WRITTEN TESTIMONY OF
JOHN A. KOSKINEN
COMMISSIONER
INTERNAL REVENUE SERVICE
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ON THE STATE OF THE IRS
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I. INTRODUCTION

Chairman Boustany, Ranking Member Lewis and Members of the Subcommittee, thank you for the opportunity to appear before you today to give you an overview of IRS operations and also to discuss the IRS' enforcement efforts in a number of high-priority areas associated with refund fraud.

I am honored to serve as IRS Commissioner and to have the opportunity to lead this agency and its dedicated employees, because I believe that the success of the IRS is vital for this country. The agency collects about $2.9 trillion each year, which is more than 90 percent of the revenue collected by the federal government. The activities of the IRS touch virtually every American. This is a challenging time for the agency, as it must continue to fulfill its dual mission of tax compliance and taxpayer service while dealing with substantial budget reductions as well as the management problems that came to light last year.

I want to begin by outlining for you what I believe are the IRS' key challenges and what I will focus on going forward. First and foremost, we have just started a new filing season, and our employees have spent the last several months in planning and preparation to ensure that it goes smoothly, not only to ensure proper revenue collection but also to ensure that taxpayers can fulfill their tax obligations as quickly and easily as possible.

Another priority for our agency is to put to rest all of the issues and concerns surrounding applications for tax-exempt status. The management problems associated with the 501(c)(4) application process have shaken public trust in the IRS. Under the leadership of former Acting Commissioner Danny Werfel, the IRS made a great deal of important progress in this area, and it is my job to complete the work that he began. Taxpayers need to be confident that the IRS will treat them fairly, no matter what their background or their affiliations. Public trust is the IRS' most important and valuable asset.

It will also be critical to build upon the important work being done to improve tax compliance in a number of areas, including refund fraud caused by identity theft, which I will discuss in more detail later in this testimony. Enforcing the tax laws is vital to preserving our system of voluntary compliance. The vast majority of taxpayers are law abiding, and they must always feel confident that the system is fair, and that everyone is required to play by the rules. Along with enforcement, we must continue to improve taxpayer service, which is critical to ensuring that our system of voluntary compliance works properly. The IRS also must continue to fulfill our responsibilities to implement tax-related provisions of major legislation that Congress has enacted, including the Affordable Care Act (ACA) and the Foreign Account Tax Compliance Act (FATCA).

On the management side, I strongly believe that the success of the IRS depends on the experience, skills and enthusiasm of our employees and I intend to do everything I can to make the most of this very valuable resource. I have been very impressed by the experience and professionalism of the IRS employees I have met so far, both here in Washington and in the IRS offices I have visited over the last few weeks. What I have seen in all of those places reinforces my long-held belief that the people in an organization who know the most about what is going on are the frontline employees. I intend to listen to our employees and make sure they understand that we appreciate their dedication and look forward to benefitting from their insights and suggestions. I have told our employees that I will do everything possible to ensure that they have the leadership, systems and training to support them in their work and allow them to reach their full potential to best serve taxpayers.

In discussing the state of the IRS, no challenge facing our agency is greater than the significant reduction in funding that has occurred over the last several years. Later in this testimony I will outline the important work that our agency has done recently to reduce costs and increase efficiencies. But even with these efforts, which are ongoing, I am deeply concerned about the ability of the IRS to continue to fulfill its mission if the agency lacks adequate funding. Our current level of funding is clearly less than what the agency needs, especially to provide the level of taxpayer services the public has a right to expect. At the same time, we recognize that there has been a loss of confidence within Congress in regard to the way we manage operations. One of my responsibilities is to ensure that we are minimizing risks and quickly solving management and operational problems that may arise, so that Congress can be confident that, when we request additional funding, that money will be used wisely. Taxpayers provide the funds we receive and they deserve to be confident that we are careful stewards of those resources.

It is vital that we find a solution to our budget problem, and I look forward to working with Congress to do just that. I hope that one of the legacies of my four years as IRS Commissioner will be that we put the agency’s funding on a more solid and sustainable footing.

II. STATE OF IRS OPERATIONS

Filing Season

Each year the IRS works to deliver a smooth and successful filing season. The numbers showing what we undertake can be mind boggling. In Fiscal Year (FY) 2013, the IRS collected about $2.9 trillion in revenue to fund the federal government, which represents more than 90 percent of all federal receipts. In FY 2013, the IRS processed 147.7 million individual tax returns and issued 109.6 million refunds to taxpayers totaling $301.9 billion. In addition, IRS employees responded accurately to 95.7 percent of tax law questions and 96.0 percent of taxpayer account questions answered via phone.

The IRS' e-file program continued to grow in FY 2013, with 121.9 million individual returns, or 82.5 percent, filed electronically, an increase of 2.5 percent from the previous year.

Preparing for the 2014 filing season, which opened on January 31, was challenging as a result of the 16-day government shutdown last October – the longest shutdown the IRS has ever experienced. About 90 percent of our operations were closed during this period, with work being stopped, for example, for 3,000 to 4,000 IT staffers, many of whom would have been working to deliver the 2014 filing season.

