efforts to Address the Non-Filer Population Have Produced Questionable Business Results for the IRS, While Creating Serious Burden for Many Taxpayers).*

[57] *See* National Taxpayer Advocate 2011 Annual Report to Congress (Most Serious Problem: *The IRS Does Not Emphasize The Importance of Personal Taxpayer Contact as an Effective Tax Collection Tool*); National Taxpayer Advocate 2010 Annual Report to Congress vol. 2, 40-70 (TAS Research Study: *An Analysis of the IRS Collection Strategy: Suggestions to Increase Revenue, Improve Taxpayer Service, and Further the IRS Mission*); National Taxpayer Advocate 2006 Annual Report to Congress 62-82 (Most Serious Problem: *Early Intervention in IRS Collection Cases*), 83-109 (Most Serious Problem: *IRS Collection Payment Alternatives*), 110-129 (Most Serious Problem: *Levies*), 141-156 (Most Serious Problem: *Collection Issues of Low Income Taxpayers*); National Taxpayer Advocate 2009 Annual Report to Congress 17-40 (Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance and Unnecessarily Harm Taxpayers*); National Taxpayer Advocate 2008 Annual Report to Congress 114-125 (Most Serious Problem: *Navigating the IRS*); National Taxpayer Advocate 2004 Annual Report to Congress 226-245 (Most Serious Problem: *IRS Collection Strategy*).

[58] Response to TAS information request (Sept. 28, 2011). The IRS is currently testing a streamlined offer in compromise (OIC) program that requires "outbound" calls to taxpayers. Under the standard

between 2006 and 2011 as its enforcement budget expanded; these recommendations – although they could increase collections while reducing both IRS and taxpayer burden – may be even less likely to be adopted in an environment of declining resources.

Recommendation: The IRS should call or visit certain delinquent taxpayers (*e.g.*, those with higher-dollar notice accounts, repeated delinquencies, and potentially defaulted installment agreements or offers in compromise) before sending their accounts to the collection queue.[59]

iii. Automated Enforcement Tools Prompt Taxpayers to Try to Communicate with the IRS.

When a taxpayer is trying to resolve a tax problem proactively, he or she may try to contact the IRS. Similarly, when the IRS sends the taxpayer an assessment or collection notice, or issues notices of lien and levy, it often prompts the taxpayer or representative to call or write to resolve the problem. Increasingly, however, nobody at the IRS answers the phone or reads correspondence – at least not promptly.

iv. The IRS Does Not Always Answer the Phone.

Taxpayers, particularly low income taxpayers who are frequently subject to automated IRS procedures, often call the IRS for clarification before responding to a letter.[60] However, they often have difficulty reaching the IRS by phone. Although IRS telephone customer service representatives (CSR) achieved an 88 percent level of service (LOS) in FY 2004, the LOS declined to 70 percent in FY 2011, and due to funding constraints, *the IRS has reduced its LOS goal to 61 percent for FY 2012.*[61]

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program, 48.07 percent of cases are resolved within six months. Under the streamlined program, 68.46 percent are resolved within six months, even though that figure includes cases that were already aged before being brought into the program.

[59] National Taxpayer Advocate 2011 Annual Report to Congress 336.

[60] One survey of those who were subject to an Earned Income Tax Credit (EITC) audit found that:

> Even though slightly over half of the respondents indicated that they understood what was being questioned and knew what they needed to do, overall, more than 90 percent contacted the IRS. Seventy-two percent of the respondents said that they either called or visited the IRS in response to the letter. More than 75 percent of those taxpayers contacting the IRS about their audit letter did so by telephone. National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 103-104 (*IRS Earned Income Credit Audits — A Challenge to Taxpayers*).

[61] IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services – CAS* (week ending Sept. 30, 2011); Wage and Investment, Business Performance Review 4 (Feb. 2012), http://win.web.irs.gov/strategy/stratdocs/bpr_document.pdf ("CAS received a reduction in funding for Toll-free telephone and correspondence services resulting in a CSR LOS goal for FY 2012 of 61%, compared to 70% achieved in FY 2011. This decrease translates to longer customer wait times, increased customer abandons, and an increased number of customers redialing the IRS Toll-free lines for service."). As of April 14, 2012, the LOS for FY 2012 stood at 67.5 percent, as compared with 75.2

In other words, in FY 2011, nearly one in three calls did not get through, and *the IRS's goal for FY 2012 is that only* about *six in ten* calls get through. Even last week – the last week of the filing season when the IRS typically staffs its phones at the highest levels of the year – the LOS stood at 71.6 percent.[62] Further, when taxpayers do reach the IRS by phone, the person they reach often cannot resolve the issue.[63]

v. The IRS Does Not Always Timely Respond to Mail.

When a taxpayer writes to the IRS, the IRS does not always timely process the letter.[64] For example, one report suggested the IRS was late in responding to math error correspondence about 40 percent of the time.[65] Comparing the final week of FY 2004 with the final week of FY 2011, the backlog of taxpayer correspondence in the tax adjustments inventory jumped by 158 percent (from 357,151 to 920,768), and the percentage classified as "over-age" increased by 309 percent (from 11.5 percent to 47.0 percent of correspondence).[66]

The IRS's inability to timely respond to taxpayers could worsen very quickly. When the IRS does not respond to calls or it cannot resolve the matter by phone, some taxpayers send in correspondence. If the IRS does not respond to their first letters, some will call or write again, increasing IRS backlogs even further. Others may give

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percent at the same point in FY 2011. IRS, Joint Operations Center Executive Level Summary Report (Apr. 14, 2012).

[62] IRS, Joint Operations Center Executive Level Summary Report (Apr. 14, 2012) (IRS-wide figures). The LOS was 65.3 percent on the National Taxpayer Advocate toll free line and 71.7 percent on the 1040 line during the same period. *Id.*

[63] National Taxpayer Advocate 2007 Annual Report to Congress 259, 271 (Most Serious Problem: *Automated Underreporter*) (noting that when callers did get through to the AUR toll-free operation the IRS resolved just seven percent of the cases).

[64] *See, e.g.*, National Taxpayer Advocate 2010 Annual Report to Congress 235 (Most Serious Problem: *The IRS Does Not Process Vital Taxpayer Responses Timely*) (noting that over 75 percent of IRS correspondence received in two Compliance Service Collection Operations took more than 14 days to be processed and that for all Correspondence Imaging System cases closed in FY 2009, it took between 15 and 30 days to assign the correspondence).

[65] TIGTA, Ref. No. 2011-40-059, *Some Taxpayer Responses to Math Error Adjustments Were Not Worked Timely and Accurately* 4 (July 7, 2011) (Figure 3), http://www.treasury.gov/tigta/auditreports/2011reports/201140059fr.pdf.

[66] *Compare* IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Oct. 1, 2011) *with* IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 25, 2004). Correspondence generally is considered over-age when it is 45 days old or older and the issue it addresses has not been resolved. W&I FY 2012 Account Management Program Letter and Operating Guidelines (Dec. 12, 2011). In some instances, the definition of over-age varies based on factors such as the type of work, the program, the site, and inventory levels. TAS conversation with Joint Operations Center Paper Inventory Analyst (Dec. 13, 2011).

up trying to comply, potentially reducing voluntary compliance and increasing the tax gap today or in the future.

2. Taxpayer Service Levels May Decline Further if Additional Budget Reductions Are Enacted, Potentially Increasing the Tax Gap.

In a recent letter to the chairmen and ranking members of key committees of Congress, the Commissioner of Internal Revenue warned:

> [C]uts of the magnitude contemplated in the current appropriations bills (approximately $525 million from core IRS accounts in the Senate bill and $650 million in the House bill) would lead to noticeable degradation of both service and enforcement and would have a serious detrimental impact on voluntary compliance for years to come. . . .
>
> Responses to taxpayers' letters (including taxpayers who have received a notice and are trying to resolve account issues) would be delayed up to 5 months. Approximately half of the nation's taxpayers attempting to call the IRS would either be unable to get through or hang up in frustration.[67]

The Chairman of the IRS Oversight Board expressed similar concerns in a letter to the chairmen and ranking members of House and Senate Appropriations Committees. He also stated:

> The private sector experience of the Board members reinforces our belief that taxpayers who contact the IRS seeking assistance deserve service, and when taxpayers experience delays in obtaining service, the results are dysfunctional. For example, taxpayers may make costly mistakes, put themselves in jeopardy of enforcement action by the IRS, and in the long term, lose confidence in the tax system.[68]

The Internal Revenue Service Advisory Council (IRSAC), a federal advisory committee composed of members of the public, has also sounded alarm bells. In a section of its recently released 2011 annual report titled "The IRS Must Receive Consistent, Adequate and Appropriate Funding to Achieve the Proper Administrative Balance Between Service, Compliance and Tax Enforcement," the IRSAC wrote:

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[67] Letter from Douglas H. Shulman, Commissioner of Internal Revenue, to the Chairs and Ranking Members of the House and Senate Appropriations Subcommittees on Financial Services and General Government, the House Committee on Ways and Means and its Subcommittee on Oversight, and the Senate Committee on Finance (Oct. 17, 2011).

[68] Letter from Paul Cherecwich, Jr., Chairman of the IRS Oversight Board, to the Chairs and Ranking Members of the House and Senate Committees on Appropriations (Oct. 20, 2011). The board recently expressed similar concerns. *See* IRS Oversight Board, *FY2013 IRS Budget Recommendation Special Report* (Apr. 2012), http://www.treasury.gov/irsob/reports/2012/IRSOB%20FY13%20BUDGET%20REPORT.pdf.

> Limited resources are forcing the IRS to continually streamline its services. An example of this approach is the limited ability of taxpayers to interface with a local IRS representative when responding to a notice, when seeking resolution of an issue, or during the process of tax collection or the processing of offers in compromise. Instead, taxpayers and representatives often encounter numerous erroneous notices and lengthy holding periods on the telephone followed by a non-discretionary approach that sometimes fails to comprehend the unique issues involved. Every taxpayer is not alike and the need for face-to-face interaction should not be overlooked or ignored in favor of budgetary concerns. . . .
>
> Congress should appropriately fund the IRS to assure continued success in service, compliance, and enforcement. Without adequate funding, both taxpayers and the tax system will continue to suffer.[69]

The National Taxpayer Advocate shares the concerns expressed by the Commissioner, the Oversight Board, and the IRSAC. If these concerns are not addressed, the IRS's enforcement revenue may suffer. As I've noted earlier, the real danger is not a decline in the two percent of tax revenue the IRS collects directly though enforcement, but that any significant portion of the 98 percent stops being paid voluntarily and timely, as taxpayers become frustrated by automated procedures, conclude that the IRS does not really detect tax cheating unless there is a document mismatch, or simply lose faith in the system and give up trying to comply.

Obtaining a little extra money to bring in a lot of extra money remains an intractable challenge for the IRS, and that is unfortunate. Without additional resources, the IRS will be unable to provide timely and effective taxpayer service and will be unable to make much, if any, progress in reducing the tax gap.

Recommendation: ☐I recommend thatdue to the IRS's unique role as revenue collector, Congress develop new budget procedures designed to fund the IRS at a level that will enable it to meet taxpayer needs and maximize tax compliance, with due regard for protecting taxpayer rights and minimizing taxpayer burden.

II. Tax-Related Identity Theft

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. Since 2004, I have written extensively about the impact of identity theft on taxpayers and tax administration and have worked closely with the IRS to improve its efforts to assist

[69] Internal Revenue Service Advisory Council, 2011 General Report (Nov. 16, 2011), http://www.irs.gov/taxpros/article/0,,id=250783,00.html.

taxpayers who are identity theft victims.[70] The IRS has made significant progress in this area in recent years, including adopting many of my office's recommendations. Notwithstanding these efforts, it is clear that combating identity theft continues to pose significant challenges for the IRS.

In general, tax-related identity theft occurs when an individual intentionally uses the Social Security number (SSN) of another person to file a false tax return with the intention of obtaining an unauthorized refund.[71] Today, identity theft can be an organized, large-scale operation. Indeed, the most recent IRS data show more than 450,000 identity theft cases servicewide.[72]

My written testimony at a Senate Finance subcommittee hearing last month addresses this subject in considerable detail.[73] I will highlight four points that I think deserve particular emphasis.

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[70] *See* 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*); *Tax Fraud by Identity Theft Part 2: Status, Progress, and Potential Solutions: Hearing before the S. Comm. on Finance, Subcomm. on Fiscal Responsibility and Economic Growth*, 112th Cong. (Mar. 20, 2012) (statement of Nina E. Olson, National Taxpayer Advocate); *The Spread of Tax Fraud by Identity Theft: A Threat to Taxpayers, a Drain on the Public Treasury: Hearing Before the S. Comm. on Finance, Subcomm. on Fiscal Responsibility and Economic Growth*, 112th Cong. (May 25, 2011) (statement of Nina E. Olson, National Taxpayer Advocate); *Filing Season Update: Current IRS Issues: Hearing Before the S. Comm. on Finance*, 111th Cong. (Apr. 15, 2010) (statement of Nina E. Olson, National Taxpayer Advocate); *Identity Theft: Who's Got Your Number: Hearing Before the S. Comm. on Finance*, 110th Cong. (Apr. 10, 2008) (statement of Nina E. Olson, National Taxpayer Advocate).

[71] This type of tax-related identity theft is referred to as "refund-related" identity theft. In "employment-related" identity theft, an individual files a tax return using his or her own taxpayer identification number, but uses another individual's SSN in order to obtain employment, and consequently, the wages are reported to the IRS under the SSN. The IRS 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 for this testimony.

[72] Data provided by the IRS Office of Privacy, Government Liaison, and Disclosure (e-mail dated Apr. 17, 2012).

[73] *Tax Fraud by Identity Theft, Part 2: Status, Progress, and Potential Solutions: Hearing Before the S. Comm. on Finance, Subcomm. on Fiscal Responsibility and Economic Growth*, 112th Cong. (Mar. 20, 2012) (statement of Nina E. Olson, National Taxpayer Advocate).

A. The IRS Should Continue Working with the Social Security Administration (SSA) to Restrict Access to the Death Master File.

I am concerned that the federal government continues to facilitate tax-related identity theft by making public the Death Master File (DMF) – a list of recently deceased individuals that includes their full name, SSN, date of birth, date of death, and the county, state, and ZIP code of the last address on record.[74] There is some uncertainty about whether the SSA has the legal authority to restrict public access to DMF records in light of the Freedom of Information Act. For that reason, I strongly support legislation that would eliminate the uncertainty by making clear that public access to the DMF can and should be limited. However, I want to be clear that my legal staff believes the SSA has at least a reasonable basis for seeking to limit public access to the DMF, and if legislation is not enacted, I encourage the SSA to act on its own.

B. Creating New Exceptions to Taxpayer Privacy Protections Poses Risks and Should Be Approached Carefully, If At All.

I am aware that some state and local law enforcement agencies would like more information to enable them to help combat identity theft and are seeking access to taxpayer return information to do it. I have significant concerns about loosening taxpayer privacy protections and believe this is an area where we need to tread carefully. But I think we may have a solution. I am very pleased that the IRS Office of Chief Counsel recently advised that because a return filed by an identity thief may be considered return information of the victim, the victim may obtain a copy of the bad return as well as other information pertaining to the processing of the bad return. The victim then may authorize the IRS to share all of this information with state and local law enforcement agencies. I believe this approach strikes an appropriate balance – protecting taxpayer return information while simultaneously giving state and local law enforcement authorities more information to help them investigate and combat identity theft. However, this approach makes it all the more urgent for Congress to adopt my legislative recommendation that misuse and re-disclosure safeguards and penalties apply to recipients of tax return information shared via taxpayer consent.[75]

C. The Taxpayer Protection Unit Needs Significantly More Staffing to Increase Its Level of Service.

I am pleased that, this filing season, the IRS has established a dedicated Taxpayer Protection Unit (TPU) to answer phone calls from legitimate taxpayers who have been caught up in identity theft filters and to try to assist them. Initially, the TPU was woefully

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[74] *See* Office of the Inspector General, SSA, *Personally Identifiable Information Made Available to the General Public Via the Death Master File*, A-06-08-18042 (June 2008).

[75] *See* National Taxpayer Advocate 2011 Annual Report to Congress 505; National Taxpayer Advocate 2003 Annual Report to Congress 232.

understaffed to handle the volume of calls that came in. For the week ending March 10, the level of service on this unit's phone line was 11.7 percent, meaning that only about one out of every nine calls was answered.[76] And those callers that did get through had to wait on hold an average of an hour and six minutes![77]

In the following weeks, the IRS provided additional staffing for the TPU, and the level of service for this line has improved. For the week ending April 14, the TPU achieved a 35.3 percent level of service, with the average wait time remaining at one hour and six minutes.[78] This performance is unacceptable; the TPU clearly requires more support. I note, however, that in a zero-sum budget environment, providing more resources for this unit means another unit in the IRS will have less.

D. When Analyzing the Impact of Identity Theft, a Broad Perspective Is Necessary.

I want to squarely present a "big picture" issue that Congress and others will need to consider carefully if tax-related identity theft and other refund fraud continue at the current pace. At the same time that the IRS is being urged to do much more to combat identity theft, taxpayers are clamoring for the IRS to process returns and issue refunds faster. While there is still room for the IRS to make marginal improvements in both areas, the two goals are fundamentally at odds. Given the constantly evolving nature of identity theft schemes, IRS identity theft filters will never be perfect. Therefore, we have to set our priority.

If our overriding goal is to process tax returns and deliver refunds as quickly as possible for the vast majority of taxpayers who file legitimate returns, it is inevitable that some identity thieves will get away with refund fraud and some honest taxpayers will be harmed. On the other hand, if we decide to place a greater value on protecting taxpayers against identity theft and the Treasury against fraudulent refund claims, the IRS will need more time to review returns and the roughly 110 million taxpayers who receive refunds will have to wait longer to get them, perhaps considerably longer.[79] Alternatively, the IRS will require a considerably larger staff to enable it to review questionable returns more quickly. There is no way around these trade-offs.

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[76] IRS, Joint Operations Center Executive Level Summary Report (Mar. 13, 2012). Level of service (LOS) measures the relative success rate of taxpayers that call for toll-free services seeking assistance from customer service representatives (CSRs). LOS is calculated by dividing the number of calls answered by the total number of callers attempting to reach the CSR queue. *See* IRS Performance Measures 2009 Data Dictionary (Aug. 4, 2009).

[77] The average speed of answer was 3,962 seconds. IRS, Joint Operations Center Executive Level Summary Report (Mar. 10, 2012).

[78] The average speed of answer was 3,967 seconds for this period. IRS, Joint Operations Center Executive Level Summary Report (Apr. 14, 2012).

[79] In calendar year 2011, the IRS processed 145,320,000 individual tax returns, with 109,337,000 requests for refunds. IRS, *Filing Season Statistics – Dec. 31, 2011*, *at* http://www.irs.gov/newsroom/article/0,,id=252176,00.html (last visited Apr. 17, 2012).

Mr. PLATTS. Thank you, Ms. Olson.

Inspector General George?

STATEMENT OF J. RUSSELL GEORGE

Mr. GEORGE. Thank you, Chairman Platts, Ranking Member Towns, Mr. Connolly. Thank you for the opportunity to testify on the tax gap and the efforts by the Internal Revenue Service to enforce compliance with the tax code.

My comments will also address the growing risk of identity theft and tax fraud. In January 2012, the IRS released updated estimates of the tax gap for tax year 2006, which indicated that the Nation's 83 percent voluntary compliance rate was essentially unchanged from prior estimates. The IRS estimated that the gross tax gap increased from $345 billion to $450 billion, as was indicated by Mr. Miller.

My written statement includes a table that shows the comparison between the prior and current tax gap estimates.

As also stated earlier, the IRS reports that the gross tax gap is comprised of three primary components, again, $376 billion in under-reporting of tax liabilities, $28 billion due to non-filing of tax returns, and $46 billion in under-payment of tax liabilities. The IRS reported that the growth in the tax gap from tax year 2001 to 2006 was concentrated in the under-reporting and under-payment forms of non-compliance, which jointly account for more than nine out of ten tax gap dollars.

The IRS also reported that the tax gap is caused by both unintentional taxpayer errors, whether due to tax law complexity, confusion or carelessness, and willful tax evasion, or cheating.

The IRS needs to overcome institutional impediments to more effectively address the tax gap. These impediments refer to the established policies, practices, technologies or business requirements that add unintended costs or are no longer optimal, given today's society. We at TIGTA believe the current institutional impediments the IRS faces can point the way to improved opportunities, namely, address incomplete compliance research, re-assess insufficient compliance strategies, determine how best to fix incomplete document matching programs, and find a way to handle the insufficient enforcement resources.

