

**WRITTEN TESTIMONY OF
COMMISSIONER OF INTERNAL REVENUE SERVICE
MARK EVERSON
BEFORE
SENATE FINANCE COMMITTEE
ON
FILING YOUR TAXES: AN OUNCE OF PREVENTION IS WORTH
A POUND OF CURE
APRIL 12, 2007**

Introduction

Chairman Baucus, Ranking Member Grassley, and members of the Committee, thank you for the opportunity to appear this morning. While I recognize that the prime focus of this hearing is to discuss identity theft, electronic return originators (EROs), and tax preparers, I would also like to take this opportunity to update the Committee on a number of other matters relating to the operations of the IRS.

Specifically, I would like to discuss the results of our efforts in Fiscal Year (FY) 2006 to continue to balance a strong taxpayer service program with an aggressive enforcement strategy that respects taxpayer rights. I would also like to offer some details of our proposed FY 2008 IRS budget. Finally, I would like to update you on the 2007 filing season, which ends in a few days.

Producing Results

In FY 2006, we continued making improvements in both our service and enforcement programs. This is not just our assessment, but also that of the IRS Oversight Board in its most recent annual report. According to the Board, the IRS has made steady progress towards “transforming itself into a modern institution that provides efficient and effective tax administration services to America’s taxpayers.”

Improving Taxpayer Service

According to a survey commissioned by the Board in 2006, taxpayers increasingly recognize that the IRS provides quality service through a variety of channels, such as its Web site, toll-free telephone lines, and Taxpayer Assistance Centers (TACs). This is supported by the metrics that we use to determine the effectiveness of our taxpayer service efforts. In category after category, we continue to see improvement in the numbers in our telephone services, electronic filing, and IRS.gov access. This is demonstrated by the following FY 2006 business results:

- Electronic filing by individuals continued to increase. It rose three percentage points from FY 2005, to 54 percent of all individual returns.

- The level of service for toll-free assistance was 82 percent, about the same level as FY 2005 and up substantially from FY 2001. The level of customer satisfaction with the toll-free line remains 94 percent.
- The tax-law accuracy of toll-free responses improved to 91 percent and account accuracy increased to over 93 percent.
- Visits to the IRS Web site jumped nearly 10 percent in FY 2006 to more than 197 million visits.
- More taxpayers used the online refund status tool “Where's My Refund.” In FY 2006, there were 24.7 million status checks, up nearly 12 percent from FY 2005.

At the IRS, we continue to work to improve services. Clearly, we are making progress, and these numbers underscore that point.

Another development in our taxpayer service program is the Taxpayer Assistance Blueprint (TAB). This collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate began in July, 2005 in response to a Congressional mandate to develop a five-year plan for taxpayer service delivery. We sent Phase 1 of the Blueprint to Congress in April, 2006. Phase 1 identified and reported the following five strategic service improvement themes for increasing taxpayer, partner, and government value:

- *Improve and expand education and awareness activities:* This theme addresses the critical need for making taxpayers and practitioners aware of the most effective and efficient IRS service options and delivery channels for meeting their tax obligations and receiving benefits they are due.
- *Optimize the use of partner services:* This theme emphasizes the critical role of third parties in the delivery of taxpayer services, and calls for improving the level of support and direction provided to partners to ensure consistent and accurate administration of the tax law.
- *Enhance self-service options to meet taxpayer expectations:* This theme focuses on providing clear, standard, and easily customized automated content to deliver accurate, consistent, and understandable self-assistance service options—particularly for transactional tasks.
- *Improve and expand training and support tools to enhance assisted services:* This theme highlights the need for ensuring accurate information across all channels by improving and expanding training, technology infrastructure, and support for employees, partners, and taxpayers.
- *Develop short-term performance and long-term outcome goals and metrics:* This theme provides for the development of a comprehensive set of performance goals and metrics to evaluate how effectively the IRS is meeting taxpayer expectations, and how efficiently it is delivering services.

Phase 2 of the Blueprint was delivered to Congress yesterday. Throughout this project, extensive research allowed us to refine our understanding of taxpayer and partner needs, preferences, and behaviors and to identify current planning documents, decision

processes, and existing commitments affecting IRS service delivery. Certain recurring findings emerged from the wealth of data analyzed. These findings, combined with agency-wide considerations and priorities, led to the development of the five-year TAB Strategic Plan for taxpayer service.

The TAB Strategic Plan includes a suite of service improvement initiatives across all delivery channels, a portfolio of performance metrics, and an implementation strategy, which recommends numerous future research studies. The TAB Strategic Plan outlines a decision-making process for prioritizing service improvement initiatives based on taxpayer, partner, and government value and ensuring continued stakeholder engagement. This process is designed to help the IRS to balance quality service with effective enforcement to maximize compliance

As a first step in incorporating Blueprint results into the IRS budgeting process, the FY 2008 budget request includes the funding necessary to implement some of the telephone service and Web site enhancements recommended by the TAB Strategic Plan. Enhancing telephone service will contribute to the goal of increasing taxpayer, partner, and government value. Improving IRS.gov will help us to make the Web site the first choice of individual taxpayers and their preparers when they need to contact the IRS for help.

The TAB Strategic Plan also recommends a suite of multi-year research studies to continue to refine and improve our understanding of optimal service delivery. In addition to funding for research regarding noncompliance, the FY 2008 budget includes funding for research to understand better the effect of service on compliance.

Expanding Enforcement Efforts

Another reason for the Oversight Board's positive assessment of our work in FY 2006 is that IRS enforcement efforts have increased in virtually every area. According to the Board, "As demonstrated by a variety of measures, the IRS' performance on enforcement has improved considerably, and real progress has been achieved over the past six years."

One of the most obvious measures is the increase in enforcement revenue, which has risen from \$34 billion in FY 2002 to almost \$49 billion in FY 2006, an increase of 43 percent.

In FY 2006, both the levels of individual returns examined and coverage rates have risen substantially. We conducted nearly 1.3 million examinations of individual tax returns. This is almost 75 percent more than were conducted in FY 2001, and reflects a steady and sustained increase since that time. Similarly, the individual audit coverage rate has risen from 0.58 percent in FY 2001 to more than 0.97 percent in FY 2006.

While the growth in examinations of individual returns is visible in all income categories, it is most visible in examinations of individuals with incomes over \$1 million. The number of examinations in this category rose by almost 78 percent compared to FY 2004,

the first year the IRS began tracking audits of individuals with income over \$1 million. The coverage rate has risen from 5 percent in FY 2004 to 6.3 percent in FY 2006.

Growth in audit totals and coverage rates extend to other taxpayer categories. IRS examined over 52,000 business returns in FY 2006, an increase of nearly 12,000 over FY 2001. The coverage rate over the same period rose from 0.55 percent to 0.60 percent. For corporations with assets over \$10 million, examinations rose from 8,718 in FY 2001 to 10,578 in FY 2006, an increase in the coverage rate from 15.1 percent to 18.6 percent. For the largest corporations, those with assets over \$250 million, examinations have increased by over 29 percent growing from 3,305 in FY 2001 to 4,276 in FY 2006.

