HEARING BEFORE THE
COMMITTEE ON APPROPRIATIONS
SUBCOMMITTEE ON FINANCIAL SERVICES AND GENERAL GOVERNMENT
U.S. HOUSE OF REPRESENTATIVES

"Budget Hearing – Office of Treasury IG and Office of Treasury IG for Tax Administration"

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

March 7, 2012

Washington, D.C.

TESTIMONY OF
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before the
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Chairwoman Emerson, Ranking Member Serrano, and Members of the Subcommittee, I thank you for the opportunity to testify on the President's Fiscal Year (FY)[1] 2013 budget request for the Treasury Inspector General for Tax Administration (TIGTA). My comments will focus on our analysis of the Internal Revenue Service's (IRS) FY 2013 budget request and the most significant issues currently facing the IRS, as well as on TIGTA's FY 2013 budget request.

TIGTA is mandated to provide independent audit, investigative, and inspection and evaluation services necessary to improve the quality and credibility of IRS operations, including the oversight of the IRS Chief Counsel and the IRS Oversight Board. TIGTA reviews IRS programs; makes recommendations to improve effectiveness and efficiency; and investigates allegations of fraud, waste, and abuse. Oversight activities are explicitly designed to identify high-risk systemic inefficiencies in IRS operations and to investigate exploited weaknesses in tax administration. TIGTA ensures that the American taxpayer can have confidence that the IRS collects over $2 trillion in tax revenue in an effective and efficient manner without fraud and abuse.

OVERVIEW OF THE IRS'S FISCAL YEAR 2013 BUDGET REQUEST

The IRS is the largest component of the Department of the Treasury and has primary responsibility for administering the Federal tax system. The IRS's budget request supports the Department of the Treasury's goals to pursue comprehensive tax and fiscal reform and to increase voluntary tax compliance.[2] The IRS strives to enforce the tax laws fairly and efficiently while balancing service and education to promote voluntary compliance and reduce taxpayer burden. To achieve these goals, the

[1] A 12-consecutive-month period ending on the last day of any month, except December. The Federal Government's fiscal year begins on October 1 and ends on September 30.
[2] U.S. Department of the Treasury Strategic Plan, Fiscal Years 2012 – 2015.

proposed FY 2013 IRS budget requests appropriated resources of $12.8 billion.[3] The total appropriations amount is an increase of $945 million, or approximately eight percent more than the FY 2012 enacted level of approximately $11.8 billion. The budget request includes a net staffing increase of more than 4,500 full-time equivalents (FTE),[4] to a total of 95,257 appropriated FTEs. However, the FY 2013 increase represents only approximately 700 additional employees over the FY 2011 enacted level because of the budget cuts the IRS sustained in FY 2012.

IRS FY 2013 Budget Request Increase
Over FY 2012 Enacted Budget
(in Thousands)

Appropriations Account	FY 2012 Enacted	FY 2013 Request	$ Change	% Change
Taxpayer Services[5]	$2,239,703	$2,253,133	$13,430	0.60%
Enforcement	$5,299,367	$5,701,670	$402,303	7.59%
Operations Support	$3,947,416	$4,476,200	$528,784	13.40%
Business Systems Modernization	$330,210	$330,210	$0	0%
Total Appropriated Resources	**$11,816,696**	**$12,761,213**	**$944,517**	**7.99%**

The three primary appropriations accounts are Taxpayer Services, Enforcement, and Operations Support. The Taxpayer Services account provides funding for programs that focus on helping taxpayers understand and meet their tax obligations, while the Enforcement account supports the IRS's examination and collection efforts. The Operations Support account provides funding for functions that are essential to the overall operation of the IRS, such as infrastructure and information services. Finally, the Business Systems Modernization account provides funding for the development of a new taxpayer account database and investments in electronic filing.

[3] The FY 2013 budget request also includes approximately $135 million from reimbursable programs, $218 million from user fees, and $239 million in available multi-year/no-year funds for a total amount of $13.4 billion in available resources.
[4] A measure of labor hours in which one FTE is equal to eight hours multiplied by the number of compensable days in a particular fiscal year.
[5] In FY 2012, administrative resources for the Health Coverage Tax Credit were moved to the Taxpayer Services appropriation under the Consolidated Appropriations Act 2012 (Public Law 112-74) and are no longer funded as a separate appropriation.

ANALYSIS OF THE FISCAL YEAR 2013 BUDGET REQUEST

Changes to the Base

The IRS is requesting approximately $108 million to fund the proposed 2013 employee pay raises, inflation, and an increase in its Federal Employment Retirement System participation. Non-labor inflation adjustments include rent, postage, supplies, and equipment.

These increases are offset by a decrease of approximately $71 million related to efficiency and cost savings. The three largest areas of savings include targeted program reductions such as reduced staffing in support and analysis functions (a $59.7 million decrease), increased electronic filing (e-file) savings (an $8.6 million decrease), and reduced travel (a $2.6 million decrease).