Every year, more than one half of all taxpayers pay someone else to prepare their Federal tax returns. Third party reporting and transparency is crucial to high compliance among individual taxpayers. Business reporting associated with the buying and selling of securities was an area that needed third party reporting based on previous studies that showed low levels of compliance. The new merchant card reporting requirements were established in 2011. They provide third party reporting data on business receipts for the first time, making it much easier for the IRS to identify businesses that are either under-reporting receipts or not reporting at all.

Globalization of the U.S. economy has been a major trend for many years. The scope and complexity of the international financial system creates significant enforcement challenges for the IRS. The IRS continues to be challenged by a lack of information reporting on many cross-border transactions. The mis-classification of millions of employees as independent contractors is a nationwide

problem that continues to grow and contribute to the $72 billion under-reporting employment tax gap.

TIGTA identified more than 74,000 taxpayers who may have avoided paying approximately $26 million in Social Security and Medicare taxes in 2008.

TIGTA has continued to assess the IRS's efforts to identify and prevent identity theft. Unscrupulous individuals are stealing identities at an alarming rate for use of submitting tax returns with false income and withholding documents. For processing year 2011, the IRS reported that it had detected 940,000 tax returns involving identity theft and prevented the issuance of fraudulent tax refunds totaling $6.5 billion. The amount of fraudulent tax refunds the IRS detects and prevents is substantial. The IRS does not know how many identity thieves are filing fictitious tax returns and how much revenue is being lost, resulting from the issuance of fraudulent tax refunds.

We have fond that the issuance of fraudulent tax refund based on false income documents goes beyond the amount detected and prevented by the IRS. An upcoming report will provide further data.

Access to third party income and withholding information at the time tax returns are processed is the single most important tool the IRS could have to identify and prevent tax fraud. Chairman Platts, Ranking Member Towns, thank you for the opportunity to share my views.

[Prepared statement of Mr. George follows:]

TESTIMONY OF
THE HONORABLE J. RUSSELL GEORGE
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION
before the
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
SUBCOMMITTEE ON
GOVERNMENT ORGANIZATION, EFFICIENCY, AND FINANCIAL MANAGEMENT
U.S. HOUSE OF REPRESENTATIVES

"Problems at the Internal Revenue Service: Closing the Tax Gap
and Preventing Identity Theft"

April 19, 2012

Chairman Platts, Ranking Member Towns, and Members of the Subcommittee, I thank you for the opportunity to testify on the Tax Gap and the efforts by the Internal Revenue Service (IRS) to enforce compliance with the tax code. My comments will focus on how the Treasury Inspector General for Tax Administration (TIGTA) provides oversight of the IRS's efforts to ensure that taxpayers comply with their tax obligations, as well as what the IRS is doing to address the growing risk of identity theft and tax fraud.

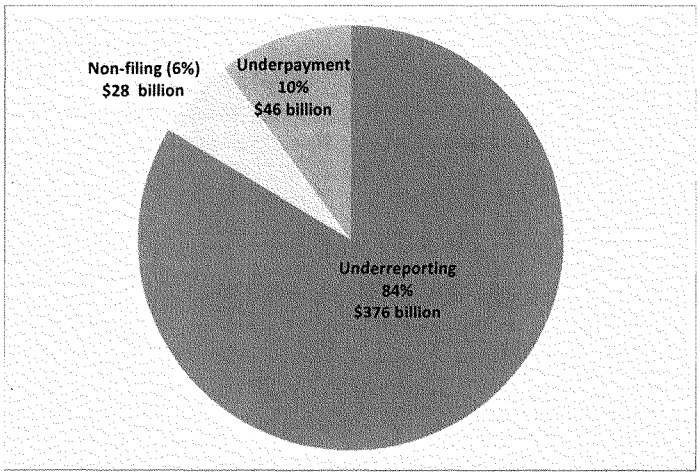
The IRS defines the Tax Gap as the difference between the estimated amount taxpayers owe[1] and the amount they voluntarily and timely pay for a tax year. In January 2012, the IRS released updated estimates of the Tax Gap for Tax Year (TY)[2] 2006, which indicated that the Nation's voluntary compliance rate was essentially unchanged from the prior estimates. The IRS states that the increase in the dollar amount is due almost entirely to the increase in total tax liabilities over the intervening period and does not reflect any significant change in compliance rates. The following table shows the comparison between the prior and the current Tax Gap estimates.

[1] This includes all types of tax liabilities, including: Individual Income Tax, Corporation Income Tax, Employment Tax, Estate Tax, and Excise Tax.
[2] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

	Tax Year 2001 (billions)	Tax Year 2006 (billions)
Total Tax Liabilities	$2,112	$2,660
Gross Tax Gap	$345 (83.7% compliance)	$450 (83.1% compliance)
Enforcement and Late Payments	$55	$65
Net Tax Gap	$290	$385

The Gross Tax Gap is defined as the amount of true tax liability that taxpayers do not pay on time. The Net Tax Gap is defined as the amount of true tax liability that is not paid on time and is not collected subsequently, either voluntarily or as the result of enforcement activities.

The IRS reports that the Gross Tax Gap is comprised of three primary components:



- Underreporting of tax liabilities. Of the $450 billion gross Tax Gap in TY 2006, $376 billion (approximately 84 percent) is estimated to result from the underreporting of tax liabilities. Specifically, the underreporting Tax Gap (henceforth the "underreporting gap") is defined as the amount of tax liability

not voluntarily reported by taxpayers who file required returns on time. For income taxes, the underreporting gap arises from three types of errors: underreporting taxable income, overstating offsets to income or to tax, and net math errors. Taxable income includes such items as wages and salaries, rents and royalties, and net business income. Offsets to income include income exclusions, exemptions, statutory adjustments, and deductions. Offsets to tax are tax credits. Net math errors involve mathematical mistakes or transcription errors made by taxpayers that are corrected at the time the return is processed. In addition to developing an estimate of the aggregate underreporting gap, it is possible to break aspects of this estimate down into measures of the underreporting gap attributable to specific line items on the tax return.

- Non-filing of tax returns. Of the $450 billion gross Tax Gap in TY 2006, $28 billion (approximately 6 percent) is estimated to be associated with tax returns that were filed after the filing deadline (or valid extension date) or were not filed at all. It is reduced by amounts paid on time, such as through withholding, estimated payments, and other credits. However, it does not include legitimate nonfilers (i.e., those who have no obligation to file).

- Underpayment of tax liabilities. For TY 2006, $46 billion of taxes reported on time were not paid when due. Stated another way, the underpayment gap is the portion of the total tax liability that taxpayers report on their timely filed returns but do not pay on time. This arises primarily from insufficient remittances from taxpayers themselves. However, it also includes employer under-deposits of withheld income tax. In the case of withheld income tax, employees have the responsibility to report the corresponding tax liability on timely filed returns, and employers are responsible for depositing those withholdings with the Government on time.

The IRS reported that the growth in the Tax Gap from TY 2001 to 2006 was concentrated in the underreporting and underpayment forms of noncompliance, which jointly account for more than nine out of ten Tax Gap dollars. The underreporting gap grew by 32 percent and the underpayment gap grew by 38 percent. In contrast, the nonfiling gap grew by only 4 percent.

The IRS further reported that more than a third of the growth in the underreporting gap was attributable to corporate income taxes. Several factors contributed to this increase: First, the 2001 estimate was calculated based on old data and was likely understated. Second, the new estimate relied on more recent and

improved data. And finally, between TY 2001 and 2006, corporate income tax liabilities more than doubled, while the individual income taxes grew by only 15 percent.

Compliance is far higher when reported amounts on tax returns are subject to information reporting and withholding. For example, when there is substantial information reporting and withholding[3] the compliance rate is 99 percent. For amounts subject to substantial information reporting but not withholding,[4] the rate is 92 percent. For amounts subject to little or no information reporting, such as business income, the rate is only 44 percent.

The IRS reported that for TY 2006, the amount of enforced and other late payments it will eventually collect is estimated to be $65 billion. Both types of payments were estimated using IRS data of prior revenue and late payments received. However, the IRS does not have good data on the amounts that are paid late without enforcement efforts, and amounts to be collected in future years were estimated using data on payment patterns from earlier years.

The IRS uses a variety of techniques to identify unpaid tax liabilities, including (1) identifying taxpayers who file tax returns without fully paying the tax reported to be owed, (2) checking for obvious errors when processing returns, (3) finding additional tax liabilities by auditing a filed tax return, (4) assessing a penalty for some taxpayer action or inaction, and (5) sending a bill to a taxpayer who did not file a required tax return.

If the taxpayer does not cooperate, the IRS may take enforced collection action. Enforcement action could include serving a notice of levy that is attached to the taxpayer's income or assets such as bank accounts. In some cases, the IRS will take enforcement action by seizing and selling property. The IRS takes these actions only after giving the taxpayer an opportunity to voluntarily pay the debt, make arrangements to pay, or supply information to show that payment would create a hardship.

In the IRS's 2007 report on *Reducing the Federal Tax Gap*, the IRS states that voluntary compliance rates appear to have remained relatively stable at around 85 percent for decades. The report further states that to make a meaningful improvement in this rate will require a long-term, focused effort involving taxpayer service, modernization, and enforcement. The Department of the Treasury's 2006 report, *A Comprehensive Strategy for Reducing the Tax Gap,* describes the extensive challenges to reducing the Tax Gap. According to the report, addressing the Tax Gap involves improving voluntary compliance, reducing opportunities for evasion through legislative

[3] Wages and salaries.
[4] Pensions and annuities, unemployment compensation, dividend and interest income, Social Security benefits.

proposals, and making it easier for the IRS to administer the tax laws, accompanied by broader simplification and reform of the tax code and significant advances in compliance technology.

The IRS also reported that the Tax Gap is caused by both unintentional taxpayer errors (whether due to tax law complexity, confusion, ignorance, or carelessness) and willful tax evasion or cheating, although the IRS does not have sufficient data to distinguish the amounts attributable to each. In addition, a wide range of factors influence voluntary compliance, including tax law changes, the economy, and changing demographics of the taxpayer population. There are also indirect effects of IRS enforcement activities beyond the direct effects of additional revenue collections. These refer to "spillover" effects when enforcement activity on one set of taxpayers has positive effects on the compliance behavior of the rest of the taxpayer population in response to heightened enforcement activity. However, the IRS also stated that it is very difficult to determine the impact that any IRS activity has on voluntary compliance.

From the perspective of tax administration, the IRS also needs to overcome institutional impediments to more effectively address the Tax Gap. These impediments refer to the established policies, practices, technologies, business processes or requirements that add unintended costs or are no longer optimal given changes to strategies, goals, and technologies. TIGTA's perspective is that the current institutional impediments the IRS faces can point the way to improvement opportunities, to wit:

- **Incomplete compliance research** that does not identify all the sources of noncompliance so that IRS resources can be targeted properly. The IRS reported that new research is needed on the relationship between taxpayer burden and compliance and on the impact of customer service on voluntary compliance. Additional research would also assist in establishing benchmarks and measures to assess the effectiveness of IRS efforts to address taxpayer compliance.

- **Insufficient compliance strategies** that do not always address the areas of highest risk of noncompliance. The IRS's systems that identify returns for examination need improvement. IRS examinations continue to result in no change to the return, resulting in an inefficient use of examination resources and increased burden on compliant taxpayers. In addition, IRS collection activity that extends for years has a lower rate of collection for delinquent liabilities. The IRS reported it is working to reengineer examination and collection procedures based on improved data from its National Research Project study of individual taxpayers. This effort, coupled with investments in

technology, should result in efficiency gains and better targeting of examination efforts. These efficiency gains translate into expanded examination coverage, higher audit yields, and reduced burden on compliant taxpayers.

- **Incomplete document matching programs** because the IRS does not have reliable third-party data for all taxpayer sectors and for all types of tax returns, most notably income earned by the self-employed. The IRS reported that, without this data, it cannot easily detect errors or potential fraud except through expensive and intrusive examinations.

- **Insufficient enforcement resources** to handle a growing caseload. The IRS has identified noncompliance and potential fraud cases it did not have the resources to work, allowing billions of dollars to be fraudulently refunded each year.[5] In addition, in Fiscal Year[6] (FY) 2010, the Collection function was unable to work all of the existing accounts in the Queue[7] with current staffing, and the number of new taxpayer delinquent accounts was outpacing closures. If changes do not occur, a significant number of cases will continue to not receive additional contact to resolve the tax delinquency.[8]

The IRS often faces constant changes as a result of temporary tax provisions and new tax law. For example, during FY 2010, the IRS encountered many challenges, including a variety of tax provisions that were created, extended, or expanded. Specifically, the provisions were the:

- **American Recovery and Reinvestment Act of 2009 (Recovery Act).**[9] The Recovery Act included 56 tax provisions (20 related to individual taxpayers and 36 related to business taxpayers). These provisions will continue to challenge the IRS over multiple filing seasons.

- **Worker, Homeownership, and Business Assistance Act of 2009.**[10] The Worker, Homeownership, and Business Assistance Act of 2009 revised, extended, and expanded the First-Time Homebuyer Credit (Homebuyer

[5] 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* (February 2011).
[6] A 12-consecutive-month period ending on the last day of any month, except December. The Federal Government's fiscal year begins on October 1 and ends on September 30.
[7] An automated holding file for unassigned inventory of delinquent cases for which the Collection function does not have enough resources to immediately assign the cases for contact.
[8] TIGTA, Ref. No. 2011-30-071, *Trends in Compliance Activities Through Fiscal Year 2010* (July 2011).
[9] Pub. L. No. 111-5, 123 Stat. 115.
[10] Pub. L. No. 111-92, 123 Stat. 2984.

Credit) to a broader range of home purchases and added new documentation requirements. Initially, the IRS did not have math error authority[11] to disallow the Homebuyer Credit during processing if documentation was not provided. Congress has since passed legislation requiring documentation for the Homebuyer Credit and provided the IRS with math error authority to disallow the Credit if the documentation was not provided.

- **Hiring Incentives to Restore Employment Act of 2010 (HIRE Act).**[12] The HIRE Act enacted tax benefits to employers who expanded payrolls and hired previously unemployed individuals. Eligible business taxpayers will be exempt from their share of Social Security taxes on wages to eligible employees. These taxpayers may also be eligible for a credit of up to $1,000 for qualified employees. Additionally, Title V of the HIRE Act included the Foreign Account Tax Compliance Act. A provision of this Act included the requirement that individual taxpayers indicate on their income tax returns the maximum value of foreign financial assets held during the tax year. This provision will allow the IRS to increase enforcement on taxpayers hiding assets overseas.

- **Patient Protection and Affordable Care Act of 2010 (Affordable Care Act).**[13] At least 42 of the 514 Affordable Care Act provisions add to or amend the Internal Revenue Code, and at least eight require the IRS to establish new operations. Collectively, these provisions represent the largest set of tax law changes in 20 years. The Affordable Care Act contains $438 billion of revenue provisions in the form of new taxes and fees. It also contains credits which provide incentives for medical research and for businesses to offer employees health care insurance. Additionally, new reporting requirements have been established for certain business transactions. The Affordable Care Act further imposes penalties administered through the tax code for individuals and businesses that do not obtain health coverage for themselves or their employees. Other provisions raise revenue to help pay for the overall cost of health insurance reform.

These tax provisions are examples of the impact that tax law changes have on how the IRS conducts its activities, how many resources are required, and how quickly or whether the IRS can meet strategic goals. The IRS has the challenging task of

[11] This is a program in which the IRS contacts taxpayers through the mail or by telephone when it identifies mathematical errors or mismatches of taxpayer information that would result in a tax change.
[12] Pub. L. No. 111-147, 124 Stat. 71.
[13] Pub. L. No. 111-148, 124 Stat. 119.

maintaining a quality workforce and enforcing tax laws in an environment of constantly changing tax legislation.

The IRS also faces significant challenges in obtaining complete and timely compliance data and in developing methods necessary to interpret the data. Despite a 19 percent increase in enforcement staffing levels since FY 2006 and the IRS's more vigorous use of collection enforcement tools, FY 2010 enforcement results were mixed when compared to FY 2009 results. The number of delinquent accounts closed by full payment and the amount collected on delinquent accounts increased. However, the Collection function received more delinquent accounts than it closed, gross accounts receivable rose, and the number of tax delinquency investigation cases[14] closed with the receipt of a delinquent tax return fell.[15] In addition, there were increases in the number of delinquent accounts that may never be worked because they were shelved or surveyed and in accounts receivable. For examinations, the large staffing level increases in FY 2009 and FY 2010 resulted in the most tax returns examined in the past five years. The dollar yield per hour for examinations increased in FY 2009 but decreased in FY 2010. In addition, the no-change rates[16] for several types of examinations increased in FY 2010 compared to FY 2009. The IRS continues to conduct studies with the goal of improving the return selection process to increase rates of return across the enforcement program.

One means the IRS employs to collect unpaid taxes is the notice stream.[17] The notice stream is the least costly of the IRS's approaches to collecting unpaid taxes. While the notice stream collects billions of dollars in delinquent taxes annually, reducing the time between notices could result in the annual collection of millions of dollars more. During FY 2010, the IRS sent approximately 21.9 million balance-due notices to individuals to attempt to collect unpaid taxes. By a wide margin, the first notice (also known as the Master File notice) closed the most cases, collected the most money, and generated the highest number of taxpayer responses. Cases not resolved after the Master File notice continue in the notice stream, and those taxpayers receive various sequences of notices. The IRS allows 35 days between notices for the taxpayer to respond, but TIGTA's analysis shows that the time between notices can be reduced. As these balance due modules progress within the notice stream, the probability of collection diminishes.

TIGTA recommended that the IRS consider reducing the time between each notice by seven days. This could result in the potential collection of as much as $363

[14] An unfiled tax return for a taxpayer. One tax delinquency investigation case exists for all tax periods.
[15] TIGTA, Ref. No. 2011-30-071, *Trends in Compliance Activities Through Fiscal Year 2010* (July 2011).
[16] Percentage of examinations where the examiner closed the case with no recommended tax change.
[17] A series of balance-due notices sent by the IRS to the taxpayer to prompt payment.

million more each year. In addition, taxpayers could potentially save $1.8 million each year in interest payments. The IRS agreed with TIGTA's recommendations and plans to take corrective actions. However, in its response, the IRS stated that 35 days between notices were necessary to process taxpayer inquiries and correspondence. TIGTA's report noted that the IRS has controls in place to prevent the next notice from being sent when taxpayers' correspondence is being processed.[18]

The IRS reported the following initiatives that it has begun to implement to address the Tax Gap:

Tax Return Preparers

Every year, more than one-half of all taxpayers pay someone else to prepare their Federal income tax returns. During the 2011 Filing Season,[19] the IRS processed approximately 66.9 million individual Federal income tax returns prepared by paid tax return preparers.

In December 2009, the IRS announced a suite of proposed reforms to improve oversight of the return preparer community. TIGTA is monitoring the IRS's implementation of the new Return Preparer Program. In September 2011, TIGTA reported that it will take years for the IRS to implement the Return Preparer Program and to realize its impact.[20] When the decision was made to register preparers, the IRS had not established all of the program requirements. The IRS also had not: (1) established the organizational structure of the program, (2) determined how it will verify that all preparers met the requirements, (3) determined how it will enforce program requirements, or (4) developed the system(s) and processes necessary to administer and oversee the program. It will not be until Calendar Year[21] 2014 that all preparers will be subjected to all suitability and competency tests. In the meantime, IRS management stated they will develop and implement an enforcement strategy. Currently, the IRS does not have a sufficient management information system to gather data on preparers. Further, the IRS will need to ensure that taxpayers understand the new requirements and the importance of using only registered preparers to prepare their tax returns.

Of the 66.9 million individual Federal income tax returns prepared by paid tax return preparers and processed by the IRS in Calendar Year 2011, 90 percent were e-

[18] TIGTA, Ref. No. 2011-30-112, *Reducing the Processing Time Between Balance Due Notices Could Increase Collections* (September 2011).
[19] The period from January 1 through April 15 when most individual income tax returns are filed.
[20] TIGTA, Ref. No. 2010-40-127, *It Will Take Years to Implement the Return Preparer Program and to Realize Its Impact* (September 2010).
[21] The 12-consecutive-month period ending on December 31.

filed.[22] In November 2009, Congress approved a Federal e-file mandate for tax return preparers. TIGTA's review of the IRS's implementation of the mandate found that for the first few years, the IRS plans to use a "soft" approach to enforcement that emphasizes educating and collaborating with preparers in implementing e-file requirements. Additionally, the continued use of multiple preparer identification numbers makes it difficult to match all tax returns to the preparers. However, improvements are under way to ensure the effectiveness of controls and system validations over the preparer registration process.

