

**WRITTEN STATEMENT OF**

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**HEARING ON**

**“TAX FRAUD, TAX ID THEFT AND TAX REFORM:  
MOVING FORWARD WITH SOLUTIONS”**

**BEFORE THE**

**COMMITTEE ON FINANCE**

**UNITED STATES SENATE**

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Chairman Baucus, Ranking Member Hatch, and distinguished Members of the Committee:

Thank you for inviting me to testify today about the 2013 tax filing season and to present a taxpayer perspective on several priority issues in tax administration.<sup>1</sup> As requested, I will focus much of my statement on tax fraud and identity theft, and I will also discuss the two overriding concerns in tax administration today – the need for comprehensive tax simplification and the effects of recent cuts to the IRS budget on taxpayer service and revenue collection. In this statement, I will make the following points:

1. The tax reform options paper developed by the staff of this committee last month constitutes, in my view, an excellent starting point for improving the tax system. It has been 27 years since Congress last enacted comprehensive tax reform,<sup>2</sup> and it has been 15 years since Congress last passed major taxpayer rights legislation.<sup>3</sup> There is a significant need for legislation in both areas.<sup>4</sup>
2. Significant reductions in the IRS's budget since 2010 are harming taxpayers and undermining the IRS's ability to raise the revenues on which the rest of government depends.<sup>5</sup> For calendar year 2013 (through March 30), the IRS has been unable to answer three out of every ten calls it receives from taxpayers seeking to speak with a telephone assister, and taxpayers lucky enough to get through have had to wait more than 13

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<sup>1</sup> 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.

<sup>2</sup> Pub. L. No. 99-514, Tax Reform Act of 1986 (Oct. 22, 1986).

<sup>3</sup> Pub. L. No. 105-206, Internal Revenue Service Restructuring and Reform Act of 1998 (July 22, 1998).

<sup>4</sup> For a detailed discussion of the burdens of tax code complexity and recommendations for simplification, see National Taxpayer Advocate 2012 Annual Report to Congress 3-23 (Most Serious Problem: *The Complexity of the Tax Code*). For a detailed discussion about the need for taxpayer rights legislation, see National Taxpayer Advocate 2011 Annual Report to Congress 493-518 (Legislative Recommendation: *Enact the Recommendations of the National Taxpayer Advocate to Protect Taxpayer Rights*).

<sup>5</sup> In our most recent report, I designated the inadequacy of funding for the IRS as one of the most serious problems facing taxpayers. See National Taxpayer Advocate 2012 Annual Report to Congress 34-41 (Most Serious Problem: *The IRS Is Significantly Underfunded to Serve Taxpayers and Collect Tax*).

minutes on hold.<sup>6</sup> From a taxpayer perspective, this state of affairs is unacceptable. Moreover, it is self-defeating to apply across-the-board budget cuts to the IRS as a means to reduce the budget deficit, because the IRS collects substantially more than one dollar in federal revenue for each dollar it receives in appropriated funds. I recognize that this Committee does not have jurisdiction over the budget, but since you oversee the IRS and understand these issues well, I encourage you to work with your colleagues on the Appropriations Committee to ensure that the agency is adequately funded to do its job.

3. Tax-related identity theft continues to impose significant burdens on taxpayers and the IRS. While the IRS is taking the problem very seriously and has made some meaningful improvements in its processes, I remain deeply concerned that victims often have to wait in excess of six months to have their cases resolved and receive their refunds, and the IRS has yet to implement an effective program for overseeing cases with multiple issues that require coordination among functions, thereby allowing too many victims to fall between the cracks of IRS bureaucracy.<sup>7</sup>
4. I recommend that Congress, Treasury, and the IRS develop a long-term plan to enable the IRS to process information returns, particularly Forms W-2, before it processes tax returns and issues refunds. Front-end data verification would go a long way toward eliminating tax fraud and identity theft and could substantially reduce taxpayer burden. I originally recommended these measures in my 2009 Annual Report to Congress,<sup>8</sup> and the IRS has since taken some steps to move forward. One obvious requirement will be for Congress to move up the statutory deadlines by which employers and other payors of income must file information reporting documents with the government. Some significant issues, including taxpayer rights concerns, remain to be studied and overcome, but I believe the benefits of front-end data verification justify making this a near-term priority.
5. I recommend that Congress take steps to restrict immediate public access to the Death Master File (DMF). The DMF is one source of information that identity thieves use to victimize taxpayers. Several proposals have been

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<sup>6</sup> IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (week ending March 30, 2013). The IRS's "Level of Service" is computed based on calls received on the Accounts Management phones lines.

<sup>7</sup> For a detailed discussion of tax-related identity theft, see National Taxpayer Advocate 2012 Annual Report to Congress 42-67 (Most Serious Problem: *The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft*).

<sup>8</sup> National Taxpayer Advocate 2009 Annual Report to Congress 338-345 (Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reverse the "Pay Refunds First, Verify Eligibility Later" Approach to Tax Return Processing*).

made that would allow DMF data to be made available to entities that have a legitimate business need for the information while curtailing general public access for several years.<sup>9</sup>

6. As part of the law enforcement response to tax-related identity theft, the IRS has embarked on a program of sharing taxpayer return information with state and local authorities to facilitate prosecutions. While this information-sharing program has certain benefits, I am deeply concerned that the Internal Revenue Code (IRC) § 6103 rules that require IRS employees to keep taxpayer return information confidential do not apply to state and local authorities. With hundreds of smaller municipal governments now receiving tax return information, it is only a matter of time before one or more local officials – who unlike IRS employees do not receive regular training about the importance of protecting this information – use tax return information carelessly or inappropriately. I have raised this concern with the IRS, and its position seems to be that there is no problem because it only releases tax return information if a taxpayer executes a consent form. While it is true that the IRS is releasing return information only when taxpayers sign consent forms, my position is that most taxpayers are not experts on confidentiality waivers and may assume that state and local law enforcement authorities have the same legal obligations as IRS employees to keep their tax information confidential. It is critical that safeguards be put in place immediately to prohibit law enforcement authorities who receive tax return information for a specified purpose from using or re-disclosing that information for any other purpose without additional taxpayer consent.
7. Since 2002, I have recommended that tax return preparers be required to register with the IRS, pass a basic competency test, and take continuing education courses in order to improve industry standards and protect taxpayers from preparer errors.<sup>10</sup> In 2010, the IRS began to implement such a program, but a U.S. District Court recently held that the IRS lacks the legal authority to do so.<sup>11</sup> The Justice Department has appealed the case to the U.S. Court of Appeals for the District of Columbia, and there is a reasonable chance the D.C. Circuit will reverse the lower court decision. If it does not, however, I recommend that Congress move quickly to grant

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<sup>9</sup> National Taxpayer Advocate 2011 Annual Report to Congress 519-523 (Legislative Recommendation: *Restrict Access to the Death Master File*); Department of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals 203 (Apr. 2013); Identity Theft and Tax Fraud Prevention Act of 2013, S. 676, 113<sup>th</sup> Cong. § 8 (2013).

<sup>10</sup> See National Taxpayer Advocate 2011 Annual Report to Congress 427-436 (Status Update: *The IRS Has Made Significant Progress in Developing and Implementing a System to Register and Test Return Preparers*); see also National Taxpayer Advocate 2002 Annual Report to Congress 216-230 (Legislative Recommendation: *Regulation of Federal Tax Return Preparers*).

<sup>11</sup> *Loving v. IRS*, 111 A.F.T.R.2d (RIA) 589 (D.D.C. Jan. 18, 2013).

the IRS the authority to reinstate the program. This committee has twice approved legislation along these lines – once under Chairman Baucus<sup>12</sup> and before that under former Chairman Grassley.<sup>13</sup> The program enjoys broad support from most preparer organizations and consumer groups, and should be relatively non-controversial.

## **I. Tax Reform and Taxpayer Rights Legislation Are Overriding Priorities for Taxpayers and Tax Administration.**

As this Committee knows, I have repeatedly designated the complexity of the Internal Revenue Code as the #1 most serious problem facing taxpayers.<sup>14</sup> The existing code, by our count, has reached nearly four million words and imposes unconscionable burden on taxpayers. Our analysis of IRS data indicates that individuals and businesses spend about 6.1 billion hours a year complying with tax-filing requirements. If tax compliance were an industry, it would be one of the largest in the United States. To consume 6.1 billion hours, the “tax industry” requires the equivalent of more than three million full-time workers.

I recognize that there are substantial political differences over the appropriate level of taxation and that those differences ultimately will need to be resolved. However, I believe the prospects for comprehensive structural tax reform can be improved if the tax-writing committees begin by trying to simplify the existing tax code and achieve agreement to the extent possible. Decisions about the level of taxation and tax rates could then be deferred to the end of the process.

