

**WRITTEN TESTIMONY OF THE
COMMISSIONER OF INTERNAL REVENUE SERVICE
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BEFORE
SENATE HOMELAND SECURITY AND GOVERNMENTAL
AFFAIRS COMMITTEE
SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT,
GOVERNMENTAL INFORMATION AND INTERNATIONAL
SECURITY
ON
REPORTING IMPROPER PAYMENTS: A REPORT CARD ON
AGENCIES' PROGRESS**

MARCH 9, 2006

Good afternoon, Chairman Coburn, ranking member Carper and members of the Subcommittee. I am pleased to be with you again this afternoon to discuss IRS's compliance with the Improper Payments Information Act (IPIA) of 2002.

Before turning to today's subject, I would like to briefly update you on the subject of your hearing last October --- the tax gap.

You will remember that when I appeared before this Subcommittee last October to discuss the tax gap, we were in the process of updating our preliminary estimates for the extent of the gap. As you know, the tax gap is the difference between the amount of tax imposed on taxpayers for a given year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws. Based on our updated numbers from the National Research Program's (NRP) analysis of Tax Year (TY) 2001 returns, our best estimate of the gross tax gap is \$345 billion. The net tax gap, after enforcement and the collection of late payments, is \$290 billion.

One of the advantages derived from the NRP study, other than to get a reliable estimate of the tax gap, is the opportunity to update our method of determining which returns merit further examination and to avoid examining compliant taxpayers. Using the recent NRP study data, we have developed new formulas for several examination classes. IRS implemented these new formulas in January 2006 to evaluate TY 2005 returns. We will begin examining returns selected using these new formulas in October 2006. We believe using the new formulas will allow us to improve productivity and reduce taxpayer burden by reducing significantly the number of examinations resulting in little or no change to the taxpayer's tax liability.

One of the best ways to reduce the tax gap is to fully fund the President's FY 2007 proposed budget for the IRS. This committee has long been a supporter of our budget

and we appreciate the fact that last year we received full funding. This has allowed us to pursue several new enforcement initiatives. The FY 2007 budget, if fully funded, will allow us to continue the progress on those enforcement priorities while maintaining our strong focus on service. In 2006, Congress provided a significant enforcement increase through a program integrity cap adjustment to continue these enforcement improvements. The 2007 Budget again proposes a cap adjustment to maintain this increase.

The President's proposed FY 2007 Budget also requested enactment of five legislative initiatives that will assist us further in reducing the tax gap. These include:

- Information reporting on payment card transactions. We know that compliance is significantly higher when information is reported to the IRS. Currently, more than 150 million wage earners have their wage information reported to the IRS by their employers.
- Clarification of the circumstances in which employee leasing companies and their clients can be held jointly liable for Federal employment taxes;
- Amended Collection Due Process procedures for employment tax liabilities;
- Expanded information reporting on certain payments made by federal, state, and local governments to procure property and services;
- Expansion to non-income tax returns the requirement that paid return preparers identify themselves on such returns and expansion of the related penalty provisions as well.

These changes strategically target areas where (1) research reveals the existence of significant compliance problems, (2) improvements will burden taxpayers as little as possible, and (3) the changes support the Administration's broader focus on identifying legislative and administrative changes to reduce the tax gap.

The IPIA and the IRS

The IPIA requires agencies annually to review their programs and activities to identify those that are susceptible to significant erroneous payments. "Significant" means that an estimated error rate and a dollar amount exceed the threshold of 2.5 percent and \$10 million. Once high-risk programs are identified, a method for systematically reviewing them must be developed and statistically valid samples must be conducted to determine annual error rates. If those error rates, when applied to all program funding, result in a level of improper payments that meet the significant criteria, a Corrective Action Plan must be developed to resolve the underlying causes and reduce the improper payments.

Some Federal programs are so complex that developing an annual error rate is not feasible. The government-wide Chief Financial Officers Council developed an alternative for such programs to assist them in meeting the IPIA requirements. Agencies may establish an annual estimate for a high-risk component of a complex program with Office of Management and Budget (OMB) approval. Agencies must also perform trend analyses to update the program's baseline error in the interim years between detailed program studies. When development of a statistically valid error rate is possible, the reduction targets are revised and become the basis for future trend analyses.