TIGTA recommended several actions, including that the IRS monitor preparers' compliance with the e-file mandate and ensure that suitability tests match applicants to IRS information to identify preparers who are not allowed to prepare tax returns. IRS management agreed and stated that corrective actions to address the recommendations have been taken or are planned.

The IRS reported that this compliance strategy will cut down on inaccurate and fraudulent returns. It also makes it easier for the IRS to catch unscrupulous return preparers. In addition, these efforts will help improve service to taxpayers and assist with voluntary compliance.

Basis Reporting

Third-party reporting and transparency is also crucial to high compliance among individual taxpayers. Basis reporting associated with the buying and selling of securities was an area that needed third-party reporting based on previous studies that showed low levels of compliance.

The IRS issued proposed regulations in 2009 and final regulations in 2010 under a new law[23] that will require reporting by stock brokers and mutual fund companies on an investor's adjusted basis and whether any gain or loss on the sale is classified as short-term or long-term for most stock purchased in 2011 and all stock purchased in 2012 and later years. Such reports will be made available to investors and the IRS.

Business Taxes

Third-party reporting and transparency are hallmarks of high levels of tax compliance. The IRS undertook several initiatives in recent years to improve those

[22] As of May 4, 2011.
[23] Energy Improvement and Extension Act of 2008, Pub. L. No. 110-343, § 403, 122 Stat. 3765, 3854-3858.

aspects in the world of business taxes, where the efficient allocation of limited resources is particularly important to sound tax administration.

New merchant card reporting requirements[24] were established for TY 2011. They provide third-party reporting data on business receipts for the first time, making it easier for the IRS to identify businesses that are either under-reporting receipts or not reporting at all. The IRS issued final regulations in 2010 and the new reporting requirements took effect on January 1, 2011. In general, these requirements apply to government entities and private businesses, as well as most types of payment cards, such as credit and debit cards.

In an effort to achieve greater transparency, the IRS also requires the reporting of certain tax avoidance transactions that have the potential to be abusive. These transactions are called "listed" transactions and also include other types of transactions that are the same or substantially similar to the listed transactions. Taxpayers are required to disclose their participation in listed transactions or they may be subject to penalties. In FY 2010, the IRS received approximately 35,000 of the disclosure documents.

International Compliance Efforts

Globalization of the U.S. economy has been a major trend for many years. International business holdings and investment in the United States have grown from nearly $188 billion in 1976 to over $14.5 trillion in 2007, while U.S. business and investment worldwide grew from nearly $368 billion to nearly $15 trillion over the same period. The scope and complexity of the international financial system create significant enforcement challenges for the IRS. The IRS continues to be challenged by a lack of information reporting on many cross-border transactions. In addition, the varying legal requirements imposed by different jurisdictions result in complex business structures that make it difficult to determine the full scope and effect of these cross-border transactions. Technological advances also provide opportunities for offshore investments that were once only possible for large corporations and wealthy individuals.

Over the past few years, the IRS has taken steps and made strategic internal realignments to better coordinate international tax compliance issues. It has developed a strategic plan specifically for international tax issues with two major goals: 1) enforce the law to ensure that all taxpayers meet their obligation to pay U.S. taxes and 2)

[24] Housing and Economic Recovery Act of 2008, sec. 3091, § 6050W, 112 Stat. 2654, 2908-2911.

improve service to make voluntary compliance less burdensome. In November 2009, the IRS's Global High Wealth unit began operation. It was formed to better cope with the growing complexity of income and assets of the high-income, high-wealth population. In August 2010, the IRS realigned its international efforts under its Large Business and International (LB&I) Division, which was designed to strengthen international tax enforcement in several ways, including identifying emerging international compliance issues more quickly and ensuring the right compliance resources are allocated to the right cases. During FY 2012, the IRS will merge the Office of Chief Counsel's Advanced Pricing Agreement Program with the LB&I Division's Mutual Agreement Program to form the Advanced Pricing and Mutual Agreement Program. This combined program will be a component of the LB&I Division's Transfer Pricing Operations. The IRS expects that efforts like these will improve international tax compliance by allowing it to focus on high-risk issues and cases with greater consistency and efficiency.

The Congress, the Department of the Treasury, and the IRS are concerned about the International Tax Gap – that is, taxes owed, but not collected on time, from a U.S. or nonresident person whose cross-border income is subject to U.S. taxation. The IRS has not estimated the size of the International Tax Gap, but non-IRS estimates range from $40 billion to $123 billion[25] annually. While there might be overlap between the overall IRS Tax Gap estimate and the International Tax Gap estimate, it is unlikely that the $450 billion Tax Gap estimate includes the entire International Tax Gap. The primary reason for this is that identifying hidden income within international activity is very difficult and time-consuming.[26]

The IRS's strategic initiatives focus on strengthening reporting requirements, enhancing IRS access to international data, and aligning resources to cases and issues with the highest compliance risk. One reporting requirement is the *Report of Foreign Bank and Financial Accounts* (FBAR) report, which is an information report required when U.S. citizens, residents, and domestic entities owns or has signature or other authority over foreign financial accounts worth over $10,000 in any calendar year. Congress set up FBAR penalties because some taxpayers use these foreign accounts to evade U.S. taxation.

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[25] TIGTA, Ref. No. 2009-IE-R001, *A Combination of Legislative Actions and Increased IRS Capability and Capacity Are Required to Reduce the Multi-Billion Dollar U.S. International Tax Gap* (January 2009).
[26] GAO, Ref. No. GAO-07-237, *Tax Administration: Additional Time Needed to Complete Offshore Tax Evasion Examinations* (March 2007).

In addition, the Foreign Account Tax Compliance Act (FATCA) [27] requires foreign financial institutions to report to the IRS information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. FATCA will be phased in by the IRS in the next several years. Individual taxpayers with an aggregate balance of more than $50,000 in foreign financial assets are required to file a disclosure statement with their income tax return.

In August 2010, TIGTA reported that taxpayers excluded $19.2 billion in foreign earned income on TY 2008 tax returns. Our review identified 23,334 tax returns with erroneous foreign earned income tax exclusions totaling $675 million, with an estimated revenue loss of $90 million. Over five years, TIGTA estimated erroneous claims could result in a total revenue loss of $450 million. Some of the recommendations that TIGTA provided were that the IRS:

- Review the tax returns of those individuals that TIGTA identified as incorrectly claiming the foreign earned income exclusion;
- Establish a unit to address taxpayers identified as erroneously claiming the foreign earned income exclusion;
- Assess whether compliance project criteria can be used to identify erroneous claims during tax return processing; and
- Include programming to forward tax returns (both electronically filed and paper) for correction when individuals incorrectly compute their foreign earned income exclusion.

IRS management agreed with most of the recommendations, but they stated that substantial barriers prevented the implementation of certain recommendations at the time of the review. TIGTA is concerned that the lack of corrective actions will allow continued revenue loss.[28]

[27] In 2010, FATCA was enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act, Pub. L. No. 111-147, 124 Stat. 71, 97-117.
[28] TIGTA, Ref. No. 2010-40-091, *Improvements Are Needed to Reduce Erroneous Foreign Earned Income Exclusion Claims* (August 2010).

Offshore Tax Avoidance

Stopping offshore tax cheating and getting these people, especially high net-worth individuals, back into the tax system has been a top priority of the IRS. The IRS continues to work with the U.S. Department of Justice on tax evasion cases involving foreign countries with bank secrecy laws that prevent the United States from obtaining information on taxpayer transactions. In addition, both the 2009 and 2011 Offshore Voluntary Disclosure Initiatives have encouraged taxpayers with hidden offshore assets and income to come back into the tax system using the IRS's Voluntary Disclosure Program. According to the IRS, these initiatives have resulted in the collection of over $4 billion. Due to the success of the first two initiatives, the IRS is currently offering a third chance for delinquent taxpayers to disclose their hidden offshore assets. These initiatives are beneficial because they offer a uniform penalty structure for taxpayers who voluntarily disclose their hidden offshore assets and income to the IRS and, in return, ensure that the taxpayers receive consistent tax and penalty treatment.

The initiatives also provide the opportunity to calculate, with a reasonable degree of certainty, the total cost of resolving all outstanding offshore tax issues related to the undisclosed foreign bank and financial accounts and assets. On the other hand, taxpayers with undisclosed foreign accounts and assets who do not submit a voluntary disclosure run the risk of detection by the IRS. If caught, these taxpayers face the imposition of substantial penalties, including the fraud and foreign information return penalties, as well as an increased risk of criminal prosecution.

Real-Time Tax System

The IRS has started work exploring how to implement a series of long-term changes to the tax system which will result in higher compliance. Commissioner Shulman has described a vision where the IRS would move away from the traditional "look-back" model of compliance, and instead endeavor to conduct its compliance efforts in "real time," such as by matching third-party information with information provided by the taxpayer when the tax returns are first filed with the IRS. The goal of this initiative is to improve the tax filing process by reducing burden for taxpayers and improving overall compliance "up front," during the filing season instead of later through compliance or enforcement activities. In addition, the IRS plans to include more data mining and predictive analytics in this initiative, to improve identification of noncompliance and potential tax fraud.

In FY 2012, the IRS has delivered significant updates to its core tax processing system, transitioning to a daily processing cycle for individual returns. Also, IRS

processing systems are accepting all Forms 1040, U.S. Individual Income Tax Return, electronically through an updated e-filing capability. This capability is designed to eventually feed into a single, consolidated taxpayer account database that will support the deployment of the next generation of taxpayer service and enforcement functions.

TIGTA has reviewed a number of other IRS challenges in addressing the Tax Gap. One important aspect involves human capital. Like many Federal agencies, the IRS is faced with the major challenge of replacing existing talent caused by a large number of retirements expected over the next several years. In five years, about one-third of the IRS's workforce of approximately 100,000 employees will be retirement eligible. This statistic is even more pronounced in the leadership ranks, where over two-thirds of IRS executives will be retirement eligible in five years. Adding to this challenge, the IRS offered early retirement and buyouts to more than 2,200 employees in FY 2011. Replacing these employees provides an opportunity for reshaping the IRS workforce, but also represents a significant challenge since many departing employees possess unique skills and institutional knowledge that will be difficult to replace.

Revenue officers (RO) have a direct impact on the IRS's ability to meet its mission by collecting the appropriate amount of tax due. The IRS added 1,515 new ROs during the period June 2009 through February 2010, but it still struggles to keep pace with attrition and workload. If the IRS does not have a sufficient number of qualified ROs to collect delinquent taxes, it could create an unfair burden on the majority of taxpayers who fully pay their taxes on time. However, when estimating the staffing levels of ROs, the IRS does not determine the number needed to address the available workload. Instead, the IRS bases the RO staffing level primarily on a budget figure. The IRS believes there is more than enough inventory to justify staffing increases. However, the IRS does not know when hiring additional ROs will no longer be needed.

The IRS's FY 2009 budget justification projected that the RO hiring initiative would allow 88,000 additional delinquent account closures, resulting in $333.6 million in additional revenue for FY 2011. However, the IRS does not track a comparison of actual results to the original projections in the years following the budget's implementation. As a result, it is unknown if the IRS realized all or part of the additional projected revenue for this initiative, and the IRS lost an opportunity to collect information that could help improve future budgets. TIGTA recommended that the IRS:

- Establish rules for optimizing staffing levels for ROs to address Collection's potentially collectible inventory; and

- Develop methods to track actual results with projected benefits in future budget justifications.

IRS management agreed to review workload and resource levels to improve future resource allocation and staffing decisions. IRS management also stated that they initiated efforts in 2010 to develop a methodology to determine the actual revenue collected from specific enforcement initiatives proposed in the IRS's FY 2009 budget justification. However, this information was not shared with TIGTA during the review. As a result, TIGTA did not assess whether those efforts addressed the recommendation.[29] Until IRS management implements this type of methodology, they will not know the actual additional revenue realized from requested enforcement initiatives.

The misclassification of millions of employees as independent contractors is a nationwide problem that continues to grow and contribute to the $72 billion underreporting Employment Tax Gap. In a report issued in Fiscal Year 2010,[30] TIGTA determined that the IRS has opportunities to enhance compliance in its Employment Tax Program by: 1) taking measures to ensure employment tax forms are not misused to avoid paying taxes, and 2) regularly sharing the results of worker classification examinations between IRS compliance functions to ensure the greatest possible use of the agency's resources when addressing the underreporting Tax Gap. TIGTA identified more than 74,000 taxpayers who may have avoided paying approximately $26 million in Social Security and Medicare taxes in Processing Year[31] 2008.

Another of the IRS's priorities is combating tax avoidance transactions.[32] However, the IRS has identified tax returns with tax avoidance transaction issues that do not warrant examination before taxpayer contact, a process known as surveying. Surveying tax returns with a tax avoidance transaction issue without proper justification or approval could be counterproductive to the IRS's goal to combat abusive schemes. In addition, this approach can erode the public's confidence in the IRS's ability to enforce tax laws in a fair, equitable, and consistent manner. As a result, TIGTA recommended that the IRS:

- Develop internal controls and train employees to ensure that justification is in the case files to survey tax returns with a tax avoidance transaction issue;

[29] TIGTA, Ref. No. 2011-30-039, *Challenges Remain to Balance Revenue Officer Staffing With Attrition and Workload Demands* (May 2011).
[30] TIGTA, Ref. No. 2010-30-025, *Employment Tax Compliance Could Be Improved With Better Coordination and Information Sharing* (March 2010).
[31] The calendar year in which the tax return or document is processed by the IRS.
[32] A tax avoidance transaction is generally a specific tax transaction or promotion that reduces tax liability by taking a tax position that is not supported by tax law. These strategies may be organized and marketed, often through the Internet. The definition is not merely limited to activities that improperly reduce tax, but may also include transactions that conceal assets and income.

- Have an independent function review the tax return for concurrence with the group manager's decision;
- Ensure that tax returns with tax avoidance transaction issues (surveyed as excess inventory) can be readily identified, and examinations are completed once taxpayers are contacted; and
- Develop procedures to ensure surveyed tax returns are included as part of the quality review process.

IRS management disagreed with TIGTA's two recommendations related to strengthening existing controls and developing procedures to include surveyed tax returns as part of the quality review process. TIGTA continues to believe that the breakdown in controls for the approval process indicates that tax returns surveyed without documentation may have yielded examination results.

Quality Taxpayer Service

The Department of the Treasury and the IRS recognize that the delivery of effective taxpayer service has a significant impact on voluntary tax compliance. Answering taxpayers' questions to assist them to correctly prepare their returns reduces the need to send notices and correspondence when taxpayers make errors. Taxpayer service also reduces unintentional noncompliance and shrinks the need for future collection activity. The IRS continues to focus on the importance of improving service by emphasizing it as a main goal in its strategic plan. It is also seeking innovative ways to simplify or eliminate processes that unnecessarily burden taxpayers or Government resources.

Filing Season

As of March 24, 2012, the IRS received more than 84 million tax returns. Of those, 74.3 million (88.4 percent) were e-filed and nearly 9.8 million (11.6 percent) were filed on paper (a decrease of 12.3 percent from this time last year). In addition, nearly 70.2 million refunds totaling approximately $200.9 billion were issued. This Filing Season, the IRS has delivered significant updates to its core tax processing system, transitioning to a daily processing cycle for individual returns. Also, IRS processing systems are accepting all Forms 1040, *U.S. Individual Income Tax Return*, electronically through an updated e-filing capability. This capability is designed to eventually feed into a single, consolidated taxpayer account database that will support the deployment of the next generation of taxpayer service and enforcement functions.

However, some taxpayers who e-filed their tax returns early in the 2012 Filing Season experienced delays in receiving their tax refunds. The IRS indicated that it had experienced problems with its filters established to identify fraud and with the program used by the Modernized e-File system to create output files using the accepted e-file tax return data that other IRS systems need to continue with the processing of the tax return. Filters established to identify fraud initially identified taxpayers as having indicators of possible fraud, which resulted in the tax return being held for additional screening. Once the IRS identified that these filters were incorrectly identifying some taxpayers, it made adjustments to these filters correcting the problem.

The Modernized e-File programming problems resulted in delays in sending accepted e-filed tax return data to downstream processing systems. These problems delayed the processing of approximately 7.8 million tax returns. The majority of these tax returns were processed through the Modernized e-File system from February 2 through 11, 2012. The IRS indicated the delayed accepted tax returns were sent to downstream systems for processing by February 18, 2012. The problems also resulted in accepted tax return information not always being timely available for use in its customer service operations, including "Where's My Refund." The IRS indicated that these problems were addressed and processes were established to account for all tax returns accepted during the time frame the problem existed. The IRS is developing an end-to-end balancing process to track Modernized e-File system tax returns from acceptance to the posting of the tax return on the Master File.

In addition, as a result of budget constraints, the IRS expects to be able to serve fewer taxpayers at its Taxpayer Assistance Centers and answer fewer taxpayer telephone calls. The IRS anticipates it will have increased wait times, earlier cutoffs of assistance to avoid end-of-day overtime, and frequent unexpected closures of small Taxpayer Assistance Centers due to unscheduled employee absences. These centers plan to assist more than 6.1 million taxpayers in FY 2012. Between October 1, 2011, and March 31, 2012, the Taxpayer Assistance Centers served 3.2 million walk-in taxpayers, which includes 1.9 million walk-in taxpayers for the 2012 Filing Season. However, tax return preparation will only be provided on a limited number of days per week and only on a first come, first served basis. The IRS is also planning on providing only a 61 percent Level of Service on its toll-free lines. As of March 24, 2012, IRS assistors have answered 9.8 million calls and have achieved a 68 percent Level of Service and a 950 second (16 minutes) Average Speed of Answer. In addition, during visits to Volunteer Program sites as of March 30, 2012, TIGTA has had 29 tax returns prepared with a 48 percent accuracy rate. This is lower than the 60 percent accuracy rate TIGTA reported during the same time period for the 2011 Filing Season.

Finally, as of March 24, 2012, the IRS has identified tax returns with $4.4 billion claimed in fraudulent refunds and prevented the issuance of $4.3 billion (97 percent) of

the fraudulent refunds. This represents a 35 percent increase in the number of tax returns identified as of the same period last processing year.

Prisoner Fraud Oversight

In TIGTA's review of the IRS's processes to identify potentially fraudulent tax returns for screening, TIGTA auditors found that the majority of tax returns the IRS identified as being filed by prisoners were not screened to assess fraud potential. TIGTA determined that 253,929 (88 percent) of the 287,918 tax returns filed by a prisoner as of March 24, 2010, were not selected for screening. Of those tax returns not screened, 48,887 individuals had no wage information reported to the IRS by employers. These 48,887 prisoners claimed refunds totaling more than $130 million, including EITC claims of $78.5 million. Some of these refunds may have been stopped by other compliance activities. For example, TIGTA determined that the IRS prevented the issuance of nearly $18.1 million in EITC claims for 4,532 of the 48,887 prisoner tax returns.[33] In addition, the IRS is making some improvement in identifying prisoner tax returns. As of March 24, 2012, the IRS had selected 163,005 tax returns filed by prisoners for screening. This represents a 19 percent increase in the number of prisoner tax returns identified as of the same period last processing year.

Further, TIGTA's review of the IRS's compliance with the *Inmate Tax Fraud Prevention Act of 2008*[34] found that, as of October 2010, the IRS had not completed required agreements to allow the IRS to disclose prisoner tax return information to prison officials. As a result, no information has been disclosed to either the Federal Bureau of Prisons or State Departments of Corrections. TIGTA also found that the Calendar Year 2009 Report to Congress on prisoner fraud is incomplete. The report stated that the IRS identified 44,944 fraudulent prisoner tax returns during Calendar Year 2009. However, the processes the IRS uses to identify prisoner tax returns cause the IRS to understate the amount of prisoner fraud. Our review of the process used by the Criminal Investigation Division to compile the 2009 prisoner data file identified a lack of managerial oversight to ensure the accuracy and reliability of this file.