In total, this resulted in a net increase of $37.6 million but a reduction in 724 FTEs from the FY 2012 enacted level.

Program Increases

The FY 2013 budget request includes program increases of $706.5 million. The largest component of this $706.5 million increase is $431.4 million related to implementing enforcement initiatives to focus activities designed to improve compliance. In addition, the IRS is requesting an increase of more than $275 million for infrastructure initiatives related to the *Patient Protection and Affordable Care Act* (Affordable Care Act).[6] In total, this resulted in an increase of 3,590 FTEs.

Program Changes

In FY 2012, the IRS's budget was reduced by a total of $305 million. The FY 2013 budget includes a request of $200.5 million and 1,680 FTEs to restore the FY 2012 budget cuts related to tax law enforcement.

Funding Related to Business System Modernization

The FY 2013 budget request includes $330.2 million in the Business Systems Modernization appropriation to modernize IRS business systems. The budget includes a decrease of 110 FTEs that were needed to support the Business Systems Modernization program in FY 2013. Cost savings from this FTE reduction and other efficiency savings will offset the necessary costs to maintain current operating levels resulting in no change to the budget request for FY 2013.

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[6] Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of 18 U.S.C., 20 U.S.C., 21 U.S.C., 25 U.S.C., 26 U.S.C., 28 U.S.C., 29 U.S.C., 30 U.S.C., 31 U.S.C., 35 U.S.C., and 42 U.S.C.).

Included in the $330.2 million budget request is $148 million related to the continued development of the Customer Account Data Engine 2.[7] In FY 2012, the IRS implemented the first phase of the Customer Account Data Engine 2 and transitioned from a weekly processing cycle to a daily processing cycle. In FY 2013, the IRS plans to focus its efforts on the second phase of the Customer Account Data Engine 2 initiative, which addresses risks associated with the continued use of antiquated technologies and programming languages when used in the current IRS environment.

SIGNIFICANT ISSUES FACING THE IRS

As the IRS administers the Nation's tax laws, it faces a number of significant challenges, including:

Tax Compliance

A serious challenge confronting the IRS is the Tax Gap, which is defined as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely pay for a tax year (TY).[8] Despite an estimated voluntary compliance rate of 83 percent and IRS enforcement efforts, a significant amount of income remains unreported and unpaid. In January 2012, the IRS estimated the gross Tax Gap for TY 2006 to be $450 billion.

The IRS continues to need broader strategies and more research to determine what actions are most effective in addressing taxpayer noncompliance. The IRS's current strategy for reducing the Tax Gap is largely dependent on funding for additional compliance resources and legislative changes. Despite a 19 percent increase in enforcement staffing levels since FY 2006 and the IRS's more vigorous use of collection enforcement tools, FY 2010 enforcement results were mixed when compared to FY 2009 results. The number of delinquent accounts closed by full payment increased, as did the amount collected on delinquent accounts. However, the Collection function received more delinquent accounts than it closed, gross accounts receivable rose, and the number of tax delinquency investigation cases[9] closed with the receipt of a delinquent tax return fell.[10]

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[7] The Customer Account Data Engine 2 system creates a modernized processing and data-centric infrastructure that will enable the IRS to improve the accuracy and speed of individual taxpayer account processing, enhance the customer experience through improved access to account information, and increase the effectiveness and efficiency of agency operations.
[8] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
[9] An unfiled tax return for a taxpayer. One tax delinquency investigation case exists for all tax periods.
[10] TIGTA, Ref. No. 2011-30-071, *Trends in Compliance Activities Through Fiscal Year 2010* (July 2011).

One means the IRS employs to collect unpaid taxes is the notice stream.[11] The notice stream is the least costly of the IRS's approaches to collecting unpaid taxes. While the notice stream collects billions of dollars in delinquent taxes annually, reducing the time between notices could result in millions more being collected annually. During FY 2010, the IRS sent approximately 21.9 million balance-due notices to individuals to attempt to collect unpaid taxes. By a wide margin, the first notice (also known as the Master File notice) closed the most cases, collected the most money, and generated the highest number of taxpayer responses. Cases not resolved after the Master File notice continue in the notice stream, and those taxpayers receive various sequences of notices. The IRS allows 35 days between notices for the taxpayer to respond, but our analysis shows that the time between notices can be reduced. As these balance due modules progress within the notice stream, the probability of collection diminishes.

TIGTA recommended that the IRS consider reducing the time between each notice by seven days. TIGTA estimates that the notice stream could potentially collect an additional $363 million each year. In addition, taxpayers could potentially save $1.8 million each year in interest payments. The IRS agreed with TIGTA's recommendations and plans to take corrective actions. However, in its response, the IRS stated that 35 days between notices were necessary to process taxpayer inquiries and correspondence. Our report noted that the IRS has controls in place to prevent the next notice from being sent when taxpayers' correspondence is being processed.[12]

Return Preparers

Every year, more than one-half of all taxpayers pay someone else to prepare their Federal income tax returns. During the 2011 Filing Season,[13] the IRS processed approximately 66.9 million individual Federal income tax returns prepared by paid tax return preparers.