We have also been active in the tax exempt community. Overall, examination closures for tax exempt organizations have risen from 5,342 in FY 2001 to 7,079 in FY 2006. In addition, we have an innovative program utilizing correspondence contacts to leverage our activities in the compliance area. We have used it successfully in the hospital and executive compensation areas and will be using it elsewhere.

While examinations in the tax exempt community generally do not provide the tax collection “return on investment” that audits in other areas might, it is important that we keep a “cop on the beat” in order to prevent abuses in the exempt sector and an erosion of the tax base. Maintaining a strong enforcement presence in the tax-exempt sector is particularly important given the role that a small number of these entities have played in the past in accommodating abusive transactions entered into by taxable parties. In appropriate cases, this results in the collection of income or excise taxes--and in the most egregious cases, revocation of exempt status.

One area we have paid particular attention to is the credit counseling industry. Through a compliance initiative in this area, as of March 23rd, we had revoked or proposed revocation of the tax-exempt status of 45 credit counseling agencies, with another 16 examinations still in process. Proposed or final revocations to date represent 41 percent of the revenues of the credit counseling industry.

Using our correspondence contact techniques, we have also sent more than 700 questionnaires to all tax-exempt credit counseling organizations we know of that were not already under examination. Based on responses to the questionnaires and our independent research, we expect to examine at least 82 additional credit counseling organizations from this group.

We also have been actively reviewing seller-funded down payment assistance programs that provide cash assistance to homebuyers who cannot afford to make the minimum down payment or pay the closing costs involved in obtaining a mortgage. When properly structured and operated, down payment assistance programs can qualify as tax-exempt charitable and educational organizations. In May 2006, we issued Revenue Ruling 2006-27, which provides examples of organizations that may qualify for tax exempt status, but also makes it clear that organizations providing seller-funded down payment assistance do not qualify for tax exemption.

Seller-funded down payment assistance programs improperly benefit the home seller through circular funding arrangements that result in the home buyer paying for all or much of the down payment “gift” he or she receives from the organization. It also results in buyers becoming overextended as the cost of the down payment is added to the purchase price of the home. A Housing and Urban Development (HUD) commissioned study and a Government Accountability Office (GAO) report found that seller-funded programs led to underwriting problems and resulted in an increase in the cost of homeownership.

In the audits we have conducted in this area, not only have we found improper private benefit and activities, but also that the down payment assistance organizations often provide excessive compensation to their officials. Revocation of exempt status will shut down abusive seller funded programs without harming the innocent low income home buyers who participated in these arrangements.

We will continue to look at other areas within the exempt sector that have the potential for abuse.

President’s FY 2008 Budget Maintains the Balance between Taxpayer Service and Enforcement

The IRS and its employees represent the face of the Federal Government to more American citizens than any other government agency. The IRS administers America’s tax laws and collects 95 percent of the revenues that fund government operations and public services. We spent just 42 cents to collect each \$100 of tax revenue in FY 2006, the third lowest figure in the last 25 years and down from 46 cents in FY 2005.

Our taxpayer service programs provide assistance to help millions of taxpayers understand and meet their tax obligations. Our enforcement programs are aimed at deterring taxpayers inclined to evade their responsibilities, while vigorously pursuing those who violate tax laws. Delivering these programs demands a secure and modernized infrastructure able to fairly, effectively, and efficiently collect taxes while minimizing taxpayer burden.

The IRS FY 2008 President’s Budget request supports our agency-wide strategic plan as well as Treasury’s compliance improvement strategy. These documents underscore the IRS’ commitment to provide quality service to taxpayers while enforcing America’s tax laws in a balanced manner. The IRS’ strategic plan goals are:

- *Improve Taxpayer Service.* Help people understand their tax obligations, making it easier for them to participate in the tax system;
- *Enhance Enforcement of the Tax Law.* Ensure taxpayers meet their tax obligations, so that when Americans pay their taxes, they can be confident their neighbors and competitors are also doing the same; and

- *Modernize the IRS through its People, Processes and Technology.* Strategically manage resources, associated business processes and technology systems to effectively and efficiently meet service and enforcement strategic goals.

Budget Request

Our total budget request for FY 2008 is for \$11.1 billion in appropriated resources and represents a 4.7 percent increase over the recently enacted FY 2007 Joint Resolution (JR) level of \$10.6 billion.

The IRS' taxpayer service and enforcement activities are funded from three appropriations: Taxpayer Services (TS); Enforcement (ENF); and Operations Support (OS). The total FY 2008 Budget request for these three operating accounts is \$10.8 billion, supplemented by the \$180 million from user fee revenue, for a total operating level of \$10.9 billion--a 5.5 percent increase over the FY 2007 JR level. As in FY 2006 and FY 2007, the Administration proposes to include IRS enforcement increases as a Budget Enforcement Act program integrity cap adjustment. I am pleased that both the House and Senate passed Budget resolutions for 2008 include the full cap adjustment for this activity, recognizing the return on investment from these enforcement investments.

The Budget also includes \$282.1 million for Business Systems Modernization (BSM) and \$15.2 million to administer the Health Insurance Tax Credit program--a 32.6 percent and 2.6 percent increase, respectively, over the FY 2007 JR level.

Our FY 2008 Budget request provides \$409.5 million for new initiatives and \$340 million for the pay raise and other cost adjustments needed to sustain base operations. The IRS' initiatives focus on the most significant needs for FY 2008:

- *\$20.0 million to enhance taxpayer service* through expanded volunteer tax assistance, increased funding for research to determine the most effective means to help taxpayers, and implementing new technology to improve taxpayer service;
- *\$246.4 million to expand enforcement* activities targeted at improving compliance; and
- *\$143.1 million to improve the IRS' information technology (IT) infrastructure*, including \$62.1 million for the BSM program and \$81.0 million for security and infrastructure enhancements.

This request also includes several program savings and efficiencies that reflect the IRS' aggressive efforts to identify and deploy work process and technology improvements that will benefit both taxpayer service and enforcement programs. Collectively, these cost savings total \$120.0 million:

- *Taxpayer Service Efficiencies* -\$23.4 million / -527 FTE: These savings will result from operational efficiencies achieved through ongoing efforts to automate and

enhance IRS taxpayer service programs' workload distribution, such as the implementation of automated issuance of Employer Identification Numbers and Correspondence Imaging System. Additional efficiencies and savings are expected to be achieved through the implementation of optimal service delivery initiatives identified by the Taxpayer Assistance Blueprint.

Enforcement Program Efficiencies -\$60.2 million / -620 FTE: These savings will result from productivity and efficiency improvements realized through the implementation of enhanced technology and business processes, such as improved case selection tools and techniques. In addition, the completion of initial training and transition of the FY 2006 new hires back to their front-line enforcement activities will result in additional efficiencies for the examination and collection programs.

- *Shared Service Support Efficiencies* -\$36.4 million / -37 FTE: These savings will result from several efforts, including the optimization and consolidation of space projects, implementation of cost-efficient government-wide contract support, and postage savings achieved through the consolidation, automation, and renegotiation of contract services for correspondence delivery.

