

**Written Statement of**  
**Nina E. Olson**  
**National Taxpayer Advocate**

**Before the**

**Committee on Finance**

**United States Senate**

**Hearing on**

**Identity Theft in Tax Administration**

**April 10, 2008**

## TABLE OF CONTENTS

I.	Identity Theft in Tax Administration .....	2
A.	The IRS Is Unable to Quantify the Number of Identity Theft Incidents .....	3
B.	Taxpayers Are Essentially Victimized Twice – Once by the Identity Thief and a Second Time by IRS Procedures that Prevent Them from Claiming Tax Benefits to Which They Are Entitled .....	3
C.	The IRS Is Taking Some Steps to Address Recurring Identity Theft .....	7
D.	The IRS Should Consider Centralizing Its Procedures to Assist Identity Theft Victims.....	8
E.	The IRS Should Quickly Consider and Act on Recommendations Contained in the National Taxpayer Advocate’s 2007 Annual Report to Congress .....	9
F.	Preparers Should Be Required to Mask Social Security Numbers Before Transmitting Tax Return Information Abroad.....	10
II.	Other Significant Tax Administration Issues.....	13
A.	The Time Is Ripe for a Taxpayer Bill of Rights and for Related Legislation to Improve Tax Procedure .....	13
B.	The IRS Should Exert a Stronger Oversight Role in the Electronic Filing Arena.....	15
1.	To Fully Realize the Benefits of e-File, the IRS Should Enable All Taxpayers to Prepare Their Returns and File Directly with the IRS without Charge.....	15
2.	The IRS Should Assert Control over its e-File Policies so that They Serve the Best Interests of Taxpayers and Tax Administration.....	18

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

Thank you for inviting me to testify at today's hearing. In this written statement, I will first address the subject of identity theft in tax administration and then provide my perspective on two other significant tax administration issues – the need for legislation to improve tax administration, which this Committee has twice approved but has not been enacted into law, and the need for the IRS to take a more taxpayer-centric approach to e-filing issues.<sup>1</sup>

Because this hearing is taking place near the end of the 2008 filing season, I want to begin by commending the IRS for the admirable job it has done, particularly in light of the significant challenges it is facing. As I noted in my Annual Report, late-year tax-law changes impact both taxpayers and the IRS, and the uncertainty surrounding such changes increases the risk that problems will arise with basic service delivery and return processing.<sup>2</sup> These challenges increase when the IRS must devote substantial resources during the filing season to a major new initiative, such as preparing to pay out the recently authorized economic stimulus payments. To deliver these payments, the IRS not only must process payments to the over 130 million taxpayers who currently file income tax returns, but it also must identify and process returns from and payments to more than 20.5 million persons who have no filing requirement.<sup>3</sup> All of these exigencies divert the IRS from other important work, yet the fact that the IRS has managed to turn on a dime and deliver this filing season with no significant glitches is a testament to the extraordinary people who work at the IRS.

There are always tasks the IRS could perform better – and I will address some of them below – but I think it is important to take a moment to reflect on the vast responsibilities the IRS must meet to collect the revenue that our government requires to function and to acknowledge how much the IRS does very well.

---

<sup>1</sup> The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

<sup>2</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 3-12 (Most Serious Problem: The Impact of Late-Year Tax-Law Changes on Taxpayers).

<sup>3</sup> Approximately 20.5 million persons received Social Security or Veterans' benefits and are therefore likely to qualify for stimulus payments but did not file tax returns in 2006. IRS News Release, *Special Economic Stimulus Payment Packages Go to Social Security, Veterans Recipients*, IRS-2008-37 (Mar. 10, 2008). There is also an unknown number of low income taxpayers who ordinarily would not have a filing requirement but will have to file this year to receive a payment.

## I. Identity Theft in Tax Administration<sup>4</sup>

Identity theft is the number one consumer complaint in the United States, far outpacing all others.<sup>5</sup> Identity theft impacts tax administration when an individual intentionally uses the Social Security number (SSN) of another person to file a false tax return or fraudulently obtain employment. Misuse of another person's SSN or identity generally occurs in tax administration in two contexts: (1) the filing of a false return to obtain a fraudulent refund ("refund fraud") or (2) the theft and use of another person's SSN to obtain employment ("employment-related fraud").

In refund fraud, the perpetrator files early in the filing season using the personal information of the innocent taxpayer and before the lawful owner of the SSN has an opportunity to file. Typically, a perpetrator will use false Forms W-2 reflecting phantom wages and withholding credits, thus forming the basis of a fraudulent claim for a refund. To secure the fraudulent refund, the perpetrator typically will direct the IRS to transmit the refund electronically to a bank account under his or her control. When the identity theft victim later attempts to file his or her tax return, the IRS flags it as a "duplicate" return and freezes the refund.

In employment-related fraud, persons without the necessary legal status to obtain employment in the United States unlawfully use another person's SSN to appear work eligible. The employer of the undocumented worker will file a Form W-2 reflecting the worker's wages, which IRS data systems will attribute to the rightful SSN owner. The IRS will assess additional tax unless the lawful owner of the SSN acts to halt the erroneous assessment.

Regardless of the motive, identity theft results in serious consequences for the innocent taxpayer. Such consequences may include (1) the delay or denial of refunds, (2) the assessment of tax debts resulting from income reflected on the fraudulent filer's return, and (3) the requirement for victims to prove their identity to the IRS year after year. The IRS has a duty to these taxpayers to expeditiously determine the true owner of the SSN and to restore the integrity of the affected taxpayer's account.

---

<sup>4</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 96-115 (Most Serious Problem: Identity Theft Procedures); see also National Taxpayer Advocate 2005 Annual Report to Congress 180-191; National Taxpayer Advocate 2004 Annual Report to Congress 133-136; National Taxpayer Advocate FY 2008 Objectives Report to Congress 15-16, 36-40; National Taxpayer Advocate FY 2006 Objectives Report to Congress iii-3; National Taxpayer Advocate FY 2005 Objectives Report to Congress 34.

<sup>5</sup> In 2007, the Federal Trade Commission (FTC) received 258,427 complaints of identity theft. The next closest complaint was shop-at-home catalog sales with 62,811 complaints. See FTC website, <http://www.ftc.gov/opa/2008/02/fraud.pdf>.

## **A. The IRS Is Unable to Quantify the Number of Identity Theft Incidents**

I am concerned that the IRS does not know how many taxpayers are impacted by identity theft. Prior to January 1, 2008, the IRS had no method to systemically identify taxpayers whose identities were stolen. The IRS has now begun to track incidents of identity theft – but only in cases where the victim alerts the IRS *and* provides documentation verifying the identity theft and his or her identity. These conditions mean that many, and perhaps most, cases of identity theft will not be tracked by the IRS.