I have recommended that tax reform be approached in a manner similar to zero-based budgeting. For purposes of discussion, the starting assumption would be that all tax expenditures will be eliminated. A tax break would then be retained only if a majority of Members are persuaded that the benefits of that break outweigh the complexity and burden it creates. In performing this analysis, we should look at each provision in the code and ask questions like:

- Does this government incentive make sense?;
- If it does, is it better administered through the tax code or as a direct spending program?; and

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<sup>12</sup> S. 1321 (incorporating S. 832) (109<sup>th</sup> Cong.).

<sup>13</sup> H.R. 1528 (incorporating S. 882) (108<sup>th</sup> Cong.).

<sup>14</sup> See, most recently, National Taxpayer Advocate 2012 Annual Report to Congress 3-23 (Most Serious Problem: *The Complexity of the Tax Code*).

- If yes, can it be administered without imposing unreasonable burdens on taxpayers or the IRS?

Then Congress can separately consider how much revenue it wants to raise, and it can marry up this optimally-designed tax system with its revenue decisions by setting tax rates accordingly.

Because this hearing is focused on IRS issues, I will not discuss tax reform in detail in this testimony. For those interested, our recommendations are described more fully in the National Taxpayer Advocate's 2012 Annual Report to Congress.

I do want to take a moment to commend the committee for the comprehensive tax reform options paper it released on March 21. Among tax reform proposals I have seen over the years, this options paper is unusual in that it focuses heavily on the IRS and tax administration. In my view, that makes good sense because the filing of a tax return with the IRS is where the rubber meets the road for taxpayers, and if the filing process for taxpayers can be simplified, that will go a long way toward reducing taxpayer burden.

I also want to take note that the options paper includes a mention of updating taxpayer rights legislation. Congress passed significant taxpayer rights legislation in 1988, 1996, and 1998. In fact, two members of this committee – Senator Portman and Senator Cardin – were lead sponsors of the IRS Restructuring and Reform Act of 1998 when they served in the House of Representatives. However, 15 years have now elapsed since we have had major taxpayer rights legislation. Our laws have not kept pace with our notions of procedural fairness in 21<sup>st</sup> century tax administration, particularly given our tax system's expanded and diverse taxpayer base and duties.

I have recommended grouping the many discrete taxpayer rights embedded in the Internal Revenue Code into ten broad categories, modeled on the U.S. Constitution's Bill of Rights, to help make existing rights clearer and help taxpayers better understand them.

In my view, taxpayers and tax administration would benefit from an explicit statement of what taxpayers have a right to expect from their government and what the government has a right to expect from its taxpayers. The categories I have suggested are as follows:

**10 Taxpayer Rights**. I have recommended that Congress organize taxpayer rights under the following ten broad principles: (1) right to be informed; (2) right to be assisted; (3) right to be heard; (4) right to pay no more than the correct amount of tax; (5) right of appeal; (6) right to certainty; (7) right to privacy; (8) right to confidentiality; (9) right to representation; and (10) right to a fair and just tax system.

**5 Taxpayer Responsibilities.** To help taxpayers understand what the law requires of them, I have also recommended that Congress organize taxpayer responsibilities under the following five principles: (1) obligation to be honest; (2) obligation to be cooperative; (3) obligation to provide accurate information and documents on time; (4) obligation to keep records; and (5) obligation to pay taxes on time.

In addition, we have made other legislative recommendations in recent years to strengthen taxpayer rights. Most are technical and relatively noncontroversial but will bring real benefits to taxpayers. I encourage the committee to move forward with taxpayer rights legislation this year.

## **II. Recent Budget Cuts Are Impairing the IRS's Ability to Serve Taxpayers and Collect Tax.**

In my 2012 Annual Report to Congress, I warned that the significant and chronic underfunding of the IRS poses a major long-term risk to tax administration.<sup>15</sup> Over the past two years, Congress has cut the IRS's budget by nearly \$1 billion, or almost eight percent. This includes more than \$600 million in cuts in fiscal year (FY) 2013 because of sequestration and the rescission, which the IRS is struggling to absorb.<sup>16</sup>

Because of budget cuts, the IRS's full-time, permanent workforce was cut from about 86,000 to 79,000 employees from FY 2010 to FY 2012, a reduction of 8 percent.<sup>17</sup> By the end of FY 2012, the IRS had also cut its training budget compared with FY 2010 from about \$168 million to about \$63 million, a reduction of 62 percent,<sup>18</sup> and significant additional cuts are being made in FY 2013. The IRS has publicly estimated that the reduction in its training spending by the end of FY 2013 will be 83 percent.<sup>19</sup> As a result, the IRS has many fewer employees than it had just two years ago, and those employees – particularly newer ones – often are not receiving

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<sup>15</sup> National Taxpayer Advocate 2012 Annual Report to Congress 34-41 (Most Serious Problem: *The IRS is Significantly Underfunded to Serve Taxpayer and Collect Tax*); see also National Taxpayer Advocate 2011 Annual Report to Congress 3-27 (Most Serious Problem: *The IRS Is Not Adequately Funded to Serve Taxpayers and Collect Taxes*).

<sup>16</sup> See Hearing Before Subcomm. on Financial Services and General Government of H. Comm. on Appropriations, 113th Cong. (2013) (statement of Steven T. Miller, Acting Commissioner of Internal Revenue), at <http://appropriations.house.gov/uploadedfiles/hhrq-113-ap23-wstate-millers-20130409.pdf>.

<sup>17</sup> IRS Integrated Financial System, Commitments, Obligations, Expenditures & Disbursements report. These figures track employees in "pay status" and exclude employees who were on Leave Without Pay or related statuses.

<sup>18</sup> IRS Integrated Financial System, Commitments, Obligations, Expenditures & Disbursements report.

<sup>19</sup> IRS Fact Sheet, FS-2013-05, *IRS Achieves \$1 Billion in Cost Savings and Efficiencies* (April 2013), at [http://www.irs.gov/uac/IRS-Achieves-\\$1-Billion-in-Cost-Savings-and-Efficiencies](http://www.irs.gov/uac/IRS-Achieves-$1-Billion-in-Cost-Savings-and-Efficiencies) (last visited April 12, 2013).

the training they require to do their jobs well or assist taxpayers adequately, particularly with complex or atypical issues.

### **A. Taxpayer Services: Reduced Funding Means Taxpayer Needs Are Not Being Met.**

I am concerned that the IRS is not receiving sufficient funds to meet the basic needs of taxpayers seeking to comply with the law. In each of the last two fiscal years, the IRS has received more than 115 million calls, a staggering volume that the IRS cannot come close to fully handling.<sup>20</sup> Last year, the IRS answered only about 68 percent of calls from taxpayers seeking to speak with a telephone assistant, and those who got through had to wait on hold for an average of nearly 17 minutes.<sup>21</sup> That level of service represents a sharp drop-off in performance compared with the IRS's high-water mark in FY 2004, when it answered 87 percent of its calls and the average hold time was just over 2½ minutes.<sup>22</sup>

The IRS's ability to timely process taxpayer correspondence has also diminished in recent years. Last year, the IRS received more than ten million letters from taxpayers responding to IRS adjustment notices.<sup>23</sup> Comparing the final week of FY 2012 with the final week of FY 2004, the backlog of correspondence in the tax adjustments inventory increased by 188 percent (from 357,151 to 1,028,539 pieces), and the percentage classified as "overage" jumped by 316 percent (from 11.5 percent to 47.8 percent).<sup>24</sup>

The impact of reduced taxpayer service is felt on the compliance side as well. Few individuals or businesses enjoy receiving a notice informing them that the IRS is reviewing their tax return or taking action to collect an outstanding tax liability. When that happens, however, it is essential that the taxpayer be able to talk to an IRS employee – whether to clarify what the notice says, present documentation to support the return position, or demonstrate that collection action would impose financial hardship and should not be taken. Among the consequences of budget cuts:

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<sup>20</sup> IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (weeks ending Sept. 30, 2011 and Sept. 30, 2012); see Most Serious Problem, *The IRS Telephone and Correspondence Services Have Deteriorated Over the Last Decade and Must Improve to Meet Taxpayer Needs*.

<sup>21</sup> IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (week ending Sept. 30, 2012). The Accounts Management phone lines (previously known as the Customer Account Services phone lines) receive the significant majority of taxpayer calls. However, taxpayer calls to compliance phone lines and certain other categories of calls are excluded from this total.

<sup>22</sup> IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (week ending Sept. 30, 2004).

<sup>23</sup> See, e.g., IRS, Joint Operations Center, *CAS Accounts Management Paper Inventory Reports: FY12 July-September Fiscal Year Comparison*.

<sup>24</sup> Compare IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 29, 2012) with IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 25, 2004).