2007 Filing Season

This filing season presented the potential to be one of the most challenging in recent memory. The Tax Relief and Health Care Act of 2006 (TRHCA), which was enacted late last year, included the extension of several significant tax benefits. Since forms and publications for Tax Year 2006 were printed and distributed prior to enactment, we were required to notify taxpayers on IRS.gov and through other channels as to how to modify those forms to claim the allowable benefits. We are also faced with implementing the Telephone Excise Tax Refund Program (TETR). In addition, this was the first filing season that we allowed taxpayer refunds to be split and deposited into separate accounts. And, because the normal April 15th filing date falls on a Sunday and the following Monday is a legal holiday in the District of Columbia, we had to adjust our programs to provide taxpayers an extra two days to file and pay this year.

Despite these challenges, I am proud to report that thus far the filing season has gone very well. By early February, we were able to begin processing tax returns claiming the tax benefits authorized by the enactment of TRHCA in December. We have also taken a number of steps to make sure that taxpayers understand how to claim the benefits. For example, we provided instructions on IRS.gov and conducted extensive outreach and media events to publicize these provisions. In addition, we sent a special mailing of Publication 600, which included the state and local sales tax tables and instructions for claiming the sales tax deduction on Schedule A (Form 1040), to 6 million taxpayers who had previously claimed the state and local sales tax deduction.

I will discuss the TETR Program later in my testimony, but let me first give an update on some of the numbers we are looking at approximately one week from the return due date.

Numbers Thus Far

We expect to process over 136 million individual tax returns in 2007, and we anticipate a continued growth in the number of those that are e-filed. In the 2006 filing season, 54 percent of all income tax returns were e-filed. We fully expect to exceed that number this year. As of April 7, we have received almost 61.3 million tax returns electronically, an increase of 6.11 percent compared to the same period last year.

This increase in e-filing is being driven in large part by people preparing their own returns using their personal computers. The total number of self-prepared returns that are e-filed is up by over 8.4 percent compared to this time a year ago. Over 17 million returns have been e-filed by people from their personal computers, up from over 15.8 million for the same period a year ago.

Overall, 69.6 percent of the 88.1 million returns filed through April 7th have been e-filed. Encouraging e-filing is good for both the taxpayer and for the IRS. Taxpayers who use e-file can generally have their tax refund deposited directly into their bank account in two weeks or less. That is about half the time it takes us to process a paper return. The error reject rate for returns e-filed with the IRS is significantly lower than that for paper returns.

More people are choosing to have their tax refunds directly deposited into their bank account than ever before. So far this year, we have directly deposited almost 49.9 million refunds, or 68 percent of all refunds issued this tax filing season. This is up from 65 percent for the same period in 2006.

People are also visiting our Web site, IRS.gov, in record numbers. Through April 7th, we have recorded over 111.2 million visits to our site this year, up almost 8 percent from 103.1 million for the same period a year ago. The millions of taxpayers that have visited IRS.gov have benefited from many of the services that are available through the Web site. We have made it easier for taxpayers to get answers to many of their tax questions online. The Web site:

- Assists the taxpayer in determining whether he or she qualifies for the Earned Income Tax Credit (EITC);
- Assists the taxpayer in determining whether he or she is subject to the Alternative Minimum Tax (AMT);
- Allows more than 70 percent of taxpayers the option to file their tax returns at no cost through the Free File program;
- Allows taxpayers who are expecting refunds to track the status via the “Where’s My Refund?” feature; and
- Allows a taxpayer to calculate the amount of their Sales Tax Deduction

As of April 7, we have received almost 88.1 million returns. We have issued 73.6 million refunds so far this year, for a total of \$174.2 billion. The average refund thus far is

\$2,366, which is \$76 more than last year. In addition, as of April 7, 23.3 million taxpayers have tracked their refund on IRS.gov, up more than 23 percent over last year.

As of March 31st, our Taxpayer Assistance Centers (TACs) are reporting a very slight increase in face- to-face contacts this filing season as compared to last year. We have seen a slight decline in the number of calls answered (-1.82 percent) as well as automated calls (-5.79 percent). The decline in the number of calls answered can be attributed to a few weather-related temporary call site closures earlier this winter and a slight decrease in overall caller demand.

Free File

Free File started slowly this filing season but has been steadily increasing. We remain cautiously optimistic that the program will reach 2006 totals by the end of the filing season. As of April 5th, almost 3.1 million people have utilized Free File, down 4.65 percent from last year. This year, anyone with adjusted gross income of \$52,000 or less is eligible for Free File. This would include 95 million taxpayers. The number of Free File returns compared to the prior year has been steadily increasing.

A key difference in this year's program is that Free File Alliance members are no longer offering ancillary products, such as refund anticipation loans (RALs), through the Free File program. IRS data from the last filing season shows that only 0.5 percent of Free File users chose to utilize a RAL. The Free File Alliance may still offer customers the option of having their state tax return prepared for a fee, though some Alliance members are offering to do the state return at no cost along with the Federal.

In the 2006 filing season, an indicator was included for the first time on Free File returns allowing the IRS to identify those taxpayers using Free File. As a result, the Service was able to obtain important information such as customer satisfaction and demographic data that had never before been available. This information allowed us to verify that there was a high level of customer satisfaction with Free File. According to a survey conducted for the IRS, 94 percent said they intend to use Free File again next year; the same number said they found Free File very easy or somewhat easy to use; and 97 percent said they would recommend Free File to others. Convenience, not the free cost, was the most appealing factor of Free File.

VITA/TCE Sites and Other Community Partnerships

The use of tax return preparation alternatives, such as volunteer assistance at Volunteer Income Tax Assistance (VITA) sites and Tax Counseling for the Elderly sites (TCEs), has steadily increased. In FY 2006, over 2.2 million returns were prepared by volunteers. As of March 31st, volunteer return preparation is up over 13 percent above last year's level. Volunteer e-filing is also up slightly, by 1 percent over the same period in the last tax filing season. This is reflective of continuing growth in existing community coalitions and partnerships.

We have also made a concerted attempt to improve outreach to taxpayers, particularly those taxpayers who may be eligible for the EITC. For example, we sponsored EITC Awareness Day on February 1, in an effort to partner with our community coalitions and partnerships to reach as many EITC-eligible taxpayers as possible and urge them to claim the credit.

Telephone Excise Tax Refunds

In the middle of 2006, the IRS announced plans to refund approximately \$13 billion in telephone excise taxes to more than 160 million taxpayers. To do this, the IRS modified every individual and business tax return form, retooled our systems to handle the forecast demand, and launched an extensive communications campaign to increase awareness and encourage people without a filing requirement to request a refund.

One difficulty in administering this refund was that taxpayers could have experienced significant burden if they had been required to find 41 months of old phone bills in order to obtain the information they needed to compute their refunds. For this reason, the IRS created a set of standard amounts that individuals can claim in lieu of actual amounts. For businesses and non-profits faced with potentially more paperwork than individuals, the IRS developed an estimation method that could require significantly less paperwork than requesting an actual amount.