In employment-related fraud cases, for example, IRS data systems generally are able to detect a “name-SSN mismatch” (*i.e.*, cases where the taxpayer's name according to IRS data files does not match the associated SSN for that name). If an identity thief uses another taxpayer's SSN but the name does not correspond, the income on information returns (e.g., Forms W-2 or Forms 1099) bearing the SSN will not be attributed to the rightful SSN owner.<sup>6</sup> While this result spares the victim immediate headaches, it also means that an identity theft marker will not be applied, even though it is clear that the SSN has been misused. In addition, the rightful SSN owner will not receive notification that his or her SSN is being misused by another person. As discussed below, there are additional circumstances under which the identity theft marker will not be applied in cases of identity theft.

Thus, even with the electronic indicator of identity theft, it is apparent that the IRS will not be able to accurately quantify the number of identity theft cases. My personal belief is that the IRS has many more cases of identity theft on its hands than it is estimating. My employees report that they are now receiving calls from senior citizens who filed for the economic stimulus payment after not filing for years, only to find that someone else had been using their SSN on tax returns. To its credit, the IRS has recently established procedures that would allow its Taxpayer Assistance Centers (TACs) to process economic stimulus payments to identity theft victims who file solely to obtain the stimulus payment.<sup>7</sup> However, one wonders why the TACs cannot do this for similarly situated taxpayers in other tax return contexts.

## **B. Taxpayers Are Essentially Victimized Twice – Once by the Identity Thief and a Second Time by IRS Procedures that Prevent Them from Claiming Tax Benefits to Which They Are Entitled**

In talking with my local taxpayer advocates and case advocates, I often hear that there is a lack of adequate procedures available to IRS employees to address the increasingly common crime of identity theft. In some respects, the IRS tries to fit a round peg into a square hole when addressing identity theft issues by using so-

---

<sup>6</sup> IRM 4.19.3.4.1 (Nov. 8, 2005).

<sup>7</sup> See IRS, SERP Alert, *Economic Stimulus Payment TAC Site Procedures for Identity Theft Situations* (Mar. 27, 2008).

called “mixed entity” procedures<sup>8</sup> and “scrambled SSN” procedures,<sup>9</sup> which were initially designed to address very different circumstances. As a result, there are significant gaps in the portion of the Internal Revenue Manual (IRM) that prescribes the IRS’s procedures for handling identity theft cases.

A taxpayer contacting the IRS about his or her tax problem – usually involving a delayed refund or in response to an examination or collection notice for income that the taxpayer did not earn – generally does not know that he or she is the victim of identity theft. The IRS customer service representative, researching the delayed refund on IRS systems, will observe a duplicate return filing. The IRS will then send the first 239C letter, Scrambled SSN Clarification to Taxpayer, to each of the taxpayers using the SSN. This initial 239C letter informs the recipient that there may be a problem with the SSN used on his or her return, requests proof of the taxpayer’s identity, and includes a questionnaire that inquires about the filer’s past use of the SSN. Up to this point, the IRS has not told the taxpayer that another person is using his or her SSN, nor has an IRS representative attempted to contact the taxpayer by phone. Thus, the taxpayer has not yet been advised that he or she is a victim of identity theft.

Under current IRS guidance, if none of the SSN users respond to the first 239C letter within 40 days, the IRS institutes the “scrambled SSN” procedures. Similarly, if both of the taxpayers respond to the first 239C letter, the IRS institutes scrambled SSN procedures. In order to avoid scrambled SSN procedures, a taxpayer must timely submit documentation (1) validating the taxpayer’s identity (such as a driver’s license, passport or Social Security card)<sup>10</sup> and (2) verifying the existence of identity

---

<sup>8</sup> The IRS uses “mixed entity” procedures when it knows which of the multiple SSN users the rightful owner is. Under mixed entity procedures, the IRS assigns a temporary IRS number (IRSN) to taxpayer(s) wrongfully using the SSN, while the rightful SSN owner can continue using the SSN. The IRS then separates out the income attributable to the fraudulent filer from the innocent taxpayer’s account, transferring the disputed income to the IRSN. See IRM 21.6.2.4.3 (Oct. 1, 2007).

<sup>9</sup> The IRS uses “scrambled SSN” procedures when it cannot determine the true owner of the SSN. In this situation, it assigns IRSNs to both (or all, if more than two) taxpayers who used the common SSN. The IRS instructs taxpayers who are assigned IRSNs to discontinue using their SSN. The 239C letter advises taxpayers:

You should use the Internal Revenue Service Number (IRSN) for federal income tax purposes until we can verify your social security number (SSN). Your IRSN is only a temporary number.

We cannot allow you credits such as the Earned Income Tax Credit, etc., unless you have a valid taxpayer identification number. However, you should file your return on time and claim any credits you are legally entitled to even though you cannot receive them until we verify your SSN.

See IRM 21.6.2.4.4 (Oct. 1, 2007).

<sup>10</sup> See IRM 21.6.2.4.4 (Oct. 1, 2007).

theft (e.g., an affidavit of identity theft obtained from the Federal Trade Commission or a copy of a police report).<sup>11</sup>

When the IRS institutes its scrambled SSN procedures, it assigns a temporary tax identification number, called an IRS number or "IRSN," to each user of the SSN, including the victim of identity theft.<sup>12</sup> A second 239C letter instructs each user of the SSN, including the identity theft victim, to use the IRSN to file his tax returns while the IRS and the Social Security Administration (SSA) seek to determine the rightful owner of the SSN in question, a process that has historically taken up to two years.<sup>13</sup> The second letter advises the taxpayer as follows:

You should use the Internal Revenue Service Number (IRSN) for federal income tax purposes until we can verify your social security number (SSN). Your IRSN is only a temporary number.

We cannot allow you credits such as the Earned Income Tax Credit, etc., unless you have a valid taxpayer identification number. However, you should file your return on time and claim any credits you are legally entitled to even though you cannot receive them until we verify your SSN.

This letter is extremely confusing to taxpayers. First, the IRS tells the taxpayer that he must use an IRSN. Second, the IRS tells the taxpayer that because he is using an IRSN, he will not receive the EITC, or the child tax credit, or other such benefits. Finally, the IRS tells the taxpayer that he should claim those credits anyway, using the IRSN on the return. Given the confusing instructions of this 239C letter, the taxpayer might not claim the EITC or other tax benefits on his return out of fear of being audited.

At the same time, the taxpayer may begin to suspect that he is a victim of identity theft and would then have to begin the laborious process of placing a fraud alert on his credit records, working with creditors to determine the extent of any fraud that may have been committed in his name, taking steps to protect against further fraud, and working to clear his record. However, because the IRS has not clearly alerted the taxpayer of potential identity theft and its related consequences, it is also

---

<sup>11</sup> See Memorandum on Standard Identity Theft Documentation, Deputy Commissioner for Services and Enforcement, Kevin M. Brown (June 11, 2007).