- Taxpayers who submit documentation at the request of the IRS often wait extended periods for the IRS to respond;<sup>25</sup>
- Taxpayers are sometimes denied tax benefits because the IRS narrowly defines the types of supporting documentation it will accept and does not have the bandwidth to consider alternative forms of documentation;<sup>26</sup> and
- Centralization of some IRS functions means the loss of employees who understand local conditions.<sup>27</sup>

Another impact of shrinking IRS budgets is pressure to make greater use of automated processes. While automating certain routine tasks frees employees to focus on higher value activities, I am deeply concerned that automated “tools” are replacing employee judgment and in some cases failing to achieve the intended goal.<sup>28</sup> Taxpayers subject to enforcement action must wait longer to speak to an employee or have an employee read their letters, and they face additional burden when automation resolves their cases improperly.

## **B. Revenue Collection: Reduced Funding Means Reduced Revenue Collection and a Larger Budget Deficit.**

Cutting the IRS budget also makes little sense from a revenue standpoint. In FY 2012, the IRS collected about \$2.52 trillion<sup>29</sup> on a budget of about \$11.8 billion.<sup>30</sup> That translates to an average return-on-investment (ROI) of about 214:1. The

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<sup>25</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 235-249 (Most Serious Problem: *The IRS Does Not Process Vital Taxpayer Responses Timely*).

<sup>26</sup> See National Taxpayer Advocate 2012 Annual Report to Congress, vol. 2, at 71-104 (*Study of Tax Court Cases in Which the IRS Conceded the Taxpayer Was Entitled to Earned Income Tax Credit (EITC)*).

<sup>27</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 260-273 (Most Serious Problem: *The Impact of IRS Centralization on Tax Administration*).

<sup>28</sup> The Automated Substitute for Return program is an example of how an automated approach to enforcement creates downstream costs for the IRS. See 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*); see also National Taxpayer Advocate 2012 Annual Report to Congress, vol. 2, at 63-90 (*An Analysis of the IRS Examination Strategy: Suggestions to Maximize Compliance, Improve Credibility, and Respect Taxpayer Rights*), which notes that automation is leading to fewer personal contacts with taxpayers and lack of awareness among taxpayers that they are facing an enforcement action.

<sup>29</sup> Government Accountability Office (GAO), GAO-13-120, *Financial Audit: IRS’s Fiscal Years 2012 and 2011 Financial Statements* 65 (Nov. 2012), at <http://www.gao.gov/assets/650/649881.pdf>.

<sup>30</sup> Department of the Treasury, *FY 2013 Budget in Brief*, at [http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/11.%20IRS\\_508%20-%20passed.pdf](http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/11.%20IRS_508%20-%20passed.pdf).

marginal ROI of additional spending will not be nearly so large, but virtually everyone who has studied the IRS budget has concluded that the ROI of additional funding is positive. In 2011, former Commissioner Shulman estimated in a letter to Congress that proposed cuts to the IRS budget would result in reduced revenue collection of *seven times* as much as the cuts.<sup>31</sup>

Cutting the IRS budget therefore means fewer dollars to put toward deficit reduction, fewer dollars for military funding, fewer dollars for our intelligence services and embassy protection, fewer dollars for social programs, fewer dollars for infrastructure renewal, fewer dollars for medical research – in short, fewer dollars for all the things we believe as a nation we should provide for our citizens. It means real harm to real people.

If the Chief Executive Officer of a Fortune 500 company were told that each dollar allocated to his company's Accounts Receivable Department would generate seven dollars in return, it is difficult to see how the CEO would keep his job if he chose not to provide the department with the resources it needed to collect its receivables. Yet that is exactly what has been happening with respect to IRS funding for years, and there has been little effort to fix this obvious problem.

Because subjecting the IRS to across-the-board cuts designed to reduce the budget deficit has the opposite effect of increasing the deficit, I encourage the Finance Committee to enter into a dialogue with Members of the Appropriations and Budget committees to try to come up with a new approach to funding the IRS that gives it sufficient resources to meet taxpayer needs and collect federal revenue.

### **C. If a “Program Integrity Cap Adjustment” Mechanism Is Used, It Should Encompass Taxpayer Service Activities as Well as Enforcement.**

In an effort to address these funding challenges, several Appropriations acts in recent years have given the IRS additional funding using a mechanism known as a “program integrity cap adjustment.” Under this mechanism, new funding appropriated for IRS *enforcement* programs generally does not count against otherwise applicable spending ceilings provided:

1. The IRS's existing enforcement base is fully funded; and
2. A determination is made that the proposed additional expenditures will generate an ROI of greater than 1:1 (*i.e.*, the additional expenditures will increase federal revenue on a net basis).

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<sup>31</sup> Letter from Douglas H. Shulman, Commissioner of Internal Revenue, to the chairmen and ranking members of the House Committee on Ways and Means (and its Subcommittee on Oversight) and the Senate Committee on Finance (Oct. 17, 2011), at [http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/media/pdf/112/Rep\\_Lewis\\_IRS\\_Letter.pdf](http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/media/pdf/112/Rep_Lewis_IRS_Letter.pdf). In addition to generating direct revenue, IRS compliance actions produce indirect revenue gains. Studies show that taxpayers who might otherwise be tempted to bend the rules report their income more accurately as the likelihood of an audit increases.

The Administration's budget proposal released last week recommends a change to the Balanced Budget and Emergency Deficit Control Act of 1985 to provide program integrity cap adjustments for the next 10 years.<sup>32</sup> While this cap adjustment mechanism may provide an easier path to providing the IRS with more resources than a fundamental change in IRS funding rules, I am concerned that taxpayer service activities have been excluded from this enhanced funding mechanism in the past. The rationale has been that the IRS is able to measure the direct ROI of its enforcement activities – *i.e.*, it can compute to the dollar the amounts collected by its Examination, Collection, and document-matching functions – but is unable to quantify the ROI of taxpayer services. Thus, it is not currently possible to document whether or to what extent its taxpayer services generate an ROI greater than 1:1.

Creating a mechanism that allows more funding for enforcement actions while excluding taxpayer service activities like outreach and education would be a mistake for two reasons. First, common sense tells us that taxpayer services are a significant driver of tax compliance and generate a very high ROI. Publishing tax forms and instructions, conducting outreach and education to taxpayers, tax preparers, and tax software manufacturers, and otherwise administering the tax filing season are absolute prerequisites for tax compliance. In general, the ROI of these service activities is probably greater than the ROI of enforcement actions, and as we document in this report, the IRS could do a lot to improve its taxpayer services if it received additional funding for that purpose.

Second, an enforcement-only cap adjustment will inherently push the IRS to become more of a hard-core enforcement agency. It should be emphasized that in FY 2011, direct enforcement revenue amounted to only \$50.2 billion<sup>33</sup> or two percent of total IRS tax collections of \$2.52 trillion.<sup>34</sup> The remaining 98 percent resulted from voluntary front-end tax compliance. If cap adjustments are applied solely to bolster enforcement funding, the relative allocation of the IRS budget between enforcement and taxpayer service will shift over time in a direction that causes taxpayers to fear the IRS more and voluntarily cooperate less. In our effort to enforce the laws against noncompliant taxpayers, we must take care to avoid steps that may alienate compliant taxpayers and thereby jeopardize the existing tax base.

If program integrity cap adjustments are used, I recommend that compliance measures be defined more broadly, so that they include both an enforcement

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<sup>32</sup> See Department of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals 187 (April 2013).

<sup>33</sup> IRS, Fiscal Year 2012 Enforcement and Service Results, at <http://www.irs.gov/pub/irs-news/FY%202012%20enforcement%20and%20service%20results-%20Media.pdf>.

<sup>34</sup> GAO, GAO-13-120, *Financial Audit: IRS's Fiscal Years 2012 and 2011 Financial Statements* 65 (Nov. 2012), at <http://www.gao.gov/assets/650/649881.pdf>.

component and a service component. Because the projected ROI of many enforcement programs is high, a more broadly constructed initiative could still produce a demonstrable ROI of greater than 1:1, even if it contained service components with ROIs that are unquantifiable.<sup>35</sup>

### **III. Despite Significant Changes to the IRS's Approach to Assisting Identity Theft Victims, the IRS Remains Inundated with Identity Theft Cases and Victim Assistance Is Taking Too Long.**

As I have written in my Annual Reports to Congress since 2004, tax-related identity theft is a serious problem – for its victims, for the IRS and, when Treasury funds are improperly paid to the perpetrators, for all taxpayers.<sup>36</sup> In general, tax-related identity theft occurs when an individual intentionally uses the SSN of another person to file a false tax return for the purpose of obtaining an unauthorized refund.<sup>37</sup>

For victims, the consequences can be significant. Apart from the time and frustration involved in dealing with the IRS to prove one's own identity, taxpayers generally do not receive their refunds until the case is resolved. So far this filing season, 84 percent of all returns processed have resulted in refunds, and the average refund

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<sup>35</sup> In our past annual reports, we have written about local compliance initiatives the IRS has undertaken that include integrated enforcement and outreach and education components. *See, e.g., National Taxpayer Advocate 2008 Annual Report to Congress 176-192 (Most Serious Problem: Local Compliance Initiatives Have Great Potential but Face Significant Challenges)*. One example: In the early 1990s, the IRS launched an initiative designed to address noncompliance by fishermen in Alaska that resulted from confusion as well as community norms and attitudes. The IRS combined stepped-up enforcement activities with an extensive outreach and education campaign in remote fishing villages and on fishing vessels that included assisting with tax return preparation and training local volunteers to assist taxpayers. By the end of the initiative, the number of nonfilers among the target population declined by 30 percent. *Id.* at 177-178.