A review of returns filed so far this year turned up a surprising fact: over 31 percent of returns we have received did not include a telephone excise tax refund request. Though one of our communications goals was to encourage taxpayers not to overlook the telephone tax refund, it appears many taxpayers are missing out. In response to these early numbers, we consulted with tax professionals, citizens groups, and tax software companies to determine potential causes for the low take-up rate. The only logical reason we were given was that despite our best efforts, some taxpayers were still not aware of the credit and how to claim it. We then conducted additional media outreach to increase awareness of the refund and were able to generate broad national media coverage, including CNN, the Associated Press, and USA Today.

As we monitored the initial returns, we also noticed some problems. Even though 99.5 percent of all taxpayers who are requesting the refund are claiming the appropriate standard amount, some tax-return preparers were requesting thousands of dollars of refunds for their clients in instances where clients are entitled to only a tiny fraction of that amount. This may indicate criminal intent on the part of the return preparer. In some cases, taxpayers requested a refund in the thousands of dollars, suggesting that the taxpayer paid more for telephone service than they received in income. While some of the large claims may be the result of misunderstandings – a number of refund requests appear to be for the entire amount of the taxpayer's phone bill, rather than just the three-percent long-distance tax – others may be deliberate attempts to scam the system.

To address this problem, in late February, IRS special agents executed search warrants seeking evidence from a small number of tax-preparation businesses suspected of

preparing returns on behalf of clients requesting large, improper amounts in telephone excise tax refunds. Special agents temporarily closed these businesses, seizing computers and documents to use in their investigations. In addition, IRS revenue agents (auditors) and special agents also visited other tax preparers who were suspected of preparing questionable telephone tax refund requests.

On a positive note, the number of returns with seemingly high telephone excise tax refunds dropped significantly this month. This suggests our enforcement actions, along with increased communications, may be having the desired effect.

Tax Scams

Each year, we alert taxpayers about the “Dirty Dozen”, 12 of the most blatant tax scams affecting American taxpayers. This is in part an effort to alert taxpayers so that they may be wary if approached and encouraged to participate in any of the listed schemes. It also alerts promoters that we are aware of the scam and will be taking steps to prevent them from getting away with it.

This year the “Dirty Dozen” highlights five new scams that IRS auditors and criminal investigators have uncovered. Topping the list this filing season are fraudulent refunds being claimed in connection with TETR, which I have already discussed. Other scams making the list include:

- **Abusive Roth IRAs:** Taxpayers should be wary of advisers who encourage them to shift under-valued property to Roth Individual Retirement Arrangements (IRAs). In one variation, a promoter has the taxpayer move under-valued common stock into a Roth IRA, circumventing the annual maximum contribution limit and allowing otherwise taxable income to go untaxed.
- **Phishing:** This is a technique used by identity thieves to acquire personal financial data in order to gain access to the financial accounts of unsuspecting consumers, run up charges on their credit cards, or apply for loans in their names. These Internet-based criminals pose as representatives of a financial institution — or sometimes the IRS itself — and send out fictitious e-mail correspondence in an attempt to trick consumers into disclosing private information. A typical e-mail notifies a taxpayer of an outstanding refund and urges the taxpayer to click on a hyperlink and visit an official-looking Web site. The Web site then solicits a social security and credit card number. It is important to note the IRS does not use e-mail to initiate contact with taxpayers about issues related to their accounts. If a taxpayer has any doubt whether a contact from the IRS is authentic, the taxpayer should call 1-800-829-1040 to confirm it.
- **Disguised Corporate Ownership:** Domestic shell corporations and other entities are being formed and operated in certain states for the purpose of disguising the ownership of the business or financial activity. Once formed, these anonymous entities can be, and are being, used to facilitate underreporting of income, non-

filing of tax returns, listed transactions, money laundering, financial crimes, and possibly terrorist financing. The IRS is working with state authorities to identify these entities and to bring their owners into compliance.

- **Zero Wages:** In this scam, which first appeared in the Dirty Dozen in 2006, a Form 4852 (Substitute Form W-2) or a “corrected” Form 1099 showing zero or little income is submitted with a federal tax return. The taxpayer may include a statement rebutting wages and taxes reported by the payer to the IRS. An explanation on the Form 4852 may cite statutory language behind Internal Revenue Code sections 3401 and 3121, or may include some reference to the paying company refusing to issue a corrected Form W-2 for fear of IRS retaliation.
- **Return Preparer Fraud:** Dishonest return preparers can cause many headaches for taxpayers who fall victim to their schemes. Such preparers make their money by skimming a portion of their clients’ refunds and charging inflated fees for return preparation services. They attract new clients by promising large refunds. Some preparers promote filing fraudulent claims for refunds on items such as fuel tax credits to recover taxes paid in prior years. Taxpayers should choose carefully when hiring a tax preparer. As the old saying goes, “If it sounds too good to be true, it probably is.” Remember that no matter who prepares the return, the taxpayer is ultimately responsible for its accuracy. In recent years, the courts have issued injunctions ordering dozens of individuals to cease preparing returns, and the Department of Justice has filed complaints against dozens of others. During fiscal year 2006, 109 tax return preparers were sentenced to prison for committing tax crimes with an average prison sentence of 18 months.
- **American Indian Employment Credit:** Taxpayers submit returns and claims reducing taxable income by substantial amounts, citing an American Indian employment or treaty credit. Although there is an Indian Employment Credit available for businesses that employ Native Americans or their spouses, there is no provision for its use by employees. In a somewhat similar scam, unscrupulous promoters have informed Native Americans that they are not subject to federal income taxation. The promoters solicit individual Indians to file Form W-8 BEN seeking relief from all withholding of federal taxation. A recent “phishing” variation has promoters using false IRS letterheads to solicit personal financial information that they claim the IRS needs in order to process their “non-tax” status.
- **Trust Misuse:** For years, unscrupulous promoters have urged taxpayers to transfer assets into trusts. They promise reduction of income subject to tax, deductions for personal expenses, and reduced estate or gift taxes. However, these trusts do not deliver the promised tax benefits. There are currently more than 150 active abusive trust investigations underway, and 49 injunctions have been obtained against promoters since 2001. As with other arrangements,

taxpayers should seek the advice of a trusted professional before entering into a trust.