<sup>12</sup> In FY 2005, the IRS assigned IRSNs to over 77,000 taxpayers. However, identity theft victims are not the sole recipients of IRSNs. For example, in mixed entity cases, perpetrators of identity theft are assigned IRSNs. See IRM 21.6.2.4.3.1 (Oct. 1, 2007).

<sup>13</sup> The IRS states that the average scrambled SSN case currently takes approximately ten months to resolve. This is a substantial reduction from prior periods and is attributable to recently implemented process improvements made by the IRS in collaboration with the Social Security Administration. See National Taxpayer Advocate 2007 Annual Report to Congress 110. However, the IRS cannot measure the actual cycle time of identity theft cases because the IRS has not tracked the incidence of identity theft in its cases, nor is it able to identify identity theft cases to enable it to pull a representative sample.

possible that the taxpayer might not take these necessary steps to protect himself. From the point of view of the affected taxpayer, the IRS instructions are very confusing.

Meanwhile, the IRS has not called the taxpayer to discuss any of these developments. All communication is done by correspondence, which might be sent to someone who has low literacy. Such an approach to likely victims of identity theft is hardly reflective of world class customer service. In fact, IRS procedures increase the harm to the victim by prematurely placing taxpayers into scrambled SSN procedures and by failing to utilize information already available to the IRS to avoid scrambled procedures.

In many instances, the IRS could avoid using scrambled SSN procedures by sending an initial notification and providing a phone number to a dedicated unit that could answer the taxpayer's questions and explain what is required for proof. In other instances, it is fairly easy to ascertain the correct owner of the SSN. For example, in several Taxpayer Advocate Service cases, including one I worked on, the owner of the SSN was a very young child. The IRS has access to various government databases that enable it to determine the age of the SSN owner, and in many cases we will know who is the mother, and sometimes the father, of the SSN owner.

If the SSN of a very young child shows up on a Form W-2 reporting wages from a full-time job, it should be fairly clear that that child did not earn those wages and should be treated as the victim rather than the perpetrator. We can at least avoid using scrambled SSN procedures with respect to these cases. Under current IRS guidance, however, such an account might be placed in scrambled SSN procedures, and the child's parents, in addition to having to straighten out the serious problem of identity theft, would be unable to claim the dependency exemption, child tax credit, and earned income tax credit (EITC) with respect to the child until the IRS and SSA reach a formal decision about the true holder of the SSN.<sup>14</sup>

This harm is compounded under the provisions of the recently enacted Economic Stimulus Act of 2008.<sup>15</sup> The Act provides that any return that does not include an SSN – whether for a primary or secondary taxpayer or a dependent – will be ineligible for the economic stimulus payment.<sup>16</sup> Thus, taxpayers who already are victims of identity theft are further victimized by IRS processes. These taxpayers in fact have an SSN. It is simply the IRS's and SSA's cumbersome processes that are

---

<sup>14</sup> Treas. Reg. § 301.6109-1(a)(1)(i) provides that taxpayer identifying numbers (TINs) include SSNs, individual taxpayer identification numbers, adoption taxpayer identification numbers, and employer identification numbers. IRC § 151(e) requires any dependent to have a valid TIN; IRC §§ 32(c)(1)(E), (c)(3)(D), and (m) require the eligible taxpayer and the qualifying child to have valid SSNs.

<sup>15</sup> Pub. L. No. 110-185, 122 Stat. 613 (2008).

<sup>16</sup> *Id.*

causing these taxpayers to wait for and possibly lose up to two years' worth of dependency exemptions, child tax credits, and earned income tax credits – and now economic stimulus payments as well.<sup>17</sup>

I have proposed that the IRS search its records to identify identity theft victims who were required by the IRS to use IRSNs on their returns, contact these taxpayers, and assist them in obtaining verification of their identities and proof of identity theft, so they will be able to receive the tax benefits to which they are entitled. If these taxpayers are to receive their economic stimulus payments this year, however, the IRS must act quickly. At the very least, it can instruct these taxpayers to claim the payment on their 2008 income tax returns.<sup>18</sup>

### **C. The IRS Is Taking Some Steps to Address Recurring Identity Theft**

Identity theft is a recurring issue for many taxpayers; victims of identity theft often find themselves needing to resolve account problems with the IRS over multiple years. The IRS finally acknowledged this reality and recently implemented a tracking system through which an indicator will be placed on an identity theft victim's account once he or she has provided verification of identity theft. In subsequent filing years, the IRS will be alerted to the fact that a taxpayer with this identity theft indicator on his or her account may have special needs and require special handling and attention.

I am very pleased with this positive development, as my office has long advocated such a tracking system.<sup>19</sup> However, there are shortcomings to this tracking system. As illustrated above, the identity theft indicator will not capture certain types of identity theft. In addition, the IRS still does not track cases where the taxpayer does not respond or provides insufficient documentation of identity theft.<sup>20</sup>

---

<sup>17</sup> The economic harm inflicted by scrambled SSN procedures is considerable for low income taxpayers. Among taxpayers who received EITC benefits and received tax refunds in tax year 2005, the average refund amount was \$3,093.46, and the average adjusted gross income was \$15,484.52. See IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2005). Thus, the average refund amounted to 20 percent of each taxpayer's annual income.

<sup>18</sup> The Taxpayer Advocate Service asked IRS Accounts Management personnel the rationale for using IRSNs in scrambled SSN situations, given that the practice results in the denial of the personal exemption. Accounts Management responded that IRSNs are used to separate tax data on scrambled cases until the owner of the common number is identified, and that the personal exemption must be denied until the Social Security Administration can determine who the true owner of the SSN is. Accounts Management further stated, "Consider that the same taxpayer may have filed all of the returns posted under the common number. Until sufficient information is received to resolve the case, the taxpayer should not be given the benefit of claiming the exemption again." Email from Accounts Management to TAS (Jan. 17, 2007). TAS has been unsuccessful in its attempts to persuade the IRS to modify its procedures.

<sup>19</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 191.

<sup>20</sup> To its credit, the IRS is applying the TC 971 indicator on phishing cases without requiring the victims to provide the two types of documentation normally required.

Moreover, the IRS needs to take a much more taxpayer-centric approach to identity theft with respect to the identity theft indicator. For example, the IRS has no central guidance about how to apply the indicator, allowing each operating division and function to create its own procedures. Thus, an identity theft victim's account may be handled differently depending on which part of the IRS he or she contacts.