A series of reports issued by TIGTA have made a strong case for regulating those who prepare Federal tax returns and led the IRS to launch its Return Preparer Review. In December 2009, the IRS announced a suite of proposed reforms to improve oversight of the return preparer community. While the IRS began implementing the new preparer requirements in FY 2011, TIGTA reported that it will take years for the IRS to implement the Return Preparer Program and to realize its impact.[14] When the decision was made to register preparers, the IRS had not established all of the program requirements. The IRS also had not established the organizational structure of the

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[11] A series of balance-due notices sent by the IRS to the taxpayer to prompt payment.
[12] TIGTA, Ref. No. 2011-30-112, *Reducing the Processing Time Between Balance Due Notices Could Increase Collections* (September 2011).
[13] The period from January 1 through April 15 when most individual income tax returns are filed.
[14] TIGTA, Ref. No. 2010-40-127, *It Will Take Years to Implement the Return Preparer Program and to Realize Its Impact* (September 2010).

program, determined how it will verify all preparers met the requirements, determined how it will enforce program requirements, or developed the system(s) and processes necessary to administer and oversee the program. It will not be until Calendar Year[15] 2014 that all preparers will be subjected to all suitability and competency tests. In the meantime, IRS management stated they will develop and implement an enforcement strategy. Currently, the IRS does not have a sufficient management information system to gather data on preparers. Further, the IRS will need to ensure that taxpayers understand the new requirements and the importance of using only registered preparers to prepare their tax returns.

Of the 66.9 million individual Federal income tax returns prepared by paid tax return preparers and processed by the IRS in FY 2011, 90 percent were e-filed. In November 2009, Congress approved a Federal e-file mandate for tax return preparers. TIGTA's review of the IRS's implementation of the mandate found that for the first few years the IRS plans to use a "soft" approach to enforcement that emphasizes educating and collaborating with preparers in implementing e-file requirements. Additionally, the continued use of multiple preparer identification numbers makes it difficult to match all tax returns to the preparers. However, improvements are under way to ensure the effectiveness of controls and system validations over the preparer registration process.

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

Globalization

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

Over the past few years, the IRS has taken steps and made strategic internal realignments to better coordinate international tax compliance issues. It has developed

[15] The 12-consecutive-month period ending on December 31.

a strategic plan specifically for international tax issues with two major goals: 1) enforce the law to ensure all taxpayers meet their obligation to pay U.S. taxes and 2) improve service to make voluntary compliance less burdensome. The IRS realigned its international efforts under its Large Business and International (LB&I) Division. Also, during FY 2012, the IRS will merge the Office of Chief Counsel's Advanced Pricing Agreement Program with the LB&I Division's Mutual Agreement Program to form the Advanced Pricing and Mutual Agreement Program. This combined program will be a component of the LB&I Division's Transfer Pricing Operations. The IRS expects that efforts like these will improve international tax compliance by allowing it to focus on high-risk issues and cases with greater consistency and efficiency.

The IRS also continues to work with the U.S. Department of Justice on tax evasion cases involving foreign countries with bank secrecy laws that prevent the United States from obtaining information on taxpayer transactions. In addition, both the 2009 and 2011 Offshore Voluntary Disclosure Initiatives have encouraged taxpayers with hidden offshore assets and income to come back into the tax system using the IRS's Voluntary Disclosure Program. According to the IRS, these initiatives have resulted in the collection of over $4 billion. Due to the success of the first two initiatives, the IRS is currently offering a third chance for delinquent taxpayers to disclose their hidden offshore assets. These initiatives are beneficial because they offer a uniform penalty structure for taxpayers who voluntarily disclose their hidden offshore assets and income to the IRS and, in return, ensure that the taxpayers receive consistent tax and penalty treatment. The initiatives also provide the opportunity to calculate, with a reasonable degree of certainty, the total cost of resolving all outstanding offshore tax issues related to the undisclosed foreign bank and financial accounts and assets. On the other hand, taxpayers with undisclosed foreign accounts and assets who do not submit a voluntary disclosure run the risk of detection by the IRS. If caught, these taxpayers face the imposition of substantial penalties, including the fraud and foreign information return penalties, as well as an increased risk of criminal prosecution.

Like the IRS, TIGTA is expanding its international program. TIGTA recently worked with the U.S. Department of State to post information on its public website regarding our mission of combating fraud in Federal tax administration. The State Department also provided guidance to more than 270 U.S. embassies and consulates around the world regarding linking their individual web pages to the Travel.State.Gov website. TIGTA also continues to build a foundation of inspections of IRS global activities that will help IRS management maximize the effectiveness of its international operations. TIGTA will also seek to establish working relationships with foreign revenue collection agencies and anti-fraud organizations that are engaged in oversight of their own revenue collection agencies.