After a careful review of all of the complex programming and system needs involved, the IRS made the decision to open the filing season on January 31, 2014, 10 days later than the date that was originally scheduled for e-filers to begin filing returns. The later date allowed the agency needed time to program and test its tax processing systems.

Taxpayer Service

The IRS provides year-round assistance to taxpayers to help them fulfill their tax obligations. By assisting taxpayers with their questions before they file, we help prevent inadvertent noncompliance, thus reducing burdensome post-filing notices and other correspondence from the IRS.

The taxpayer assistance provided by the IRS comes in many forms, including: outreach and education programs; issuance of tax forms and publications, rulings and regulations; toll-free call centers; in-person help at Taxpayer Assistance Centers (TAC); and our website, IRS.gov.

For FY 2013, as a result of the ongoing decline in agency funding, the telephone level of service for taxpayers trying to reach the IRS' toll-free lines dropped to

60.5 percent, the lowest level since FY 2008. That means that approximately 40 percent of taxpayers who called were unable to reach an IRS employee, a level of service that we find unacceptable. We will do the best that we can during the remainder of this fiscal year, but even with the most energetic response by our employees, that number is not likely to improve by much, if at all, given the current level of funding the IRS receives.

One way to ameliorate, to some extent, the decline in service levels when taxpayers call is to make the information on our website more understandable and provide more web-based tools and services so that taxpayers can securely interact with the IRS just as they would in a live service channel. The IRS started this process in 2013 and continues to address this important and complex issue. In FY 2013, taxpayers viewed IRS.gov web pages more than 450 million times. These taxpayers used IRS.gov to get forms and publications, find answers to their tax questions, and check the status of their refunds. Taxpayers used the "Where's My Refund?" electronic tracking tool 132 million times in FY 2012 and 250 million times in FY 2013. We expect that number to increase again this filing season.

The IRS has also expanded the methods by which it communicates with taxpayers. Moving beyond traditional media, such as newspapers and broadcast news, the IRS continues to employ new technologies and social media, such as YouTube and Twitter, to reach more taxpayers and provide important service and compliance messages to them.

For the 2014 filing season we have several new digital applications that will further improve taxpayers' interaction with the IRS. One of these is IRS Direct Pay, which we introduced as a pilot program in November 2013. IRS Direct Pay provides taxpayers with a secure, free, quick and easy online option for making tax payments. Use of IRS Direct Pay will be more convenient for many taxpayers and should significantly reduce the number of paper checks that we have to process, which now total about 73 million per year.

Another innovation, which we launched in January, is Get Transcript. Get Transcript is a secure online system that allows taxpayers to view and print a record of their IRS account, also known as a transcript, in a matter of minutes. Prior to the introduction of this online tool, taxpayers had to wait five to seven days after placing an order to receive a paper transcript by mail.

We are also in the final stages of revamping the IRS Online Payment Agreement, which allows taxpayers to apply for an installment payment agreement online. We have streamlined the application process to make it quicker and easier. We expect to launch this improved product this spring.

The IRS' commitment to taxpayer service also means assisting taxpayers who are facing difficult economic times and other hardships in meeting their tax obligations.

One major example of our efforts in this regard is the Fresh Start initiative, which began in 2011. Under this initiative, the IRS has increased flexibility in its collection program to help taxpayers who are struggling financially. For example, it is now easier for taxpayers to obtain lien withdrawals after paying back taxes owed. In addition, IRS now allows liens to be withdrawn when a taxpayer signs a Direct Debit Installment Agreement (DDIA). Another provision helps more small businesses get access to Installment Agreements if they sign up for a DDIA and have less than $25,000 in unpaid taxes. The rules were also changed for Offers in Compromise (OIC) so that more taxpayers could qualify for a streamlined OIC.

Our efforts to assist taxpayers also have involved helping victims of crises such as natural disasters. For example, in 2012 and 2013, the IRS moved quickly to provide tax and filing relief to victims of wildfires and tornadoes in Oklahoma, and storms and flooding in Alabama, Alaska, Colorado, Florida, Illinois, Indiana, Kentucky, Tennessee and West Virginia. In addition, the IRS provided tax and filing relief to victims of Hurricane Isaac in Mississippi and Louisiana, and to victims of Hurricane Sandy in Connecticut, Maryland, New Jersey, New York and Rhode Island.

Along with natural disasters, last year the IRS provided tax filing and payment extensions to taxpayers in and around Suffolk County, Massachusetts, including the city of Boston, who were affected by the events that occurred at the Boston Marathon on April 15, 2013.

Enforcement

Enforcement of the tax laws is a critical component of the U.S. tax system, as it enhances voluntary compliance. The IRS strives to carry out a rigorous enforcement program, which includes: a balanced examination program to help ensure that taxpayers accurately report their income, deductions and credits; an effective collection program to collect assessed tax liabilities; and efforts to detect and stop non-compliance, fraudulent schemes and tax crimes.

Taken together, the IRS' enforcement activities collected approximately $53.3 billion in taxes and penalties in FY 2013, an increase of $3.1 billion from FY 2012. Most of the increase came from a $2.6 billion rise in revenue from Appeals which, due to the timing of the Appeals process, generally relates to examinations for much earlier years. Revenue from our Collection function, the levels of which also frequently rise and fall in tandem with the overall health of the economy, increased by nearly $1 billion in FY 2013.