**D. The IRS Should Consider Centralizing Its Procedures to Assist Identity Theft Victims**

Another concern is that there is no coordinated effort to address an identity theft victim's issues from start to finish. The IRS's Automated Underreporter, Automated Collection System, Criminal Investigation, Examination, and Accounts Management functions all work identity theft cases, but none of them is responsible for addressing all federal tax issues to make the taxpayer whole.<sup>21</sup> As a result, my organization has had to devote its limited resources to resolving a high percentage of identity theft issues. Stolen identity cases within the Taxpayer Advocate Service have increased by 644 percent from FY 2004 to FY 2007.<sup>22</sup>

In my 2007 report to Congress, I recommended that the IRS develop a dedicated, centralized unit to handle all identity theft cases and a centralized chapter in the IRM to house all identity theft procedures.<sup>23</sup> A centralized unit will be able to identify trends and systemic problems, and can serve as a central contact point for discussions with SSA to improve processing. With a centralized unit dedicated to resolving identity theft issues, victims of identity theft would have a single point of entry into the IRS and could more readily check on the status of their identity theft-related account issues. I am personally seeking agreement from the IRS leadership to work with me and my staff to develop such a unit and IRM.

<sup>21</sup> In fact, the IRS estimated that there are 17 entry points at which an identity theft case can come into the system. See IRS, *Identity Theft Program Current State* (July 20, 2007).

<sup>22</sup> The Taxpayer Advocate Service utilizes three primary issue codes to track identity theft cases. The table below shows the increase in Stolen Identity (primary issue code 425), Mixed Entity (primary issue code 410), and Scrambled SSN (primary issue code 420) cases from FY 2004 to FY 2007. The total number of identity theft-related cases may be underestimated due to the system's limitation of two issue code fields.

	<b>FY 2004</b>	<b>FY 2005</b>	<b>FY 2006</b>	<b>FY 2007</b>
<b>Stolen Identity</b>	447	922	2,486	3,327
<b>Mixed Entity</b>	1,681	1,493	2,062	2,303
<b>Scrambled SSN</b>	786	1,063	1,107	858
<b>Total:</b>	2,914	3,478	5,655	6,488

Taxpayer Advocate Management Information System (TAMIS), FY 2004, FY 2005, FY 2006 and FY 2007. TAS began tracking Stolen Identity cases in March 2004; the annual total for 2004 is a 12-month estimate based on an actual nine-month count of 335 cases.

<sup>23</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 115.

**E. The IRS Should Quickly Consider and Act on Recommendations Contained in the National Taxpayer Advocate's 2007 Annual Report to Congress**

The Taxpayer Advocate Service has struggled for years with the problem of identity theft in its casework and reported on it in past Annual Reports to Congress.<sup>24</sup> In my most recent Annual Report to Congress, I identified IRS Identity Theft Procedures as the sixth most serious problem facing taxpayers.<sup>25</sup> The report included several significant recommendations to the IRS that would improve processes, minimize harm to the taxpayer, and improve its taxpayer service in this area. The specific recommendations, some of which are discussed in greater detail above, were sent to the Commissioner on February 29, 2008. Under IRC § 7803(c)(3), the IRS has three months to provide a formal response to these recommendations. The recommendations are as follows:

- The IRS should develop a dedicated, centralized unit to handle all identity theft cases, as well as a centralized IRM to house all identity theft procedures across the IRS. Such a centralized unit would be able to provide and monitor training to its employees and track cycle time and other quality measures. A centralized IRM would provide various alternatives for account resolution.
- The IRS should develop a form that taxpayers can file when they believe they have been victims of identity theft. The instructions on the form should explain which steps the IRS will take and which steps the taxpayer should take to restore the integrity of the taxpayer's account (e.g., obtaining an FTC affidavit).
- The IRS should issue a notice to taxpayers whose refunds have been frozen because of a duplicate filing. A refund freeze can have the same effect as a refund denial if the taxpayer is unaware of the freeze or the reasons behind it.
- The IRS should also freeze collection actions when a duplicate filing is present until an investigation can determine whether an identity theft has taken place. Under current procedures, a duplicate return filing is not a sufficient basis to freeze the refund.

---

<sup>24</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 96-115; National Taxpayer Advocate 2005 Annual Report to Congress 180-191; National Taxpayer Advocate 2004 Annual Report to Congress 133-136; see also National Taxpayer Advocate FY 2008 Objectives Report to Congress 15-16, 36-40; National Taxpayer Advocate FY 2006 Objectives Report to Congress iii-3; National Taxpayer Advocate FY 2005 Objectives Report to Congress 34.

<sup>25</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 96-115.

- The IRS should eliminate Form 8453-OL from the electronic return process and make the PIN process mandatory because it will increase security, save money, and help to eliminate taxpayer burden.<sup>26</sup>
- The IRS should give identity theft victims the ability to take proactive measures such as blocking the e-filing option on their accounts.
- The IRS should create a prefix for IRSNs or some other system so that it does not deny tax benefits to the rightful owner of the SSN. While assignment of IRSNs may be the only way to isolate the fraud taking place under an SSN, it is inequitable to assign the IRSN to identity theft victims and then deny tax benefits that depend on the SSN.
- The IRS should plan an Identity Theft Summit to bring together all IRS functions that deal with identity theft issues to discuss the problems in a collaborative and comprehensive manner.

**F. Preparers Should Be Required to Mask Social Security Numbers Before Transmitting Tax Return Information Abroad**

Internal Revenue Code sections 7216 and 6713 impose criminal and civil sanctions, respectively, on preparers who, with the requisite level of intent, use or disclose tax return information, except where expressly permitted to do so by an exception provided in the statute or regulations. Pursuant to recently revised final regulations under Internal Revenue Code § 7216, preparers located in the United States will be prohibited from obtaining a taxpayer's written consent to disclose the taxpayer's Social Security Number to a return preparer located overseas as of January 1, 2009. Thus, preparers will have to redact or otherwise mask taxpayers' SSNs before disclosing tax return information outside the United States.<sup>27</sup> This provision originated from a recommendation made by the Taxpayer Advocacy Panel in order to protect taxpayers from identity theft.<sup>28</sup>

I am extremely pleased that the Treasury Department has adopted this taxpayer-friendly provision and shown leadership in combating the problem of identity theft. For an identity thief, another person's SSN is the most valuable tool he can obtain to commit financial fraud, and the SSN becomes even more valuable if it is linked to other personal data of the SSN owner, like information required to prepare a tax return. As we have discussed above, it is very difficult for a taxpayer to put the "genie back in the bottle" once his or her identity has been stolen. The difficulty is

---

<sup>26</sup> Electronic filers who do not elect to use the PIN must sign Form 8453-OL, *U.S. Individual Income Tax Declaration for an IRS Online e-file Return*, and mail it to the IRS. However, the IRS does not match Forms 8453-OL before processing the returns.

<sup>27</sup> 2008-5 I.R.B. 344 (Feb. 4, 2008). The new requirement is effective January 1, 2009 and is set forth in Treas. Reg. § 301.7216-3(b)(4), as amended.

<sup>28</sup> Letter from Larry T. Combs, Chair, Taxpayer Advocacy Panel to Commissioner Mark W. Everson, (Aug. 18, 2006).

compounded if the theft occurs overseas, where the laws of the United States do not reach. Thus, it is incumbent on tax administration to take all necessary steps to protect taxpayers' SSNs from exposure.