TIGTA recommended that the IRS work with the Department of the Treasury to seek legislation to extend the period of time the IRS has to disclose prisoner tax return data to the Federal Bureau of Prisons and State Departments of Corrections. TIGTA has also made a number of other recommendations related to prisoner fraud, which include ensuring all tax returns filed by prisoners are processed through the Electronic Fraud Detection System and receive a prisoner indicator, revising prisoner filters to

[33] TIGTA, Ref. No. 2010-40-129, *Expanded Access to Wage and Withholding Information Can Improve Identification of Fraudulent Tax Returns* (September 2010).
[34] Pub. L. No. 110-428, 122 Stat. 4839, (codified as amended at 26 U.S.C. Section 6103(k)(10)).

validate wages and withholding associated with prisoners incarcerated for the year in which the tax return is filed claiming a refund, and developing a process to assess the reliability of data received from Federal and State prisons. The IRS partially agreed to our recommendations, but work remains before the IRS is fully in control of this issue.[35]

Identity Theft

Since I last testified on this topic in November 2011, TIGTA has continued to assess the IRS's efforts to identify and prevent identity theft. Unscrupulous individuals are stealing identities at an alarming rate for use in submitting tax returns with false income and withholding documents to the IRS for the sole purpose of receiving a fraudulent tax refund. For Processing Year 2011, the IRS reported that it had detected approximately 940,000 tax returns involving identity theft and prevented the issuance of fraudulent tax refunds totaling $6.5 billion. While the amount of fraudulent tax refunds IRS detects and prevents is substantial, the IRS does not know how many identity thieves are filing fictitious tax returns and how much revenue is being lost resulting from the issuance of fraudulent tax refunds.

Fraudulent tax returns are identified through the IRS's Electronic Fraud Detection System (EFDS) as well as through the manual screening of paper tax returns. Individual tax returns are sent through the EFDS and are scored based on the characteristics of the tax return and other data. The higher the score, the greater the probability that the tax return is fraudulent. For those tax returns meeting a certain score, the tax return is sent to an IRS employee to be screened for fraud potential. For the 2012 Filing Season, the IRS has developed new filters to better identify identity theft before issuing fraudulent tax refunds. As of March 7, 2012, the IRS had identified 128,242 tax returns involving identity theft with $793 million in associated fraudulent tax refunds.

As part of our assessment, we are identifying and quantifying potential tax refund losses resulting from identity theft. Using characteristics of IRS-confirmed fraudulent tax return filings involving identity theft, TIGTA analyzed tax returns filed during the 2011 Filing Season to identify additional tax returns that met the characteristics of these confirmed cases. We have found that the issuance of fraudulent tax refunds based on false income documents is significantly greater than the amount detected and prevented by the IRS.

Access to third-party income and withholding information at the time tax returns are processed is the single most important tool the IRS could have to identify and

[35] TIGTA, Ref. No. 2011-40-009, *Significant Problems Still Exist With Internal Revenue Service Efforts to Identify Prisoner Tax Refund Fraud* (December 2010).

prevent tax fraud. This information will prevent the issuance of billions of dollars in fraudulent tax refunds. To further improve IRS's ability to identify tax returns with false income documents before refunds are paid, legislation is needed to expand IRS access to the National Directory of New Hires[36] wage information for tax administration purposes for the purpose of identifying tax refund fraud. Currently, its use is limited by law to just those tax returns with a claim for the EITC. The IRS included a request for expanded access to the National Directory of New Hires in its annual budget submissions for FYs 2010, 2011 and 2012. The request was made as part of the IRS's efforts to strengthen tax administration. However, the expanded access has not been provided for in the law. The IRS has again included a request for expanded access to the National Directory of New Hires as part of its FY 2013 budget submission. The ability to use this information along with third-party income and withholding information that the IRS maintains for the prior year's tax filings would help the IRS to stop identity theft related tax fraud.

Next month TIGTA will also report on the IRS's assistance to victims of identity theft. Of continuing concern is the length of time taxpayers must work with the IRS to resolve identity theft cases. It can take the IRS more than a year to resolve these cases. The IRS does not provide taxpayers with realistic time frames for how long it will take to resolve their cases. Communications between identity theft victims and the IRS are limited and confusing, and victims are asked multiple times to substantiate their identity. Taxpayers do not speak directly with the assistors who are working their identity theft cases.

The IRS has continued to take actions to improve its Identity Theft Program. As a result of an assessment of its Identity Theft Program completed in October 2011, the IRS is currently planning improvements to the program. The IRS is reorganizing to have an Identity Theft Program Specialized Group within each of the business units and/or functions where dedicated employees work the identity theft portion of the case. It will also begin collecting IRS-wide identity theft data to assist in tracking and reporting the affect identity theft has on tax administration. Nevertheless, the improvements may not be sufficient to significantly reduce the burden identity theft has placed on tax administration and on taxpayers whose identities have been stolen.

Identity theft cases have not been prioritized during the standard tax return filing process. The IRS plans to update tax return processing procedures to include a special processing code to recognize the presence of identity theft documentation on a paper-filed tax return. This will allow certain identity theft victim's tax returns identified during processing to be forwarded and assigned to an assistor, rather than continuing

[36] A Department of Health and Human Services national database of wage and employment information submitted by Federal agencies and State workforce agencies.

through the standard duplicate tax return procedures. This will reduce the time a taxpayer must wait to have his or her identity theft case resolved from three to five months. However, the IRS does not plan to put this change into place until June 2012.

Additionally, if controls the IRS plans to implement do not decrease the incidence of identity theft and fraudulent returns filed by identity thieves continue to prevent lawful taxpayers from filing their tax returns, this inventory could remain at a high level. Resources have not been sufficient to work identity theft cases dealing with refund fraud and IRS employees who work the majority of identity theft cases are also telephone assistors who are trained to communicate with taxpayers and to know the tax laws and related IRS operational procedures. Identity theft cases can be complex and can present considerable challenges throughout the resolution process. The assistors are not examiners and are not trained to conduct examinations, which require skills and tools beyond those of the assistors.

The IRS uses little of the data from the identity theft cases to identify any commonalities, trends, etc., that could be used to detect or prevent future refund fraud. After resolving an identity theft case involving a duplicate tax return, the information from the identity thief's tax return is deleted from the legitimate taxpayer's account and moved to a temporary account. A special account is created for the identity thief using a temporary IRS Number (IRSN). However, the account is not flagged as an identity theft account. Therefore the IRS is unable to determine which accounts were created because of identity theft.

The ability to identify certain IRSN accounts as identity theft accounts would allow the IRS to use the information from the tax return to identify refunds improperly paid, and patterns and trends among perpetrators of identity theft. This would assist the IRS in establishing accurate data with respect to revenue lost due to identity theft, and to better understand the characteristics of potential identity theft cases. This information would aid in development of other treatments and approaches to identity theft tax fraud.

Criminal Investigations of Identity Theft

When the crime of identity theft occurs within our jurisdiction, TIGTA's Office of Investigations (OI) investigates it as it impacts the economy, efficiency, and effectiveness in the administration of the Internal Revenue Code. Identity theft directly and destructively impacts law-abiding citizens. One identity theft scheme that has attracted media coverage involves individuals stealing identities and then filing fraudulent tax returns before the legitimate taxpayer files his or her own return. This results in the refunds being issued to the criminals. This crime is simple tax fraud and it falls within the jurisdiction and programmatic responsibility of the IRS. However, there

are other variations of IRS-related identity theft that, although not widely covered by the media, falls within TIGTA's jurisdiction and has a significant impact on taxpayers.

TIGTA focuses its limited investigative resources on the following areas as it pertains to IRS related identity theft:

- IRS employees who are involved in committing identity theft either as the source of the identity information or through active participation in the scheme;
- Tax preparers who improperly steal and disclose client information for the purpose to commit identity theft (excluding tax preparers who prepare and file fraudulent tax returns for the purpose of personally stealing the refund); and
- Individuals who impersonate the IRS in furtherance of committing identity theft.

TIGTA has conducted investigations of IRS employees who utilize their access to taxpayer information as a means for stealing identities for the purpose of committing identity theft. Noted below is an example of identity theft by an IRS employee.

Example 1: On April 14, 2011, Monica Hernandez, a part-time data entry clerk for the IRS, was indicted for making a false income tax return. During the course of her employment with the IRS, Hernandez stole and/or misappropriated information of other taxpayers listed on various IRS forms. Hernandez used falsified and forged IRS forms to obtain large tax refunds from the IRS totaling $175,144.

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 generates widespread distrust of the IRS. TIGTA OI pursues identity theft violations and conducts criminal investigations of IRS employees involved in these crimes.

Tax preparers who improperly steal and disclose any taxpayer's Federal tax information as part of an identity theft scheme cause serious harm to taxpayers. The following case highlights an instance when a tax preparer stole and improperly disclosed the identity of her clients in order to commit identity theft.

Example 2: Kathleen Lance was a public accountant and president of her company. In this capacity, Lance obtained and used the identification of six of her clients to change the direct deposit account information on clients' tax returns before she electronically submitted their returns to the IRS. Lance thereby diverted funds from the clients' banks and redirected the deposits to her personal and business bank accounts. Lance also

assumed and disclosed the identity of the six clients and fraudulently opened credit card accounts in her name. On May 24, 2010, she was sentenced to serve 64-months imprisonment and three years' probation for wire fraud, theft of Government funds, use of unauthorized access devices, and aggravated identity theft.

Impersonation of the IRS as part of an identity theft scheme has many forms. Often, the IRS is impersonated by individuals who seek to trick unsuspecting taxpayers into revealing their personal information. The details of each scheme tend to vary, but the common thread is the use of the IRS name to lure recipients into accessing links or providing sensitive information.

- Victims are told that they are either due a refund or that a tax payment was rejected and the taxpayer needs to click on a link which either opens an attached form or takes them to a website where they enter their Personally Identifiable Information (PII), Federal tax information, and credit card information; or
- Victims are told that they are being investigated by the IRS and need to immediately respond by clicking on a link which opens an attached form or takes them to a website, where they are prompted to provide their PII to verify the status of their tax matter.

In both of these situations, the victim is presented with a website which is designed to replicate a legitimate IRS.gov website, often by utilizing authentic IRS images and seals. The case below is an example wherein an individual impersonated the IRS to commit identity theft.

Example 3: Godspower Egbufor, together with co-conspirators, operated a scheme and stole the identities of numerous individuals and defrauded them out of more than $1 million through Internet solicitations. Egbufor obtained massive e-mail distribution lists containing thousands of e-mail addresses and sent unsolicited e-mails falsely informing targeted victims that they had won a lottery or had inherited money from a distant relative. E-mails to victims falsely indicated that a Government or quasi-governmental agency, such as the IRS or the United Nations, prevented the money due to them from being awarded because advance payment of taxes and other fees were required. Follow-up e-mails instructed the victims to provide their personal and bank account information in order to receive their lottery winnings or inheritance. On December 19, 2011, Egbufor was sentenced to 108 months of imprisonment and five years of supervised release for violations of Aggravated Identity Theft and Conspiracy to Commit Wire Fraud.

In conclusion, the IRS's current strategy for reducing the Tax Gap, which is largely dependent on funding for additional compliance resources and legislative changes, is not enough. The IRS recognizes that to make meaningful improvement in voluntary compliance and to reduce the Tax Gap, it will require a long-term, focused effort encompassing taxpayer service, modernization, and enforcement, accompanied by broader simplification and reform of the tax code and significant advances in compliance technology. One of the primary challenges facing the IRS is improving research to better understand the current sources of noncompliance and to determine what actions are most effective in addressing taxpayer noncompliance.

We at TIGTA take our mandate to provide independent oversight of the IRS seriously, and we continually strive to identify ways to improve the effectiveness and efficiency of the Nation's tax system and to prevent and detect fraud, waste, and abuse I hope my discussion of the IRS's efforts to ensure taxpayers comply with their tax obligations as well as what the IRS is doing to address the growing risk of refund-related identity theft assists you with ensuring accountability over the IRS.

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

Mr. PLATTS. Thank you, Inspector General George.
Mr. White?

STATEMENT OF JAMES R. WHITE

Mr. WHITE. Chairman Platts, Ranking Member Towns and members of the Subcommittee, I am pleased to be here to discuss the tax gap, i.d. theft-based fraud and how to reduce them.

The gross tax summarized on pages 4 and 5 of my statement, as you have heard, was recently estimated by the IRS to be $450 billion for tax year 2006. This is the amount the taxpayers should have paid but did not pay on time. Note that this is the amount unpaid for just one year.

Of this, the IRS estimates, as you have heard, that it will ultimately collect $65 billion from its enforcement actions and from late payments by taxpayers, leaving a net gap of $385 billion. One piece of context is that the tax gap has persisted at about the same level as a percent of total tax liability for decades, this despite a myriad of Congressional and IRS efforts to reduce it.

Key for thinking about how to reduce the tax gap is understanding its nature. The tax gap is spread across various types of taxes, taxpayers and taxpayer behavior. Most of the tax gap is for the individual income tax. But the corporate income tax and employment tax are also significant contributors. Much of the tax gap is due to misreporting of business income, even for the individual income tax. But non-business income also contributes.

Even for a certain category of taxpayer, there is a variety of misreporting behavior. For example, in a recent report, we found that sole proprietors misreport both their receipts and their expenses, and some of each is unintentional, while some is intentional.

At one level, as you have heard, the cause of the tax gap is easy to understand. Income subject to withholding and/or information reporting to IRS by third parties, such as employers or banks, has low misreporting. Only about 1 percent of wage income withholding is misreported. On the other hand, 56 percent of rent, royalty and sole proprietor income, with little or no information reporting, is misreported.

There are opportunities to reduce the tax gap. But because of the variety of non-compliance, multiple approaches will be needed. No single approach is likely to fully and cost effectively address the tax gap.

Opportunities include more third party information reporting. Third party reports to IRS about a taxpayer's income allow IRS to easily verify through computer matching and without an audit that the taxpayer's return is accurate. As I already noted, compliance is high when income is reported by third parties, such as employers or banks. The challenge with increasing third party reporting is identifying new third parties. They must have knowledge of taxpayers' income or expenses and have tolerable reporting costs.

Also, IRS must be able to enforce the reporting requirements. So, for example, a small number of reporting entities, like banks, can be an advantage. The problem is that most third parties that meet these requirements are already required to report.

Another opportunity is improving service to taxpayers. Service has declined. For example, wait time to get through to an IRS telephone assister has been around 16 minutes this year. The model of human assisters responding to taxpayers may not be sustainable given its high cost. Different strategies for answering taxpayer questions, such as on the IRS website, or through paid tax preparers or tax preparation software, will be needed.

Another opportunity is additional resources. With tight budgets, if IRS's efforts to innovate don't keep up with workload growth, then the risk is that enforcement, and with it voluntary compliance, will go down. That could snowball. If taxpayers lose faith in the fairness of the system, they could become less willing to comply themselves.

Another opportunity is increasing pre-refund compliance checks. Doing more computerized checks before refunds are issued could reduce improper payments and might also limit refund fraud based on i.d. theft. Leveraging external resources. Such resources include paid preparers, tax software companies and whistleblowers. We have made recommendations to help IRS leverage all three to reduce the tax gap.

Modernized information systems. Such systems can route phone calls to help taxpayers get the answers they need and support IRS's enforcement staff with timely access to data.

Simplifying the tax code, which has also been discussed. Simplification can make it easier for taxpayers who want to comply do so successfully, and make it harder for those intentionally trying to evade their tax obligations to hide from IRS.

In closing, I want to highlight the value of research on the nature and causes of the tax gap. Such research is costly, but without it, Congress and IRS are left struggling to reduce the tax gap without a fact-based understanding of its causes.

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

[Prepared statement of Mr. White follows:]

United States Government Accountability Office

GAO

Testimony before the Subcommittee on Government Organization, Efficiency, and Financial Management, Committee on Oversight and Government Reform, House of Representatives

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TAX GAP

Sources of Noncompliance and Strategies to Reduce It

Statement of James R. White, Director
Strategic Issues

GAO-12-651T

April 19, 2012

GAO
Accountability * Integrity * Reliability

Highlights

Highlights of GAO-12-651T, a testimony before the Subcommittee on Government Organization, Efficiency, and Financial Management, Committee on Oversight and Government Reform, House of Representatives

TAX GAP

Sources of Noncompliance and Strategies to Reduce It

Why GAO Did This Study

In January 2012, IRS estimated that the gross tax gap—the difference between taxes owed and taxes paid on time—was $450 billion for tax year 2006. IRS estimated that it would collect $65 billion through enforcement actions and late payments, leaving a net tax gap of $385 billion. From 2001 to 2006, IRS estimated that the gross tax gap increased by $105 billion. However, the percentage of taxes owed that were paid on time remained relatively constant at 83.1 percent in 2006, compared to 83.7 percent in 2001.

Given persistent levels of noncompliance and large and growing structural deficits, it will be important to understand the causes of tax noncompliance and develop new approaches to minimize it.

This testimony addresses two questions: (1) What types of taxpayers are responsible for the tax gap, and what is the nature of their noncompliance? (2) What are strategies for reducing the tax gap? The statement also discusses potential long-term strategies to prevent refund fraud related to identity theft. This statement is based largely on GAO's recent reports and recommendations on tax noncompliance and updates GAO's 2011 testimony on the tax gap.

What GAO Recommends

GAO has made numerous prior recommendations regarding actions to close the tax gap. Congress and IRS have acted on some, while others are reflected in the strategies presented in this testimony.

View GAO-12-651T. For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

What GAO Found

Noncompliance does not have a single source but occurs across different types of taxes and taxpayers. For example, individual income tax accounts for the largest portion of the tax gap, but corporate income tax and employment tax are also significant. Further, misreporting by individuals involves business income, non-business income, deductions, and credits. The extent of misreporting depends on the extent to which income tax is withheld or reported to the Internal Revenue Service (IRS) by third parties. For example, nearly 40 percent, or $179 billion, of the 2006 gross tax gap is due to misreporting of non-corporate business income and related self-employment taxes. Much of this misreporting can be attributed to sole proprietors underreporting receipts or over-reporting expenses. Unlike wage and some investment income, sole proprietors' income is not subject to withholding and only a portion is reported to IRS by third parties.

Because noncompliance has multiple causes and spans different types of taxes and taxpayers, multiple approaches are needed to reduce the tax gap. The following strategies could help and will require actions by Congress or IRS.

Enhancing information reporting by third parties to IRS could reduce tax evasion and help taxpayers comply voluntarily. However, identifying additional reporting opportunities can be challenging because third parties may not have accurate information available in a timely manner. Also, adding reporting requirements creates burden for both third parties and IRS.

Ensuring high-quality services to taxpayers, such as by telephone and correspondence or online, can help taxpayers who wish to comply with tax laws but do not understand their obligations. However, tax law changes and funding priorities have recently affected IRS's ability to provide quality taxpayer services.

Devoting additional resources to enforcement would enable IRS to contact millions of potentially noncompliant taxpayers it identifies but cannot contact. To determine the appropriate level of enforcement resources, policymakers would need to consider how to balance taxpayer service and enforcement activities and how effectively and efficiently IRS currently uses its resources.

Expanding compliance checks before IRS issues refunds would involve matching information returns to tax returns during, rather than after, the tax filing season. This approach would require a major reworking of some fundamental IRS computer systems but could help address identity theft-related fraud and allow IRS to use enforcement resources on other compliance problems.

Leveraging external resources, such as paid tax return preparers and whistleblowers, can help improve tax compliance because paid preparers' actions have an enormous impact on IRS's ability to effectively administer tax laws, and whistleblowers provide IRS information on suspected noncompliance.

Modernizing information systems would allow 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.

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

Chairman Platts, Ranking Member Towns, and Members of the Subcommittee:

I am pleased to be here to discuss the tax gap and related fraud, such as identity theft based refund fraud, and how to reduce it. In January 2012, the Internal Revenue Service (IRS) estimated that the gross tax gap—the difference between taxes owed and taxes paid on time—was $450 billion in tax year 2006. IRS estimated that it would eventually recover about $65 billion of this amount through late payments and enforcement actions, leaving a net tax gap of $385 billion.[1] The tax gap has been a persistent problem in spite of a myriad of congressional and IRS efforts to reduce it, as the rate at which taxpayers voluntarily comply with United States tax laws has changed little over the past three decades. In past testimonies, we have said that there are no easy fixes to this problem, and given persistent levels of noncompliance, reducing the tax gap will not likely be achieved through a single solution. Rather, the tax gap must be attacked on multiple fronts and with multiple strategies over a sustained period of time. Whether mistakes are intentional or unintentional, misreporting is unfair to compliant taxpayers and undermines the equity of the tax system. Moreover, in the face of large and growing structural deficits, it will be especially important to understand the causes of tax noncompliance today and continue to develop new approaches to minimize it.

My testimony today will answer two questions: (1) What types of taxpayers are responsible for the tax gap, and what is the nature of their noncompliance? (2) What are strategies for reducing the tax gap? As requested, we will also provide information on potential long-term strategies to prevent refund fraud related to identity theft. My testimony is based largely on our recent reports on tax noncompliance and updates our 2011 testimonies on the tax gap and identity theft.[2] Additional information on our scope and methodology is available in our published products.