While we are pleased with the overall increase in receipts from enforcement in 2013 compared to the prior year, the total is still down by more than $4.2 billion from four years ago, and we are concerned about the steady decline since the high point of $59.2 billion in FY 2007. The reason for this decline is primarily due to a decline in revenue from audits, which dropped nearly $400 million in FY 2013 to $9.83 billion, the lowest level in a decade. This decline in audit revenue is attributable to a decline in the number of returns audited. The IRS audited the returns of approximately 1.4 million individuals in FY 2013, down 5 percent from FY 2012 and the lowest level since 1.39 million audits in FY 2008. The audit coverage rate – the number of audits divided by the number of tax returns – fell below 1 percent to 0.96 percent in FY 2013, the lowest level since FY 2006. Audits of high-income individuals – defined as those with $1 million or more in income – fell 3.7 percent as well last year. The IRS examined approximately 61,000 business returns in FY 2013, down 13 percent from FY 2012.

The decline in individual and business audits coincided with a decrease in key enforcement staffing personnel in three major categories in FY 2013. There were 1,300 fewer enforcement personnel overall – including those responsible for exams, collection and investigations – than in FY 2012, a drop of 6.4 percent, and the lowest number in a decade. The decrease is even more pronounced when compared with the numbers for FY 2010 when we had over 3,100 more enforcement personnel than FY 2013 working to ensure that taxes owed were collected.

The IRS has made progress in the Criminal Investigation (CI) area where prosecutions recommended by IRS CI increased to 4,364 in FY 2013 from 3,701 the previous year. This is the highest level of prosecution recommendations in more than a decade. The conviction rate for cases tried in court reached 94.7 percent, also the highest in a decade. Other key Criminal Investigation measures, such as the number of investigations initiated, also increased in FY 2013.

The IRS has also made critical progress in improving international tax compliance. Through our strategic enforcement efforts and parallel voluntary disclosure programs, the IRS has provided opportunities for U.S. taxpayers with undisclosed offshore accounts or income to come back into the tax system. Since its establishment in 2009, the Offshore Voluntary Disclosure Program has resulted in more than 43,000 disclosures of underpaid or unpaid taxes and the collection of more than $6 billion in back taxes, interest and penalties. In addition, our work on offshore tax evasion has recently included: the prosecution of three foreign banks for conspiracy to commit tax evasion resulting in restitution of $807.5 million and forfeitures of $48.3 million; indictments of almost two dozen foreign bank employees and investment advisors; and more than 100 indictments of U.S. citizens with hidden offshore accounts.

Implementing Enacted Legislation

As noted, one of my priorities as Commissioner is to ensure that the IRS fulfills its responsibilities to implement tax-related provisions of enacted legislation. A large portion of our efforts in this regard continue to center on the ACA and FATCA. The resources needed for implementation activities for ACA and FATCA, taken together, represent roughly 4 percent of the IRS' budget for FY 2014.

ACA Implementation Efforts

With regard to ACA implementation, I am pleased to be able to tell you that the systems and processes that the IRS developed to support enrollment in the new Health Insurance Marketplace were launched on schedule and are working as planned. In addition, the IRS has been working to implement the ACA's tax provisions, most of which are already in effect, such as the branded prescription drug fee, the tanning tax and the medical device excise tax. We continue to focus on two significant tax provisions that go into effect in 2014: the premium assistance tax credit and the individual shared responsibility provision. These two provisions will have a profound impact on IRS forms and procedures beginning with the 2015 filing season, and will require additional taxpayer service and education activities.

Preparations are already well underway to modify forms and instructions, enhance education and outreach to taxpayers and their advisors, and update our systems and processes in time for the 2015 filing season.

The IRS is also focusing on ensuring that returns that erroneously or fraudulently claim refundable premium tax credits (or fail to reconcile advance payments of the credit) are efficiently identified and addressed, using Marketplace information available during the filing season as well as the ever-improving IRS anti-fraud tools used for all returns.

FATCA implementation efforts

FATCA is an important new tool in our offshore compliance efforts, as it requires foreign financial institutions (FFIs) to report information to the IRS about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. Withholding requirements under FATCA go into effect on July 1, 2014, and additional regulatory guidance will be issued soon. It is important to note, however, that legal restrictions in some countries prevent FFIs from fulfilling the reporting, withholding and account disclosure requirements. For that reason, Treasury, with assistance from the IRS, is advancing an intergovernmental approach to FATCA implementation that is focused on bilateral agreements that address these legal impediments, simplify practical implementation and reduce the costs to FFIs. Currently, there are 20 signed Intergovernmental Agreements. The IRS FATCA registration website opened in August 2013 allowing financial institutions to begin to enter data. In January 2014 financial institutions were able to begin submitting their electronically signed FATCA agreements.

Exempt organizations

The IRS is continuing its efforts to implement broad managerial and operational improvements in the determination process for tax-exempt status. In this work we are focusing on applications for recognition of tax-exempt status under both sections 501(c)(3) and 501(c)(4).