The structure of IRC § 7216 reflects the urgency felt by Congress to protect the taxpayer identity and tax return information. The code section starts with a broad prohibition against the preparer's using or disclosing information provided for or in connection with preparing a return. The statute then provides three specific exceptions and authorizes the Secretary to prescribe regulations permitting other exceptions.

This statutory design mirrors that of another bedrock tax statute, IRC § 6103, which governs the disclosure of tax return information by the Internal Revenue Service. As with IRC § 7216, section 6103 starts with a sweeping prohibition against the IRS's disclosing any return or return information and requires any exceptions to be specified in the Internal Revenue Code itself. The approach common to both these statutes is no accident – confidentiality of a taxpayer's return information is absolutely necessary to maintain taxpayer confidence in the tax system and to the smooth operation of the system.

I find the approach adopted by Treasury in the final regulations to be remarkably balanced. In general, taxpayers may continue to consent to the disclosure of their tax return information overseas.<sup>29</sup> The regulation merely requires preparers to "mask" in some way the SSN of taxpayers when taxpayer information is sent overseas. In striking this balance, Treasury took note of the increased risk of harm when taxpayer data is sent abroad, where the means for oversight and remedies for harm are not as available as in the United States.

These concerns were first brought to light by the Taxpayer Advocacy Panel (TAP), a congressionally chartered Federal Advisory Committee created to advise the Secretary of the Treasury, the Commissioner of Internal Revenue, and the National Taxpayer Advocate to improve taxpayer service for individual and small business taxpayers.<sup>30</sup> The TAP is composed of volunteers from all walks of life, and brings a much-needed taxpayer perspective to tax administration. In a letter written in

---

<sup>29</sup> Taxpayers may knowingly consent to the disclosure of their tax return information to an overseas preparer for a variety of valid reasons, including to obtain expertise in international tax matters, to coordinate the filing of U.S. and foreign tax returns, or to receive the benefit of lower return preparation costs in some cases.

<sup>30</sup> See Federal Advisory Committee Act, Pub. L. No. 92-463 (5 U.S.C. App.); see also Charter for the IRS Taxpayer Advocacy Panel, available at [http://fido.gov/facadatabase/docs\\_charters/5217\\_Charter\\_\(2008-03-17-08-28-02\).doc](http://fido.gov/facadatabase/docs_charters/5217_Charter_(2008-03-17-08-28-02).doc). The Taxpayer Advocacy Panel consists of approximately 100 members, with representatives from each state, the District of Columbia, and Puerto Rico. The Taxpayer Advocate Service provides funding and staffing to support the TAP. Annual reports are submitted to the Secretary of the Treasury and the Commissioner of Internal Revenue. Copies of all reports, event notices, meeting agenda and minutes, and success stories can be found on the TAP website at [www.improveirs.org](http://www.improveirs.org).

response to the IRS Commissioner's specific request for the TAP's comments, the TAP wrote:

Outsourcing also increases the potential for identity theft and gross abuse of taxpayer data without adequate safeguards.... In addition to obtaining taxpayer consent, the preparer must be required to ... [e]nsure that when client data is sent to an offshore location, personal data, such as Social Security Numbers (SSNs), date of birth, telephone number(s), and bank account information, is replaced with a combination client number or similar cross-identifier and the identifying information redacted, thus eliminating the dissemination of personal data outside the preparer's office.<sup>31</sup>

Practitioners have recently raised some legitimate administrability concerns about the redaction requirements in the new regulations, particularly with respect to the business practices of practitioners who provide tax preparation services to expatriates and other offshore taxpayers. However, I believe that these concerns can be addressed through an IRS notice or revenue procedure supplementing the regulation. None of these concerns is insurmountable, and some appear to me to be the result of an overly broad and restrictive reading of the regulation.

As sensitive as I am to practitioners' concerns, I firmly believe the SSN redaction requirement should remain intact. A taxpayer-centric approach to identity theft – such as the one the TAP urged and Treasury adopted – would protect the overwhelming majority of taxpayers while developing procedures to address the special needs of the few. The taxpayers in most need of SSN masking protection are less sophisticated taxpayers who contract with a domestic preparer, who do not expect their SSNs to be sent abroad, and who may not fully appreciate the consequences of transmitting one's data abroad. I believe a solution exists that will address preparers' concerns yet keep this important provision intact in the regulations to safeguard the majority of taxpayers from international identity theft.

Accordingly, I am not opposed to carving out narrowly targeted exceptions to the general prohibition against disclosing SSNs overseas in situations where a strong business case can be made that the benefits of allowing disclosure outweigh the increased risks of identity theft.<sup>32</sup> Further, if technology is at issue, it is always possible to extend the effective date of the relevant regulation sections to address

---

<sup>31</sup> Letter from Larry T. Combs, Chair, Taxpayer Advocacy Panel, to Mark W. Everson, Commissioner, Internal Revenue Service (Aug. 18, 2006) (on file with the Taxpayer Advocate Service).

<sup>32</sup> This "balancing" test is consistent with Treasury's longstanding approach to exceptions under IRC § 6103. See Department of the Treasury, *Report to the Congress on Scope and the Use of Taxpayer Confidentiality and Disclosure Provisions. Vol. I: Study of General Provisions* (Oct. 2000); Staff of the Joint Committee on Taxation, *Study of Present Law Taxpayer Confidentiality and Disclosure Provisions as Required by Section 3802 of the Internal Revenue Service Restructuring and Reform Act of 1998. Vol. I: Study of General Disclosure Provisions*, JCS-1-00 (Jan. 28, 2000); National Taxpayer Advocate 2003 Annual Report to Congress 232-255.

these concerns. However, I believe it would be a serious mistake to tinker with the structure of the regulation, which mirrors the Internal Revenue Code's broad protection of taxpayer data, when there are ways to address these implementation issues through supplemental guidance.

## **II. Other Significant Tax Administration Issues**

### **A. The Time Is Ripe for a Taxpayer Bill of Rights and for Related Legislation to Improve Tax Procedure<sup>33</sup>**

On July 22 of this year, we will mark the tenth anniversary of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), a landmark piece of legislation that established many significant protections for taxpayers in their dealings with the IRS. Over the last ten years, there have been many changes in the tax world – including a new batch of tax shelters, increasing identity theft, a greater ability to electronically track financial transactions, a large increase in the number of returns filed electronically, and an increased emphasis on tax law enforcement. Despite all of these changes, there has been no significant legislation in the taxpayer rights or tax procedure arena over the last ten years.