Modernization

The IRS's Business Systems Modernization Program (Modernization Program) is a complex effort to modernize technology and related business processes. It involves integrating thousands of hardware and software components while replacing outdated technology and maintaining the current tax system. The IRS originally estimated that the Modernization Program would cost approximately $8 billion. The Program is in its 15th year; however, performance issues, appropriation shortfalls, and significant changes in the program's scope have reduced funding to $3.8 billion. Factors that characterize the IRS's complex information technology environment include widely varying inputs from taxpayers (from simple concise records to complex voluminous documents), seasonal processing with extreme variations in processing loads, transaction rates on the order of billions per year, and data storage measured in trillions of bytes. The Modernization Program is working toward providing improved benefits to taxpayers, including:

- Issuing refunds more quickly;
- Offering electronic filing capability with dramatically reduced processing error rates;
- Delivering web-based services for tax practitioners, taxpayers, and IRS employees; and
- Providing the IRS with faster and improved customer service capability.

In FY 2012, the IRS has delivered significant updates to its core tax processing system, transitioning to a daily processing cycle for individual returns. Also, IRS processing systems are accepting all Forms 1040, *U.S. Individual Income Tax Return*, electronically through an updated e-filing capability. This capability is designed to eventually feed into a single, consolidated taxpayer account database that will support the deployment of the next generation of taxpayer service and enforcement functions.

The Modernization Program has continued to help improve IRS operations and has demonstrated successes in improving business practices by implementing new information technology solutions. Management of project costs and schedules has shown improvement, but some areas continue to need attention. Since 1995, the IRS had identified and reported the Modernization Program as a material weakness. In June 2011, the IRS Commissioner certified that the previously identified internal and management control issues had been fully addressed and the Modernization Program no longer warranted being identified as a material weakness. While we support the IRS's decision, we believe the Program remains a risk for the IRS, and we suggest that it continue to stress improvements in its overall processes and performance.

Improper Payments and Fraudulent Claims

Erroneous and improper payments issued by the IRS generally involve improperly paid refunds, tax return filing fraud, or improper payments to vendors or contractors.

Identity Theft and Tax Refund Fraud

TIGTA is concerned not only about the amount of fraudulent refunds associated with identity theft, but also that the IRS is not effectively providing assistance to victims of identity theft. TIGTA is also concerned that IRS processes are not adequate to communicate identity theft procedures to taxpayers. Identity theft involving refund fraud victimizes innocent taxpayers by impeding their ability to file tax returns and receive tax refunds.

Unscrupulous individuals submit tax returns with false income documents to the IRS for the sole purpose of receiving a fraudulent tax refund. For Processing Year (PY)[16] 2011, the IRS reported that it had identified over 2.1 million tax returns with more than $16 billion claimed in fraudulent tax refunds and prevented the issuance of more than $14 billion (87.5 percent) of the refunds. The IRS also reported that of the 2.1 million tax returns identified as fraudulent for PY 2011, 938,664 of these tax returns, with $6.5 billion in associated fraudulent tax refunds, involved identity theft.

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

However, the IRS does not know how many identity thieves are filing fraudulent tax returns or the amount of revenue being lost. TIGTA is completing an evaluation of the IRS's efforts to identify and prevent fraudulent tax returns resulting from identity theft.[17] Using characteristics of IRS-confirmed fraudulent tax return filings involving identity theft, TIGTA analyzed tax returns filed during the 2011 Filing Season to identify additional tax returns that met the characteristics of these confirmed cases.

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[16] The calendar year in which the tax return or document is processed by the IRS.
[17] TIGTA, Audit No. 201140044, *Efforts to Identify and Prevent Fraudulent Tax Returns Resulting From Identity Theft* (planned report issuance in May 2012).

As TIGTA previously reported, expanding and expediting access to wage and withholding information could significantly improve the IRS's ability to identify fraudulent tax refunds, as these individuals frequently submit false income documents. To date, the actions the IRS has taken have not resulted in any significant expansion or expediting of access to this information. Access to this information at the time tax returns are processed is an important tool the IRS could use to identify and thwart tax fraud and could prevent the issuance of billions of dollars in fraudulent tax refunds.

Of further concern is the length of time taxpayers must work with the IRS to resolve identity theft. The IRS has been unable to work identity theft cases timely, and it can take more than a year to resolve them. The IRS does not provide taxpayers with realistic time frames for how long it will take to resolve their cases. Communications between identity theft victims and the IRS are limited and confusing, and victims are asked multiple times to substantiate their identity. Taxpayers do not speak directly with the assistors who are working their identity theft cases. They are instructed to call assistors in the Identity Protection Specialized Unit to discuss the status of their case. However, these assistors do not work identity theft cases and have limited information about a taxpayer's identity theft case.

As a result of an assessment of its Identity Theft Program completed in October 2011, the IRS is currently planning improvements to the program. However, the improvements may not be sufficient to significantly reduce the burden identity theft has placed on tax administration and on taxpayers whose identities have been stolen.