Section 501(c)(4) organizations

Regarding the section 501(c)(4) application process, the IRS has made important progress in addressing the concerns raised by the Treasury Inspector General for Tax Administration (TIGTA) in a May 2013 report describing problems with the process for these applications. In fact, I am pleased to report that the IRS completed action on all nine TIGTA recommendations contained in that report as of the end of January 2014.

The changes we have completed in response to the TIGTA recommendations include:

- Establishing a documentation process for the reasons why applications are chosen for further review;
- Developing training and workshops on a number of critical issues, including the difference between general advocacy and political campaign intervention, and the proper way to identify applications that require review of political campaign intervention activities;
- Establishing guidelines for IRS Exempt Organization (EO) specialists on how to process requests for tax-exempt status involving potentially significant campaign intervention; and
- Creating a formal, documented process for EO determinations personnel to request assistance from technical experts.

In addition, proposed regulations were released in November which were intended to provide clarity in determining the appropriate type of political activity that section 501(c)(4) organizations may engage in without endangering their tax-exempt status. This initial guidance also seeks comments on other aspects of the 501(c)(4) qualification requirements, including what proportion of an organization's activities must promote social welfare. There are a number of steps in the regulatory process that must be taken before any final guidance can be issued.

I believe it is extremely important to make this area of regulation as clear as possible, not only because it will help guide the IRS in proper enforcement, but will also give a better roadmap to applicants and help those that already have section 501(c)(4) status understand the applicable standards and properly administer their organizations. The proposed guidance also seeks comments regarding whether standards similar to those that have been proposed should be adopted to define the political activities that do not further the tax-exempt purposes of other tax-exempt organizations and to promote consistent definitions across the tax-exempt sector.

The Treasury and IRS have requested public comment on the proposed regulations, and will carefully consider all public feedback in working to ensure that the standards for tax exemption under section 501(c)(4) are clear and can be applied consistently.

Section 501(c)(3) organizations

Improving the section 501(c)(3) application process is a significant area of focus for our agency, and we have been working diligently to make the process less burdensome for applicants in a number of ways.

Our Exempt Organization group consistently receives more than 60,000 applications per year, including applications for 501(c)(3) status among other types of tax-exempt status. The agency has experienced a substantial rise in applications since 2010. In FY 2013, for example, we received nearly 80,000 applications for recognition of exemption. A significant cause of this increase since 2010 has been the automatic revocations that occurred under the 2006 Pension Protection Act, and the subsequent requests for reinstatement.

Those requests for reinstatement have added more than 50,000 cases to EO's workload since FY 2010. In fact, in 2013, more than 30 percent of the applications we received were from organizations seeking reinstatement following automatic revocation. On January 2, 2014, the IRS issued Revenue Procedure 2014-11, which will make the reinstatement process more efficient for revoked organizations and will allow a majority of revoked organizations to use a streamlined process to apply for retroactive reinstatement of their exempt status.

Looking beyond the issue of automatic revocations, the IRS has recently developed another way of making the determination process more efficient for section 501(c)(3) organizations. The new Interactive Form 1023, *Application for Recognition of Exemption under Section 501(c)(3)*, features pop-up information boxes that offer guidance on what information is needed. The form should result in more complete applications, thus reducing processing time by minimizing the IRS' need to request additional information to make a determination.

We are also examining the feasibility of creating a streamlined application process for certain organizations seeking tax-exempt status. I recently visited the

Cincinnati IRS office and had the opportunity to meet with members of our Lean Six Sigma[1] team that is taking the lead on this effort. I'm excited about the work that these dedicated frontline employees are doing. They are developing a process that could potentially be used by small organizations that pose a low risk of noncompliance. The goal is to come up with a procedure that is more efficient without introducing major risks into the system for approving applications.

We presently have a backlog of 60,000 section 501(c)(3) applications, many of them well over a year old. Our goal is to be able to report a significant decrease in this number by this time next year.

IRS Budget

For the IRS to keep making progress in all the areas mentioned above, it is critical for us to receive adequate resources. The agency continues to be in a very difficult budget environment, with our funding for FY 2014 now set at $11.29 billion. Since FY 2010, IRS appropriations have been cut by approximately $900 million. This represents a 7 percent cut in our annual budget since 2010 while the total population of individual and business filers grew by more than 4 percent over the same time period.

We recognize the need to become more efficient no matter what our funding level. Labor is our largest operating expense and we have been very focused on managing personnel costs. By closely managing hiring and limiting replacement behind attrition, the IRS has reduced the total number of full-time, permanent employees by about 10,000, or more than 11 percent, since 2010.

The IRS has also implemented significant reductions in its non-labor spending. Since 2010, the IRS has limited employee travel and training to mission-critical projects. By our estimates, training costs have been reduced by 83 percent and training-related travel costs have been reduced by 87 percent since 2010. We have expanded the use of alternative delivery methods for in-person meetings, training, conferences, and operational travel, but we need to restore some of these funds to ensure that IRS employees interacting with the public are properly trained and able to provide the answers and assistance expected.

Over the same period, the IRS also reduced spending on professional and technical service contracts by $200 million. Additionally, the IRS generated $60 million in printing and postage savings by eliminating the printing and mailing of selected tax packages and publications, and by transitioning to paperless employee pay statements.