- **Structured Entity Credits:** Promoters of this newly identified scheme are setting up partnerships to own and sell state conservation easement credits, federal rehabilitation credits, and other credits. The purported credits are the only assets owned by the partnership and once the credits are fully used, an investor receives a K-1 indicating the initial investment is a total loss, which is then deducted on the investor's individual tax return.
- **Abuse of Charitable Organizations and Deductions:** The IRS continues to observe the use of tax-exempt organizations to improperly shield income or assets from taxation. This can occur when a taxpayer moves assets or income to a tax-exempt supporting organization or donor-advised fund, but maintains control over the assets or income. Contributions of non-cash assets continue to be an area of abuse, especially with regard to overvaluation of contributed property. In addition, the IRS is noticing the return of private tuition payments being disguised as charitable contributions to religious organizations.
- **Form 843 Tax Abatement:** This scam rests on faulty interpretation of the Internal Revenue Code. It involves the filer requesting abatement of previously assessed tax using Form 843. Many using this scam have not previously filed tax returns, and the tax they are trying to have abated has been assessed by the IRS through the Substitute for Return Program. The filer uses the Form 843 to list reasons for the request. Often, one of the reasons is: "Failed to properly compute and/or calculate IRC Sec 83-Property Transferred in Connection with Performance of Service."
- **Frivolous Arguments:** Promoters have been known to make the following outlandish claims: the Sixteenth Amendment concerning congressional power to lay and collect income taxes was never ratified; wages are not income; filing a return and paying taxes are merely voluntary; and being required to file Form 1040 violates the Fifth Amendment right against self-incrimination or the Fourth Amendment right to privacy. Taxpayers should not believe these or other similar claims. These arguments are false and have been thrown out of court. While taxpayers have the right to contest their tax liabilities in court, no one has the right to disobey the law or else they may subject themselves to increased penalties. As part of the Tax Relief and Health Care Act of 2006 [Public Law No. 109-432], Congress amended the Code to increase the amount of the penalty for frivolous tax returns from \$500 to \$5,000 and to impose a penalty of \$5,000 on any person who submits a "specified frivolous position." We recently released guidance identifying these and other frivolous claims that--when asserted by a taxpayer on a tax return filed with the Service or submitted in a collection due process request, offer-in-compromise, application for an installment agreement, or application for a Taxpayer Assistance Order--expose the taxpayer to the \$5,000 penalty.

Now, Mr. Chairman, I would like to discuss some of the specific issues raised by both you and Senator Grassley in preparation for this hearing. I will first discuss identity theft, followed by laptop security, electronic return originators, and paid tax preparers.

Identity Theft

Taxpayer and employee privacy is a foremost concern of the IRS. We are charged with protecting the most critical information about virtually every American. In recognition of this responsibility, we continue to update our systems and our training so that employees who have access to sensitive information are aware of the steps they must take to prevent that information from being compromised.

This job has never been tougher. According to the FBI, identity theft is one of the fastest growing white collar crimes. There has been a 4,600 percent increase in computer crime since 1997. Nearly 10 million Americans each year are affected by identity theft, according to the Federal Trade Commission (FTC). Deloitte-Touche has reported that financial institutions and U.S. banks have also experienced a significant increase in the number of computer based attacks and attempted intrusions into financial systems.

The FTC also reports, "About 90% of business record thefts involve payroll or employment records, while only about 10% are generated from customer lists." These business record thefts also include job applications, personnel records, health insurance and benefits records, and payroll related tax documents that provide personal information that identity thieves use to steal employees' identities. While most identity theft is use of consumer's personal information to make purchases, almost 1.5 millions victims indicated that their personal information was misused in non-financial ways to obtain government documents or tax forms.

Through our Automated Underreporter Program (AUR), we see first hand potential instances of identity theft. The AUR matches W-2s for the same SSN to ensure that the taxpayer has reported all sources of income. If identity theft has occurred the SSN may have been used with multiple employers who have issued multiple W-2s for the SSN. In Tax Year (TY) 2004, the latest year for which we have data, there were 16,152 identity theft claims made through the AUR program. This is far less than the 30,639 cases in TY 2002, but a few more than the 12,618 claimed in TY 2003. In these cases, if the impacted taxpayer provides the necessary documentation on an identity theft claim, the income in question will not result in an additional assessment.

We have tried to take the initiative in proactively analyzing processes to identify areas of vulnerability, and in educating taxpayers and employees about identity theft. We have teamed with other federal agencies, such as the Federal Trade Commission (FTC), the Department of Justice and the Social Security Administration (SSA) to address identity theft crime.

In 2005 we began an aggressive strategy to research and address this growing problem. We established an Identity Theft Program Office charged with implementing the IRS'

policy on identity theft. This policy requires the IRS to take the necessary steps to provide assistance to victims of identity theft within the scope of their official duties. Our Identity Theft Program Office works with offices throughout the IRS to implement the agencies' Identity Theft Enterprise Strategy comprised of three components—Outreach, Prevention and Victim Assistance.

Outreach

The IRS has undertaken several outreach initiatives to provide taxpayers, employees, and other stakeholders with the information they need to proactively prevent and resolve identity theft issues. For example, the IRS:

- Revised the most widely used documents, such as the Form 1040 instructions and Publication 17, *Your Federal Income Tax*, to include information about identity theft..
- Launched an identity theft website on IRS.gov to provide victims with updated information and links to SSA and FTC and with information on how to contact the Taxpayer Advocate.
- Participated with Department of Treasury and the SSA in a multi-agency panel discussion on identity theft, which was held at the IRS nationwide tax forums in 2006 that reached approximately 30,000 tax preparers.
- Developed an internal web communication tool to alert IRS employees to issues of identity theft.
- Lead a multi-agency working group (Treasury, FTC, SSA, and Homeland Security) with a goal of providing consistent information and services to victims, consistent with recommendations being made by the President through the Identity Theft Task Force.
- Partnered with the Treasury Inspector General for Tax Administration (TIGTA) to develop and promote a consistent message to inform taxpayers that the IRS does not communicate with taxpayers via e-mail, with the goal of reducing the number of identity thefts accomplished by “phishing.”
- Jointly with TIGTA published an e-mail address on IRS.gov to serve as a repository for the fraudulent emails so they could be tracked to the source and destroyed.

Victim Assistance

We recognize that outreach alone is not enough and that we also must be prepared to assist victims when identity theft occurs. With respect to the victim assistance prong of the Enterprise Strategy:

- The IRS established a new identity theft policy that provides for consistent procedures across its functions to ensure timely resolution of identity theft issues affecting taxpayer accounts.
- The IRS has developed new standards for documentation required from taxpayers to validate the identity of the taxpayer, address, and the fact of the identity theft. These documentation standards are consistent with those required by FTC and SSA.
- The IRS has worked closely with SSA to reduce the time required to resolve cases where more than one taxpayer uses the same SSN on a tax return (called the Scrambled SSN process). The average timeframe to resolve the case is now approximately 10 months compared to 18 months previously. As of March 24, 2007, the current scrambled SSN inventory count is approximately 5,000 cases. Approximately 38,000 cases have been referred to SSA in 2003-2006.
- The IRS updated its processes and notices to help taxpayers whose name and SSN were used by an identity thief for employment purposes. When the IRS matches an identity thief's W-2 information with a legitimate taxpayer's income tax return, the IRS sends the taxpayer a notice regarding the under-reported income. This is often the first time the victim is aware of the identity theft. To aid these victims of identity theft, the under-reporter notices were updated with specific instructions on the type of documents and information needed to validate the identity theft cases.
- The IRS is taking additional steps to reduce taxpayer burden associated with identity theft. By January 2008, the IRS will implement a new service-wide identity theft indicator that will be placed on a taxpayer's account upon the authentication of identity theft. Once the new process is fully deployed, taxpayers should only have to provide identity theft authentication one time, and the IRS will be able to reject returns which do not appear to be from the legitimate owner of the SSN.