IRS employees who work the majority of identity theft cases are also telephone assistors who are trained to communicate with taxpayers and to know the tax laws and related IRS operational procedures. The assistors are not examiners and are not trained to conduct examinations. However, identity theft cases, like examination cases, can be complex and present considerable challenges, requiring skills and tools beyond those of the assistors.

The IRS has dedicated 400 additional assistors to work identity theft cases, but because of limited resources and the high demand for telephone assistance, the IRS plans to continue to have assistors who work identity theft cases also work the telephones on Mondays (and any Tuesday following a Monday holiday). This presents a considerable challenge to overcoming the backlog of identity theft cases. Additionally, if controls the IRS plans to implement do not decrease identity theft incidences and identity thieves continue to prevent taxpayers from filing their tax returns, this inventory could remain significant.

Refundable Credits

The IRS administers numerous refundable tax credits.[18] Two significant refundable credits are the Earned Income Tax Credit (EITC) and the Additional Child Tax Credit (ACTC). The *American Recovery and Reinvestment Act of 2009* (Recovery Act)[19] also authorized several temporary refundable credits, examples of which include the First-Time Homebuyer Credit (Homebuyer Credit) and the American Opportunity Tax Credit. TIGTA's reviews have shown the need for appropriate controls to be established before refundable credits are issued. This includes requiring documentation to substantiate claims, implementing filters timely to identify erroneous claims, and entering key information into IRS computers to allow its use to verify eligibility.[20]

The EITC remains the largest refundable credit based on the total claims paid, and it continues to be vulnerable to a high rate of noncompliance, including incorrect or erroneous claims caused by taxpayer error or resulting from fraud. TIGTA continues to report that the IRS does not have effective processes to ensure that claimants qualify for these credits at the time tax returns are processed and prior to issuance of fraudulent tax refunds. As we reported in February 2011, the IRS has made little improvement in reducing EITC improper payments in the years since it was required to report estimates of these payments to Congress in Calendar Year 2002. The risk continues to remain high that no significant improvement will be made in reducing improper EITC payments. In FY 2011, the IRS estimates EITC improper payments equated to $14 billion to $17 billion.

TIGTA further reported that although Executive Order 13,520 requires the IRS to intensify its efforts to reduce EITC improper payments, reduction targets and strategies have not been established to reduce billions of dollars in improper payments made each year. For example, the Executive Order requires the IRS to provide TIGTA with its plans and supporting analysis for meeting those targets. The IRS's report to TIGTA did not include any quantifiable targets to reduce EITC improper payments. IRS management noted that it did not set reduction targets because it must balance enforcement efforts among different taxpayer income levels.

The ACTC is the second largest refundable credit available to individuals. ACTC refunds processed in FY 2010 totaled $28.3 billion. TIGTA recently reported that the IRS paid $4.2 billion in these credits in PY 2010 to individuals who were not authorized

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[18] A refundable tax credit is a tax credit that is treated as a payment and can be refunded to the taxpayer. Refundable credits can create a Federal tax refund that is larger than the amount a person actually paid in taxes during the year.
[19] Pub. L. No. 111-5, 123 Stat. 115.
[20] TIGTA, Ref. No.2011-41-035, *Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits* (March 2011).

to work in the United States.[21] Furthermore, the IRS does not effectively and efficiently work ACTC cases of those individuals filing with an Individual Taxpayer Identification Number (ITIN). An ITIN is available to individuals who are required to have a taxpayer identification number for tax purposes, but do not have and are not eligible to obtain an Social Security Number because they are not authorized to work in the United States. TIGTA has recommended that the IRS work with the Department of the Treasury to seek clarification in the law as to whether this and other refundable credits may be paid to individuals who are not authorized to work in the United States.

We have found that IRS processes are not adequate to prevent ITINs from being assigned to individuals who submit questionable applications. Production goals discourage employees from identifying questionable applications. Additionally, the IRS has eliminated processes that were successful in identifying questionable ITIN application schemes and replaced them with processes that are not adequate to verify applicants' identities. TIGTA is currently evaluating IRS employees' complaints that IRS management has been requiring employees to assign ITINs even when the applications appear to be fraudulent. TIGTA will report the full results of this audit later this year.

TIGTA also recently reviewed the IRS's processing of Adoption Credit claims.[22] The Affordable Care Act increased the Adoption Credit from $12,150 to $13,170 and made the tax credit refundable. Recognizing the increased risk of erroneous claims, the IRS requires taxpayers to file via paper tax return, with each Adoption Credit claim being reviewed when the tax return is received and processed by the IRS.

Although the IRS requires taxpayers to attach documentation to their tax returns supporting Adoption Credit claims, it does not have math error authority[23] to deny the credits if documentation is not provided. As a result, tax returns without required documentation must be sent to the Examination function, increasing costs for the IRS and burden for the taxpayer. In October 2009, TIGTA recommended that the IRS work with the Department of the Treasury to seek legislation for math error authority for this credit.