<sup>36</sup> *See National Taxpayer Advocate 2012 Annual Report to Congress 42-67 (Most Serious Problem: The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft)*; National Taxpayer Advocate 2011 Annual Report to Congress 48-73 (Most Serious Problem: *Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS*); National Taxpayer Advocate 2009 Annual Report to Congress 307-317 (Status Update: *IRS's Identity Theft Procedures Require Fine-Tuning*); National Taxpayer Advocate 2008 Annual Report to Congress 79-94 (Most Serious Problem: *IRS Process Improvements to Assist Victims of Identity Theft*); National Taxpayer Advocate 2007 Annual Report to Congress 96-115 (Most Serious Problem: *Identity Theft Procedures*); National Taxpayer Advocate 2005 Annual Report to Congress 180-191 (Most Serious Problem: *Identity Theft*); National Taxpayer Advocate 2004 Annual Report to Congress 133-136 (Most Serious Problem: *Inconsistent Campus Procedures*).

<sup>37</sup> We refer to this type of tax-related identity theft as "refund-related" identity theft. In "employment-related" identity theft, an individual files a tax return using his or her own taxpayer identifying number (usually an Individual Taxpayer Identification Number, or "ITIN"), but uses another individual's SSN in order to obtain employment, and consequently, the wages are reported to the IRS under the SSN. Unlike in 1993, when I first represented a client in an identity theft case, the IRS now has procedures in place to minimize the tax administration impact to the victim in these employment-related identity theft situations. Accordingly, I will focus on refund-related identity theft in this testimony.

amount has been nearly \$2,800.<sup>38</sup> For low income taxpayers who qualify for the Earned Income Tax Credit, a tax refund may amount to 25 percent or more of their annual income. There is little doubt that longer case resolution times can translate to financial inconvenience and sometimes financial hardship. That is why prompt case resolution is so important.

In FY 2013, the IRS changed its strategy for assisting identity theft victims, adopting a specialized approach under which each department (or “function”) that deals with identity theft created a dedicated group of employees to work on those issues. There clearly are benefits in assigning identity theft cases to a small group of specially-trained employees so they can quickly become experts in resolving these types of cases.

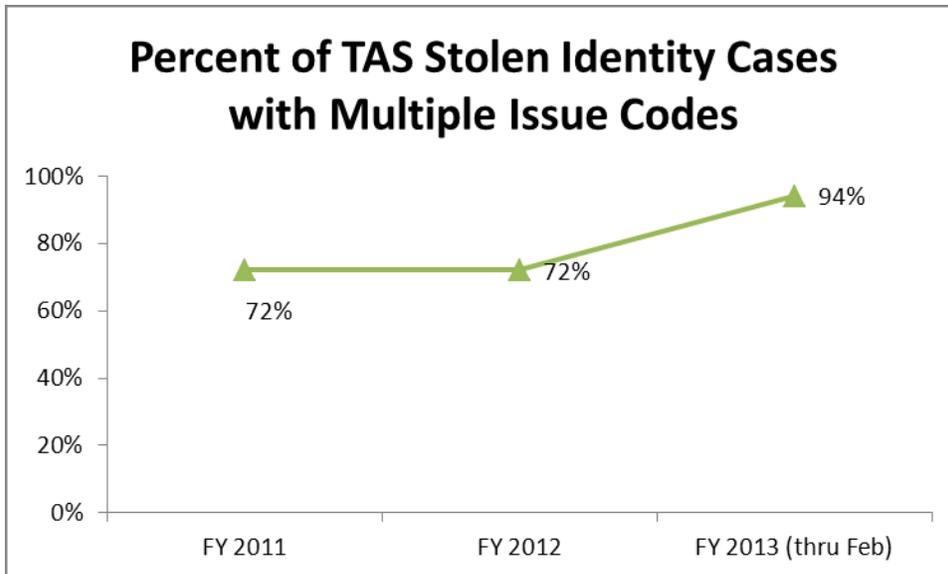
But there is another important factor that the IRS is not adequately addressing. Because identity theft cases are often very complex, they require adjustments by multiple functions.<sup>39</sup> The IRS has developed a “transfer matrix” outlining situations in which a case must be routed from one specialized function to another. The IRS believes that these occurrences are minimal. I disagree. Based on TAS’s experience with identity theft cases over the years, I believe that transfers among functions are much more common. The vast majority of identity theft cases worked by TAS involve multiple issues,<sup>40</sup> as the chart below illustrates.

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<sup>38</sup> IRS, Filing Season Statistics for Week Ending April 5, 2013, at <http://www.irs.gov/uac/Newsroom/Filing-Season-Statistics-for-Week-Ending-April-5-2013>.

<sup>39</sup> An IRS task force found that up to 28 different functions may touch an identity theft case. IRS, Identity Theft Assessment and Action Group (ITAAG) Future State Vision and Supporting Recommendations 7 (Oct. 11, 2011).

<sup>40</sup> When TAS opens a case, it assigns a primary issue code based on the most significant issue, policy or process within the IRS that needs to be resolved. When a TAS case has multiple issues to resolve, a secondary issue code will be assigned. See IRM 13.1.16.13.1.1 (Feb. 1, 2011).



To facilitate the transfer of such cases from one function to another, I have long advocated for the creation of a “traffic cop” to guide the case through the bureaucracy and serve as the single point of contact with the victim. Without this traffic cop, there is higher risk that cases requiring involvement of multiple functions will get “stuck” or lost in the process.

In May 2012, the Treasury Inspector General for Tax Administration (TIGTA) issued an audit report on IRS identity theft victim assistance.<sup>41</sup> TIGTA selected a judgmental sample of 17 identity theft cases, and its findings corroborate my position that identity theft cases are complex and vulnerable to getting lost in the IRS shuffle. TIGTA found that the IRS had opened 58 separate cases to resolve the accounts of those 17 identity theft victims – an average of nearly three and a half cases per victim.<sup>42</sup> The average cycle time for those cases was 414 days, which included an average of 86 days of inactivity.<sup>43</sup> By assigning ownership of an identity theft case to a traffic cop, the IRS can ensure that the case gets moved forward in the most efficient manner and reduce taxpayer frustration.

I have repeatedly proposed that the Identity Protection Specialized Unit or “IPSU,” the centralized IRS organization established in 2008 to assist identity theft victims, could be utilized to fulfill this traffic cop role. After initial resistance, the leadership of the IRS Wage & Investment Division recently assured me that the IPSU will monitor all identity theft cases that require involvement of more than one function. For example, if a case requires the Accounts Management function to adjust the taxpayer’s account, but also requires Collection to take some action, the IPSU will

<sup>41</sup> See TIGTA, Ref. No. 2012-40-050, *Most Taxpayers Whose Identities Have Been Stolen to Commit Refund Fraud Do Not Receive Quality Customer Service* (May 3, 2012).

<sup>42</sup> See *id.*

<sup>43</sup> See *id.*

ensure that the case gets routed to the appropriate place in the agreed-upon time. Furthermore, I was told that the IPSU will conduct an initial global account review upon receipt of the case to identify potential issues and then a final account review prior to case closure to determine whether all issues have been addressed. While I am pleased with this recent development, we will continue to track the IRS's implementation of these procedures. I have been recommending these changes for over five years, and it is high time that the IRS provide identity theft victims with the level of assistance they deserve.<sup>44</sup>

From an identity theft prevention perspective, the IRS has developed a multi-faceted approach to detecting tax returns filed by identity thieves and preventing such associated refunds from being processed. For example, the IRS utilizes a series of identity theft filters designed to detect potentially fraudulent returns, and each year it adjusts the filters as the IRS learns more about how the thieves operate. Through February 2013, the IRS stopped more than 360,000 tax returns by using these filters, an increase of more than 150 percent from the same period in 2012.<sup>45</sup>

The IRS also works cooperatively with banks and other financial institutions to thwart attempts by identity thieves to defraud the government. The IRS has a process by which private sector businesses, which often have developed their own algorithms to detect fraud, alert the IRS of suspicious transactions. The IRS will then investigate the taxpayers involved, and if it verifies fraudulent activity, will recoup the funds from the financial institution. Through this "external leads" program, the IRS has been able to recover over \$109 million from over 30,000 accounts this year.<sup>46</sup>

Yet despite the revamped identity theft victim assistance procedures, more stringent filters, and improved cooperation with the private sector, the volume of identity theft returns continues to grow at an alarming rate. The IRS had more than 1.25 million identity theft cases in inventory as of the end of February 2013, a sharp increase from a year ago, when the volume was less than 235,000 cases.<sup>47</sup> With the average cycle time for the IRS to resolve identity theft cases exceeding six months last year,<sup>48</sup> I am concerned that its cycle time will skyrocket in the coming year as it struggles to keep up with its burgeoning inventory of cases.