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[1] Lean Six Sigma is a management reengineering methodology widely used in the private sector to improve business performance.

Finally, in an effort to promote more efficient use of the Federal government's real estate assets and to generate savings, the IRS in 2012 announced a sweeping office space and rent reduction initiative that over two years is projected to close 43 smaller IRS offices and consolidate space in many larger facilities. These measures will reduce rent costs by more than $40 million and reduce total IRS office space by more than 1.3 million square feet by the end of FY 2014.

We will continue our efforts to find savings and efficiencies wherever we can. However, the budget cuts to the IRS are so significant that efficiencies alone cannot make up the difference. We face the prospect of having to make very critical performance tradeoffs.

We announced earlier this year, for example, the elimination of two e-service offerings for professional tax preparers: Disclosure Authorization and Electronic Account Resolution. Although we worked to eliminate offerings with the lowest historical usage rates, this change still generated a great deal of concern among preparers who used the services. Unfortunately, given how tight our budget situation is, and will continue to be, we were not able to reconsider the decision.

As I said during my confirmation hearing, I believe that it is vital for the IRS to receive adequate resources going forward in order for us to deliver on our dual mission of enforcing the tax laws and providing excellent taxpayer service. This view is shared by the IRS Oversight Board, the National Taxpayer Advocate, TIGTA, and the Internal Revenue Service Advisory Council.

III. PRIORITY ENFORCEMENT AREAS RELATED TO REFUND FRAUD

The IRS has worked diligently to enhance and improve its enforcement efforts as they relate to fraud and is making significant progress due to three primary factors:

- One is an increase in the use of technology, which enhances our ability to detect fraudulent returns before they are processed and also helps us improve the way we track and report the status of cases that are related to identity theft.
- A second factor is our increasing use of data analytics, which, among other things, helps us better select tax return preparers who may benefit from additional outreach, education and compliance activities to significantly reduce improper payments associated with refundable tax credits, particularly the Earned Income Tax Credit (EITC), on returns and claims for refund they prepare.
- A third factor is our increased emphasis on managing risks and providing enhanced transparency to critical risks across the IRS through such efforts as our new Enterprise Risk Management program (ERM). A major thrust

of the ERM is to establish a culture where risk identification is viewed positively, thereby enhancing the transparency of risks wherever they occur in the organization, which will better enable management to make informed decisions about mitigating those risks. As a result of the ERM program, the IRS will be better positioned to spot risks at the earliest possible point anywhere in our operations. To the extent that an identified risk relates to enforcement, this will allow the IRS to quickly make any necessary improvements in its enforcement approach.

Impediments to further progress in improvement of our enforcement programs do exist, however. One is the sheer volume and complexity of tax fraud schemes. Another is the fact that the tactics employed by unscrupulous individuals who commit these crimes are constantly evolving. Finally, the IRS needs to further upgrade its technology to implement improvements, such as more sophisticated refund fraud filters and better taxpayer authentication procedures. We are in the process of making those upgrades, to the extent we are able to do so with limited resources.

Making Progress on Identity Theft

The IRS has a comprehensive and aggressive identity theft strategy that focuses on preventing refund fraud, investigating these crimes and assisting taxpayers victimized by identity thieves.

Refund fraud detection

The IRS stopped 5 million suspicious returns in Calendar Year 2012 – up from 3 million suspicious returns stopped in CY 2011. This upward trend has continued: in CY 2013, through November, we suspended or rejected 6.7 million suspicious returns, worth more than $15.9 billion.

In 2008, we began placing an indicator on the accounts of taxpayers who had experienced identity theft. These indicators initially served two primary purposes: to speed up account reconciliation for the legitimate taxpayer, and to reduce the likelihood that a taxpayer's information could be used for a fraudulent refund claim in subsequent years.

In 2011, we launched a pilot program to test the Identity Protection Personal Identification Number (IP PIN). The IP PIN is a unique identifier that authenticates a return filer as the legitimate taxpayer at the time the return is filed. The growth in the use of the IP PIN has been significant from 250,000 IP PINs issued in filing season 2012 to 770,000 issued in filing season 2013. For the 2014 filing season, we have issued more than 1.2 million IP PINs as of December 31. Also this year, we are offering a limited pilot program to test the idea of issuing IP PINs to individuals who have not previously been identity theft victims, but who reside in locations with high incidences of identity theft.

Over the last two fiscal years the IRS has made numerous improvements in catching fraud before refunds are issued:

- We have implemented new identity theft screening filters to improve our ability to spot false returns before we process them and issue refunds.

- One of our areas of concern involves cases where dozens or even hundreds of refunds go to a single bank account or single address. While there can be legitimate reasons for multiple refunds to go to a single address, our level of concern about the potential for improper payments is such that for the 2013 filing season we added identity theft filters that flag these multiple refund situations for further review.

- We have accelerated the use of information returns in order to identify mismatches earlier. We will accelerate the use of more types of information return data in 2014.

- We have implemented a variety of mechanisms to stop the growing use by criminals of deceased individuals' identity information to perpetrate fraud. We routinely lock accounts of deceased taxpayers, and have locked more than 24 million accounts to date. Also, the budget agreement enacted in December 2013 directs the Secretary of Commerce to establish a certification program for access to the Death Master File, the intent of which is to help reduce identity-theft related tax fraud.