[1]Throughout this statement, references to the tax gap refer to the gross tax gap unless otherwise noted.

[2]GAO, *Tax Gap: Complexity and Taxpayer Compliance*, GAO-11-747T (Washington, D.C.: June 28, 2011), and *Taxes and Identity Theft: Status of IRS Initiatives to Help Victimized Taxpayers*, GAO-11-721T (Washington, D.C.: June 2, 2011).

This testimony and the reports and testimonies upon which it is based were conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

For this hearing, we updated prior reported information about the estimated amounts for various components of the 2006 tax gap, the data and methodology used to estimate the 2006 tax gap, and actions IRS has taken to address our recommendations to improve taxpayer compliance. We confirmed the new information with IRS officials.

The Tax Gap Is Spread across Various Types of Taxpayers and Taxes

Characteristics of the Tax Gap

The gross tax gap has grown in dollar terms since IRS's previous estimate for tax year 2001, increasing from $345 billion to $450 billion for tax year 2006.[3] However, given the growth of the economy and total federal tax liability over that period, the percentage of taxes owed that taxpayers paid voluntarily and on time, known as the voluntary compliance rate, has remained relatively constant—83.7 percent in 2001 and 83.1 percent in 2006.[4]

[3]These amounts have not been adjusted for inflation.

[4]This 30 percent increase in the size of the gross tax gap from 2001 to 2006 is similar to the increase in the size of the United States economy (gross domestic product) over the time period. Likewise, total tax liabilities increased nearly 26 percent, from about $2.1 trillion to about $2.7 trillion, from tax years 2001 to 2006. (Dollar amounts for total tax liabilities do not match percentage increase because of rounding.) IRS also estimated that corporate income tax underreporting increased by $37 billion during this time. However, this growth may not indicate increased corporate noncompliance. According to IRS, the 2001 estimate of this portion of the tax gap was estimated based on old empirical data and was likely understated. In addition, from 2001 to 2006, corporation income tax liabilities more than doubled, while individual income tax liabilities grew by 15 percent.

The tax gap estimate is an aggregate of estimates for the three primary types of noncompliance: (1) underreporting of tax liabilities on tax returns; (2) underpayment of taxes due from filed returns; and (3) nonfiling, which refers to the failure to file a required tax return altogether or on time.[5] The estimate also covers the five types of taxes that IRS administers—individual income, corporate income, employment, estate, and excise taxes.

The tax gap includes unintentional errors as well as intentional evasion, such as intentionally underreporting income, intentionally over-reporting expenses, and engaging in abusive tax shelters or frivolous tax schemes. It does not include legal tax avoidance activities (legally lowering tax liability), taxes due from illegally derived income, or various forms of fraud. For example, in general, refund fraud related to identity theft would not be included in the tax gap estimate because it does not involve evading a tax liability. Nevertheless, as discussed later in the testimony, actions taken to improve overall compliance and reduce the tax gap could also potentially address identity theft related fraud.

A critical step toward reducing the tax gap is to understand the sources and nature of taxpayer noncompliance. As shown in table 1, noncompliance does not come from a single source but rather occurs across different types of taxes and taxpayers. For example, individual income tax accounted for most of the tax gap estimate for tax year 2006. However, corporate income tax and employment tax also contributed a significant portion.

[5]Taxpayers who receive filing extensions, pay their full tax liability by payment due dates, and file returns prior to extension deadlines are considered to have filed on time.

Table 1: IRS's Tax Year 2006 Gross Tax Gap Estimates by Type of Noncompliance and Type of Tax

Dollars in billions

	Type of tax					
Type of noncompliance	Individual income tax	Corporate income tax	Employment tax	Estate tax	Excise tax	Total
Underreporting	$235	$67	$72	$2	No estimate	$376
Underpayment	36	4	4	2	0.1	46
Nonfiling	25	No estimate	No estimate	3	No estimate	28
Total	**$296**	**$71**	**$76**	**$7**	**$0.1**	**$450**

Source: IRS.

As shown in table 2, individual income tax underreporting includes both nonbusiness income tax and business income tax underreporting. Business income for individuals includes income from a variety of business types, including sole proprietors,[6] partnerships, and S corporations,[7] many of which are small businesses. Nearly 40 percent, or $179 billion, of the 2006 gross tax gap can be attributed to these types of business taxpayers who underreport their business income tax, and by extension their self-employment tax, on their individual income tax returns.[8] Further, the misreporting of business income tax can take on a variety of forms. For example, misreporting of non-corporate business income tax can be largely attributed to sole proprietors who understated receipts or overstated expenses.[9] A key reason for this misreporting is

[6]Sole proprietors are self-employed individuals who should file a Schedule C with their individual tax returns to report profits and losses from their businesses. Sole proprietors include those who provide services, such as doctors or accountants; produce goods, such as manufacturers; and sell goods at fixed locations, such as car dealers and grocers.

[7]S corporations provide limited liability protection to shareholders and "pass through" gains and losses to shareholders' individual tax returns without generally paying taxes at the entity level. Limited liability protection means that a shareholder's financial liability for a company is limited to the amount of their investment in the company. Owners of S corporations are referred to as shareholders.

[8]Self-employed individuals are generally required to calculate and remit Social Security and Medicare taxes to the U.S. Treasury each quarter. As employment taxes and income taxes for self-employed taxpayers are largely assessed on the same income, self-employed individuals who underreport their income consequently underreport the employment tax due on that income.

[9]GAO, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance*, GAO-07-1014 (Washington, D.C.: July 13, 2007).

well known. Unlike wage and some investment income, sole proprietors' income is not subject to withholding and only a portion is subject to information reporting to IRS by third parties.

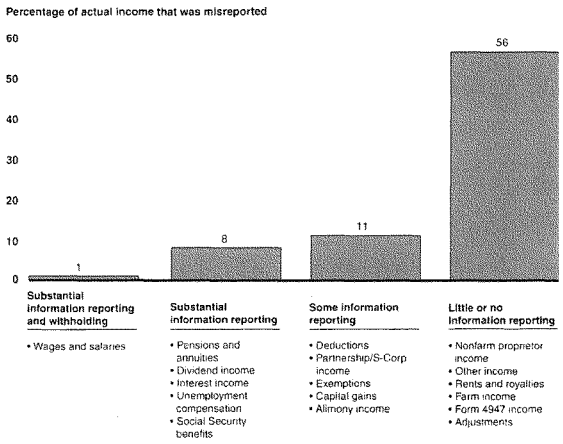
Table 2: Underreporting Portion of IRS's Tax Year 2006 Gross Tax Gap Estimates

Dollars in billions	
Tax gap component	**Estimated underreporting amount**
Individual income tax	**$235**
Nonbusiness income	68
Business income	122
Adjustments, deductions, and exemptions	17
Credits	28
Corporate income tax	**$67**
Small corporations	19
Large corporations	48
Employment tax	**$72**
Self-employment tax	57
FICA and unemployment tax	15
Estate tax	**$2**
Total underreporting	**$376**

Source: IRS.

As shown in figure 1, the extent to which individual taxpayers accurately report their income is related to the extent to which the income is reported to them and IRS by third parties or taxes on the income are withheld. For example, for types of income for which there is little or no information reporting, such as business income, individual taxpayers tend to misreport over half of their income. In contrast, employers report most wages, salaries, and tip compensation to employees and IRS through Form W-2. Also, banks and other financial institutions provide information returns (Forms 1099) to account holders and IRS showing the taxpayers' annual income from some types of investments. Findings from IRS's study of individual tax compliance indicate that nearly 99 percent of these types of income are accurately reported on individual tax returns.

Figure 1: Effect of Information Reporting on Taxpayer Compliance, Tax Year 2006



Source: IRS.

Taxpayers misreport income and expenses for a variety of reasons. Some misreporting is intentional; some is unintentional. Often it is impossible to tell from a tax return whether errors are intentional or unintentional or even who made the error. For example, paid tax return preparers could make errors or taxpayers could fail to share relevant information with their preparers. Our past reports shed some light on the extent of unintentional errors. In our report on securities cost basis reporting,[10] we found that among individual taxpayers who misreported securities sales, roughly one-third over-reported income (i.e., they

[10]Generally, a taxpayer's gain or loss from a securities sale is simply the difference between the gross proceeds from the sale and the original purchase price, or original cost basis. However, before taxpayers can determine any gains or losses from securities sales, they must determine if and how the original cost basis of the securities must be adjusted to reflect certain events, such as stock splits, nontaxable dividends, or nondividend distributions.

overstated gains or understated losses).[11] For sole proprietors, we reported that 9 percent over-reported their net income, while 61 percent underreported their net income in 2001.[12] It seems likely that such instances of over-reporting could be due to unintentional errors.

Measuring the Tax Gap

We have long encouraged regular tax gap measurement because these estimates are important to gauge progress in addressing the tax gap and, perhaps more importantly, because analyzing the data used to estimate it can help identify ways to improve tax compliance. One source of such data is the National Research Program (NRP), which uses audits of a stratified, random sample of tax returns to produce statistically valid estimates of noncompliance for the entire population of tax return filers. IRS uses the NRP sample results to better target its enforcement examinations of noncompliant taxpayers. Better targeting examinations to taxpayers who are noncompliant reduces burden on compliant taxpayers.

Updated compliance data can also help identify changes in tax laws and regulations that may improve compliance. For example, we analyzed NRP data on individual taxpayer compliance and reported that, among other things, Congress could consider requiring brokers to report to both taxpayers and IRS the adjusted basis of securities that taxpayers sell.[13] Congress enacted this provision,[14] which the Joint Committee on Taxation estimated would raise $6.7 billion in revenue through 2018.

As we have reported in the past, closing the entire gap may not be feasible since it could entail more intrusive recordkeeping or reporting than the public is willing to accept or more resources than IRS is able to commit.[15] However, given the size of the tax gap, even modest reductions

[11]GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, GAO-06-603 (Washington, D.C.: June 13, 2006).

[12] GAO-07-1014.

[13]GAO-06-603.

[14]Energy Improvement and Extension Act of 2008, Pub. L. No 110-343, § 403, 122 Stat. 3768, 3854 (Oct. 3, 2008).

[15]GAO, *Taxpayer Compliance: Analyzing the Nature of the Income Tax Gap*, GAO/T-GGD-97-35 (Washington, D.C.: Jan. 9, 1997).

would yield very significant financial benefits. We have made numerous recommendations over time that could address the tax gap, as follows.

Various Strategies Are Required to Reduce the Tax Gap

Multiple approaches are needed to reduce the tax gap. No single approach is likely to fully and cost-effectively address noncompliance since the noncompliance has multiple causes and spans different types of taxes and taxpayers. While the tax gap will remain a challenge into the future, the following strategies could help. These strategies would require actions by Congress or IRS.

Enhancing Information Reporting by Third Parties to IRS

Information reporting is a powerful tool that reduces tax evasion and helps taxpayers comply voluntarily. Several major new information requirements have recently taken effect, based at least in part on our work and recommendations.

- Brokers are required to report their clients' basis for securities sales, starting in 2012.[16]
- Banks and other third parties are required to report businesses' credit card and similar receipts, starting in 2011.[17]
- Under the Foreign Account Tax Compliance Act, starting in 2014, U.S. financial institutions and other entities are required to withhold a portion of certain payments made to foreign financial institutions that have not entered into an agreement with IRS to report details on U.S. account holders to IRS.[18]

As these three sets of information reporting requirements have only recently taken effect, it is too soon to tell the actual impact they are having on taxpayer compliance.

We have identified other options for information reporting.

[16]GAO-06-603.

[17]GAO, *Tax Administration: Costs and Uses of Third-Party Information Returns*, GAO-08-266 (Washington, D.C.: Nov. 20, 2007).

[18]GAO, *Reporting Foreign Accounts to IRS: Extent of Duplication Not Currently Known, but Requirements Can Be Clarified*, GAO-12-403 (Washington, D.C.: Feb 28, 2012).

- **Service payments to corporations.** Currently, businesses must report to IRS payments for services they make to unincorporated persons or businesses, but payments to corporations generally do not have to be reported.[19]
- **Service payments made by landlords.** Taxpayers who rent out real estate are required to report to IRS expense payments for certain services, such as payments for property repairs, only if their rental activity is considered a trade or business. However, the law does not clearly spell out how to determine when rental real estate activity is considered a trade or business.[20]

Broader requirements for these two forms of information reporting, covering goods in addition to services, were enacted into law in 2010 but were later repealed. We believe the more narrow extensions of information reporting to include services, but not goods, remain important options for improving compliance.

Additionally, we have identified existing information reporting requirements that could be enhanced.

- **Higher education expenses.** Eligible educational institutions are currently required to report information on qualified tuition and related expenses for higher education so that taxpayers can determine the amount of educational tax benefits they can claim.[21] IRS revising the information reporting form could improve the usefulness of reported information.[22]
- **Mortgaged properties.** Requiring third parties, such as mortgage lenders, to report mortgaged property addresses in addition to

[19]GAO, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements*, GAO-09-238 (Washington, D.C.: Jan. 28, 2009).

[20]GAO, *Tax Gap: Actions That Could Improve Rental Real Estate Reporting Compliance*, GAO-08-956 (Washington, D.C.: Aug. 28, 2008).

[21]26 U.S.C. § 6050S.

[22]GAO, *2009 Tax Filing Season: IRS Met Many 2009 Goals, but Telephone Access Remained Low, and Taxpayer Service and Enforcement Could Be Improved*, GAO-10-225 (Washington, D.C.: Dec. 10, 2009).

information they are already required to report on mortgaged properties would help IRS identify potential noncompliance.[23]

Identifying additional third-party reporting opportunities is challenging. Considerations include whether any third parties have accurate information available in a timely manner, the burden of reporting on the third parties, and whether IRS can enforce the reporting requirement. To illustrate, in a 2009 report, we found that a major reason why little information reporting on sole proprietor expenses exists is because of the difficulty identifying third parties.[24] For example, there is no third party that could verify the business use of cars or trucks by sole proprietors.

Ensuring High-Quality Services to Taxpayers

Ensuring high-quality taxpayer services, such as by telephone and correspondence or online, can help taxpayers who wish to comply with tax laws but do not understand their obligations. However, in recent years and continuing this year, IRS's service performance has seen declines. Tax law changes and other funding priorities have affected IRS's ability to provide quality taxpayer services. For example, we recently reported that call volume has increased nearly 35 percent from the same time period last year, which IRS attributed, in part, to taxpayer questions about tax law changes.[25] Concurrently, taxpayers' ability to get through to IRS telephone assistors has declined.[26] Through late February of this year, 65 percent of callers seeking to talk to an IRS telephone assistor got through, compared to 70 percent for 2011. To improve service, we have recommended that IRS determine the costs and benefits of creating additional automated telephone applications and finalize a more

[23]GAO, *Home Mortgage Interest Deduction: Despite Challenges Presented by Complex Tax Rules, IRS Could Enhance Enforcement and Guidance*, GAO-09-769 (Washington, D.C.: July 29, 2009); *Tax Administration: Expanded Information Reporting Could Help IRS Address Compliance Challenges with Forgiven Mortgage Debt*, GAO-10-997 (Washington, D.C.: Aug 31, 2010); and GAO-08-956.

[24]GAO, *Tax Gap: Limiting Sole Proprietor Loss Deductions Could Improve Compliance but Would Also Limit Some Legitimate Losses*, GAO-09-815 (Washington, D.C.: Sept. 10, 2009).

[25]GAO, *2011 Filing Season: Processing Gains, but Assistance Could Be Enhanced by More Self-Service Tools*, GAO-12-176 (Washington, D.C.: Dec. 15, 2011).

[26]GAO, *Internal Revenue Service: Interim Results of 2012 Tax Filing Season and Summary of the Fiscal Year 2013 Budget Request*, GAO-12-566 (Washington, D.C.: Mar. 20, 2012).

comprehensive plan for online services, including an assessment of granting taxpayers the ability to update their account information online.

Devoting Additional Resources to Enforcement

Devoting additional resources to enforcement would enable IRS to contact millions of potentially noncompliant taxpayers that it currently identifies but cannot contact given resource constraints. However, determining the appropriate level of enforcement resources to provide IRS requires taking into account factors such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities. For example, in a 2009 report, we found that despite investing nearly a quarter of all revenue agent time in 2008, IRS was able to examine (audit) about 1 percent of estimated noncompliant sole proprietors. Not only are these exams burdensome for businesses, they are also costly for IRS and yield less revenue than examinations of other categories of taxpayers, in part because most sole proprietorships are small in terms of receipts.[27]

Expanding Compliance Checks Before IRS Issues Refunds

IRS could reduce the tax gap by expanding compliance checks before issuing refunds to taxpayers. The Commissioner of Internal Revenue has talked about a long-term vision to increase compliance activities before refunds are sent to taxpayers. In one example, IRS is exploring a requirement that third parties send information returns to IRS and taxpayers at the same time as opposed to the current requirement that some information returns go to taxpayers before going to IRS. The intent is to allow IRS to match those information returns to tax returns during tax return filing season rather than after the filing season is complete.[28] As will be discussed later, this approach could also help IRS address identity theft-related fraud and could also allow IRS to use its enforcement resources on other significant compliance problems. However, the Commissioner made clear that his vision for more prerefund compliance checks will take considerable time to implement, will require a major reworking of some fundamental IRS computer systems, and could impose some additional burden on third parties.

[27]GAO-09-815.

[28]GAO, *Taxpayer Account Strategy: IRS Should Finish Defining Benefits and Improve Cost Estimates*, GAO-11-168 (Washington, D.C.: Mar. 24, 2011).

Leveraging External Resources Such as Paid Tax Return Preparers and Whistleblowers

Another way IRS may be able to reduce the tax gap is by leveraging external resources.

- Paid tax return preparers prepare approximately 60 percent of all tax returns filed, and IRS has acknowledged that paid preparers' actions have an enormous impact on its ability to administer tax laws effectively. Based in part on our work and recommendations, IRS recently developed new requirements for paid preparers, such as competency testing, which it has concluded will increase tax compliance.[29] IRS's goals for the program include leveraging relationships with paid preparers and improving the accuracy of the tax returns they prepare.
- Tax whistleblowers can help improve tax compliance by providing information to IRS on others' suspected tax noncompliance. We have made several recommendations for IRS to improve its whistleblower program through enhanced data collection and whistleblower claim processing timeliness.[30] According to IRS, it is in the process of implementing these recommendations.

Modernizing Information Systems

Modernization of IRS's information systems could improve taxpayer compliance. IRS is engaged in a multiyear effort to replace the systems it uses to process individual tax returns and receive electronically filed tax returns.[31] IRS had identified various compliance benefits to replacing the system it uses to process individual tax returns, including increasing taxpayer and paid preparer voluntary compliance and examination case selection.[32] Among other benefits, replacing its electronic filing system will allow IRS to accept taxpayers' prior-year returns and portable document format (PDF) files attached to their tax returns. According to IRS officials,

[29]GAO, *Tax Preparer Regulation: IRS Needs a Documented Framework to Achieve Goal of Improving Taxpayer Compliance*, GAO-11-336 (Washington, D.C.: Mar. 31, 2011); *Tax Preparers: Oregon's Regulatory Regime May Lead to Improved Federal Tax Return Accuracy and Provides a Possible Model for National Regulation*, GAO-08-781 (Washington, D.C.: Aug. 15, 2008); and *Internal Revenue Service: Fiscal Year 2009 Budget Request and Interim Performance Results of IRS's 2008 Tax Filing Season*, GAO-08-567 (Washington, D.C.: Mar. 13, 2008).

[30]GAO, *Tax Whistleblowers: Incomplete Data Hinders IRS's Ability to Manage Claim Processing Time and Enhance External Communication*, GAO-11-683 (Washington, D.C.: Aug. 10, 2011).

[31]GAO-12-176.

[32]GAO-11-168.

posting more comprehensive information from individual income tax returns to its computer systems could facilitate the examination process, expedite taxpayer contacts for faster resolution, and potentially better define specific tax gap issues.[33]

Simplifying the Tax Code or Fundamental Tax Reform

Tax code complexity can lead to noncompliance. Efforts to simplify or reform the tax code may help reduce the tax gap by making it easier for individuals and businesses to understand and voluntarily comply with their tax obligations. For example, eliminating or combining tax expenditures, such as exemptions, deductions, and credits, could help taxpayers reduce unintentional errors and limit opportunities for tax evasion.