In my 2007 Annual Report to Congress, I recommend that Congress clarify taxpayer rights by creating a true “Taxpayer Bill of Rights” (TBOR). Modeled after the U.S. Constitution’s Bill of Rights, this TBOR would serve as a clear statement of the social contract between the government and its taxpayers – that taxpayers agree to report and pay the taxes they owe and the government agrees to provide the service and oversight necessary to ensure that taxpayers can and will file and pay their taxes. I believe it is in the best interest of taxpayers and tax administration for this unspoken agreement to be explicitly articulated in a formal Taxpayer Bill of Rights, which should incorporate a clear statement of taxpayer rights as well as a statement of taxpayer obligations.<sup>34</sup>

I am hopeful a Taxpayer Bill of Rights may also serve as a vehicle for more comprehensive taxpayer rights and tax procedure legislation that fills some of the gaps identified since the passage of RRA 98. In recent years, the tax-writing committees have made efforts to pass such legislation. In 2003, the Ways and Means Committee reported and the full House approved the Taxpayer Protection and IRS Accountability Act,<sup>35</sup> and in 2004, the Finance Committee and the full Senate approved the Tax Administration Good Government Act.<sup>36</sup> However, no conference committee was formed, and the bills were never enacted. In 2006, the

---

<sup>33</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 478-489 (Legislative Recommendation: Taxpayer Bill of Rights and *De Minimis* “Apology” Payments).

<sup>34</sup> For a discussion of the specific taxpayer rights and obligations, see National Taxpayer Advocate 2007 Annual Report to Congress 478-489.

<sup>35</sup> H.R. 1528, 108<sup>th</sup> Cong. (2003).

<sup>36</sup> S. 882, 108<sup>th</sup> Cong. (2004).

Senate Finance Committee tried again, approving a significant taxpayer rights and tax administration package as part of the Telephone Excise Tax Repeal Act, but it was not considered by the full Senate.<sup>37</sup>

The passage of time has only increased the need for such legislation. Among the proposals I believe should be included are the following:

- Protect the more than 60 percent of taxpayers who rely on paid tax preparers by imposing minimum standards of competence. At present, anyone can prepare federal tax returns; there are no standards at all. Preparers should be required to pass a basic competency test and take periodic Continuing Professional Education courses. Greater accuracy in return preparation will benefit both taxpayers and the IRS.
- Increase electronic filing by allowing taxpayers to prepare and file their returns electronically without having to pay a fee to private vendors. The IRS should make an e-filing template available and develop a direct filing portal. A direct filing portal will not only attract taxpayers concerned about costs but will also reassure taxpayers who have data security concerns about routing their personal tax information through third-party vendors.
- Protect low income taxpayers by regulating refund anticipation loans (RALs), especially by prohibiting cross-collection agreements.
- Reduce the burdens on partners in partnerships by advancing the initial partnership return filing deadline from April 15 to March 15. At present, partnerships generally cannot prepare Schedules K-1 on which they report each partner's income and other tax attributes until they finish preparing the full partnership return, and hundreds of thousands of partners receive their K-1s on or after April 15, requiring them to file for extensions.
- Protect low income senior citizens by exempting Social Security payments from levies or by requiring the IRS to develop and utilize an effective screen so that levies are not automatically imposed on taxpayers who are likely to suffer economic hardship.
- Simplify the "kiddie tax" computation rules.

This is not a comprehensive list of proposals that I believe should be adopted, but it represents a good start in combination with proposals included in prior legislation approved by the Finance Committee. I urge this Committee to take up the Taxpayer Bill of Rights this year.

---

<sup>37</sup> S. 1321, 109<sup>th</sup> Cong. (2006).

## **B. The IRS Should Exert a Stronger Oversight Role in the Electronic Filing Arena<sup>38</sup>**

While the IRS has made impressive progress in increasing the rate of electronic filing, it is still far from reaching the congressionally mandated goal of 80 percent.<sup>39</sup> During the 2007 filing season, almost 57 percent of all individual returns were filed electronically.<sup>40</sup> As the tax administrator, the IRS has the authority to determine the policies and criteria that entities must meet to participate in the e-file program. In important respects, however, it appears that the IRS has historically relinquished control of the electronic filing program to private industry and faces difficulty in re-asserting ownership of the program. Considering the significant benefits e-filing affords to both the IRS and taxpayers, we are pleased that the IRS is currently evaluating its role in the e-file program in order to increase the rate of e-file and to properly align its policies and procedures to meet the best interests of taxpayers and the agency itself. We encourage the IRS to consult with the National Taxpayer Advocate on this important matter, and we look forward to lending support in any manner possible.

### **1. To Fully Realize the Benefits of e-File, the IRS Should Enable All Taxpayers to Prepare Their Returns and File Directly with the IRS without Charge**

The IRS has an incentive to increase the rate of electronic filing to the highest level possible. Electronic filing of tax returns brings benefits to both taxpayers and the IRS.<sup>41</sup> From a taxpayer perspective, e-filing improves accuracy by eliminating the risk of IRS transcription errors, pre-screens returns to ensure that certain common errors are fixed before returns are accepted, and speeds the delivery of refunds. From an IRS perspective, e-filing eliminates the need for data transcribers to input

---

<sup>38</sup> See National Taxpayer Advocate 2004 Annual Report to Congress 89-109 (Most Serious Problem: Electronic Return Preparation and Filing) and 471-477 (Legislative Recommendation: Free Electronic Filing for All Taxpayers); see also National Taxpayer Advocate 2007 Annual Report to Congress 83-95 (Most Serious Problem: The Use and Disclosure of Tax Return Information by Preparers to Facilitate the Marketing of Refund Anticipation Loans and Other Products with High Abuse Potential) and 547-548 (Legislative Recommendation: Authorize Treasury to Issue Guidance Specific to Internal Revenue Code Section 6713 Regarding the Use and Disclosure of Tax Return Information by Preparers); National Taxpayer Advocate 2006 Annual Report to Congress 197-221 (Most Serious Problem: Oversight of Unenrolled Preparers); and National Taxpayer Advocate 2005 Annual Report to Congress 162-179 (Most Serious Problem: Refund Anticipation Loans: Oversight of the Industry, Cross-Collection Techniques, and Payment Alternatives).

<sup>39</sup> The IRS Restructuring and Reform Act of 1998 directed the IRS to set a goal of having 80 percent of all returns filed electronically by 2007. See Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105-206, § 2001(a)(2), 112 Stat. 685 (1998). The 80 percent e-filing goal was not achieved by 2007. However, we believe Congress should reiterate its commitment to requiring the IRS increase the e-filing rate as quickly as possible.

<sup>40</sup> IRS News Release, *IRS E-File Opens for 2008 Filing Season for Most Taxpayers*, IR-2008-5 (Jan. 10, 2008).