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<sup>44</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 115 ("The IRS should develop a dedicated, centralized unit to handle all identity theft cases"); National Taxpayer Advocate 2008 Annual Report to Congress 94 ("Provide global account review and account monitoring (if necessary) for all identity theft victims").

<sup>45</sup> IRS Identity Theft Advisory Council, *Identity Theft Status Update* (Mar. 28, 2013); IRS Identity Theft Advisory Council, *Identity Theft Status Update* (Mar. 7, 2012).

<sup>46</sup> IRS Identity Theft Advisory Council, *Identity Theft Status Update* (Mar. 28, 2013).

<sup>47</sup> IRS Identity Theft Advisory Council, *Identity Theft Status Update* (Mar. 28, 2013); IRS Identity Theft Advisory Council, *Identity Theft Status Update* (Mar. 7, 2012).

<sup>48</sup> See National Taxpayer Advocate 2012 Annual Report to Congress 50.

When a taxpayer whose account has been marked with an identity theft indicator fails a series of filters designed to safeguard the account (called “business rules” in IRS parlance), or if a taxpayer who was issued an Identity Protection Personal Identification Number (IP PIN) did not use a valid IP PIN when filing the return, the return will be marked “unpostable” – meaning it will not be processed. So far in this filing season, the IRS has marked 182,181 returns as unpostable, an increase of 345 percent over the same period in 2012.<sup>49</sup> If a taxpayer files a legitimate return that was erroneously marked unpostable, processing is delayed an average of 28 days, an increase of over 50 percent from last year.<sup>50</sup> Preliminary analysis suggests that an astonishing 89 percent of tax returns flagged as unpostable are eventually deemed legitimate.<sup>51</sup>

I am worried about the exceptionally high rate of legitimate returns becoming ensnared in the business rules. I am interested in working with the IRS to try to determine the cause of the spike in unpostable returns this year. It is not acceptable for so many legitimate taxpayers to be harmed by having their returns initially rejected and delayed nearly a month.

I have often said that TAS’s case receipts are a barometer of the effectiveness of the IRS’s procedures. From FY 2011 to FY 2012, TAS stolen identity cases rose by 61 percent,<sup>52</sup> and they have continued to trend upward this year. TAS received 26,354 identity theft cases during the first two quarters of FY 2013, a 66 percent increase over the same period in FY 2012 and a 157 percent increase from FY 2011.<sup>53</sup>

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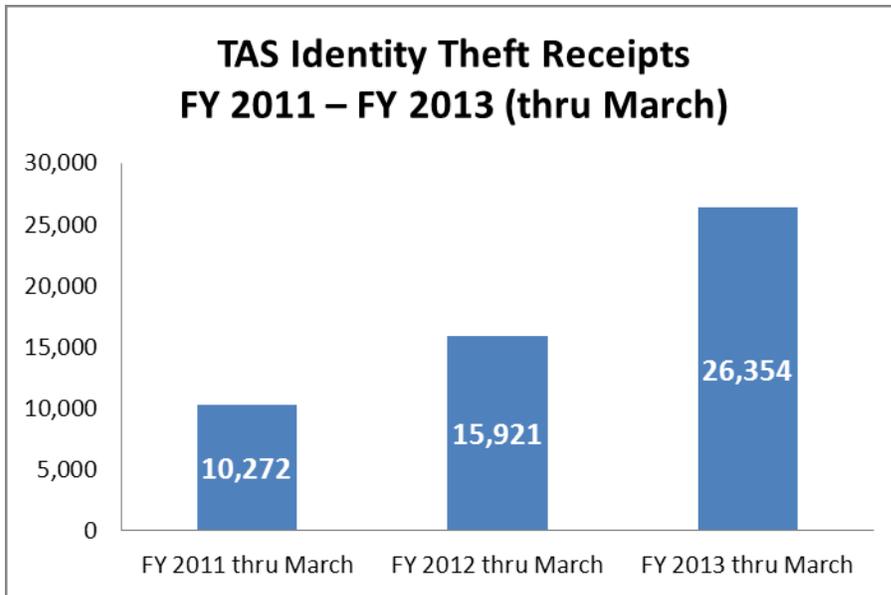
<sup>49</sup> The IRS is screening for more criteria that create unpostable returns in 2013 than in 2012. See IRS, GUF Reports 5540 and 5570.

<sup>50</sup> Average days to resolution for closed cases was combined with average days open or currently unresolved open cases. See IRS, GUF Reports 5540 and 5570.

<sup>51</sup> IRS, GUF Reports 5540 and 5570.

<sup>52</sup> Data obtained from BPMS reports on October 3, 2012, showing TAS received 34,006 identity theft cases as of September 30, 2011, and 54,748 cases as of September 30, 2012.

<sup>53</sup> Taxpayer Advocate Management Information System (TAMIS) (Apr. 1, 2012; Apr. 1, 2011).



The growth in TAS’s identity theft casework reflects both the increase in identity theft incidents and the IRS’s inability to address the victims’ tax issues promptly.

**IV. To Reduce Taxpayer Burden and Cut Down on Tax Fraud, the IRS Should Be Empowered to Process Information Reporting Documents Like Forms W-2 Before Processing Tax Returns and Issuing Refunds.**

I have repeatedly recommended that the IRS develop a long-term plan to accelerate third-party reporting so it could match third-party data before processing tax returns and releasing associated tax refunds. Upfront matching would reduce the incidence of tax fraud, identity theft, and inadvertent errors while also providing significant taxpayer service. In particular, enabling the IRS to receive and process Forms W-2, *Wage and Tax Statement*, before releasing refunds would be an important step to deter perpetrators from committing tax fraud and identity theft. Finally, providing taxpayers and their representatives with direct electronic access to third-party data before return filing deadlines would alleviate taxpayers’ burden and reduce the downstream consequences of inadvertent noncompliance.

The acceleration of third-party reporting in general would serve to increase tax compliance. Approximately 97 percent of taxpayers receive at least one information return. Traditionally, the IRS has not matched this data with the items reported on the taxpayers’ tax returns until long after the filing season.<sup>54</sup> In 2010, the IRS closed 4.3 million cases in which it identified a discrepancy between the taxpayer’s return and third-party information, leading to \$7.2 billion in additional assessments.<sup>55</sup> The

<sup>54</sup> IRS, PowerPoint, Real Time Tax System Initiative, Public Meeting 2 (Dec. 8, 2011), at [http://www.irs.gov/pub/irs-utl/rtts\\_deck.pdf](http://www.irs.gov/pub/irs-utl/rtts_deck.pdf) (last visited April 8, 2013).

<sup>55</sup> *Id.*

real volume of mismatches is significantly larger, because this data only reflects mismatches large enough for the IRS to work, and does not include others below the IRS's established thresholds. For perspective, the IRS identified almost 23.8 million mismatches on tax year (TY) 2010 returns, but only worked about 5.3 million cases (22 percent).<sup>56</sup>

There is broad agreement that accelerated information reporting is necessary to increase compliance and improve taxpayer service. In my 2009, 2011, and 2012 annual reports, I wrote about the benefits of accelerated third-party information reporting to both taxpayers and tax administration.<sup>57</sup> In its response to the 2012 analysis, the IRS acknowledged that it had taken early steps toward the development of a real-time tax system (RTTS) with the ultimate goal of reducing taxpayer burden and increasing compliance.<sup>58</sup> In addition, the IRS solicited comments from a diverse group of stakeholders at two public meetings. While the participants expressed concerns about how the IRS would achieve this system, there was consensus that the goal of the initiative would serve both taxpayers and tax administration.<sup>59</sup>

In general, the goal of an RTTS is to enable the IRS to match information during the filing season and prior to releasing the associated refunds.<sup>60</sup> If the IRS identified mismatches before releasing refunds, both taxpayers and the government would avoid the subsequent consequences of assessments.<sup>61</sup>

An RTTS would substantially reduce taxpayer burden in several ways:

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<sup>56</sup> IRS response to TAS information request (Oct. 17, 2012).