The risk assessments performed across all Treasury programs in FY 2005 resulted in all programs and activities being rated as having low or medium risk susceptibility to improper payments except one, the Earned Income Tax Credit (EITC).

The Earned Income Tax Credit

The EITC is one of the government's most successful anti-poverty programs. In 2003, 4.3 million people were lifted above the poverty line because of the EITC. In FY 2005, 22 million taxpayers received nearly \$40 billion in payments through the EITC.

Taxpayers eligible for the EITC receive a refundable federal tax credit that offsets taxes owed through the income tax system. If the credit exceeds the amount of taxes owed, a lump sum payment is provided to those who qualify.

When I became the Commissioner of the IRS in 2003, one of my priorities was to develop a program strategy for the EITC around a very simple philosophy that everyone who qualifies for the EITC should receive it, but only those who qualify.

That simple philosophy led us to a five point plan around which the EITC program is currently organized. The essential tenets of that plan are as follows:

1. Reduce the backlog of pending EITC examinations to ensure that eligible taxpayers whose returns are being examined receive their refunds quickly.
2. Minimize burden and enhance the quality of communications with taxpayers by improving the existing audit process.
3. Encourage eligible taxpayers to claim the EITC by increasing outreach efforts and making requirements for claiming the credit easier to understand.
4. Ensure fairness by refocusing compliance efforts on taxpayers who claimed the credit but were ineligible because their incomes were too high.
5. Pilot a certification effort to substantiate qualifying child residency eligibility for claimants whose returns are associated with a high risk of error.

I am pleased to report that we have made significant progress in each of these areas in the last three years. Since 2003, our backlog of cases has fallen 77 percent. Audit cycle times from 2003 until the end of 2005 declined from 206 days to 180 days.

Our outreach efforts also appear to be succeeding. In the 2005 filing season, over 7.7 million people reviewed our EITC pages on IRS.gov, nearly a million used the EITC Assistant, approximately 75,000 professionals accessed our electronic toolkits, 220,000 information emails went to paid tax preparers, and we provided answers to more than 160,000 EITC questions from our call site to illustrate a few of our methods.

We have been able to refocus our compliance efforts on those most likely to be in non-compliance by utilizing some new methodologies under the automated under-reporter program. We completed our initial test of certification which showed that it does reduce erroneous EITC payments and claims, but it also deters some eligible taxpayers from claiming the credit. We have launched subsequent tests to refine our selection methodology and to evaluate the effect of a certification requirement on the institutions that provide assistance to these taxpayers.

We have a robust research program. We take the data from that research, analyze it, and based on that analysis, we make decisions. The certification program is a good example. We have reached no conclusion on whether to implement it, and we'll rely on the data and analysis to determine how to proceed.

On our web site, IRS.gov, taxpayers can now go to the *EITC Assistant* to determine if they may qualify for the EITC and, if they do, to determine estimate the amount of their refund. This year, we significantly revised this feature to reflect changes in the law as a result of Hurricane Katrina. This *EITC Assistant* is available in both English and Spanish.

Some have suggested that the *EITC Assistant* might not be that useful since many of those eligible may lack access to a computer. Even if they do not have a computer in their homes, they may have access through other means, such as public libraries. Nearly three-quarters of all EITC returns are done by paid preparers and the *EITC Assistant* can help them better assist taxpayers. In TY 2005 we had nearly 1 million hits on this feature of our web site.

A key service offered by the IRS to assist EITC claimants in the preparation of their returns are the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) centers. These sites are not limited to EITC claimants, but serve low-income and elderly taxpayers, who are often eligible for the EITC. In the 2005 filing season, these centers processed over 2.1 million returns and we anticipate that this number will grow again this year.

I have visited two VITA sites in recent weeks. The first was in Harlem. Mayor Bloomberg and I toured the FoodChange Food and Finance Center, the largest VITA site in the country. Despite the high volume of returns processed, it has one of the lowest

processing error rates of any such site. I have also visited the Employment and Family Services Southgate VITA site in Cleveland. I can't begin to tell you how impressed I was with the competence, professionalism, and dedication of all the volunteers who staff these sites.