Policymakers may find it useful to compare any proposed changes to the tax code based on a set of widely accepted criteria for assessing alternative tax proposals. These criteria include the equity, or fairness, of the tax system; the economic efficiency, or neutrality, of the system; and the simplicity, transparency, and administrability of the system. These criteria can sometimes conflict, and the weight one places on each criterion will vary among individuals. Our publication, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, may be useful in guiding policymakers as they consider tax reform proposals.[34]

Our recent reports show how changing tax laws to include more consistent definitions across tax provisions could help taxpayers more easily understand and comply with their obligations.

- For example, higher education expenses that qualify for some of the savings and credit provisions in the tax code differ by provision. These dissimilar definitions require that taxpayers keep track of expenses

[33]GAO, *Tax Administration: 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should be Evaluated*, GAO-08-38 (Washington, D.C.: Nov. 15, 2007).

[34]GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, GAO-05-1009SP (Washington, D.C.: September 2005).

separately, applying some expenses to some tax preferences but not others.[35]

- Likewise, more clarity would help taxpayers determine how to treat certain financial derivative products for tax purposes. Unique characteristics of financial derivatives make them particularly difficult for the tax code and IRS to address. Deferring gains or accelerating losses, changing ordinary income into capital gains or vice versa for losses, and altering the source of gains to avoid withholding taxes are examples of inconsistent tax rules for financial derivatives resulting in equivalent economic outcomes being taxed differently.[36]

Challenges to Addressing Identity Theft

Identity theft creates problems for both taxpayers and IRS. In refund fraud cases, an identity thief uses a legitimate taxpayer's identity to fraudulently file a tax return and claim a refund during the filing season. In these cases, the identity thief typically uses a stolen Social Security Number (SSN) to file a forged tax return and obtain a refund early in the filing season. The legitimate owner of the SSN may not be aware that this has occurred until he or she files a tax return later in the filing season and IRS discovers that two returns have been filed using the same SSN. In this instance, the legitimate taxpayer's refund will likely be frozen until IRS can determine the legitimate owner of the SSN.[37]

In our June 2011 testimony before this subcommittee, we reported that IRS faced various challenges in resolving, detecting, and preventing identity theft. These challenges included limitations in coordinating with other agencies and taxpayers because of privacy and other laws, inability

[35]GAO, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on Effectiveness of Tools to Assist Students and Families through Title IV Student Aid and Tax Preferences*, GAO-05-684 (Washington, D.C.: July 29, 2005).

[36]GAO, *Financial Derivatives: Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse*, GAO-11-750 (Washington, D.C.: Sept. 20, 2011).

[37]Identity theft may also involve employment fraud. This occurs when an identity thief uses someone else's name and SSN to obtain a job. In this instance, IRS would receive a Form W-2 or a Form 1099 reporting income on the taxpayer's account, which the rightful owner of the SSN had not earned and does not report as income to IRS. As a result, the taxpayer may be subject to enforcement action when, during the filing process, IRS matches what the employer and the taxpayer report and it appears that he or she earned more income than was reported on his or her tax return.

to detect suspicious cases until after fraud has occurred, and the lack of resources and authority to investigate and prosecute identity thieves.[38]

Addressing these challenges will require significant, long-term changes in IRS's operations and systems. As previously discussed, the Commissioner's long-term vision to increase up-front compliance activities could help. For example, matching employer information with tax returns before refunds are issued could prevent identity thieves from using phony W-2s to claim fraudulent refunds. However, significant changes would be needed before this matching could occur. Third-party information returns would need to be filed with IRS earlier in the filing season.[39] IRS would also need to improve its automated processing systems; IRS's current Customer Account Data Engine (CADE 2) effort is one key step.[40]

Chairman Platts, Ranking Member Towns, and Members of the Subcommittee, this completes my prepared statement. I would be pleased to respond to any questions that you may have at this time.

GAO Contacts and Staff Acknowledgements

If you or your staff have any questions about this testimony, please contact me at (202) 512-9110 or whitej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. GAO staff who made key contributions to this testimony are listed in appendix II.

[38]GAO, *Tax Administration: IRS Has Implemented Initiatives to Prevent, Detect, and Resolve Identity Theft-Related Problems, but Needs to Assess Their Effectiveness*, GAO-09-882 (Washington, D.C.: Sept. 8, 2009), and GAO-11-721T.

[39]Many information returns, such as forms W-2 filed by employers, are not due to the government until the end of February.

[40]GAO-11-18.

Appendix I: 2006 Tax Gap Estimate Data and Methodology

The Internal Revenue Service's (IRS) tax gap estimates are based on a variety of data sources and methodologies. For example, IRS studied individual taxpayer compliance through the National Research Program (NRP) and used the resulting compliance data to estimate the tax gap for individual income tax underreporting and the portion of employment tax underreporting attributed to self-employment taxes for tax year 2006.

The 2006 Individual NRP involved auditing a random selection of about 13,000 to 14,000 individual tax returns and is much smaller than the tax year 2001 Individual NRP of approximately 45,000 returns. Starting with the 2006 Individual NRP compliance study, IRS is using a rolling sample, which will combine samples across three years. According to IRS, this change will reduce cost and provide more up to date compliance data. The sample design for the 2006 Individual NRP included 11 primary strata, which were based on the examination classes used in audit workload selection. Also, the 2006 Individual NRP was designed to oversample returns with business income reported on Schedule C, E, or F or Form 2106.

The individual underreporting gap for tax year 2006 was based on findings from the 2006 Individual NRP and from an econometric analysis of tax year 2001 NRP data. This econometric analysis, called Detection-Controlled Estimation (DCE), attempts to account for income that taxpayers do not report on their tax returns and that NRP auditors could not detect. Because insufficient NRP data has been accumulated for tax year 2006 and later years for full DCE analysis, an improved DCE was undertaken using tax year 2001 NRP data and adjusted using other information to estimate undetected income for tax year 2006 NRP returns.

We have not verified the accuracy of IRS's estimate of the tax gap. According to IRS, a significant portion of IRS's 2006 tax gap estimate is based on recent compliance data and improved estimation methods. However, the tax gap estimate continues to be incomplete and partly based on older data. For example, the underreporting estimates for both FICA and unemployment taxes are projections based on applying the estimated compliance rates for 1984 to currently reported taxes.

To estimate the 2006 individual nonfiling gap, IRS used tax year 2005 third-party information returns, rather than the Census Exact Match study, as it did for the tax year 2001 estimate. The underpayment component of the tax gap is not an estimate but rather represents the actual tax amounts that taxpayers reported on time, but did not pay on time.

Mr. PLATTS. Thank you, Mr. White, and again, I thank all four of you.

Perfect timing, clock is at zero on the Floor, so I am going to run over. Mr. Towns, Mr. Connolly and I will return very quickly, as soon as the vote is concluded. And then we will get into questions with you. I appreciate your testimony.

This hearing stands in recess until the call of the Chair.

[Recess.]

Mr. PLATTS. The hearing will come to order.

I appreciate everyone's patience while we concluded Floor votes. We will move right into questions, and I will yield myself five minutes to begin.

Certainly the numbers are pretty staggering when you think of a tax cap of almost $400 billion, even after netting some recovery of taxes that were not properly paid. When we talk about taxpayer identity theft, fraud, the fact that we have hundreds of thousands of Americans being victimized and again, billions of dollars at risk. So the issues that we are trying to address today are real issues that are about real money for the American people, and about trying to protect American people as well, that they are not paying $3,400 of somebody else's tax bill, or they are not being victimized by criminals.

Starting with the area of the tax gap, Commissioner Miller, I guess kind of a structural question or framework, the data we are looking at, it is 2006 data, we are in 2012. Prior to that it was 2001, five years back before we had similar data. One, is there a plan that, this year you are going to update it again, five years, now six years, to update the data about the tax gap? And what is the difficulty in having it be more current? Having six-year old data certainly is helpful, but it wouldn't be as helpful as if it was one-year old or two-year old data.

Mr. MILLER. I think that is right, Mr. Chairman. The process has been to do examinations. So for example, if we were to do 2011 year, those returns are now coming in. It would be a while before we do our statistical sample. And using 1040s as an example, we are doing 14,000 research audits per year to try to update this. So it is a continuing path we are on.

It will be a while, it will be a few years, before we complete those audits, before we are able to roll up the information with respect to those audits. Two thousand and six is a long time ago, but I am not sure how much better we would be able to get. I think we will have an easier time going forward than we had in 2001. We did a better job in 2006, we had better data, better estimating models. And we will get more current. But I don't think we will ever be, the 2011 gap is, as we said, in 2012.

Mr. PLATTS. And I certainly don't expect that in 2012 we could look and say, in 2011, this was what the tax cap was. But it is, the fact that it is six-year old data that we are still using, especially with technology and I guess what concerns me a little bit is that we are still doing audits and haven't really completed and compiled the information from audits from 2006, well, 2007, 2008, so four year back, five years back that we still have that.

Because I think that is one of the issues that I think the Inspector General raises in the ability to use the data we have. And

whether it deals with identity theft, whether it deals with the tax gap is that, I understand that it costs money. But if we do it well and then act on what we learn it will save money in the long run by helping us to close that tax gap in this case.

So that is a concern that jumps out, is that we are relying on six-year old data and the need to make that more current so we can be more effective in how we can respond to whatever that data tells us.

Ms. OLSON. Mr. Chairman, if I may add, jump in here. I do think that the IRS is doing a rolling research study. So they are going to be doing three years rolled up at a time. So you would be able, even though you may be a bit behind, when 2006 is done, you would do 2007, 2008 and 2009 rolled together. And then you just move one year on as you go along.

And to the point about how long it really does take, if you have even 2006, some people are filing in October 15th and you may want those people in your random sample, because they may be some complex returns. So you are waiting for those to go through the processing. And then taxpayers have rights. So even those 14,000 audits that we have, they may want to go to appeals before they go to tax court. If they go to tax court, it may take a year and a half before they are out of tax court. And we have to wait until we are final on the whole issue. We don't know what is going to be in that 14,000 case sample, whether there are going to be some tax court ones or not.

So it is not an easy thing. But I do think that the IRS's proposal about the rolling sample really will work, that will give us, even though we will have some years of lag, it will give us good data going forward.

Mr. PLATTS. I certainly appreciate that some of these cases are going to be very complex, especially those that go into tax court. But again, we don't need the data from all 14,000 to be able to assess what is working or not. If we lost 4,000, we had 10,000 to look at. But it is three-year old data instead of six-year old data, that certainly would be more beneficial.

Inspector George?

Mr. GEORGE. I was just going to add, sir, that there are certain segments of the tax gap that the IRS just really hasn't adequately addressed, too. For example, the international tax gap. Our office estimates that is in the hundreds of billions of dollars, again, per year, that is due to the American taxpayer, the Treasury, and isn't being paid on time, if at all.

So again, it is an enormous task, as was pointed out, that does need additional resources. But it is something that needs to be addressed.

Mr. PLATTS. Commissioner Miller, do you want to comment on that? I know that is an area where we have, in my understanding, the most limited information regarding what efforts are. Again, I realize this is an issue of resources. I am not an appropriator, although I want to look at how we can try to make the case, and the Taxpayer Advocate well documents the return on investment if we invest in taxpayer services and what a dramatic return on investment that is compared to enforcement and how we can help to promote what your needs are.

But when we hear hundreds of billions of dollars that maybe we are not getting in that one category, how can we do better?

Mr. MILLER. On the international tax gap, I am not familiar with the Inspector General's numbers, to be honest with you. So I am not going to speak directly on that.

On international, I can say two things. Really, you are not looking at a single number, you are looking at different components. You are looking at what is cross-border activity of large corporations, and that is one set of documentation that we would look at. And we are doing operational audits there, and we do look at that. That is our window into that world.

The other world is offshore accounts, which as you may be aware, we have done a remarkably good job in. We have 33,000 people that have come into us in the last two years, three years, with over $4.4 billion of declared money coming into the Treasury as we go out and attack bank secrecy jurisdictions.

Do we know the total number? Do we know the full pie in either case? Probably not. But we are on our way doing good things in both areas.

Mr. PLATTS. I don't want to suggest that we are not moving in the right direction, but I think to the American people that are paying their taxes and doing their best to pay, whether it is $5,000 or $3,000 or $10,000, and then when they see numbers that are, if it was even tens of billions, but it is hundreds of billions that is not being paid, that we need to do a better job, out of fairness to those who are complying with the law and paying their fair share.

One other question before yielding to the Ranking Member. One of the issues, Ms. Olson, you talked about, is in the current system, we use an electronic system of collection, especially for the withholding of income taxes and employment taxes. And we have a mandatory 94 percent requirement for IRS in using electronic collection. Can you expand on that. The way I understood it is, your suggestion and recommendation is, if we apply that same approach to estimated tax payments, it would not just help the taxpayer be more compliant but ultimately generate more collection if we took that approach?

Ms. OLSON. With estimated, we were very successful once the IRS was given sort of a little nudge to say, achieve this goal in employment taxes, in getting electronic payments, which saves the whole government money, obviously, because you are not processing checks. But it also makes it easier for the taxpayer, after they get used to it.

But we should apply that to estimated taxes. I think that in some areas, it is very hard for taxpayers to save up money to pay estimated taxes quarterly. So if they can pay it monthly like they pay other bills, and most, they pay lots of bills through their bank accounts, just setting up payments. And we don't have a good interface. So I think that if we could get some kind of a nudge from Congress that sets a goal, the IRS has always responded well with that and developed a strategy. Then we would get the different parts of Treasury together to make it a really good user interface for the taxpayer.

Mr. PLATTS. Is it kind of the same argument on making it clear that voluntary withholding agreements would achieve, in essence, that same goal?

Ms. OLSON. Yes. And that proposal actually came from some trade associations that met with me that said, for example, the hair salons, they do have an employee like the receptionist. So they are already in the payroll tax system. And the people who cut hair really are independent contractors, they are renting booths from them. But they get in trouble, and then they move on, because they don't pay their estimated taxes.

So the hair salon was saying, if we could enter into an agreement where these are not our employees, because they are renting and everything, but we are already in the system, we will withhold a percentage and keep them in compliance, we will have these people stay with us and we won't have so much upheaval. And when we worked with counsel, they have said that we don't have the legal authority to enter into those agreements the way that particular code section is written.

Mr. PLATTS. The IRS general counsel?

Ms. OLSON. Yes, the IRS general counsel.

Mr. PLATTS. They need additional statutory authority?

Ms. OLSON. They need additional statutory authority. And so this really was a user-friendly, taxpayer-friendly proposal.

Mr. PLATTS. Something that we are glad to look at as a committee and try to see if we can work to allow that. I think it sounds like a win-win for the person who has those independent contractors working in their facility. They don't get the turnover, the independent contractor is more——

Ms. OLSON. And it is not mandatory. It is totally voluntary.

Mr. PLATTS. Right, and ultimately the taxes that are owed are better collected.

Ms. OLSON. Right.

Mr. PLATTS. I yield to the Ranking Member, Mr. Towns, for the purpose of questions.

Mr. TOWNS. Thank you very much, Mr. Chairman.

Let me begin with you, General George. Your testimony indicates that the IRS has institutional impediments that prevents them from effectively addressing the tax gap. And of course, you mention specifically that even when the IRS examines a tax return that needs improvement, often there is no change made to the return. And this increases the burden on compliant taxpayers.

Could you just elaborate on this just a little bit more?

Mr. GEORGE. Certainly, Mr. Towns.

The IRS, the bottom line is the IRS has incomplete compliance research. Specifically, the IRS does not know all the sources of noncompliance, so the IRS's resources cannot be targeted appropriately. The research which is needed is on the relationship between the taxpayers' burden and compliance and on the impact on customer service on voluntary compliance.

These are various studies that they may have engaged in in the past, but we don't believe they have done so adequately. Additional research is also needed to measure how establishing benchmarks and other measures to assess the effectiveness of some of the ef-

forts that IRS has engaged in in the past, whether something is working or isn't working.

So for example, we know for a fact that when they reach out to a taxpayer by letter, the initial contact normally results in a relatively high response from the taxpayer. That is, the taxpayer will either acknowledges that he or she owes the tax and pay it. Yet if the IRS delays reaching out to the taxpayer by, I don't have the exact numbers yet, whether the number of weeks or number of days, we know that the response rate declines.

So in a recent report, we encouraged the IRS to increase the frequency in which they communicate with taxpayers. The IRS, to my understanding, has declined to do so, again, citing resources. But that is just one example.

Incomplete compliance strategies, the IRS's systems that identify returns for examination need improvement to identify potentially non-compliant returns. The collection activity that extends for years has a lower rate of collection for delinquent liabilities. The IRS has something called the queue, which is a data base in which tax returns for people who owe taxes which aren't handled by IRS revenue officers or any other method within the IRS literally are put in line. And that line contains millions of tax returns.

Keep in mind, there is a statute of limitations on when someone has to comply with their tax obligations. So millions of dollars are potentially, and in reality, being lost because the IRS has not simply addressed these returns, had someone assigned to them to look at them.

But one of the most disconcerting aspects of all of this is that the IRS has an incomplete document matching program. So the IRS does not have reliable third party data for taxpayers, for all taxpayer sectors, at least, and for all types of tax returns. Most notably, income earned by the self-employed.

I carry this card with me and I cite this at every opportunity that I can, because this is information that comes from the IRS that is just very compelling. You heard earlier today, there is a very high correlation between tax compliance and third party reporting. The IRS estimates individuals whose wages are subject to withholding report 99 percent of their wages for tax purposes. Self-employed individuals who operate non-farm businesses are estimated to report only 68 percent of their income for tax purposes.

But the most striking number is self-employed individuals who operate businesses on a cash basis are estimated to report only 19 percent of their income. So there is no question that if the IRS, and again, it would have to have authority from Congress in some of these instances, were able to mandate third party reporting, the levels of compliance would go up, astronomically, I would argue.

Mr. TOWNS. Right. Mr. Chairman, I just need a minute to give Mr. Miller an opportunity to respond to some of that. Also Mr. White, very quickly.

Mr. MILLER. Thank you, Mr. Towns. There is a whole batch that was wrapped into General George's comment. A few things I would like to clarify. One, our national research program that comes up with the tax gap is also used on an annual basis to improve our filters. So it has a benefit to us to do these things to improve our selection process. Because we have a living process that filters back

in the results, so that we can target better our non-compliance. There is no doubt that we can improve, and we are improving on an annual basis.

Other things I will mention, the queue in the collection area exists, no question about that. Cases go to the queue when they are lower priority than other cases. Other cases can be a high priority, one, because we think they are better dollar cases, or two, because we don't have the resources to reach them at this point.

We are doing a better job of selecting cases for collection. It is not first in first out, I do want to make that very clear. It is based on the attributes of the given case.

Mr. TOWNS. Let me ask you this very quickly. I appreciate your generosity. Has anybody ever estimated or looked at the fact that you indicate you have 35,000 employees who detect identity theft. What would happen if you had 55,000 or 45,000? Would the resources increase? I am not sure that not having more staff is an economical way to go.

Mr. MILLER. Mr. Towns, I would agree with you. I think that Nina has said, and others at this table have said, that we believe the IRS is a pretty good investment, in that we are in essence the people who bring in $2.4 trillion and in the 90 percent, upper 90 percentile of every dollar that comes into the government on an annual basis.

So I think that as we pull people, and we have pulled many people to work on identity theft, as we had to and as we should, that does impact other programs.

Ms. OLSON. Sir, if I might comment on some of the earlier points from the Inspector General. The IRS does have a project right now that is looking into the impact of service on compliance. My office is working very closely with the Office of Research and with the Wage and Investment Division. We are doing a lot of surveys of taxpayers. It will be very interesting what we find out. And this is a constantly developing area.

I have been very critical of the IRS's collection strategy and their use of automation and their failure to just pick up the phone and talk to taxpayers. Because I think you can really get resolution. But the notice stream, where we send out notices to taxpayers early in the system, or in the process is very effective. But what that leaves us with are those taxpayers who aren't going to willingly come forward. And they need maybe a little nudging. And it is how you do the nudging.

The main point I want to talk about is the comment about our incomplete document matching. We have been given some significant tools with the merchant card reporting. But you all just repealed a provision that would have given the IRS more information about the purchases that businesses made. But the upshot, and we really criticized the provision, because it imposed so much burden on the businesses who are going to have to do the reporting. I think that is the tradeoff.

And in the self-employed area, the way to get information reporting on the self-employed is to get the householder to report on the person who is cutting their grass every week. And you are not going to get that done. That is just not something we can impose on those taxpayers.