<sup>57</sup> National Taxpayer Advocate 2009 Annual Report to Congress 338-345; National Taxpayer Advocate 2011 Annual Report to Congress 284-295; National Taxpayer Advocate 2012 Annual Report to Congress 180-191.

<sup>58</sup> National Taxpayer Advocate 2012 Annual Report to Congress 190.

<sup>59</sup> During the meeting held on December 8, 2011, the IRS heard statements from the members of three panels: (1) tax practitioners, (2) federal and state government representatives, and (3) taxpayer and consumer advocates. During the second meeting, which was held on January 25, 2012, the IRS solicited comments from four panels consisting of (1) payroll/W-2 filers, (2) Form 1099 issuers, (3) software providers, and (4) state revenue agencies. For written and oral statements of panelists at the two RTTS public meetings, see <http://www.irs.gov/Tax-Professionals/Real-Time-Tax-Initiative> (last visited April 8, 2013).

<sup>60</sup> IRS, PowerPoint, Real Time Tax System Initiative, Public Meeting 2 (Dec. 8, 2011), at [http://www.irs.gov/pub/irs-utl/rts\\_deck.pdf](http://www.irs.gov/pub/irs-utl/rts_deck.pdf) (last visited April 8, 2013).

<sup>61</sup> When the IRS's Automated Underreporter (AUR) system identifies a mismatch between items reported on the taxpayer's return and information reports, it generates a CP 2000 notice to be mailed to the taxpayer. In TY 2010, the IRS mailed 3,823,766 of these notices to taxpayers, and the estimated response rate was 45 percent. These numbers have declined from 4,546,817 notices in TY 2009 (with an estimated response rate of 60 percent) and 4,788,360 notices in TY 2008 (with an estimated response rate of 57 percent). IRS response to TAS information request (Oct. 17, 2012) (data through Oct. 16, 2012).

- Taxpayers would be better equipped to answer questions about an underlying economic transaction if the IRS identified the mismatch within months rather than a year or more after the fact.
- Matching data before the IRS releases refunds would prevent taxpayers from facing IRS collection actions long after they have spent the refunds.
- Taxpayers would save money by avoiding the long-term accrual of penalties and interest on unintentionally omitted or under-reported items.
- Upfront matching would reduce taxpayers' vulnerability to identity-theft related refund fraud.<sup>62</sup>
- Giving taxpayers access to third-party data before the return filing deadline would help them prepare returns and prevent inadvertent omissions and understatements.

In addition, the government would benefit from the revenue protection aspect of upfront matching. A real-time tax system would allow the IRS to protect revenue by resolving mismatches at the outset and preventing the release of erroneous refunds. This system would deter fraud by stopping the refund associated with an upfront mismatch. Further, the IRS would devote fewer resources to compliance and collection activities on basic omission and understatement cases, and could use the savings to resolve more complex issues.<sup>63</sup>

Legislative action may be necessary to accelerate third-party reporting deadlines, tighten e-file mandates, and enable the IRS to receive Form W-2 data at the same time taxpayers receive the forms from their employers.<sup>64</sup> In this regard, I encourage Congress to consider the following issues:

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<sup>62</sup> IRS, PowerPoint, Real Time Tax System Initiative, Public Meeting 2 (Dec. 8, 2011), at [http://www.irs.gov/pub/irs-utl/rtts\\_deck.pdf](http://www.irs.gov/pub/irs-utl/rtts_deck.pdf) (last visited April 8, 2013). For more information on identity-theft refund fraud, see National Taxpayer Advocate 2012 Annual Report to Congress 42-67 (Most Serious Problem: *The IRS Has Failed to Provide Effective and Timely Assistance to Victims of Identity Theft*).

<sup>63</sup> IRS, PowerPoint, Real Time Tax System Initiative 1, Public Meeting (Dec. 8, 2011), at [http://www.irs.gov/file\\_source/pub/irs-utl/rtts\\_deck.pdf](http://www.irs.gov/file_source/pub/irs-utl/rtts_deck.pdf) (last visited April 8, 2013).

<sup>64</sup> If certain data fields on an information return require more time to complete than others due to complexity or record-keeping issues, it may be necessary to bifurcate the information reporting deadlines. For example, if employers need more time to report pension benefit calculations, the IRS could require earlier reporting of the basic Form W-2 data such as wages and withholdings and allow employers more time to file a supplemental earnings statement with the more complicated items later. Taxpayers and the IRS would receive the information they need for return filing early in the filing season and the IRS would receive the other, more complex information soon enough for compliance purposes. This bifurcation may be relevant for the upcoming reporting requirements under the Affordable Care Act that may be critical for return filing. See National Taxpayer Advocate 2009 Annual Report to Congress 338-345; United States Government Accountability Office, GAO-11-747T, *Hearing*

- When the IRS identifies a mismatch between third-party data and tax return information, it is unclear what type of compliance contact the IRS would make during the filing season. In developing procedures, the extent of taxpayer burden must be a significant consideration. The extent of taxpayer burden would depend largely on the accuracy of the third-party data and on the level of staffing allocated to problem resolution when mismatches occur.
- Moving up the deadlines for employers and payors of income to submit Forms W-2 and other information returns to the government would be necessary, but earlier deadlines could also be burdensome for some filers. The IRS should continue to consult with these stakeholders to determine the best way to accomplish a real-time tax system.<sup>65</sup>
- Even if the reporting deadline is moved up, the IRS would still need time to process the Forms W-2 and the other information returns it receives. Therefore, consideration should be given to moving back the date for issuing tax refunds by a month or two to allow the IRS sufficient time to perform document matching and verify the accuracy of refunds claimed on filed returns.
- I would strongly caution against the expansion of math error authority to cover mismatched third-party data. I have written extensively about my concerns on this subject,<sup>66</sup> and these concerns were also expressed by others during the taxpayer and consumer advocate panel at the first RTTS public meeting.<sup>67</sup>
- As part of this initiative, I believe the IRS should provide taxpayers with electronic access to a real-time transcript of data received by the IRS to help them prepare their returns and avoid inadvertent omissions. The IRS would drive compliance rates even higher by providing a way for taxpayers to download the third-party data directly into their return preparation software and by developing an IRS-provided partially pre-populated return option. Thus, taxpayers should have the choice of one of the following ways to access third party data in preparing a tax return: (1) view and print out the third-party data to assist in return preparation, (2) download the data into commercial return

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*before the Committee on Finance, U.S. Senate on Tax Gap: Complexity and Taxpayer Compliance 14-17 (statement of Michael Brostek, Director, Tax Issues, Strategic Issues, June 28, 2011).*

<sup>65</sup> See IRS Public Hearing, *Proposed Real-Time Tax System, Comments from the National Payroll Reporting Consortium* (Jan. 25, 2012).

<sup>66</sup> See National Taxpayer Advocate 2011 Annual Report to Congress 74-92; National Taxpayer Advocate 2012 Annual Report to Congress 180-191.

<sup>67</sup> IRS, Transcript of the Public Meeting on Real Time Tax System Initiative 92-94 (Dec. 8, 2011), at <http://www.irs.gov/Tax-Professionals/December-8,-2011-Meeting> (last visited April 8, 2013).

preparation software, or (3) pre-populate the data into an IRS-provided basic electronic tax form.<sup>68</sup>

## **V. Restricting Access to the Death Master File Would Eliminate a Source of Personal Data that Identity Thieves May Utilize to Commit Tax Fraud.**

Among the proposals included in the tax reform options paper released by this committee last month was a proposal to limit access to personal identifying information, such as the Death Master File. The DMF is a list of recently deceased individuals that includes their full names, SSNs, dates of birth, dates of death, and the county, state, and ZIP code of the last address on record.<sup>69</sup> I have recommended that Congress pass legislation to clarify that public access to the DMF can and should be limited.<sup>70</sup>

The public availability of the DMF facilitates tax-related identity theft in a variety of ways. For example, a parent generally is entitled to claim a deceased minor child as a dependent on the tax return that covers the child's year of death. If an identity thief obtains information about the child from the DMF and uses it to claim the dependent on a fraudulent return before the parent (the legitimate taxpayer) files, the IRS will stop the second (legitimate taxpayer's) return and freeze the refund. The legitimate taxpayer then may face an extended delay in obtaining the refund, potentially causing an economic hardship, and will bear the emotional burden of persuading the IRS that the deceased child was really his or hers.