- We have developed better procedures to use information about identity theft victims received from law enforcement officials who discover this information in the course of investigating identity theft schemes or other criminal activity. We use the data to flag taxpayer accounts and block returns filed by identity thieves.

- Another important part of protecting taxpayers' identities is the IRS' Social Security Number (SSN) Elimination and Reduction program. Under that program, we eliminate or reduce the use of SSNs within our systems, forms, notices and letters where the collection or the use of the SSN is not necessary. To date, we have eliminated or reduced the use of the SSNs on 20.4 million annual non-payment notices we mailed to taxpayers. Also, we recently began to deploy SSN masking on 33 million annual notices mailed to taxpayers requesting installment agreement payments.

- We have developed procedures to better stop the processing of fraudulent returns from prisoners. In FY 2013 we stopped more than 163,000 fraudulent returns filed by prisoners, representing more than $1.1 billion in refunds stopped. The IRS has collaborated with the Bureau of Prisons, and also with states that choose to partner with us, to help identify prisoners who may be engaged in tax fraud. Our authority to share return information with prisons, which was made permanent in the American Taxpayer Relief Act enacted in 2013, also enables us to better stop tax fraud by prisoners. Also, the budget agreement enacted in December 2013 includes a provision that gives the Treasury Department the legal authority to obtain the Social Security Administration's Prisoner Update Processing System (PUPS) data which will help reduce prisoner-related tax fraud.

- We are collaborating with software developers, banks, and others to determine how we can better partner with them to address identity theft and prevent federal monies from reaching the hands of identity thieves. For example, we established a cooperative agreement in 2013 with approximately 80 financial institutions to reject questionable deposits of tax refunds. The IRS has also established relationships with representatives of the prepaid access card industry, which has enabled us to leverage their security protocols designed to detect and prevent fraudulent use of prepaid cards. In many cases, these companies can identify potentially fraudulent tax refunds and freeze or cancel the cards.

The IRS' current fraud detection capability is strong, but is limited by the technology in place, so we are investing in a significant new set of technologies. For instance, the Return Review Program (RRP) will greatly expand our current efforts, by enhancing our real-time filtering and identity theft modeling capabilities. We intend to launch the first version of RRP in 2014, and it will operate alongside the legacy Electronic Fraud Detection System until 2016, when RRP will become our primary fraud detection system. With RRP fully implemented, we will have more flexibility to stay ahead of identity thieves because we will be able to act more quickly to incorporate what we learn about fraud schemes into our filters.

Assisting victims

Being victimized by identity theft is a frustrating, complex situation. The IRS has 3,000 people working directly on identity theft related cases – more than double the number in late 2011. And we have trained 37,000 employees who regularly work with taxpayers to help with identity theft situations when they arise.

Critical to the IRS' efforts to assist identity theft victims is our Identity Protection Specialized Unit, which provides taxpayers with a single point of contact at the IRS via a special toll-free telephone line. We also have several identity theft specialized groups to assist with processing identity theft cases.

During FY 2012, the IRS reengineered its identity theft process to close cases more efficiently, accurately, and in a less burdensome manner. Cases identified with a high probability of identity theft are reassigned for review more quickly than in the past. Other procedural enhancements are helping us to reduce delays in releasing refunds to the legitimate filer in cases where duplicate returns are filed. This past fiscal year, taxpayers who became identity theft victims received their refunds and had their problem resolved in roughly 120 days, far more quickly than in previous years when cases could take over 300 days to resolve. While this marks a significant improvement, we are continuing to find ways to shorten this time and ease the burden identity theft places on these victims. In CY 2013, the IRS worked with victims to resolve and close approximately 963,000 cases.

Investigating fraud-related crimes

The investigative work done by the IRS is a major component of our efforts to combat tax-related identity theft. CI investigates and detects tax and other financial fraud, including fraud related to identity theft. In addition, CI coordinates with other IRS divisions to ensure that false refunds involving identity theft are addressed quickly and that the IRS accounts of identity theft victims are marked to help prevent future problems. CI recommends prosecution of refund fraud cases, including cases involving identity theft, to the Department of Justice.

Investigations of tax fraud related to identity theft have increased significantly over the past three fiscal years. The number of investigations opened increased from fewer than 400 in FY 2011 to 900 in FY 2012, and increased again to nearly 1,500 in FY 2013. Indictments in identity theft-related cases totaled 1,050 in FY 2013, with 438 individuals sentenced and an average time to be served of 38 months.

State and local law enforcement agencies also play a critical role in fighting identity theft. CI regularly collaborates with these agencies, and, in March 2013, the IRS announced the nationwide expansion of the Law Enforcement Assistance Program, which began as a pilot program in Florida in 2012.
This program provides for the disclosure of federal tax returns and return information associated with the accounts of known and suspected victims of identity theft when the victim provides express written consent for disclosure. To date, more than 3,900 victims in 37 states have provided these consents, resulting in disclosures to 383 state and local law enforcement agencies.

Improvements to the ITIN Program

Individual Taxpayer Identification Numbers (ITINs) assist with the filing and collection of taxes from foreign nationals, resident and non-resident aliens, and others who have filing or payment obligations under U.S. law but who do not qualify for SSNs.