So that is why you have to do vigorous audits and look at areas of risk and then think of some alternative strategies. I am not convinced that information reporting is the end all, be all for this tough area that we have.

Mr. TOWNS. Right.

Mr. White, just before you answer or respond, also include in your response getting back to the third party reporting. Do you think the IRS is taking full advantage of third party reporting? And then whatever else you have to add, I would appreciate it.

Mr. WHITE. Let me start with a quick example that highlights the importance of research. I want to follow up on Mr. Miller's point there.

The recently-enacted basis reporting requirements for financial transactions, financial securities, that policy proposal was based in significant part on research that was done using the compliance data that IRS develops to estimate the tax gap. So that is an example of how you can use that data to make changes to reduce the tax gap. It is estimated that the first seven years of that basis reporting proposal bring in $7 billion. That is a reduction in the tax gap.

In terms of information reporting, third party information reporting, one of the advantages there, as I think has been discussed somewhat, is that IRS can match that information to tax returns rather than having to do an audit. Audits are labor-intensive, very costly for IRS. More importantly, they are very burdensome on taxpayers. So this is an alternative to audits for enforcement processes.

The difficulty is in identifying new information reporting sources. There are some that we have raised in recent reports, some additional sources. One is payment for services.

Mr. PLATTS. Mr. White, if I can ask you, Mr. Towns, if you don't mind, Mr. Connolly needs to run for a Floor statement. IF we can kind of come back, let Mr. Connolly get in and then we are going to come back to those examples of additional sources. Is that okay?

Mr. TOWNS. That is fine.

Mr. PLATTS. Yield to the gentleman from Virginia.

Mr. CONNOLLY. I thank my colleagues.

Mr. Chairman, I would ask unanimous consent that my opening statement be entered into the record in full.

Mr. PLATTS. Without objection, so ordered.

Mr. CONNOLLY. I would further request that Colleen Kelley's, the President of the National Treasury Employees Union, statement prepared for this hearing also be entered into the record in full.

Mr. PLATTS. Without objection, so ordered.

Mr. CONNOLLY. I thank the Chair.

Mr. George, you talked about, I think you said a $450 billion tax gap?

Mr. GEORGE. Gross, yes.

Mr. CONNOLLY. That is this year?

Mr. GEORGE. That is as of 2006.

Mr. CONNOLLY. 2006 and it is growing?

Mr. GEORGE. Yes, it is. I believe it is a lowball figure, and again, part of the earlier discussion indicated that is an ongoing review. And it doesn't include aspects such as the international tax gap.

Mr. CONNOLLY. Understood. Do you think there could be some relationship between that growing gap and the fact that we have had a 20 percent reduction since 1995 in revenue offices and revenue agents?

Mr. GEORGE. There is no question that if the IRS had additional resources, they would be able to collect additional tax receipts.

Mr. CONNOLLY. I would point out to my colleagues, just for the sake of argument, $450 billion in money owed the Government we are not collecting. That is what the tax gap is, correct?

Mr. GEORGE. Roughly.

Mr. CONNOLLY. Times ten is $4.5 trillion.

Now, here we are sweating can we go big at $4 trillion, sweating a sequestration that would be $1.2 trillion. This would be a big dent in the debt if we simply put the resources into IRS to collect the money that is owed.

Now, over and above that, this Subcommittee, led by my colleagues, Mr. Platts and Mr. Towns, has done a lot of work on the issue of improper payments. And Mr. Miller, I think you were covering that in your testimony. What is the estimate of annual improper payments, mistakes get made, refunds get sent to people who really didn't qualify for them or the amounts are wrong or whatever it may be? What is the estimated annual improper payment for IRS?

Mr. GEORGE. Just to give two examples, under the——

Mr. CONNOLLY. Well, no, is there a global figure? You have $450 billion as the tax gap. What is the comparable figure for annual improper payments?

Mr. GEORGE. Let me respond by saying that I can tell you definitively that under the additional child tax credit it is estimated at $4.2 billion a year, although the IRS under an interpretation from Treasury disputes whether or not that is an actual improper payment. We don't believe we, the IG's office, don't believe that Congress, the law, authorizes the payment of the additional child tax credit to people who are not U.S. citizens and who don't have——

Mr. CONNOLLY. Yes, but we are trying to deal with global numbers here. It would be useful to have a number. The total amount estimated for the entire Federal Government is $125 billion a year.

Mr. GEORGE. And then of course the earned income tax credit is estimated at about $13 billion a year. But no, I do not have a golden number.

Ms. OLSON. Our tax gap numbers say that tax credits as part of the under-reporting gap are about $28 billion of that $450 or 6 percent of the gross tax gap. So that includes a number of refundable tax credits.

Mr. CONNOLLY. Mr. Miller?

Mr. MILLER. Sir, the only thing I would caution is, there is a difference between the improper payment, which is what went out that shouldn't have gone out, and the tax gap which includes all sorts of different pieces.

Mr. CONNOLLY. Yes, I agree with you. I am making that distinction, and I am trying to get what is the number for the former.

Mr. MILLER. And I don't have that number. We can come back to the Committee with that.

Mr. CONNOLLY. That would be helpful. Because again, if you set a goal of making it zero, understanding that that is probably an impossible task, but backing into that, what would be required? What would be required to close that $450 billion gap and to better get our handle on the improper payments? Because we are making incredible and, in my opinion, sometimes egregious policy decisions that are going to do real damage to the United States of America. We are cutting back on investments that are very important if we are going to stay competitive.

And here right in front of us is a source of revenue we are owed. Except this body is not willing to make the investments in IRS that we need to make. And what is very clear from your testimony is that for every dollar we invest in IRS, especially in terms of compliance, we have a big return without pain and suffering. It puzzles one why Congress wouldn't seize on that opportunity as one measure to put a real dent in the debt without having to create weeping and gnashing of teeth.

Let me ask a question of Mr. Miller. Oops, if I may, Mr. Chairman?

You talked about offshore tax havens, is that correct?

Mr. MILLER. Yes, sir.

Mr. CONNOLLY. That is kind of something every ordinary, average American taxpayer has, right?

[Laughter.]

Mr. MILLER. I hope not, actually.

Mr. CONNOLLY. Well, what percentage of tax filers have offshore accounts?

Mr. MILLER. We know the ones, and I don't have the percentage with me, but we don't know, we know the ones who are declaring them either under the FBAR rules or under our new rules that call for a check box on the 1040. We will find that out when the 2011 returns fully come in.

Mr. CONNOLLY. And that is a legal loophole in the law that somebody can take advantage of?

Mr. MILLER. It is a permissible act. Obviously, we have made inroads on offshore, and we also have the FACA rules now that are going to require banks to report to the United States those who have foreign bank accounts.

Mr. CONNOLLY. Can't think of anybody who has those kinds of accounts—oh, yes, I can think of one.

According to one study, the percentage of income paid in taxes for the top one-tenth of 1 percent of taxpayers in that top bracket has declined from 70 percent to 40 percent. And if you look at the middle income quintile, it has increased from 15.9 percent to 20 percent. That suggests a rather dramatic regression in taxes paid and the de facto tax code we are living with. Would you comment?

Mr. MILLER. I really wouldn't be able to comment on that.

Mr. CONNOLLY. Well, are those numbers accurate?

Mr. MILLER. I don't know. I would have to check on that.

Mr. CONNOLLY. Well, would you not agree that if the top one-tenth of 1 percent, which used to pay 70 percent of the percentage of income paid in taxes is now 40 percent, that is certainly not progress that is called regression?

Mr. MILLER. That is outside of what the Deputy at the Internal Revenue Service would be speaking about, sir.

Mr. CONNOLLY. Ms. Olson?

Ms. OLSON. Sir, I don't have those numbers. I would be glad to look into them and get back to you.

Mr. CONNOLLY. Would you agree if those numbers are accurate, that would suggest that the de facto income tax in this Country is becoming more regressive, not more progressive? If the top one-tenth of 1 percent is paying almost half of what it used to pay and the middle quintile is paying more?

Ms. OLSON. Sir, the reason why it is difficult to answer that question is that I have just been looking at historical data. And it is not clear to me that the highest income tax payers are paying less than what they might have done historically. So that is why I am saying I would need to look at what you are asking me and look at the charts that I have and be able to answer for the record.

Mr. CONNOLLY. I have to say to you, Ms. Olson, the numbers available to me are quite clear. They are not ambiguous. They have declined significantly in terms of the total percentage of income tax collected by the IRS.

Mr. Chairman, I thank you, and I thank you, Mr. Towns, for your indulgence.

Mr. PLATTS. I thank the gentleman. And before coming back, Mr. Towns, I would associate myself with the gentleman's comments about the need for us to do a better job of making that investment with the revenue officers to get the return on that investment for the American taxpayers. And similar to how the three us worked together on the funding levels for the Government Accountability Office and advocating to the Appropriations Committee members and staff on the return, I think there was like $86 for every dollar spent at GAO, glad to work with you and Mr. Towns on something similar to that that makes a case. The Advocate's numbers really presented pretty well on what that return on investment is.

With that, I will come back to Mr. Towns, and if it is okay, Mr. White, if you wanted to conclude. You were referencing some examples of additional data collection that would be helpful.

Mr. WHITE. This would be additional information reporting. Two things we have recommended in recent reports, one is payments for services to corporations. This is not payments for goods, but this would be purchases of services from perhaps, from contractors, outside contractors who may be incorporated. If you are incorporated, that does not have to be reported to IRS. If you are not incorporated, it does have to be reported to IRS.

So one suggestion for additional information reporting there is to extend that to contractors who are incorporated. Payments for services by owners or rental real estate is another area where we have recommended increased reporting.

And then there are also cases where reporting is done now but where additional information could be provided. One example is on reporting on mortgages. Currently the 1098 forms that report mortgage information do not include the address of the mortgaged property. That creates problems for IRS in sorting out suspicious returns from correct returns. Because it is not easy to tell even how

many properties somebody owns. So there are both sorts of opportunities there.

One other point I would mention is, there has been quite a bit of discussion about return on investment. This is something, our recent work, we have highlighted with IRS the importance of doing more estimates of return on investment, both for proposed initiatives, which the Service is now doing, and then after the fact, trying to calculate, trying to measure the actual return from investment on compliance initiatives. So that the Service learns what has been effective, what has been more effective than they thought it would be, what has been less effective than they thought it would be. That raises then the possibility of redirecting resources to areas to get the biggest bang for the buck.

Mr. TOWNS. Thank you. Mr. George?

Mr. GEORGE. Mr. Towns, I beg your indulgence just to touch on what Mr. White discussed. Throughout this session, we have talked about the need for the IRS to receive additional information, third party information and how that would enhance revenue collection. But what is just as important is, once the IRS receives this information, what it does with it. And that is a problem that we have reported on before, whether it is a 1099 or what have you. The IRS will receive this information from an employer and then will receive a tax return or return seeking a refund, and it won't match the two in time to ensure that the information is accurate.

So if someone wants to commit tax fraud, they are able to claim more in a refund than they are entitled to, because the IRS didn't on a timely basis compare the information. That is a major problem, yes, it is a resource, you don't derive in terms of their having fewer computer systems or revenue officers. I will defer to Mr. Miller to address how they handle that internally. But it is a significant problem.

Mr. TOWNS. Right. Mr. Miller?

Mr. MILLER. Mr. Towns, I agree with General George that it is a significant problem and it stems from a number of reasons, the key of which is timing. We don't have the 1099 or the W–2 often when the return comes in for refund. We do what we can. But under the current systems, we don't have the information to match.

We have recently started talking to the community about being more real time, which would, has in mind exactly what General George is talking about. The most information we can have at the time of that refund, the better off we will all be.

We should have the W–2, we should have the 1099s with respect to that person, so that we can validate, one, that it is the person that should be getting the refund and two, that the amount is correct.

Mr. TOWNS. Why can't we get that?

Mr. MILLER. We receive, many 1099s are due March 30th, and we already are 70 million into the refund stream by that time.

Mr. TOWNS. What changes would have to be made? This is why we are having this hearing, to see in terms of what we can correct. That is the purpose. So what needs to be done?

Ms. OLSON. This is something that my office has proposed several years ago. We did a study, looked at many different countries around the world. Many countries, and I alluded to this in my tes-

timony a little bit, don't start the filings, they don't issue refunds until the filing season is closed and they have received all the returns and they have had a chance, including information returns, and they have had a chance to run everything against, and do matching. And then they issue the refunds.

Now, in the United States, people are showing up the first week of January to file their returns to get a refund. And it would mean a major shock to the system.

I do understand, I understand that some of the payroll processing companies have said that if all we needed was gross wages and withholding on the W–2s, they could basically provide us that information within the first couple of weeks of January. It is all the information classifying non-taxable health insurance and retirement plans. That is what takes a little bit longer for them to process.

So I think that the IRS is looking, as Commissioner Miller said, we are engaging in conversations now with the information reporting sector to see what we can get early.

I could also tell you that Australia took a very interesting approach, sort of what the United States is doing. They sat down with many of their partners, like the major banks and some of the major employers, and they said, what information can you get us very quickly. And people voluntarily came in and said, we can get you this very quickly. And then they told the taxpayers, if you wait until this date, filing season starts here, but if you wait until this date, you can go online and you can see the information that we have, so you can be sure about what you get.

So they voluntarily asked taxpayers to sort of wait in the filing season. And because they had a pre-filled return, so that taxpayers could just sort of download that information and fill in the rest of the stuff, it was viewed as a very positive thing.

Now, they are really getting about 40 percent of their taxpayers are actually waiting and using the information that the agency is getting voluntarily. And they are getting to the point where they might be able to say, okay, now we are changing deadlines, because we are seeing people move to later in the filing season.

And that is the approach that we have recommended. Use if voluntarily, make it as a desirable thing, taxpayers will wait because they want the certainty. Negotiate with your partners like the IRS is beginning to do. And rather than bringing a huge shock to the system where taxpayers are really desperately waiting for their refunds up early.

Mr. TOWNS. Right. Mr. White?

Mr. WHITE. I would just add a little bit to this. A few other considerations in addition to the burden on the third parties, changing the filing date for the information returns, there does need to be enough time allowed for them to ensure that those information returns are accurate. If they are not accurate, if they have errors in them, then they are much less useful for IRS, because it means they are finding false positives. At that point, contacting taxpayers about a mismatch when there may not be a true mismatch.

One other point about the value of this kind of information return matching early on, before refunds are issued, is that it would to some extent be a long-term solution, or at least a partial solution

to the i.d. theft problem. IRS would be able to do more verification before issuing refunds to detect illegitimate claims.

Mr. TOWNS. You mentioned, and this is it for me, Mr. Chairman, you mentioned in terms of statute of limitations. There is no statute of limitation on fraud.

Ms. OLSON. Correct.

Mr. GEORGE. That is correct.

Mr. TOWNS. Okay, Mr. Chairman.

Mr. GEORGE. But proving the fraud, it is which comes first. So it is in the queue. If it is there for five years, and that is the statute of limitations for it, for someone having to pay their tax obligation, if the IRS hasn't gotten to it, it is out of the queue. That is my understanding, and you can correct me if I am wrong, Commissioner.

So if they haven't proven it by then, how do they know it was fraudulent?

Mr. WHITE. And much of the tax gap is not in that queue. There are significant parts of the tax gap that IRS does not detect in the sense of identifying the particular taxpayers that owe that amount.

One of the issues here is that a significant portion of the tax gap is in very small amounts of money spread over millions of taxpayers. There are a lot of small businesses that have reporting problems, both intentional and unintentional. They are small, by definition the tax liabilities there are small. And it raises the question of whether it is worth going after them. Because to find the unpaid taxes, in many cases, you would have to audit them.

And then another question is how intrusive you want the tax system to be to find those relatively small amounts spread over, again, millions of taxpayers.

Mr. MILLER. Sir, if I could, just one correction to General George. There is a 10-year statute for us to collect the money. And actually, I think I would agree that the older and colder the debt, the less likely it is we are going to collect it. It is just like any other debt.

But we do have offsets that occur constantly and we have other liens and other tools that do make use of that data. And those accounts are collected on.

Ms. OLSON. Something that Mr. White said, there are things other than direct enforcement that are very valuable tools. Commissioner Miller mentioned the refund offsets. A large percentage of collection occurs because a taxpayer has a debt with us but they are also getting a refund in a future year. That is just the computer seeing the refund and grabbing it. And it goes into the public treasury.

But another thing that the IRS is doing this year is some behavior modification, if you will. We had recommended several years ago on the sole proprietorship return that you break out the lines for reporting income where you say, here is income from 1099s, that is reported on 1099s filed to me, and here is other income. I just know as a former return preparer that my client would come in and they would just show me their 1099 income. And I would say, well, clearly, I am not going to audit your books, but clearly you have more money than this that you earned, that you brought in. And they would go, oh, yes, $100 or something.

Well, if you force taxpayers to have to articulate, they are going to look at, they have put all their money under the 1099, they are going to think, oh, the IRS is going to audit me if I don't report some money on this other line, the non-1099 income. So suddenly you disappear, even if people were now reporting $100 and they go up to $1,000, that is $900 per taxpayer. And that is a lot of money.

So we have used that in the past, little behavior modifications that drive people to a little bit more compliant behavior because they think we are looking at them. That is a very important tool. That is really the policy behind information reporting, but you don't just need it for third party. You could do it through what they have to report on their returns.

Mr. TOWNS. Thank you, Mr. Chairman, for your generosity.

Mr. PLATTS. The gentleman is more than welcome. I want to turn the discussion a little more toward specifically identity theft and the issue that the Ranking Member and I have focused a lot of time on with our staff, and both sides, with the Subcommittee staff. I certainly want to commend the IRS for increased focus on this issue. It certainly is a necessity as we see the numbers going up each year of those who are seeking to defraud the American people through identity theft related to tax refunds.

I know one of the issue is the taxpayer protection units that have been established. As someone who has been a victim of identity theft, or believes they have, to have a designated unit, I think that is an important step. But I will tel you, one of the things that jumped out to me, and it was the Taxpayer Advocate's testimony, that is just unacceptable, is how I would say it, is the level of service numbers. I understand that in general, the goal this year was about 60 plus percent level of service. And yet when the taxpayer protection unit level of service in mid-March was under 12 percent, and even in this past week and kind of the heaviest time was only at 35 percent.

I look at that as saying, we are going to create a special unit for those who have been victimized, and I emphasize victimized by criminals because of identity theft. And we set up a special unit for them to call, and we are only helping not even two-thirds, when we have the highest level of assistance dedicated to their assistance. And even those who do get through to get assistance, according to the Advocate's testimony, the average wait on hold was one hour and six minutes. That is not how we should be treating victims.

And it goes to our previous discussions here that we need to recognize this for what it is. It is a crime and there is a victim of the crime. And that we set up a special unit is a good thing. But if the unit can't deliver to help the victims, that is not a good thing.

So dropping to 60 percent level of service overall is of concern. But dropping to 12 percent for those that are supposed to help those who have been victimized, and even those who got help had to wait over an hour on hold, anybody in this room enjoy being on hold for over an hour? I don't think so. I am amazed that anybody stayed on hold for over an hour, quite frankly. That is just not acceptable. That is not how you treat a victim of a crime.

So I want to recognize that you are trying to do the right thing here, but we are far from where we need to be.

Ms. OLSON. Chairman Platts, just to make a clarification, the unit that that number went to is different from the unit where taxpayers who think they have been identity theft victims calls the IRS out of the blue. The unit that those statistics go to is a unit where the IRS has sent taxpayers letters and said, we think there is a question about your return and we are not going to hold it. So I just wanted to make that distinction.

Mr. PLATTS. Yes, absolutely. But where there is a belief that there is identity theft here, and so we set up a special unit for them then to respond, and then we put them on hold for an hour, if they get through, and as the numbers show, the overwhelming majority do not.

Mr. MILLER. I agree, Mr. Chairman. I was unaware of the 35 percent, I wasn't aware of the earlier problems. I thought we had resolved that. I know we have added more staffing, and maybe we have not added enough.

Mr. PLATTS. Yes.

Mr. GEORGE. Not only do they not have adequate staffing and extended wait times, if someone calls back to find out what the status is of their case, they are assigned to someone who may not have seen the case before. They are not handed to the same person who has the institutional knowledge of their case.

In addition, in times such as recently, with the tax filing deadline, people who are normally assigned to those types of cases are reassigned to answering regular tax concerns from other taxpayers who dial the 800 number or who walk into taxpayer assistance centers. So there is a way that the IRS could certainly run this system a lot better than it is.