Legislation could relieve survivors of this burden by restricting access to the DMF to those with a legitimate business purpose, or by simply delaying release of the information for several years. Proposals introduced in recent years in both houses of Congress would limit access to the DMF.<sup>71</sup>

I recognize the practical difficulties of passing legislation, and am concerned that taxpayers will continue to be harmed if DMF information remains available without restriction. As I discussed in depth in prior testimony, I believe that the Social Security Administration (SSA) has the legal authority to place limits on the disclosure of DMF information administratively, given the changes in the factual and legal landscape that have taken place over the past three decades.<sup>72</sup> Therefore, if

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<sup>68</sup> See National Taxpayer Advocate 2012 Annual Report to Congress 189.

<sup>69</sup> See Office of the Inspector General, SSA, Ref. No. A-06-08-18042, *Personally Identifiable Information Made Available to the General Public via the Death Master File* (June 2008).

<sup>70</sup> See National Taxpayer Advocate 2011 Annual Report to Congress 519-523 (Legislative Recommendation: *Restrict Access to the Death Master File*).

<sup>71</sup> See S. 676, Identity Theft and Tax Fraud Prevention Act, 113<sup>th</sup> Cong. (sponsored by Sen. Bill Nelson); H.R. 3475, Keeping IDs Safe Act of 2011, 112<sup>th</sup> Cong. (sponsored by Rep. Sam Johnson).

<sup>72</sup> For a detailed discussion regarding the application of the Freedom of Information Act to the DMF, see *Identity Theft and Income Tax Preparation Fraud*, Hearing Before Subcomm. on Crime, Terrorism,

legislation is not forthcoming, I urge the SSA to reconsider its contrary legal analysis and take steps to restrict access to the DMF.

## **VI. State and Local Law Enforcement Agencies Should Be Restricted from Re-disclosing Taxpayer Data Obtained from the IRS.**

Taxpayers have the right to expect that any information they provide to the IRS will be kept confidential unless authorized by the taxpayer or other provision of law. The Internal Revenue Code contains significant protections for the confidentiality of returns and return information.

IRC § 6103 generally provides that returns and return information shall be confidential and then delineates a number of exceptions to this general rule. Section 6103(i)(2) authorizes the disclosure of return information in response to requests from federal law enforcement agencies for use in criminal investigations. There is no corresponding exception in IRC § 6103 that allows for the release of identity theft information to *state or local* agencies.<sup>73</sup> However, IRC § 6103(c) provides that a taxpayer may consent to disclosure of returns and return information to any person designated by the taxpayer.

The tax reform options paper issued by this Committee last month included a proposal for the IRS to “improve information sharing with federal, state, and local law enforcement” as a means of combatting identity theft.<sup>74</sup> I support this proposal for the IRS to responsibly share information pertaining to identity thieves. I note that the IRS has, in fact, implemented a program facilitating consent-based sharing of identity theft information with state and local law enforcement agencies.<sup>75</sup> This program, initially started as a pilot in the state of Florida but now expanded to all 50 states and the District of Columbia,<sup>76</sup> is an effective way for local law enforcement agencies to work with the IRS to pursue identity thieves. I believe this approach strikes an

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and Homeland Security of H. Comm. on the Judiciary, 112<sup>th</sup> Cong. (June 28, 2012) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>73</sup> Note, however, that certain disclosures to state law enforcement agencies are permissible. See IRC § 6103(i)(3)(B)(i) (disclosure of return information, including taxpayer return information, can be made to the extent necessary to advise appropriate officers or employees of any state law enforcement agency of the imminent danger of death or physical injury to any individual; such disclosure cannot be made to local law enforcement agencies). While identity theft may cause emotional and economic injury, the typical identity theft situation does not pose an imminent danger of death or physical injury. In addition, state tax agencies routinely receive federal tax return information under IRC § 6103(d), but only for purposes of State tax enforcement.

<sup>74</sup> See Senate Finance Committee, *Simplifying the Tax System for Families and Business* (Mar. 21, 2013).

<sup>75</sup> See IRS Identity Theft Advisory Council, *Identity Theft Status Update* (Mar. 28, 2013).

<sup>76</sup> IR-2013-34, *IRS Expands Law Enforcement Assistance Program on Identity Theft to 50 States; Victim Assistance and Criminal Investigations Grow* (March 28, 2013), at <http://www.irs.gov/uac/Newsroom/IRS-Expands-Law-Enforcement-Assistance-Program-on-Identity-Theft-to-50-States>.

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, I am concerned that once the information is in the hands of state and local law enforcement agencies, there is no prohibition in the tax code against redisclosure. With hundreds of smaller municipal governments now receiving tax return information, it is only a matter of time before a local official (who may not have received regular training about the importance of protecting taxpayer return information, as IRS employees do) rediscloses such information, either inadvertently or willfully. I have raised this concern with the IRS, and its position seems to be that there is no problem because it only releases tax return information if a taxpayer executes a consent form. My position is that most taxpayers are not experts on confidentiality waivers and may assume that state and local authorities have the same legal obligations as IRS employees to keep their tax information confidential. It is critical that safeguards be put in place immediately to prohibit law enforcement authorities who receive tax return information for a specified purpose from re-disclosing that information for any other purpose without additional taxpayer consent.

I have suggested that the IRS require state and local law enforcement agencies to sign an agreement that would restrict them from using IRS information for any purpose unrelated to the investigation or prosecution of the identity thief. In my initial meeting with senior IRS officials at which we discussed this disclosure initiative, I raised my concerns about protecting taxpayer information and discussed requiring a memorandum of understanding (MOU) with state and local agencies that wish to participate in the disclosure program.<sup>77</sup> Despite this initial conversation, I have recently been informed that the IRS believes such an approach would be administratively unfeasible, as more than a hundred state and local law enforcement agencies now participate in the program. If state and local agencies do not wish to agree to such restrictions on redisclosure, I believe the IRS has an obligation to taxpayers to refrain from sharing this information.

If the IRS continues to refuse to require that state and local law enforcement agencies enter into MOUs that explicitly prohibit the use or re-disclosure of taxpayer information for unrelated purposes, I recommend that Congress consider modifying IRC § 6103(c) to explicitly limit the use of tax return information to the purpose agreed upon by the taxpayer (*i.e.*, to allow state or local law enforcement agencies to use the information solely to enforce state or local laws) and to prohibit the redisclosure of such information.<sup>78</sup> Indeed, such legislation may be more effective than a contract-based approach to limiting redisclosure.

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<sup>77</sup> See IRS, *IRS Identity Theft Future State Report* 34 (Oct. 11, 2011) (implementation step included “obtain an agreement for sharing identified data and address disclosure”).

<sup>78</sup> See National Taxpayer Advocate 2011 Annual Report to Congress 505.

**VII. Taxpayers Are More Vulnerable to Incompetent and Unscrupulous Return Preparers Because of the Recent *Loving* Decision, and if the Decision Is Not Overturned by the Court of Appeals, Congress Should Act Quickly to Authorize the IRS to Reinstate Its Rules Designed to Protect Taxpayers by Improving Standards in the Tax Return Preparation Industry.**

Since 2002, I have advocated for the regulation of return preparers. I recommended:

- A program to register, test, and certify preparers;
- Increased penalties, and improved due diligence requirements;
- A comprehensive advertising and taxpayer education campaign focused on how to choose a competent preparer and the requirement for paid preparers to
  - sign the tax return and
  - provide a copy of the return to the taxpayer;<sup>79</sup>

In January 2010, the IRS published a study of federal tax return preparers which in most important respects reflected our recommendations.<sup>80</sup> Subsequently, the IRS issued regulations requiring that all preparers register with the IRS by obtaining a preparer tax identification number (PTIN). The IRS also required that certain preparers meet testing and continuing education requirements.<sup>81</sup> Implementation began with the 2011 filing season, when the IRS required paid return preparers to obtain PTINs.<sup>82</sup> The continuing education requirement began during the 2012 calendar year. The IRS launched the registered tax return preparer competency test in November 2011 with a deadline to take the test by December 31, 2013.<sup>83</sup>

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<sup>79</sup> See National Taxpayer Advocate 2009 Annual Report to Congress 41-69; National Taxpayer Advocate 2008 Annual Report to Congress 503-512; National Taxpayer Advocate 2006 Annual Report to Congress 197-221; National Taxpayer Advocate 2005 Annual Report to Congress 223-237; National Taxpayer Advocate 2004 Annual Report to Congress 67-88; National Taxpayer Advocate 2003 Annual Report to Congress 270-301; National Taxpayer Advocate 2002 Annual Report to Congress 216-230; *Fraud in Income Tax Return Preparation: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 109th Cong. (2005) (statement of Nina E. Olson, National Taxpayer Advocate).

<sup>80</sup> IRS Pub. 4832, *Return Preparer Review* (Dec. 2009).

<sup>81</sup> Treas. Reg. § 1.6109-2(d); 31 C.F.R. § 10.2 et seq.

<sup>82</sup> See IRS News Release, IR-2010-106, *IRS Begins Notifying Tax Return Preparers on PTIN Renewals* (Oct. 25, 2010).