As of December 23, 2011, the IRS received 101,627 tax returns with Adoption Credit claims. Of these claims, approximately 43 percent (43,295) had to be referred to the IRS's Examination function because of incomplete or missing required documentation in support of the Adoption Credit claim.

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[21] TIGTA, Ref. No. 2011-41-061, *Individuals Who Are Not Authorized to Work in the United States Were Paid $4.2 Billion in Refundable Credits* (July 2011).
[22] TIGTA, Ref. No. 2011-40-128, *The Passage of Late Legislation and Incorrect Computer Programming Delayed Refunds for Some Individuals During the 2011 Filing Season* (September 2011).
[23] A program whereby the IRS contacts taxpayers through the mail or by telephone when it identifies mathematical errors or mismatches of taxpayer information that would result in a tax change.

Recovery Act - Hope Scholarship Credit

The Recovery Act amended the Hope Scholarship Credit to provide a refundable tax credit called the American Opportunity Tax Credit to offset the costs of higher education. TIGTA identified 2.1 million taxpayers who appear to have received $3.2 billion in erroneous education credits.[24] This includes 1.7 million taxpayers who received $2.6 billion in education credits for students for whom there was no supporting documentation in IRS files establishing that they attended an educational institution. This is further indication that the IRS needs to have processes in place to verify eligibility for refundable credits at the time a tax return is processed.

The IRS did not agree with the amount of erroneous claims TIGTA identified. However, in subsequent communications IRS management informed TIGTA that they have found a high percentage of the claims we identified to indeed be erroneous. As of July 2011, IRS audit results showed that 72 percent of the claims reviewed were erroneous, and the IRS had proposed assessments totaling over $2.2 million for 1,477 audited tax returns. IRS management noted that they expect the percentage of claims found to be erroneous to further increase and, as a result, have expanded the number of tax returns that they plan to review with this condition in FY 2012.

Furthermore, subsequent analysis TIGTA performed showed that the age distribution for those students for whom the credit was claimed was significantly different than the age distribution for college students when compared to Census data. For example, TIGTA's analysis identified that these college tax credits were claimed for 13,870 students who were age 10 or under.

Recovery Act - Homebuyer Credit

TIGTA previously estimated[25] that IRS control weaknesses allowed taxpayers who most likely did not qualify for the Homebuyer Credit to receive potentially erroneous refunds totaling more than $513 million with no IRS scrutiny.

As of July 30, 2011, the IRS had processed more than 4.3 million claims for the Homebuyer Credit, totaling almost $30.4 billion. Qualified taxpayers who purchased a home in 2008, 2009, or 2010 were able to take advantage of the Homebuyer Credit and claim up to an $8,000 refundable credit on their tax return. The Homebuyer Credit may be an interest-free loan or a fully refundable credit, depending on when the taxpayer purchased his or her home. While the IRS completed 495,592 Homebuyer Credit examinations and disallowed credits totaling nearly $1.6 billion, a large number of high-

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[24] TIGTA, Ref. No. 2011-41-083, *Billions of Dollars in Education Credits Appear to Be Erroneous* (September 2011).

[25] TIGTA, Ref. No. 2009-41-144, *The Internal Revenue Service Faces Significant Challenges in Verifying Eligibility for the First-Time Homebuyer Credit* (September 2009).

risk claims were not examined, and many of the examinations conducted were not productive. The IRS never ran some of the high-risk claims through the filters designed to select claims for examination. Its methods for determining the highest risk claims were flawed. Moreover, it continued to apply examination resources to large volumes of pre-refund audits of Homebuyer Credit claims, even after the establishment of other controls made these audits unproductive.

Based on TIGTA's recommendations, the IRS modified its case selection methodology, shifted examination resources to more productive cases, and agreed to ensure that all claims for the Homebuyer Credit are run against IRS automated examination filters, with the highest risk cases being selected for post-refund examinations. TIGTA estimates that these actions have or will result in funds put to better use of approximately $115 million.

Contract and Other Payments

As of October 1, 2011, the IRS administered 976 procurements, including 783 contracts of varying types and 193 Blanket Purchase Agreements and Interagency Contracts and Agreements. These 976 active contracts have a reported systems life value of approximately $49.6 billion. A number of past TIGTA investigations and audits have identified millions of dollars in questioned costs and several instances of contractor fraud. During FYs 2010 and 2011, court-ordered civil settlements directed $156 million and $113 million, respectively, to be paid back to the U.S. Treasury as a result of TIGTA's criminal investigative efforts. During these investigations, two recurring trends emerged: Contracting Officer's Technical Representatives were frequently overwhelmed by their workloads, and current business practices have not enhanced the IRS's ability to identify anomalies warranting additional review.