ITINs play a critical role in the tax administration process, as they are essential to the processing of tax returns that report tens of billions of dollars in taxable income and billions in tax revenue for individuals who have a U.S. tax filing obligation and otherwise would not have a U.S. taxpayer identification number.

The IRS has taken steps to improve the process of issuing ITINs in order to verify the applicant's identity and foreign status. It is important to note, however, that while a system of robust controls is important, it must be balanced against the need to issue ITINs efficiently and with as little burden as possible on legitimate applicants who are trying to comply with their U.S. tax obligations. We will continue to strengthen our efforts in this critical and complex area.

ITIN application process

Under procedures in place since last year, the IRS, with few exceptions, only issues ITINs to taxpayers and dependents who provide original documentation, such as passports and birth certificates, or copies of these documents certified by the issuing agency, to verify their identity. To further protect the integrity of the system, ITINs issued starting January 1, 2013 will expire after five years.

These procedures also include tighter requirements for becoming a Certifying Acceptance Agent (CAA) and remaining in the CAA program. CAAs play an important role in the ITIN application process as intermediaries who review identity documents of the applicant. Under the tighter requirements, CAAs must certify to the IRS that they have verified the authenticity of the original or issuing agency-certified documents supporting the ITIN application. CAAs are also now required to undergo forensics training, and the IRS has begun compliance reviews of CAAs.

Investigating and detecting ITIN fraud

Reducing refund fraud involving the misuse of ITINs, in which individuals use ITINs to file returns claiming tax credits to which they are not entitled, continues to be a priority for the IRS, and we have made important progress in this area. CI has increased investigative time spent on ITIN investigations by approximately 400 percent since 2008. Between 2008 and early December 2013, CI identified nearly 2,700 ITIN schemes that encompassed more than 322,000 ITIN returns. Several fraud detection filters are in place specifically to help detect issues with the Child Tax Credit (CTC) and Advance Child Tax Credit (ACTC).

Notably, last year the IRS detected specific patterns indicating potential fraud in returns with ITINs and was able to develop filters on a real-time basis during the filing season to stop these refunds from being issued. In addition, we have developed new methods of clustering suspicious returns together to catch large numbers of returns that appear similar. These clusters include identifying multiple returns using the same address or the same filing and refund patterns.

Strengthening Tax Compliance in Regard to Refundable Credits

Refundable tax credits play an important role in fulfilling Congressional policies, but they are inherently subject to a number of tax administration challenges. There are numerous refundable credits currently administered by the IRS, including the EITC, the CTC and the American Opportunity Tax Credit (AOTC). The IRS has a dual mission when it comes to administering refundable credits. We must balance the mandate to get refunds out as quickly as possible to those who qualify with the need to ensure that the money goes only to individuals who are eligible to receive it.

There are a number of factors that present challenges to our compliance efforts as they relate to refundable credits. They include the following:

- *Complexity*. Complexity in the rules governing eligibility for and the operation of certain refundable credits creates challenges for both taxpayers and the IRS. Mistakes in the application of the law cause a significant portion of claims that are made in error. In addition, the eligible population for the EITC shifts by approximately one third each year, making it difficult for the IRS to use prior year data to assist in validating compliance.
- *Lack of Third-Party Data*. In many cases, the IRS lacks real-time third-party data sources that could be used to verify taxpayers' eligibility. In many cases, definitive third-party data verifying eligibility does not exist. Even if data exists, the IRS is often in the position of having to process returns and determine the validity of a refund before receiving the third party data that could be matched against the return to verify data. For example, Form 1098-T, which verifies the eligibility for the AOTC, is not due to be filed with the IRS until after most refunds claiming the credit are processed.
- *Cash Payments*. Refundable credits allow for overpayments beyond income tax liability. This makes refundable credits particularly enticing targets for fraudsters and makes it difficult for the IRS to recoup the erroneous payment after it is made.

Given these challenges, the IRS has dedicated significant attention and resources to improving tax compliance in regard to claims made for refundable credits in order to reduce improper payments associated with these credits. One of the biggest enforcement priorities for us in this area is the EITC.

Enforcing EITC rules

Congress created the EITC as part of the Tax Reduction Act of 1975, to offset Social Security taxes. The credit has evolved into an important program that now lifts millions of children and families above the poverty line each year.

To qualify to claim the earned income credit, individuals generally must: have earned income; have a valid SSN for themselves and for each qualifying child they claim; meet certain filing status and income limits; have investment income of no more than a certain amount ($3,300 for 2013); and be a U.S. citizen or resident alien for the entire year for which the credit is claimed.

The amount of the earned income credit that an individual may claim varies based on whether the individual has any qualifying children, and if so, the number of qualifying children that the individual is able to claim. For a child to be considered a qualifying child, the following tests must be met:

- *Age:* The child must be under age 19 at the end of the year (under age 24 in the case of a student) and younger than the taxpayer (or younger than both the taxpayer and the taxpayer's spouse if filing a joint return), or the child must be permanently and totally disabled at any time during the year for which the EITC is claimed;
- *Residency:* The child must have lived with the taxpayer for more than half of the year for which the credit is being claimed, although certain exceptions to this rule apply; and
- *Relationship*: The child must be the taxpayer's son, daughter, stepchild, eligible foster child, brother, sister, stepbrother, stepsister or a descendant of any of these individuals, such as a grandchild, niece or nephew. Adopted children also qualify, including those lawfully placed with the taxpayer for legal adoption.