<sup>41</sup> See S. Rep. No. 105-174, at 39-40 (1998).

return data manually (which permits the IRS to shift resources to other areas), allows the IRS to capture return data electronically, and enables the IRS to process and review returns more quickly.<sup>42</sup>

Nearly one-third of all individual returns processed by the IRS through October 2007 – or 43 million returns – were prepared using software yet mailed in rather than submitted electronically.<sup>43</sup> These taxpayers could have e-filed their returns once they were prepared using computer software, but for some reason, the taxpayers chose to file paper returns. If the IRS successfully converts a significant portion of these taxpayers to electronic filing, it would approach, and perhaps surpass, the 80 percent e-filing goal.

I have advocated for years for the IRS to place a basic, fill-in template on its website to permit taxpayers to self-prepare their tax returns and file directly with the IRS for free.<sup>44</sup> There is no reason why taxpayers should be required to pay transaction fees to file their returns electronically. A free template and direct filing portal would address some taxpayers' cost and security concerns and would result in a greater number of e-filed tax returns. For those taxpayers who are comfortable preparing their returns without assistance, the government should provide the means for them to do so without charge. For those taxpayers who do not find a basic template sufficient and would prefer to avail themselves of the additional benefits of a sophisticated software program, they will remain free to purchase one.

During a visit to the Australian Taxation Office (ATO) last month, I had the opportunity to learn first-hand about Australia's e-file program. The ATO built e-tax, a direct filing program, completely in-house and officially launched the program in 1999. The resulting e-file (e-tax) rates are impressive.<sup>45</sup> For the 2005-2006 tax year, approximately 49 percent of all individuals who self-prepared lodged their returns through e-tax, compared to approximately 8 percent of U.S. taxpayers who self-prepared their returns using Free File for tax year 2006.<sup>46</sup> Further, only tax

---

<sup>42</sup> See IRS Fact Sheet, *2008 IRS E-File*, FS-2008-4 (Jan. 2008).

<sup>43</sup> IRS Tax Year 2006 Taxpayer Usage Study (through Oct. 26, 2007).

<sup>44</sup> See, e.g., National Taxpayer Advocate 2004 Annual Report to Congress 471-477. We have proposed that the IRS create an electronic tax return that is analogous to the paper environment, but that also incorporates the benefits of electronic technology. Specifically, the return should be fill-in, with math checking and number-transfer capability. The fill-in return should link to line-by-line IRS instructions for each form, and where the IRS instructions reference a publication, there should be active links to specific sections of the forms. Where the instructions or publications have worksheets embedded in them, these worksheets should be fill-in, with math-checking and number-transfer capability. These capabilities are important, since they will substantially reduce the number of "math error" notices the IRS must issue each year.

<sup>45</sup> Unlike Free File, e-tax is available to taxpayers at all income levels. For information on e-tax, see <http://www.ato.gov.au/corporate/content.asp?doc=/content/83847.htm&pc=001/001/001/005&mnu=&mfp=&st=&cy=1> (last visited April 7, 2008).

<sup>46</sup> Australian Taxation Office, *Taxation Statistics 2005-06*, available at [http://www.ato.gov.au/content/downloads/00117625\\_2006CH2PER.pdf](http://www.ato.gov.au/content/downloads/00117625_2006CH2PER.pdf) (last visited April 7, 2008); E-

agents (the Australian equivalent to tax return preparers) use commercial software to prepare and file returns.<sup>47</sup> It is our understanding that the IRS is currently evaluating the Australian taxation system. We hope the IRS can apply lessons learned from Australia's experience to our own e-file program, especially with regard to ATO's direct filing program, e-tax.

Recent, highly publicized phishing schemes confirm the need for the IRS to develop a free fill-in template and direct filing portal. During the 2007 filing season, for example, an Internet tax scam lured taxpayers into entering confidential tax return information on sites masquerading as Free File sites, and these taxpayers became victims of identity theft.<sup>48</sup> It is understandable that some potential Free File users fall victim to scams, especially when taxpayers wishing to prepare their returns pursuant to an IRS sanctioned program visit the official IRS website only to be directed to one of 19 potentially unfamiliar commercial websites. *All taxpayers* should have the option to prepare and file their federal income tax returns *on* the IRS's own website.<sup>49</sup> Although Free File is accessible *through* the official IRS website, not all taxpayers are eligible to use the program. Approximately 30 percent of individual taxpayers – which amounts to more than 40 million taxpayers – are ineligible for IRS Free File.<sup>50</sup> Moreover, the IRS exerts little control over the content of each Free File program. As a consequence, each of the programs has its own eligibility requirements, capabilities and limitations, and the complexity is confusing to taxpayers.

Despite the IRS's best efforts, some paper filers will refuse to convert to e-file. For those cases, the IRS should develop 2-D bar code technology, which would provide

---

Gov, *IRS Free File Performance Measures - Summary View*, available at <http://www.whitehouse.gov/omb/egov/c-7-3-irs.html> (last visited April 7, 2008).

<sup>47</sup> Tax agents are regulated by the statutorily created Tax Agent Boards located in every state. For more information on the relationship between tax agents and tax administration in Australia, see <http://www.ato.gov.au/corporate/content.asp?doc=/content/66215.htm> (last visited March 27, 2008).

<sup>48</sup> See IRS News Release, *Late Tax Scam Discovered; Free File Users Reminded to Use IRS.gov*, IR-2007-87 (April 13, 2007). The IRS is also aware of several phishing schemes during the 2008 filing season. See IRS News Release, *IRS Warns of New E-Mail and Telephone Scams Using the IRS Name; Advance Payment Scams Starting*, IR-2008-11 (Jan. 30, 2008).

<sup>49</sup> Congress contemplated the IRS developing a basic electronic template in the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (1998). The RRA 98 conference report states that "the conferees also intend that the IRS should continue to offer and improve its Telefile program and make available a comparable program on the Internet." H.R. Rep. No. 105-599, at 235 (1998) (Conf. Rep.).

<sup>50</sup> Taxpayers must have adjusted gross income of \$54,000 or less to be eligible. See IRS Fact Sheet, *2008 IRS E-File*, FS-2008-4 (Jan. 2008); Free Online Electronic Tax Filing Agreement Amendment (2005), available at [http://www.irs.gov/pub/irs-efile/free\\_file\\_agreement.pdf](http://www.irs.gov/pub/irs-efile/free_file_agreement.pdf) (last visited on April 7, 2008). Ironically, some members of the Free File Alliance provided free services to 100% of taxpayers under the initial term of the Free File Agreement and wanted to continue to do so, but the Treasury Department agreed with the Free File Alliance to place a cap on the number of taxpayers who would qualify for free tax preparation and filing services. As a consequence, Free File members are now *restricted* in the number of taxpayers to whom they may offer their services.

taxpayers and the IRS with many of the same benefits as electronic filing.<sup>51</sup> It is my understanding that the IRS has already incorporated this technology into other functions.