Taxpayer Service

As demand for taxpayer services continues to increase, resources have decreased, thereby affecting the quality of customer service that the IRS is able to provide. Despite other available options, most taxpayers continue to use the telephone as the primary method to make contact with the IRS. In addition, more taxpayers are calling the IRS's toll-free telephone lines each year. In August 2011, TIGTA reported an increase in call demand and limited resources continue to adversely affect the IRS's level of service[26] for its toll-free telephone lines. In the 2011 Filing Season, the IRS received approximately 80 million attempts to call the toll-free telephone lines. This is up from 54 million (48 percent) during the 2007 Filing Season, the last filing season with a level of service of more than 80 percent. Taxpayers waited an average of 10 minutes

[26] The primary measure of service to taxpayers. It is the relative success rate of taxpayers who call for live assistance on the IRS's toll-free telephone lines.

to speak to an assistor - a 137 percent increase since the 2007 Filing Season. Nevertheless, the IRS has reduced the operating hours for its main toll-free help line (800-829-1040) by three hours.

From the 2007 to the 2011 Filing Season, the IRS's ability to process taxpayer correspondence in a timely manner also declined. Assistors who answer the toll-free telephone lines also handle taxpayer correspondence (including processing amended returns and identity theft cases). During the filing season when call demand is usually at its highest, more resources are shifted to the telephones to answer calls, and correspondence inventory processing is placed on hold until call demand subsides. As call volumes have increased and assistors have been moved to answer telephone calls, paper correspondence inventories have substantially increased. The correspondence inventory rose from approximately 480,000 at the end of FY 2007 to more than 628,000 at the end of FY 2010, representing an increase of nearly 31 percent.

Each year, more taxpayers also seek assistance from one of the IRS's 401 walk-in offices, called Taxpayer Assistance Centers. These centers plan to assist more than 6.1 million taxpayers in FY 2012. However, as a result of the IRS's smaller operating budget, the centers will not be able to offer tax return preparation assistance to as many taxpayers. The IRS is also limiting tax return preparation to current tax returns and to two or three days a week. Taxpayers will not be allowed to make appointments. The IRS hopes that these efforts will help those taxpayers who need assistance the most, including those with tax law and accounts issues. The IRS also will not provide extended hours for the centers during the 2012 Filing Season. It had planned to extend hours of operation in approximately 47 centers during the week and on some Saturdays. However, hours were not extended due to budget cuts and continuing staffing shortages.

Affordable Care Act Administration

The Affordable Care Act contains an extensive array of tax law changes that will present many challenges for the IRS in the coming years. While the Department of Health and Human Services will take the lead role in developing the policy provisions of the Act, the IRS will administer the law's numerous tax provisions. The IRS estimates that at least 42 provisions will either add to or amend the tax code and at least eight will require the IRS to build new processes that do not exist within the current tax administration system.

The IRS received funding for implementing provisions of the Act from the Health Insurance Reform Implementation Fund, which is administered by the Department of Health and Human Services as provided for in the Act. The legislation provided $1 billion in funding for implementation of the provisions. The funding was to be distributed to the IRS and other participating agencies to implement the provisions with effective dates in Calendar Years 2010 and 2011. Up to $350 million was made available to the IRS for implementation costs. The IRS requested and was provided more than $20 million in FY 2010 and obligated more than $168 million for FY 2011.

Small Business Health Care Tax Credit

Among the credits contained in this legislation was the Small Business Health Care Tax Credit, which was designed to encourage small employers to offer health-care insurance. In general, this credit is available only to small employers who pay at least one-half the cost of health insurance coverage for their employees. The IRS's efforts to implement this credit were mostly successful, but some improvements are needed.

Despite the IRS's efforts to inform 4.4 million taxpayers who could potentially qualify for the Small Business Health Care Tax Credit, the claims for the credit have been low. Through mid-October 2011, the IRS reported that only 309,000 taxpayers claimed the credit for a total amount of $416 million, which is substantially lower than the Congressional Budget Office's estimate that taxpayers would claim up to $2 billion of the credit for TY 2010. The time and effort required to claim the credit were among reasons given by industry groups and professional organizations for the low volume of claims.

Although the Small Business Health Care Tax Credit is specifically targeted to small employers, certain taxpayers may claim the credit even when they have not filed employment tax returns. This is the case when a company enters into a contractual relationship with a Professional Employer Organization that manages human resources. Form 8941, *Credit for Small Employer Health Insurance Premiums*, does not contain all of the data and calculations needed to verify each step of credit eligibility and calculation. Based on the information that was available, TIGTA found that both taxpayers and tax practitioners were making mistakes when completing Form 8941.[27]

TIGTA made several recommendations. IRS management agreed and plans to take corrective actions.

Human Capital

Human capital is the Federal Government's most critical asset. At a time when agencies are preparing for increased retirements and taking on such challenges as health care reform, the recruitment and retention of employees plays a key role in maintaining a quality workforce. Like many Federal agencies, the IRS is faced with the major challenge of replacing existing talent caused by a large number of retirements

[27] TIGTA, Ref. No. 2011-40-103, *Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed* (September 2011).

expected over the next several years. In five years, about one-third of the IRS's workforce of approximately 100,000 employees will be retirement eligible. In the leadership ranks, over two-thirds of IRS executives will be eligible for retirement in five years. Adding to this challenge, the IRS recently offered early retirement and buyouts to more than 2,200 employees.