In addition, a taxpayer claiming the credit cannot be the qualifying child of another taxpayer, and cannot use the "married filing separately" filing status. Additional requirements apply for individuals who do not have qualifying children.

The IRS engages in significant education and outreach efforts so that taxpayers are aware of their potential eligibility for the credit. These efforts, coupled with strategic programs addressed to taxpayers and tax return preparers, are used to improve compliance and, therefore, reduce improper payments. Because approximately 67 percent of the returns claiming the EITC are prepared by tax return preparers, preparer education and outreach has significant potential to reduce the improper payment rate. The estimated improper payment rate for FY 2013 is between 22 and 25 percent.

Much of the difficulty in enforcing compliance with the EITC derives from its eligibility requirements. EITC eligibility depends on items that the IRS cannot readily verify through third-party information reporting, including marital status and the relationship and residency of children.

The IRS' EITC-focused enforcement programs currently protect approximately $4 billion annually from being paid out improperly. The following programs contribute to the broader strategy of identifying improper EITC refund claims as early in the process as possible:

- *Math error*. This refers to an automated process in which the IRS has been granted statutory authority to identify certain math or other irregularities on the return and automatically adjust the return for a taxpayer. These upfront systemic processing checks protect approximately $320 million against improper EITC refund claims annually;
- *Document matching*. This process involves comparing income information provided by the taxpayer with matching information from third-party returns, such as Form W-2 and Form 1099, to identify discrepancies. This post-refund process protected $1.4 billion against improper EITC refund claims in FY 2013. The IRS conducted almost 1 million of these reviews, in addition to 500,000 audits.
- *Examinations*. The IRS identifies tax returns and amended returns for examination and holds the EITC portion of the refund until an audit can be conducted. Of the approximately 500,000 EITC audits conducted by the IRS each year, 70 percent are conducted before the EITC portion of the refund is paid. The tax returns to be examined are selected using an effective risk-based audit selection model, resulting in a change rate of more than 90 percent. Examinations protected almost $2.1 billion against improper EITC refund claims in FY 2013.

The IRS continues to improve and expand its existing compliance efforts to stop improper EITC payments. Notably, our increased efforts in regard to identity theft-related fraud detection have helped improve EITC enforcement results. In CY 2013 through early December, we protected nearly $500 million against improper EITC refunds sought by identity thieves claimed on fraudulent returns. Further compliance efforts directed at the tax return preparer community, including the requirement that preparers obtain a preparer tax identification number, an increase in the penalty amount for preparers who fail to satisfy the EITC due diligence requirement, and increased enforcement and education, have also contributed to reducing improper EITC payments.

Additionally, the IRS has expanded its traditional treatment of EITC preparers to test a new early-intervention component. Over the previous two years the IRS has used data analytics - including an innovative “test and learn” approach - to significantly reduce improper payments associated with the EITC as well as the CTC.

Using this approach, a small data-driven pilot in 2012 identified a group of tax return preparers with a history of submitting incorrect or potentially fraudulent tax returns falsely claiming the EITC, then designed and implemented interventions with these preparers to stop improper claims. The interventions included letters, calls and site visits to selected preparers, both before and during tax filing season to allow preparers to immediately adjust their practices. These efforts reduced improper EITC payments in 2012 by an estimated $198 million for returns prepared by preparers who received the interventions.

An expanded preparer pilot that concluded in 2013 protected an additional $590 million in revenue from being paid out improperly. The 2013 pilot program included a broader set of randomly selected preparers and a broader set of interventions, including the addition of preparer-focused taxpayer audits (for returns that otherwise would have qualified for audit even absent the pilot). Many preparers whose error rates did not improve as a result of interventions during the 2012 pilot did so in 2013 after being subject to additional intervention. Preparers who had improved due to IRS interventions during the initial 2012 pilot generally maintained their improved behavior with respect to EITC and related tax credits claimed on returns and claims filed during 2013.

Use of interventions for preparers before and during the filing season is slated to continue on an expanded basis in 2014 with continued testing of selected strategies (e.g., new methods of contacting preparers during filing season) and ongoing monitoring of all key program elements, including tracking the differential impacts of various treatments on different preparers.

IV. CONCLUSION

Chairman Boustany, Ranking Member Lewis and members of the Subcommittee, thank you again for the opportunity to provide you with an overview of IRS operations and discuss our enforcement activities in a number of high-priority areas. Our work in all of these areas is critical, and despite some recent successes, more needs to be done. Going forward, our biggest obstacle to further progress in these and other areas, including taxpayer service, will be our significantly reduced level of funding. As I recently told our employees, it is important for us to remember that the challenges and problems we face won’t be solved overnight. But I am confident that, working together, and with the help of Congress, we can meet those challenges and ensure that our agency can continue to deliver for the American taxpayer in the years to come. This concludes my statement, and I would be happy to take your questions.