Mr. PLATTS. And General George, you raise an important point in whether the IRS has looked at this in the past or not. Especially when you set up that special unit to respond to specifically, and certainly at a fraction of the numbers here. But I will equate it to my office or Ranking Member Towns' office, we open about, over 4,000 new constituent cases a year as an office. And that is individuals.

Now, if somebody calls in and the person they were working with is not in, another member of my staff can pull up their case to see if there has been anything updated in it since they last talked to the staffers. But there is a dedicated staff person that they are working with. And that does make a huge difference than having to start over.

So I don't know if that is anything that the IRS has looked at doing, so that when you call in, once you make that contact, that you then have, all right, here is your case manager that you should be dealing with, so you are not starting over and having to re-educate every time you call in. Is that something considered?

Mr. MILLER. It is considered. And I don't know whether it would work here or not, to be honest with you. Generally, and I think the Taxpayer Advocate and I may disagree on this, we don't necessarily have the resources to say, this is your person. What we ought to be doing is to ensure whoever does get on the phone with you has all the information in front of them, and that is what we try to do.

Mr. PLATTS. Is that done through the case files electronically, that whoever helps you, that they are then well documenting?

Mr. MILLER. That is our attempt. Our attempt is to have, and remember, we are talking about, this is a microcosm of the way we are doing business on the phone generally, where we can't necessarily, our systems do not permit a single person, we don't believe it is the most efficient way to do it, and we can't do a single number to a single person at this point.

So we are looking at it. In a perfect world, yes, I would have an individual who was assigned to my account. And we have not been able to get there in terms of resources or systems to date.

Ms. OLSON. All I know is that, not just in identity theft, but in correspondence exam and in automated collection, some of the most significant and frequent complaints we get are taxpayers saying, I have talked to four different people, I have had to explain my situation over and over again for each one. I have looked personally at some of the notes that people take. And you cannot read, you can't build a story from the notes. You don't know what the person before you did.

And to Mr. White's point, this is where you go into the return on investment, to do the analysis to say, by saving pennies by having anybody answer the phone, whoever is the next available person, are you really saving money downstream, where you get the wrong result and the taxpayer keeps calling back. And then you go to a taxpayer advocate service, where you have two employees working the case, mine and the IRS employer. You go to appeals, which is a higher-graded employer, you go to tax court, where you have the lawyers and the paralegals and the tax court personnel involved. And can we really do a good return on investment on that? I would say no, you are not saving money.

Mr. PLATTS. And when you add to that the data that has been shared here today, that we know that our best chance of eliminating the tax gap is voluntary compliance. So the person who is calling in is trying to figure out, I will use the example of the victim calling in because they have been defrauded or victimized. But for anybody calling in, the fact that they are calling in is a good thing. They are trying to resolve their case.

So we want to get them the assistance they need and the data shows that. And that goes to that issue of taxpayer services, the return on investment versus enforcement. And so yes, I think it is a penny saved and a pound lost. It doesn't seem to be a well thought-out approach.

An issue where I want to acknowledge what I think is a very positive step in the area of identity theft, if I understand this correctly, and this s something we raised in the first hearing on identity theft last June, I guess it was. That is, somebody files a return fraudulently. The legitimate taxpayer then submits their return, finds out, hey, somebody already filed and got a $4,000 refund, and it is going to take a while for us to work through.

But even when that happens, and we are working on shortening that time frame for the victim to be made whole, that in the past, the victim couldn't get any information about the fraudulent conduct, even though it was submitted in their name, their Social Security number, as I understand, your General Counsel has issued an opinion now that says, the legitimate taxpayer has a right to that information, of the fraudulent material that was submitted,

and then can authorize, I want that information and I want to be able to share it with law enforcement.

I will use the example of a couple of the citizens who testified last year. I guarantee you, if they had been given it a year ago, the information, they probably would have gone to New York with the information, gone to the NYPD and said, listen, here is where the check went, let's go get the photos from the bank that will show who came in and collected that money, if they had that information. At that point, they were being told no.

But is that correct that it has been changed, that they have a right to that information?

Mr. MILLER. It is correct, Mr. Chairman, that we have the opinion of counsel that we can share that information. It will require, and what we are doing, as we speak, we are rolling out a pilot with some local law enforcement.

The real issue is, we cannot share this information with local law enforcement.

Mr. PLATTS. But the taxpayer can authorize it to be shared, right?

Mr. MILLER. The taxpayer can authorize through waiver for it to be shared. We are rolling that out as we speak.

Mr. PLATTS. That is great. I have heard of it being used in cases in Tampa and local law enforcement in Florida. If the legitimate taxpayer can say, hey, I want to work with the local police, give them everything you have, I think that is going to be an important step. Because I understand when we are talking about an average of I think $3,500 or $4,000 as the fraudulent return refund, that from a prioritization resources the cost of, at the national level, trying to go after those.

But the local guys, that is what they do every day. That is what my local police are doing, helping citizens every day with those smaller types of crimes or fraudulent conduct. So I think that is a very positive step. While I am very displeased with the level of service on the TPU, the taxpayer protection unit, I do want to recognize that is a very important step in the right direction.

Maybe two other issues here before we wrap up and I appreciate all our witnesses' patience, the issue of the Social Security Death Master list and the fact that is pretty much open game for fraudulent conduct, or those who want to commit fraudulent conduct. I know the IRS, I believe the position is to restrict access to that. Is that correct, that you would like legislative action to restrict who can access that information?

Mr. MILLER. I think we are working with the Social Security Administration and the Administration more generally on legislation that would do that.

Mr. PLATTS. So that is an ongoing effort, but not ready yet to say, here is what we think is the right approach within the Administration?

Mr. MILLER. I think that is right. I think your question would be very well answered to go to SSA and have that discussion. I think they are actively engaged in talking to people about it as we speak.

Mr. PLATTS. It is something that we want to look at, of how to do that. To me, the fact that that information is too freely shared,

sometimes for legitimate purposes shared, but it is just too big a target for those who are committing the identity theft.

Mr. MILLER. Yes.

Mr. PLATTS. The other final issue is more of a broad issue. That is the balance, and if any of the four of you would like to comment, when it comes to the fraudulent, and this goes to the issue of the timing of matching documentation with returns, I know it is a balance between a quick refund, which those who are entitled to refunds want it to be quick, because they can.

Although I would also say that most taxpayers don't have to wait for a refund if they wanted to adjust the filings and get the money in their paycheck, so they could get an instantaneous refund every paycheck rather than one lump sum.

Ms. Olson, you were talking about human nature and behavioral management, I will admit I am one that, it is kind of a forced savings and I would rather get $1,000 back than have to write a check for $1,000. I think it is a mental psyche of how you look at it.

But it is a choice that every taxpayer has, to try to ensure that they don't have to get a refund. In fact, if they want, they can owe money and come out ahead because they had the money and then write a lump sum check.

But given that, how do we balance that quick refund against the risk, and that we are not able to match? Today with electronic filings, as the use of electronic filings more and more the norm, more and more the norm also is that typical individual doesn't just have a computer, but they also have a printer that is also the scanner. That is the norm with printers today. If you buy a printer, it can scan, fax and print.

Have you looked at saying, if you want to file electronically, and maybe it is not all refunds, maybe it is a pilot to look at, but you have to scan in your W–2s, so rather than waiting for anything to be mailed in or matched up from the third party, if you want an electronic return, you scan in your W–2. So when you electronically submit and especially when it is paid taxpayers, what is the percentage, Commissioner Miller, is it 65 percent or higher than use paid?

Mr. MILLER. It is above 60, yes, in that range.

Mr. PLATTS. For those, it would especially be, I guarantee you, if you are a paid provider, your ability to scan a document is a given. Is that something that we should consider?

Mr. MILLER. If I could start out, a couple of things. I think two separate points altogether, which is enforce savings. I think it is absolutely true for you and I, I think it is less true as you go down the income scale, where you have the earned income tax credit and maybe one-third of people float in and out of on an annual basis. It is a changing circumstance.

Mr. PLATTS. I think that is a very relevant point.

Mr. MILLER. On the second piece, I think we should look at everything we possibly can. We need to get better at our screening, we need to get as much information as fast as we can to apply it to refunds as they come in.

On the scanning item, we certainly should look at it. I think at this point, to be honest with you, we still get a lot of paper fraud in. They have dummied up W–2s. So I am not sure that that, in

and of itself, it may be a piece of a larger strategy and is absolutely worth looking at. But I am not sure in and of itself that that will be a game changer for us.

Mr. PLATTS. Mr. White?

Mr. WHITE. I agree. I have the same concern about the scanning, that the i.d. thieves are making up W–2s. So getting one from the taxpayer doesn't guarantee that it is legitimate. What you need to do is get the information return, the W–2 from the third party employers faster. That is where technology may help, that a lot of the deadline that Mr. Miller mentioned earlier, for due dates for those information returns were set many years ago. With more modern technology it may be possible for third parties, for at least certain kinds of information returns, to submit them much earlier in the filing season, so that they could be matched to returns.

Now, there are some other things that need to be in place to make this work as well. IRS is modernizing its information systems. But obviously you need systems in place that can handle massive amounts of data. IRS gets billions of information returns each year. So you are talking about a lot of information that you would have to match very quickly so that you are not making taxpayers wait for refunds.

Mr. GEORGE. Mr. Chairman, I would note though, certain software tax packages, Turbo Tax being one, do allow for people to download their W–2s electronically. So it does exist, but again, you are right, it is $65 to purchase that package, and some people just don't want to make that expense.

Ms. OLSON. We have thought a lot about behavioral modification. I think that the demise of refund anticipation loans has, what refund anticipation loans did was tell taxpayers, you can get your dollars tomorrow. So suddenly the IRS getting you money through direct deposit and electronic filing within 10 days looked like an enormously long time.

I think we have to really think hard about messaging and communicating with taxpayers to talk to them about what is the reality of the filing season, and that they actually really do want us to do these refund screens. The first year it may be hard because you are depending on this money like you have always. But if you can adjust your behavior, then you can depend on it in the future at the same time every year.

The lower income really used this for paying their heating bills. The studies showed that they used it for things like buying refrigerators, buying school clothes, stuff like that. So I think we have to work with a larger community to get people used to it. But I think the IRS has to step up to that plate and really change expectations and behavior.

Mr. PLATTS. Mr. Towns, I just have two more questions, then we will wrap up and conclude.

Two final questions here. One is, with the information that is provided with the push on certified tax preparers that you are moving forward with, when there is a professional tax preparer, paid tax preparer, do they have to certify, I know that they sign they prepared the document, the return. But do they have to certify in some way that they have seen the W–2s or the supporting documentation? Is there an affirmation they have to make?

Mr. MILLER. I don't think the signature means that, Mr. Chairman. I can come back to you on a more detailed discussion of under Circular 230 what exactly are they signing when they sign the return. But the due diligence that they are required to do I think is at a broader level than that.

But I can come back to you with a more specific answer on that.

Mr. PLATTS. That would be great.

And the final thing is, in looking again at conduct and the type of fraud, are we able today, when we talked last year, it was about the issue of debit cards and what percentage of identity theft fraud is paid out on debit cards versus a deposit into a bank account, because of the ability for a criminal that they have to go in and access money in a bank account, there is much more of a trail to be followed if we are going to pursue the criminal conduct, different than with a debit card.

Mr. MILLER. I will have to come back to you with that as well. I think we have seen an increase in the use of debit cards, and you are quite right, there are pluses and minuses to that.

Mr. PLATTS. I think that goes to the broader issue of assessment of the information that we have. If we are identifying, say there is 400,000 possible cases or actual cases of identity theft that were identified and stopped, what percentage of those were asking for refunds on debit cards. And as to, shall we be issuing debit cards.

Ms. OLSON. I am not sure we would know that.

Mr. MILLER. That is why I said——

Mr. PLATTS. That is what I am getting after is, I think we need to know that.

Ms. OLSON. I think that the debit card has an account that is the same as a bank account.

Mr. MILLER. And the Financial Management Services, actually the part of Treasury that is making the payment, it sees an account number. It does not know, I don't believe, whether it is a debit card or a bank account. That would be something that was known by the software providers. And those are discussions that are ongoing. I agree, we need to get our arms around that.

Mr. PLATTS. Because when you hear the testimony or the information from, like in Tampa, when they go in, and a former drug dealer, I think, went in and they have 50 debit cards with $4,000 in each of them that were fraudulent returns, that seems like some evidence that the criminals, who are organized criminals doing this, are using that method more likely than any other method.

Again, it is a data analysis that's what I am after.

Mr. MILLER. Right. I think one other point, because there is one no doubt that we are seeing the same stories you are, where there are rows of debit cards. I want to make it clear, if we have stopped the refund, the criminal will have a debit card, he or she will have a debit card, there will be nothing loaded on it. And when he or she goes to load, there will be nothing there, because it will have been stopped, either by us or frankly, by the debit card company because it is finding fraud as well.

Those stacks, I am sure some of them have money, don't get me wrong, but it shouldn't be assumed that they all have money on them.

Mr. PLATTS. I am going to make a final comment, then we need to wrap up. On the issue of identity theft, I want to just re-emphasize that this is about the victims, legitimate taxpayers who are victimized by criminals. There is maybe no more egregious example of what I heard reported this week of a fallen hero of this Nation, who gave his life in defense of the Nation, and then his parents come to learn that not only did they lose their son, but their deceased son, who gave his life in defense of this Nation, was victimized by identity theft related to taxpayer refund. That just epitomizes the type of victimization that is occurring. We need to do right by that family and by every individual or family out there, that those legitimate, hard-working, law-abiding citizens are not victimized. And if and when they are, that we prioritize them.

So I know we can do a lot better in that regard.

I want to thank each of you for your testimony, your patience here, especially with the break, with the Floor votes. I thank the Ranking Member. As hopefully came through, we are not about gotcha, we are about trying to work through this issue with you and how can we help. Whether it is the issue of adequate funding for the resources that make that return on investment, that we invest and the taxpayers come out ahead, whether it be on legislative authority that you don't have that we need to provide. But on all aspects, we want to work with each and every one of you and your offices.

General George, did you have a final comment?

Mr. GEORGE. I just wanted to clarify one thing. In response to Mr. Towns' question about the statute of limitations, Mr. Miller was correct in terms of it is 10 years to collect. There is no statute of limitations on fraud if it is willful fraud. But there is a three-year statute of limitations on the IRS's ability to conduct examinations on tax returns.

So it is something that needs to be clarified here in the overall record.

Mr. PLATTS. I appreciate the clarification.

Mr. Towns, did you want to make a closing remark?

Mr. TOWNS. Actually, I want to associate myself with your remarks and thank the witnesses for being here. And to say that if there is something that we need to do on this side, feel free to let us know. I just think there are some areas here that need to be dealt with. I think that working together, we can deal with it.

I thank you very much, Mr. Chairman, for this hearing.

Mr. PLATTS. Again, we will have the record open for seven days for some of that extraneous material or responses to some of the questions. I appreciate our witnesses' testimony and this hearing stands adjourned.

[Whereupon, at 12:15 p.m., the committee was adjourned.]

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Opening Statement

Rep. Edolphus Towns, Ranking Member
Hearing on "Problems at the Internal Revenue Service: Closing the Tax Gap and Preventing Identity Theft"
Subcommittee on Government Organization, Efficiency and Financial Management

April 19, 2012

Today's hearing is the third in a series held by this committee examining how the IRS handles the growing problem of identity theft and tax fraud. As of March 3, 2012, the IRS had already identified over 440,000 tax returns with $2.7 billion claimed in fraudulent refunds. Fortunately, IRS screening prevented 97% of those fraudulent claims from being paid. Today's IRS is doing a better job protecting the taxpayer and the treasury from criminals than ever before.

But more is required of us to stay ahead of the criminals and to help the victims. One of the first priorities we must address is the quality of assistance given to taxpayers victimized by employment or tax refund fraud. The Inspector General does not paint a pretty picture of how the IRS will be able to handle this problem going forward. It seems as if taxpayers will have fewer walk-in help centers with shorter business hours, and longer hold time on the phone with IRS agents. Budget cuts are the primary reason, but I hope can find alternate solutions to these issues.

Today we will also focus on the $450 billion tax gap. This tax gap equals nearly 20 percent of our forecasted deficit for this fiscal year; we simply can't afford to look the other way.

Part of the tax gap is the result of tax cheats who simply refuse to comply with the law, which increases burdens on the rest of us. But a portion is due to taxpayer confusion and unintentional errors as well. I am sure that we can all agree that the tax code is extremely complex. This complexity makes it hard for taxpayers who honestly want to pay their taxes to figure out what they actually owe, and as a result, they can accidentally overpay or underpay.

We must do more to understand the sources of the tax gap and compliance burdens so we can make progress uncovering new, creative solutions. We cannot close the tax gap by enforcement against the average American who is doing their best to comply with tax laws. We all have to share the burden and do more. Let us work to reform our tax code in a way that will

help us collect more of the taxes that are owed but not paid. And let us continue our work to make the tax code more fair and simple.

I thank our witnesses, Inspector General George, Mr. Miller, Mr. White and Ms. Olson for your appearances and testimony today. I look forward to the testimony.

Mr. Chairman, I yield back.

Contact: Ashley Etienne, Communications Director, (202) 226-5181.

Statement of Congressman Gerald E. Connolly

April 19th, 2012

Thank you, Chairman Platts and Ranking Member Towns for holding this series of hearings on closing the tax gap and combating identity theft. America is fortunate to have a culture of tax compliance, which is what differentiates us from countries like Greece. As Greece continues to demonstrate, when tax evasion is widespread it is impossible to balance budgets and maintain both economic growth and confidence in a nation's central government. Unfortunately, recent cuts in Internal Revenue Service funding have resulted in larger tax gaps and lower tax compliance at a time when increased internationalization of finance makes tax evasion easier for sophisticated individuals.

As testimony submitted by the National Treasury Employees Union for this hearing noted, the number of revenue officers and revenue agents has declined by 20% since 1995, with a loss of 450 positions between FY 2010 and FY 2011. Declining resources have resulted in deteriorating tax enforcement, with a loss of $2.6 billion in enforcement revenue in the last year. Each dollar invested in IRS tax enforcement yields $200 in returns. We cannot afford to shortchange the IRS at a time when tax evasion has become easier due to tax code complexity and offshore tax havens. Moreover, the complexity of the tax code means that average people often need more help from agency officials to ensure their returns are accurate. Perhaps one day Congress will rationalize and simplify our tax code, but for now we must recognize that evasion and code complexity call for sufficient IRS resources to provide both guidance and enforcement for taxpayers.

According to the Congressional Research Service, America loses $100 *billion* annually as a result of offshore tax havens, some of which are used in violation of the law. In addition to sheltering money offshore, underreporting of taxable income represents a major revenue loss for the federal government, in the neighborhood of $376 billion annually. To address both improper use of offshore tax havens and underreporting of taxable income, it is imperative that we protect the IRS's ability to enforce tax laws. As the economists Emmanuel Saez and Thomas Picketty have documented, increasingly regressive taxation in the United States corresponds to sluggish income growth for middle class individuals and diminishing economic mobility. Between 1960 and 2004, the share of income paid in taxes by the top 1/10th of 1% of Americans fell from 71.4% to 40.8%. During the same time period, taxes as a share of income increased for individuals in the median quintile from 15.9% to 20%. Failure to enforce tax laws, particularly for higher income individuals and companies, exacerbates the extent to which our relatively feudal tax system undermines wage growth and reduces mobility for middle class wage earners.

In addition to improving tax enforcement, we need to help taxpayers by providing resources to help complete taxes accurately while preventing identity theft. At previous hearings of this

Subcommittee we discussed computer algorithms that can be used to identify potentially fraudulent returns submitted by identity thieves in order to steal other individuals' tax refunds. We must ensure that the IRS has the technological expertise and resources necessary to have the best available filters to identify those potentially fraudulent returns, a subject that is worthy of a hearing on its own. In addition, I look forward to learning more about improving accuracy of reporting by average taxpayers. Data suggests that accuracy improves when we do not rely on average individuals to figure out complex tax returns. The federal government has an interest, both in terms of fairness and revenue collection, in automating tax collection and making tax filing as simple as possible. The IRS has done a laudable job incorporating free-file tax systems provided by contractors, which expedite tax returns and improve accuracy for consumers. This Committee could consider how to improve the ease with which customers use those systems, cognizant of our need to treat private tax processing systems without discrimination.

Thank you again for convening this hearing. This is a complex yet vitally important subject, and by holding multiple hearings you have allowed this subcommittee to consider multiple factors that affect the tax gap as well as potential steps to improve tax collection. Every function of the federal government and the health of our economy is dependent upon a reliable tax collection system, so this inquiry has implications which reach far beyond its immediate impact on internal IRS management.