These sites serve several important purposes. First and foremost, they allow low income taxpayers to have their income taxes done reliably, at no cost. Second, they often allow taxpayers to have their returns filed electronically, meaning that the taxpayers will get their refunds in two weeks or less. This should reduce the demand for refund anticipation loans (RALs). These RALs are used by banks, tax preparation companies and others to give the taxpayer his or her refund immediately. However, the cost of the RALs are significant and as a result they have become a scourge, preying on those people least able to afford turning over a healthy portion of their EITC refund just to get their money a few days sooner. Third, the sites help educate the taxpayers about their eligibility for not only EITC, but other tax credits as well.

Reducing EITC Improper Payments

As much success as we have had in meeting our objective of having every taxpayer who is eligible, applies for the EITC, there remains a significant problem with erroneous payments under the program. Our latest estimates for TY 2005 are that \$9.6-11.4 billion (23-28 percent) is paid out erroneously.

The primary source for this estimate of erroneous payments is the NRP study results for the EITC claimant subset of NRP returns (approximately 6,400 of about 44,000 total returns analyzed). Other data and information sources used for the estimates included IRS Enforcement Revenue Information System data, Treasury Department estimates of the effect of the EITC provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 on EITC erroneous claims, and FY 2006 budget estimates.

The IRS has in place a robust, balanced, and comprehensive plan to help reduce improper payments. First, we wanted to make the base program better by increasing program efficiency within existing resources. Second, we wanted to test potential business process enhancements to reduce error.

Base Program

In 2005, the IRS spent approximately \$165 million on EITC activities, the bulk of which was used in three key areas:

- *Examinations* --- We identify and examine selected tax returns;
- *Math Error* --- This refers to an automated process in which IRS identifies math or other statistical irregularities and automatically prepares an adjusted return; and
- *Document Matching* --- This involves comparing income information provided by the taxpayer with document matching information (e.g. W-2s, 1099s) from employers to identify discrepancies.

Collectively, these three enforcement initiatives prevented nearly \$2 billion from being paid out erroneously. The bulk of that was saved through examinations (\$1.34 billion). Math error corrections saved \$330 million. Under both examinations and math error, the IRS identifies the mistake before the refund check is mailed. The taxpayer is sent a letter notifying him or her of the correction and provided an opportunity to offer evidence to support the original claim. With document matching, the check is sent and any overpayment is recaptured generally against future claims.

We estimate that these EITC enforcement efforts have directly protected an estimated \$6.52 billion in revenue from FY 2002 through FY 2005. In addition, we project that continued enforcement efforts will protect a total of \$12.21 billion in revenue through FY 2008.

Business Process Enhancements

In 2003 and 2004, we received a total of \$75 million to fund a number of EITC business process improvement initiatives. The initiatives included the use of private sector solutions to better identify egregious cases, apply appropriate collection methods, assign and manage case inventory more efficiently, catch problems with amended returns, improve communications with taxpayers, better focus on under-reported income, and explore use of new notices to improve taxpayer response.

We used several private sector solutions to implement these initiatives and improve error detection and prevention. I have talked about the *EITC Assistant* as one means of prevention. We also have *EITC CERT*, a web and phone self-service application that allows participants in the qualifying child certification test to determine the status of the documentation they have provided to establish eligibility.

For error detection, we have a risk-based scoring system that helps the IRS work high-risk cases more effectively by scoring potential errors and determining the best treatment based on the characteristics of the claim.

We have also completed the first test of an initiative to address egregious EITC return preparers. We have opened discussions with several states having an interest in sharing information to prevent erroneous payments and we are evaluating potential new ways to share data to improve our revenue protection activities. These include a review of external databases that could help identify taxpayers who are not eligible for the EITC as well as developing possible new candidates for math error authority.

In addition, we have initiated a longitudinal study to determine the characteristics of EITC claimants and EITC filing trends/patterns over time. This study will enable us to make data driven decisions on how to better target areas of non-compliance. The IRS has also begun the final phase of testing of certification as a means of reducing EITC errors.

This year, we are launching the second phase of the EITC return preparer strategy. We will incorporate new selection tools to determine more effective compliance treatments for return preparers. We also plan to test new solutions to reduce duplicate claims of qualifying children in 2007.