The IRS's challenge of having the right people in the right place at the right time is made more difficult by many complex internal and external factors. The work performed by IRS employees continually requires greater expertise as tax laws become more complex, manual systems used to support tax administration become computer based, and attempts by taxpayers and tax practitioners to evade compliance with the tax laws become more sophisticated. The IRS must also compete with other Federal agencies and private industry for the same human resources, which becomes more complicated as younger generations of employees move between jobs more frequently than employees in the past. Further, budget constraints, legislative changes, and economic shifts can create unforeseen challenges for the IRS in addressing its long-term human capital issues.

While the IRS is improving its human capital management practices and has developed a comprehensive agency-wide recruitment strategy, there is still much work to be done. For example, TIGTA recently determined that the IRS was struggling to accomplish the basic tasks in acquisition workforce planning, including identifying its acquisition workforce, determining the number of acquisition workforce personnel it needs to accomplish its mission, and determining the skills that its employees have compared to the skills it requires.[28]

TIGTA also found that while the IRS added 1,515 new revenue officers (ROs)[29] during a nine-month period, it still struggles to keep pace with attrition and workload. If the IRS does not have a sufficient number of qualified ROs to collect delinquent taxes, it could create an unfair burden on the majority of taxpayers, who fully pay their taxes on time. However, when estimating the staffing levels of ROs, the IRS does not determine the number needed to address the available workload. Instead, the IRS bases the RO staffing level primarily on a budgetary figure. The IRS believes that there is more than enough inventory to justify staffing increases. However, the IRS does not know when hiring additional ROs will no longer be needed.

[28] TIGTA, Ref. No. 2011-10-072, *Additional Actions and Data Are Needed to Further Analyze the Size and Skills of the Acquisition Workforce* (July 2011).

[29] Employees in the IRS's Collection Field Function who attempt to contact taxpayers and resolve collection matters that have not been resolved through notices sent by the IRS campuses (formerly known as service centers) or the Automated Collection System.

The IRS's FY 2009 budget justification projected that the RO hiring initiative would allow 88,000 additional delinquent account closures, resulting in $333.6 million in additional revenue for FY 2011. However, the IRS does not compare actual results to the original projections, as would be consistent with guidance from the Office of Management and Budget. As a result, it is unknown if the IRS realized all or part of the additional revenue, and the IRS lost an opportunity to collect information that could help improve future budgets. TIGTA recommended that the IRS establish rules for optimizing RO staffing levels and develop methods to track actual results with projected benefits in future budget justifications.

IRS management agreed to review workload and resource levels to improve future resource allocation and staffing decisions. IRS management also stated that they initiated efforts last year to determine the actual revenue collected from specific enforcement initiatives proposed in FY 2009. However, this information was not shared with TIGTA during the review. As a result, TIGTA did not assess whether those efforts addressed the recommendation.[30]

TIGTA'S BUDGET REQUEST AND JUSTIFICATION

The President's FY 2013 $153,834,000 budget request for TIGTA strikes a balance in addressing the critical needs of the Nation. The FY 2013 request represents an overall increase of 1.41 percent above the FY 2012 enacted budget and includes $324,000 needed to support the Council of the Inspectors General on Integrity and Efficiency. However, TIGTA's budget request reduces existing programs by $2,306,000 below the FY 2012 enacted level. These cuts reflect the tough choices that the Nation currently faces. TIGTA is reviewing all of its functions in an effort to reduce only those programs that will have the smallest impact on its critical mission.

The FY 2013 budget request includes an additional $4,500,000 for 29 FTEs for oversight of the IRS's implementation of the Affordable Care Act tax provisions. This funding will support auditors, evaluators, and special agents specifically to provide oversight of Affordable Care Act issues. The oversight of the implementation of this law is a significant priority for TIGTA.

Going forward, FY 2013 will be an important year for the oversight of the Affordable Care Act. Several key provisions take effect in FY 2013 and FY 2014, and many provisions that previously became effective will require continued oversight to ensure that appropriate corrective actions are taken. TIGTA's oversight will require close coordination among its Audit, Investigations, and Inspections and Evaluations functions. Each program office brings unique skills and experience, but our overall

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[30] TIGTA, Ref. No. 2011-30-039, *Challenges Remain to Balance Revenue Officer Staffing With Attrition and Workload Demands* (May 2011).

success depends greatly upon these offices' close collaboration. As such, TIGTA has developed a multi-year oversight strategy that includes audit, evaluations, and investigative resources to assess, and to proactively detect and deter efforts to impede, the IRS's implementation of the Act.

We at TIGTA take our mandate to provide independent oversight of the IRS seriously. I hope my discussion of the IRS budget request and some of the major challenges facing the IRS assists Congress in ensuring accountability over the IRS.

Chairwoman Emerson, Ranking Member Serrano, and Members of the Subcommittee, thank you for the opportunity to share my views.