Prevention

There are three types of identity theft crimes in tax administration: refund crimes, employment and income diversion.

- Refund crimes are perpetrated by criminals who use another person's tax information to fake a return and steal a refund. The Refund Crimes Unit of the IRS' Criminal Investigation Division identifies those returns through the Questionable Refund program.

- The IRS is developing several initiatives to reduce the incidence of theft related to employment, such as working with SSA to explore initiatives to improve the accuracy of SSN reporting.
- Individuals who make false identity claims to underreport income will face additional tax and penalties, as will preparers who promote such schemes.

To augment the IRS Identity Theft Enterprise Strategy composed of outreach, assistance, and prevention, the IRS initiated a Service-wide Identity Theft Risk Assessment to qualify and quantify existing threats and vulnerabilities related to IRS processes that could directly or indirectly facilitate identity theft and/or taxpayer burden. As an output of this risk assessment, the IRS developed (and has begun the implementation of) targeted remediation strategies designed to address the identified threats and vulnerabilities.

Where justified, we have referred cases of identity theft to our Criminal Investigation (CI) unit. In the past two years, CI has successfully investigated a number of cases that were successfully prosecuted in which identity theft has led to tax fraud. Just last month, two women from Ohio were sentenced to 63 and 188 months, respectively, and ordered to pay \$300,000 in restitution for perpetuating an identity theft scheme. As part of this scheme, the women claimed nearly \$114,000 in tax refunds to which they were not entitled.

Last November, a Florida man was sentenced to 63 months in prison to be followed by three years of supervised release for making false claims against the IRS and for identity theft. He was also ordered to pay a personal money judgment of \$152,171, and to pay \$152,171 in restitution to the IRS. To carry out this scheme, the man used the Internet to obtain personal information, including names and dates of birth, for at least 150 Florida inmates.

We are also reviewing ways we can protect our employees from identity theft. The IRS Office of Privacy is studying the existing usage of employee SSNs and identifying ways to reduce or eliminate the agency's use of employee SSNs in certain applications to minimize the risk of improper use. We are closely coupling privacy and identity theft protections with the agency security program, so that when we do need to collect SSNs – either employee or citizen, we can ensure that they are adequately protected within our systems.

The main focus for the annual IRS' Security Awareness Week, last November, was "Identity Theft/Fraud." Activities were focused on raising awareness and making employees aware of their responsibilities.

While research shows that the IRS has one of the lowest rates of identity theft in all the Federal government, we still take this situation very seriously. We have made significant progress, but additional work remains--including implementing additional mediation strategies and conducting in-depth analyses of the remaining high-priority processes.

Laptop Security

Every year, the IRS processes over \$2 trillion in revenues to fund the U.S. operating budget. Although the majority of this is collected in an automated banking system throughout the year, about \$300 billion is collected through 8 IRS campuses where taxpayers send their tax returns for processing. We house computing systems that hold data on all taxpayers, and also process enormous volumes of paper data in our more than 500 offices across the country. We have more than 82,000 full time and 12,000 part-time employees across the U.S. Our workforce is highly mobile, as revenue agents and officers are often in the field working directly with taxpayers. As a result, the IRS has assigned 52,000 laptops to its employees.

IRS computers, networks, and databases are protected by multiple layers of security, including modern security technology devices such as firewalls, encrypted communication links, and automatic intrusion detection devices.

The IRS is one of the few government agencies operating its own 24/7 computer security incident response center (CSIRC) to monitor IRS computer and network security, and to collect and follow up on any security incidents. The IRS' CSIRC works in close coordination with the Treasury Department and the Department of Homeland Security's CSIRCs and the US-CERT incident reporting center.

The FY 2008 Budget for IRS proposes \$21 million to be used to enhance CSIRC and the network infrastructure security. This infrastructure initiative will provide \$13.1 million to fund enhancements to the CSIRC necessary to keep pace with the ever-changing security threat environment through enhanced detection and analysis capability, improved forensics, and the capacity to identify and respond to potential intrusions before they occur. The remaining \$7.9 million will fund enhancements to the IRS' network infrastructure security. It will provide the capability to perform continuous monitoring of the security of operational systems using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

The IRS has always had policy guidance in place requiring employees to protect taxpayer information and other personal and private data. Protection of taxpayer information is emphasized and stressed in all employee orientation and refresher training as one of the Service's highest priorities.

Prior to January 2007, all IRS laptops included encryption tools that IRS employees were required to use to encrypt all sensitive information. We recognize that this previous generation of encryption tools may have been technically complex and challenging for many employees and as a result some may have not have done the proper encryption. Therefore, we have recently completed installation of an automatic full disk encryption product on all IRS laptops that automatically encrypts all data on the laptop, without requiring any employee action. This encryption system has been tested and certified to

meet mandatory standards. Physical security locks have also been provided with all IRS laptops.

IRS employees have reported the loss or theft of over 500 laptop computers over the last five years. Prior to May 2006, these reports primarily focused on reporting the theft or loss of IT equipment. Given the heightened awareness across the Federal Government in 2006 to the protection of sensitive personally identifiable information (PII), all government agencies now are focused more on the reporting of any sensitive information that may have been lost when a laptop is lost or stolen.

The IRS laptop losses were reported to TIGTA, which investigated these incidents and provided reports back to IRS management. Very few devices were recovered, as these devices are quickly re-sold. We have not received any reports indicating that any of the IRS lost or stolen laptops resulted in a case of identity theft for any citizen. Many of these laptops are used by revenue agents or officers in the field, and typically include a working case load involving a small number of cases (an average of 10 to 25 cases with there being one individual per case).

We are also working with our Federal and State partners with whom we share information to implement encryption solutions on data tapes. The encryption solutions are planned to be completed by October 1, 2007. In the interim, the IRS is using special security shipping containers and courier services to ensure that tapes shipped from IRS are protected. Recipients of the data are subject to implementing specific safeguards and complying with published standards for the protection of the data. Appropriate documentation is required for the transport of the tapes.

As the President's Taskforce on Identity Theft recommended, the Office of Management and Budget (OMB) is working closely with all agencies, including the IRS, to develop policy guidance for notification in instances where an individual's personally identifiable information has been compromised. The IRS has everything in place to comply with this new policy. We have reviewed all incidents, and there are a few that likely will require follow up (notification).

Electronic Return Originators

One of the IRS' top priorities is to encourage e-filing. In fact, in the IRS Restructuring and Reform Act of 1998, Congress set a goal that by 2007, 80 percent of all returns would be e-filed. Although we have not yet reached that target, e-filing has shown a steady growth each year. In the 2006 filing season, 54 percent of all returns were e-filed. As of the end of March, we are running almost 6 percent ahead of last year's pace. Nearly 57 million people have filed their returns electronically thus far in the 2007 filing season. People are rapidly coming to the realization that electronic filing is the most efficient way to file their Federal tax return.

In order for all of these taxpayers to file electronically, the IRS has created a process by which returns can be batched and provided to an electronic return originator (ERO) for

submission to the IRS. An ERO is a firm or business entity and not an individual. There are currently 264,303 EROs registered with the IRS.