Challenges with the EITC Program

A number of factors serve as barriers to reducing erroneous claims in the EITC program. These include:

- The complexity of the tax law;
- The structure of the earned income credit;
- Confusion among eligible claimants;
- High program turnover;
- Unscrupulous preparers; and
- Fraud

No one of these factors can be considered the primary driver of program error. Furthermore, the interaction among the factors makes addressing the credit's erroneous claims rate problematic.

Under the IPFA requirements, the EITC program must establish annual targets for error reduction and develop action plans to achieve these targets. While this approach works conceptually, there are several concerns and issues that should be taken into consideration.

First, the EITC program expenditures are such a small fraction of program benefits and program error that a very large increase in expenditures would be needed to make a noticeable change in the EITC error rate using current strategies. Current administration costs are less than 1 percent of the benefits delivered. These costs appear quite low compared to other non-tax benefit programs, in which administrative costs can run as high as 20 percent of program expenditures.

Second, new error reduction strategies require multiple years to take effect and, therefore, will not be reflected in annual estimates.

Third, current improper EITC estimating technologies are too imprecise to capture the effects of annual program changes in EITC. Due to this lack of precision and because the incremental improvements the IRS is able to achieve with its current approach are relatively small, any reduction in the EITC error rate is unlikely to be significant or measurable.

As a result, we expect audit rates for the EITC to flatten out in terms of actual numbers and to decline as a percentage of our overall audits. We believe we are devoting an appropriate amount of resources to the EITC program.

Possible Legislative Changes

There are two legislative proposals contained in the President's FY 2007 budget that will serve to simplify eligibility criteria, improve enforcement for the EITC, and allow us to access important information from other Federal agencies.

- *Simplify EITC Eligibility Requirements:* To qualify for the EITC, taxpayers must satisfy requirements regarding filing status, the presence of children within their households, and their work and immigration status in the United States. These rules are confusing, require significant record keeping, and are costly to administer. The President's FY 2007 budget proposes to make certain changes simplifying these rules.

- *Reduce Computational Complexity of Refundable Child Tax Credit:* Taxpayers with earned income in excess of \$11,300 may qualify for a refundable (or "additional") child tax credit even if they do not have any income tax liability. About 70 percent of additional child tax credit claimants also claim the EITC. However, the two credits have a different definition of earned income and different U.S. residency requirements. In addition, some taxpayers have to perform multiple computations to determine the amount of their additional child tax credit. The President's budget proposal proposes certain changes to the additional child tax credit rules to address these issues.

Questionable Refund Program

In its annual report to Congress, the Taxpayer Advocate Service (TAS) called the IRS to task for its Questionable Refund Program (QRP). The QRP is a program administered out of our Criminal Investigation (CI) division. CI places a freeze on refund claims each year that it believes may contain indicia of fraud. Many of these returns involve claims for the EITC.

Shortly after the TAS report was issued, I requested a review of the program and pledged to send notices to taxpayers if their refunds were frozen. As a result of that review, we are implementing new procedures for this filing season, in partnership with the National Taxpayer Advocate, to notify taxpayers that we are freezing their refunds at the time we initiate the freeze. We will also automatically release refunds after an established time period if CI has not determined a particular return requires additional verification, and will minimize automatic freezes on taxpayers' accounts in future years.

In addition, we will refine our identification and selection criteria and review refunds frozen from 2004 and prior tax years. Determining the proper disposition of these cases will require additional time and resources. We will either process the refund or notify the taxpayer to give him or her opportunity to substantiate the claim. We hope to have these completed by the end of the year.

Conclusions

In summary, Mr. Chairman, I would like to emphasize the following points:

- The EITC is one of the largest Federal anti-poverty programs paying out \$40 billion to 22 million taxpayers;
- We have a balanced approach to the EITC. We want everyone who qualifies to receive the credit, but only those who qualify.
- We plan to continue the growth of the VITA and TCE sites so low income families can have their returns done accurately, at no cost, and without the need for refund anticipation loans.
- Adoption of the President's FY 2007 proposed budget, including adoption of proposed legislative changes, remains the most important step that Congress can take to improve the EITC program.

Thank you and I will be happy to respond to any questions that you may have.