<sup>83</sup> See IRS News Release, IR-2011-111, *IRS Moves to Next Phase of Return Preparer Initiative; New Competency Test to Begin* (Nov. 22, 2011).

In January 2013, however, a U.S. district court judge in *Loving v. Internal Revenue Service* disagreed with the IRS's view that it has the authority to implement these requirements on its own, and it invalidated the testing and continuing education requirements.<sup>84</sup> The Department of Justice has appealed the district court's decision to the U.S. Court of Appeals for the District of Columbia.<sup>85</sup>

Regardless of the legal aspects of the *Loving* case, my main focus is the retention of minimum standards for return preparation. If the Court of Appeals reverses the district court's ruling in *Loving*, the IRS would reinstate the rules requiring certain preparers to take a competency exam and complete continuing education credits. If the district court ruling stands, I urge members of Congress to move quickly to protect taxpayers by granting the IRS the authority to reinstate the program it was in the process of implementing.

The rationale for IRS oversight is clear. Because preparers play a critical role in tax administration, it is essential that the IRS ensure preparers are competent, visible, and accountable. Without meaningful IRS oversight, anyone can hang out a shingle as a "tax return preparer" with no knowledge or experience required. The Taxpayer Advocate Service has witnessed widespread problems in the tax return preparation industry. We recently have seen many misconduct cases in which the preparer has altered return information without the client's knowledge or consent in an attempt to obtain improperly inflated refunds or divert refunds for their personal benefit.<sup>86</sup> In addition, problems with return accuracy and ethical standards were substantiated by a series of "shopping visits" GAO and TIGTA conducted, where auditors posed as taxpayers and visited tax return preparation businesses.<sup>87</sup> I believe the IRS needs to set minimum standards as a consumer protection measure.<sup>88</sup> Such standards also would improve professionalism and reduce preparer-facilitated noncompliance.<sup>89</sup>

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<sup>84</sup> *Loving v. I.R.S.*, 111 A.F.T.R.2d (RIA) 589 (D.D.C. Jan. 18, 2013). The government filed a motion to suspend the injunction pending appeal. The U.S. District Court for the District of Columbia denied the motion but modified the terms of the injunction. See *Loving*, 111 A.F.T.R.2d (RIA) 702 (D.D.C. Feb. 1, 2013). On February 25, 2013, the government filed a motion for a stay pending appeal. On March 27, 2013, the U.S. District Court for the District of Columbia denied the motion for stay.

<sup>85</sup> See *Government Files Brief in D.C. Circuit Court in Return Preparer Oversight Case*, Tax Notes Today, 2013 TNT 62-20 (Apr. 3, 2013); *Loving v. IRS*, No. 1:12-cv-00385 (D.D.C. 2013) (USCA Case No. 13-5061).

<sup>86</sup> For a more detailed description of return preparer misconduct and IRS procedures to assist victims of the misconduct, see National Taxpayer Advocate 2012 Annual Report to Congress 68-94 (Most Serious Problem: *The IRS Harms Victims of Return Preparer Misconduct by Failing to Resolve Their Accounts Fully*).

<sup>87</sup> Government Accountability Office, GAO-06-563T, Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors 2 (Apr. 4, 2006) (statement of Michael Brostek, Director - Strategic Issues, Before the Committee on Finance, U.S. Senate); Treasury Inspector General for Tax Administration, Ref. No. 2008-40-171, Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors (Sept. 3, 2008).

<sup>88</sup> See, e.g., *Brief Amici Curiae of Former Commissioners of Internal Revenue in Support of Defendants-Appellants, Loving v. I.R.S.*, No. 13-5061 at 14 (D.C. Cir. April 5, 2013) ("[I]njunctive relief is available only once the bad acts have occurred and ... barring bad tax return preparers from striking

Preparer oversight has received widespread support from stakeholders and members of Congress, so any associated legislation should be relatively non-controversial to enact. This Committee has twice approved legislation to regulate federal tax return preparers – once under Chairman Baucus<sup>90</sup> and once under former Chairman Grassley.<sup>91</sup> The full Senate also once approved similar legislation.<sup>92</sup> In 2005, the House Ways and Means Subcommittee on Oversight held a hearing at which representatives of five outside organizations testified in support of regulating return preparers.<sup>93</sup> More recently, several bills included proposals to regulate preparers – S. 1219, the Taxpayer Protection and Assistance Act of 2007; H.R. 5716, the Taxpayer Bill of Rights Act of 2008; and S. 3215, the Taxpayer Bill of Rights of 2010.<sup>94</sup> Each of these proposals included provisions requiring preparers to have knowledge and skills to prepare accurate returns.

In the meantime, until either the courts or Congress reinstates the IRS's authority to require preparers to demonstrate minimum competence to prepare tax returns, taxpayers remain vulnerable to incompetent or unscrupulous preparers. Accordingly, the Taxpayer Advocate Service is working to ensure that taxpayers are vigilant when they hire an individual or firm to prepare their returns. Specifically, our communications suggest that taxpayers proactively protect themselves by taking the following steps:<sup>95</sup>

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again is wholly consistent with the Treasury Department's authority to regulate commercial tax return preparers in ways reasonably designed to prevent these bad acts from happening in the first instance.”).

<sup>89</sup> By statute, the IRS cannot require attorneys and accountants to pass the competency exam or satisfy continuing education requirements to preparer returns. See 5 U.S.C §§ 500(b) & (c) (granting attorneys and certified public accountants the authority to represent clients before federal agencies upon submitting a written declaration stating qualifications).

<sup>90</sup> S. 1321 (incorporating S. 832) (109<sup>th</sup> Cong.).

<sup>91</sup> H.R. 1528 (incorporating S. 882) (108<sup>th</sup> Cong.).

<sup>92</sup> *Id.*

<sup>93</sup> The organizations testifying in support of return preparer regulation were the American Bar Association, the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, the National Society of Accountants, and the National Association of Tax Professionals. See *Fraud in Income Tax Return Preparation: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 109<sup>th</sup> Cong. (2005).

<sup>94</sup> S. 1219, § 4, 110<sup>th</sup> Cong. (2007); H.R. 5716, § 4, 110<sup>th</sup> Cong. (2008); S. 3215, §202. 111<sup>th</sup> Cong. (2010).

<sup>95</sup> See IRS Pub. 5074, *Protect Your Refund Poster* (distributed by the Taxpayer Advocate Service to all Taxpayer Assistance Centers, Low Income Taxpayer Clinics, and Local Taxpayer Advocate offices). See additional communications at <http://www.taxpayeradvocate.irs.gov/Tax-Professionals/Tax-Preparer-Regulation> (last visited April 9, 2013); <http://www.taxpayeradvocate.irs.gov/Individuals/Choosing-A-Tax-Preparer> (last visited April 9, 2013).

- Ask the preparer directly about his or her qualifications and experience level in preparing tax returns. The taxpayer should feel confident that the preparer possesses sufficient knowledge of relevant tax law – not merely completion of return preparation software training.
- Make sure the preparer signs the return and fills in his or her Preparer Tax Identification Number where indicated on the tax return.
- Obtain from the preparer a copy of the signed and filed return and keep the copy in the event there is a problem with the return.

In addition, consistent with my longstanding position that the IRS should mount a comprehensive taxpayer awareness campaign, I believe it is more important than ever that the IRS increase its outreach and education about choosing a preparer, with particular emphasis on the populations at most risk, such as low income taxpayers and the elderly.

## **VIII. Conclusion**

Shrinking budgets and rising identity theft cases, among other things, are posing significant challenges for the IRS. But there are many opportunities for substantial improvement in tax administration, and in my testimony, I have tried to identify a number of positive steps Congress can take to make the most of these opportunities. Specifically, I recommend that Congress:

- Simplify the tax code to reduce burden on taxpayers and the IRS.
- Enact a Taxpayer Bill of Rights so taxpayers better understand their rights and responsibilities in dealing with the IRS.
- Work to change the rules that govern funding decisions about the IRS budget, because more IRS funding means better taxpayer service *and* more revenue (assuming the funds are well spent).
- Improve the filing season by giving the IRS access to third-party reports like Forms W-2 and 1099 before it processes tax returns and issues refunds, which has the potential to improve the taxpayer experience, improve tax compliance, and make a big dent in identity theft.
- Restrict access to the DMF so the surviving relatives of decedents are less susceptible to identity theft problems.

- Require that state and local law enforcement agencies that receive taxpayer return information to pursue identity theft crimes keep the information confidential and use it solely for its intended purpose.
- Finally, grant the IRS the authority to continue to implement its well-designed initiative to improve standards in the tax preparation industry *if* the U.S. Court of Appeals for the District of Columbia ultimately concludes that the IRS does not now have that authority.