It is important to note that the ERO may or may not have prepared the return that is being submitted. For example, a small accounting firm may forward all of the returns they prepare to an ERO for electronic filing. Or, someone who does their own return online may forward the return to the ERO who in turn submits it to the IRS. In these cases, the ERO has no responsibility for the content of the return—it simply ensures that the return gets to the IRS properly.

The critical point is to distinguish between the preparation of the return and its electronic submission to the IRS. E-file supplements return preparation, but is not part of it.

In order to become an ERO, the applicant must complete an application and submit it to the IRS. The IRS processes all new applications by checking the firm and the identified Principals and Responsible Officials against IRS records for prior IRS *e-file* sanctions and any tax compliance issues and also by checking criminal backgrounds of some of the individuals.

If applicants answer “yes” to any of the compliance questions on the application, the IRS completes additional appropriate checks. If an applicant answers “yes” to the criminal background question, the fingerprint card of the individual is forwarded to the FBI for a complete report.

The IRS Criminal Investigation Division (CI) reviews the FBI criminal activity reports and recommends if the related application should be accepted or denied. This process can take up to 45 days to complete and applicants are advised by mail as to whether they have been approved.

Once a provider has been approved, it is issued credentials each year in the form of an acceptance letter that allows continued participation in IRS e-file. The letter includes an assigned Electronic Filing Identification Number (EFIN). The letter is sent prior to December to the mailing address of each provider. All providers must include their identification numbers with the electronic return data on all returns that are transmitted to the IRS.

If more than one authorized IRS e-file provider is involved in the origination and transmission of the return data, applicable electronic filing identification numbers for each provider must be included in the electronic record. Providers are required to have the appropriate identification numbers and the annual acceptance letter to participate in IRS e-file. When IRS becomes aware of an EFIN that has been compromised, the IRS deactivates the EFIN.

We also have a program in place to monitor the work of EROs. Monitoring is accomplished through visits to e-file providers’ establishments, including its collection points (satellite offices) and seasonal offices, by the Electronic Monitoring Coordinator

(EMC) and/or e-file Monitors. The e-file Monitors are Tax Compliance Officers and Revenue Agents trained by the EMC to perform visits and monitoring functions.

There are four types of visits:

- **Referral Visits** – mandatory if the referral clearly suggests noncompliance and warrants immediate attention. Referrals are received from other authorized IRS e-file providers, other tax preparers, taxpayers, IRS Campuses, and other IRS functions.
- **Follow-up Visits** – conducted from the previous year’s referrals that involved any identified violations to verify that corrective action was taken.
- **Random Visits** – A random visit is based upon a non-discriminatory sampling of active providers selected from a central database in the monitor’s geographic area.
- **Targeted Visits** – A targeted visit is based on selection criteria indicating that e-file compliance issues may be present in a particular EROs e-file practice.

Referrals and follow-up visits are made unannounced and used to investigate allegations and complaints submitted against authorized IRS e-file providers. Random and targeted visits are made by appointment and used to determine general compliance within IRS e-file. Our headquarters office determines the number of total visits to be performed from a central database of active providers in the monitor’s geographic area.

Monitoring includes, but is not limited to:

- Investigating complaints;
- Scrutinizing advertising material;
- Checking Form 8453 submissions, which are used to provide the taxpayer’s signature on a paper declaration for the electronic return;
- Observing office procedures;
- Inspecting the acknowledgement files, from which they pull a sample of tax returns to review;
- Verifying compliance with the provision of Internal Revenue Code Section 6659(g), which relates to the due diligence requirements for returns claiming the Earned Income Tax Credit (EITC) if the provider is an income tax return preparer;
- Reviewing Form 8879, the signature requirements for transmitting e-file returns; and
- Questioning the provider to verify the taxpayers received a copy of the electronic tax return.

Violations, depending on the seriousness of the infraction, may result in a warning, written reprimand, suspension, or expulsion of the authorized IRS e-file provider. These visits are also a means of detecting potential fraudulent activities. Non-compliance issues

outside of the IRS e-file are not addressed during a visit, but a referral is made later to the appropriate function.

In calendar year 2006, we made 1129 monitoring visits to EROs. We issued warnings in 190 instances. We gave a written reprimand in 146 cases. In 43 cases, we proposed suspensions and in 12 other cases we issued immediate suspensions. In addition, we referred six cases for criminal investigation.

In addition, our CI division's Electronic Fraud Detection System (EFDS) has components that can identify ERO's filing suspicious tax returns. IRS-CI uses EFDS to primarily identify false claims for refunds, but the computer system is also able to use complex algorithms to identify EROs that are preparing suspicious tax returns that appear to follow particular patterns, such as abusing various tax credits, claiming false EITC, or claiming false expenses. The IRS-CI Fraud Detection Centers develop leads from EFDS on potentially bad ERO return preparers. These leads then are disseminated to IRS special agents throughout the country to initiate criminal investigations.

IRS-CI also coordinates outreach efforts with the EITC Program Office and our Small Business/Self Employed (SBSE) division by providing leads from EFDS for EITC due diligence audits of EROs. CI provided the names of over 200 EROs for FY 2006.

Paid Tax Preparers

As contrasted with an ERO, a paid tax preparer is someone who prepares tax returns for individuals or businesses for a fee. A tax preparer's basic responsibilities are to:

- Review financial records;
- Calculate form preparation fee according to the complexity of the return;
- Compute taxes owed, following tax form instructions and tables;
- Consult tax law handbook or bulletins;
- Verify totals;
- Interview clients for allowable credits and deductions; and
- Identify themselves on the return as the paid preparer.

A tax return preparer may or may *not*:

- Have credentials as an Enrolled Agent, Certified Public Accountant (CPA), or tax attorney. Only attorneys, CPAs and enrolled agents can represent taxpayers before the IRS in all matters including audits, collection actions and appeals. Other return preparers may represent taxpayers only in audits regarding a return that they signed as a preparer.
- Be affiliated with a professional organization that provides or requires its members to pursue a continuing education and holds them accountable for a code of ethics.

While most preparers provide excellent service to their clients, we have consistently urged taxpayers to be very careful when choosing a tax preparer. Taxpayers should be as careful in choosing the person who prepares their taxes as they would be in choosing a doctor or a lawyer. It is important to know that even if someone else prepares a tax return, the taxpayer is ultimately responsible for all the information on the tax return.

Specifically, we have urged taxpayers to:

- Be careful with tax preparers who claim they can obtain larger refunds than other preparers.
- Avoid preparers who base their fee on a percentage of the amount of the refund.
- Use a reputable tax professional who signs your tax return and provides you with a copy for your records.
- Consider whether the individual or firm will be around to answer questions about the preparation of your tax return months, or even years, after the return has been filed.
- Review your return before you sign it and ask questions on entries you don't understand.
- Never sign a blank tax form.
- Find out the person's credentials.
- Find out if the preparer is affiliated with a professional organization that provides its members with continuing education and resources and holds them to a code of ethics.
- Ask questions. For example does the taxpayer know anyone who has used the tax professional? Were they satisfied with the service they received?

In addition to alerting the taxpayer to be careful when choosing a tax preparer, we also routinely reach out to tax professionals to ensure that they adhere to professional standards and follow the law. This comprehensive outreach includes educational campaigns, ethics workshops, phone forums, e-news for Tax Professionals, and Tax Talk Today.

However, one only has to look to recent press reports to understand that despite our best efforts, a number of paid tax preparers have not adhered to professional standards and some have even resorted to tax fraud. Last week, we and the Department of Justice (DoJ) requested an injunction that would prevent 5 Jackson Hewitt franchisees, operating 125 retail outlets, from continuing to prepare Federal tax returns. This was the largest enforcement action of its kind and is particularly disturbing in that it involves franchisees of the country's second largest tax preparation firm.

A year ago, this Committee held a hearing at which the GAO reported that they had visited 19 different tax preparation firms and all had made substantive errors in the preparation of the return. I can report that we have followed up on all 19 cases.

Four of the cases have been identified as "Program Action Cases" or PACs. These are the preparers that we have deemed from case building analysis to be the most non-compliant based on a detailed analysis of client return information.

The PAC process involves a sample of 30 client returns. These thirty clients are audited in the field to determine whether or not the suspected non-compliance issues are corroborated. If the client audits determine that a pattern of non-compliance exists, the remainder of client returns is sent to an IRS Campus for a correspondence exam. Meanwhile, the 30 field audits are used to support penalties against the preparer. If, during the audit of the client returns, the non-compliance appears particularly egregious and/or it appears the behavior is likely to continue, the Service may consider transferring the cases to the Abusive Tax Avoidance Transaction (ATAT) program for an investigation.

During the case building evaluation of the GAO cases, 10 other case issues were identified that indicated there may be abuses in the EITC arena. Thus, these cases were referred for possible EITC due diligence visits. This is part of our return preparer strategy aimed at reducing abuses with the EITC and putting bad preparers out of business. If EITC violations are further developed, these cases may then be turned into PACs, as described above, and the same process is followed.

I would also note that during the case building process, it was apparently determined that some of these preparers are also EROs and thus should be subject to a monitoring visit. Those visits are currently being planned.

The review of the final five cases indicated that there does not appear to be a pattern of noncompliance among the client returns that were examined. Therefore, these cases did not warrant the initiation of a Program Action Case or preparer penalties. These will be closed without further action.

I should also note that our CI division conducted a detailed analysis of the information provided by GAO and concluded that in none of the cases did the conduct identified meet the criteria for initiating a criminal investigation. This analysis included a review of the volume of returns prepared by each preparer during previous filing seasons. It also consisted of reviewing these returns to determine potential fraudulent filing patterns based on common characteristics that could be indicative of fraud.

Based on the characteristics of the cases that IRS-CI has successfully recommended for prosecution and in reviewing the results from the scenarios in the GAO cases, it was determined that although these preparers made errors, there was no pattern of fraud or intent by the return preparer to knowingly file a fraudulent return. These cases were more an indicator as to the complexities of the tax law and the knowledge or competence levels of the return preparer providing these services.

In order to become a criminal case, IRS-CI is required to prove that the return preparer had the *prerequisite knowledge* of the tax law and *intended* to defraud the government.

In the case of prerequisite knowledge, the IRS needs to prove that the return preparer had the knowledge and that they were committing an illegal act, which means that the return preparer has the education and skill set to have known that the information they are putting on the return is in fact not accurate.

The second part of the Criminal Investigation equation, *intent*, means that the return preparer showed their intent to defraud the government by committing a pattern of certain overt acts in order to perpetrate the fraud.

In Return Preparer investigations that the IRS-CI pursues, the return preparer has likely committed numerous acts of fraud on each return. These acts include but are not limited to, completely fabricating Schedule A itemized deductions to reduce the Taxable Income, or completely fabricating Schedule C loss to lower the taxable income, which results in claiming a higher Earned Income Tax Credit (EITC). Conversely, Schedule C's may be prepared with a gain to fabricate income, when the client had no income in order to qualify the client for EITC as well as to falsify qualifying children to make the client appear eligible for EITC, and other child-related tax benefits. More sophisticated return preparers will form complex business entities on behalf of the client, such as partnerships and Sub S Corporations. They will fabricate a business return with significant losses that will flow through to the clients' personal tax return, which will significantly reduce or eliminate any tax.

The most egregious return preparers victimize their clients. These egregious return preparers file a different return than the one provided to the client, wherein they claim a significantly higher refund, have the refund deposited to a bank account that they control and provide the lower amount to the client. The client has no knowledge the return preparer received the higher refund until they are contacted by the IRS.

In the last several months, we have had several successful prosecutions of return preparer cases. In one case in Texas, a man was sentenced to 18 years for preparing fraudulent returns. In Florida, another man was sentenced to 37 months after pleading guilty to filing false tax returns and preparing false tax returns. A North Carolina woman was sentenced to 18 months for preparing fraudulent federal tax returns in order to generate large refunds for herself and for some of her clients. She also prepared nine tax returns without the knowledge of the taxpayers for her own personal gain.

In total in FY 2006, IRS-CI initiated 197 return preparer fraud investigations and recommended 153 prosecutions. There were 135 indictments and 109 tax preparers were sentenced to prison. The average sentence was 18 months.

Tax practitioners can also become subject to disciplinary action by the IRS Office of Professional Responsibility (OPR). OPR monitors CPAs, tax attorneys and enrolled agents. Once a complaint is received, it is assigned to an OPR attorney who will develop it by investigating the allegations. If the evidence indicates the allegations, taken as true, would constitute a violation of Circular 230, a letter will be sent to the practitioner

informing him or her of the charges and affording the individual the right to respond in writing or by requesting a conference with OPR.

If OPR finds that violations have occurred, it has a range of sanctions that it can impose. These include disbarment, suspension, censure and reprimand. Disbarment is the permanent revocation of a practitioner's privilege to represent taxpayers before the IRS. While a practitioner may petition the OPR for reinstatement after a period of five years, the decision to reinstate a practitioner rests within the discretion of the OPR Director.

A suspension is the revocation of a practitioner's privilege to practice before the IRS for a certain period. A censure is a public reprimand. A reprimand is a private admonishment from the OPR Director to the practitioner.

In FY 2006, OPR issued suspensions or disbarment to 87 practitioners. Reprimands were issued to 8, and 205 were given expedited suspensions.

Regulating the tax preparer community beyond what OPR does would be a monumental task beyond the reach of existing IRS resources. Traditionally, regulation of these types of services occurs at the state level.

Summary

Mr. Chairman I have attempted this morning to detail our efforts in a number of areas in which you and your staff have expressed interest. These are all areas which we take very seriously and in which we have ongoing programs. We will continue to work these areas as we move forward consistent with my desire to provide a balanced program that recognizes the need for both strong taxpayer service programs and aggressive enforcement that respects taxpayer rights.

I appreciate the opportunity to be here and I will be happy to respond to any questions.