Pursuant to an Appropriations directive, the IRS Office of Electronic Tax Administration and Refundable Credits (ETA) is developing a comprehensive strategic plan to meet the 80 percent e-file goal.<sup>52</sup> ETA has commissioned MITRE to conduct the Advancing E-File Study, and we are pleased that the study will determine or review the following items:

- The characteristics of paper and e-filers as well as potential barriers to e-file;
- The current third-party model of tax administration and current trends in state and foreign governments; and
- Potential strategies to increase the rate of e-file or any other means to receive return information electronically. This will entail a review of direct filing with the IRS, 2-D bar coding, and Telefile.<sup>53</sup>

I believe this study represents an important first step in the government's fulfilling its core responsibility to taxpayers in a secure and straightforward fashion, without competing with the private sector. The Appropriations directive states that this strategic plan should be developed in consultation with me and other stakeholders, and I look forward to continuing to work with the IRS on this study.

## **2. The IRS Should Assert Control over its e-File Policies so that They Serve the Best Interests of Taxpayers and Tax Administration**

Currently, the IRS relies completely on private industry to develop and update tax return preparation and filing software. Furthermore, when the industry encounters a problem or determines that a certain software programming update is not feasible or

---

<sup>51</sup> To utilize 2-D bar code technology, a taxpayer or preparer uses software to complete the return. Once printed, the return has a horizontal and vertical bar code containing tax return information. The IRS scans the return, captures the data, decodes it, and processes the return as if it had been sent electronically.

<sup>52</sup> Staff of H. Comm. on Appropriations, 110<sup>th</sup> Cong., H.R. 2764, Consolidated Appropriations Act, 2008, Pub. L. 110-161, Explanatory Statement at 871 (Comm. Print 2007); Staff of H. Comm. on Appropriations, 110<sup>th</sup> Cong., Financial Services and Government Appropriations Bill, 2008, at 28 (Comm. Print July 2007). Although the deadline for submission of the study was March 1, 2008, the IRS Office of Electronic Tax Administration and Refundable Credits has faced considerable challenges during the current filing season, and it is planning to complete the study later this year.

<sup>53</sup> Information Provided by Electronic Tax Administration (Jan. 30, 2008); Diane Freda, *IRS to Study Direct Filing Portal, 2-D Bar Coding to Boost E-Filing*, BNA Daily Tax Report (Jan. 29, 2008); MITRE IRS FFRDC, Center for Enterprise Modernization, *IRS Advancing E-File Study: Draft Overview of Findings to Date* (Jan. 31, 2008) (on file with the Office of the Taxpayer Advocate).

cost-effective, taxpayers and the IRS are left to deal with the downstream consequences.

The consequences of the IRS's sole reliance on the e-file industry for electronic return preparation are illustrated by a recent issue involving the economic stimulus package. Eligibility for a 2008 economic stimulus payment is based on information reported on an individual's 2007 filed income tax return. Therefore, low income taxpayers who are not typically required to file a return pursuant to IRC § 6012(a) will need to file a 2007 return in order to receive the economic stimulus payment. However, the IRS e-file systems are not programmed to accept returns reporting zero adjusted gross income (AGI). To address this limitation, the IRS quickly developed a solution that permits eligible individuals to enter \$1 in AGI, without the threat of compliance-related consequences, for the sole purpose of effectuating the electronic filing of the return.<sup>54</sup> Yet this solution requires a certain amount of cooperation among commercial software providers due to the requisite prompts the software would need to provide the user.

The IRS has a small degree of control over Free File participants' products, but it cannot force Free File or any other software vendors to make last-minute programming changes of this nature. As of March 25, 2008, the IRS Free File webpage indicated that only five of the 19 Free File participants had accommodated the \$1 work-around solution, having reprogrammed their software to alert taxpayers to this issue and directing affected taxpayers to print out step-by-step instructions to report the \$1 AGI item.<sup>55</sup> While the IRS Free File page will seek to guide affected taxpayers to use those products that support the \$1 work-around, we are concerned about the level of confusion that inevitably ensues when taxpayers without a sophisticated understanding of these issues seek to navigate the Free File site. We are also concerned about the confusion and frustration that taxpayers who do not use the Free File site encounters when they unwittingly purchase software products that do not support the \$1 work-around.

The economic stimulus package as well as other late-year tax legislation presented potentially unprecedented challenges for all parties involved. The IRS was called upon to make mid-filing season systems programming changes on very short notice and managed to resolve the issues in a timely manner. At the same time, many software companies struggled to reprogram their products to accommodate the changes required by all of the late legislation. The rationale for the government's initial decision to enter into Free File and refrain from providing e-filing products itself was largely that the private sector is more innovative, nimbler, and better able to serve taxpayer needs than the IRS. However, the IRS has demonstrated this year that it *also* has the ability to rise to the occasion and meet enormous challenges on a moment's notice.

---

<sup>54</sup> See IRS Notice 2008-28, 2008-10 I.R.B. 546; Rev. Proc. 2008-21, 2008-12 I.R.B. 657.

<sup>55</sup> See <http://www.irs.gov/efile/lists/0,,id=179739,00.html> (last visited Mar. 25, 2008).

The 2007 filing season provided an additional example of the IRS's reactive role in the e-file arena and the resulting impact on tax administration. Taxpayers using Intuit Inc. tax return preparation and filing software products (Lacerte, ProSeries, and TurboTax) during the 2007 filing season experienced filing problems at the eleventh hour. Specifically, a significant number of taxpayers attempting to file returns through Intuit were unable to do so on April 17 (the standard April 15 deadline was extended because of a weekend and holiday) because of a slowdown in the company's electronic filing server. As a result, the IRS granted these taxpayers a two-day filing extension and agreed not to impose late-filing penalties. While the IRS and Intuit worked quickly to minimize the impact on these taxpayers, many of them still experienced unnecessary frustration and anxiety. It would be understandable if some of the affected taxpayers revert back to paper filing in 2008 – while continuing to use software to prepare their returns – after such a negative experience with the e-file process in 2007.<sup>56</sup>

Finally, it has come to my attention that a nonprofit-operated free return preparation and filing product faced initial opposition to its request for a listing on the IRS official website as a Free File program participant or, alternatively, as an IRS e-file partner that provides both free preparation and free filing services. The program I-CAN! E-FILE is run by the Legal Aid Society of Orange County, California (LASOC), which also happens to operate a Low Income Taxpayer Clinic (LITC).<sup>57</sup> The initial denial of a listing on the IRS website placed I-CAN! E-FILE in a difficult position and potentially harmed taxpayers who stand to benefit from the product, because the IRS has actively warned taxpayers about phishing schemes and informed them that the only real way to avoid becoming a victim of a potential scam is to access an e-file product through the official IRS website. Free File denied LASOC membership on two grounds: (1) membership is limited to commercial software companies, and (2) the Alliance developed its software using federal funds received through the Legal Services Corporation, a nonprofit corporation, and through the LITC grant program (which the organization vigorously disputes).<sup>58</sup> The IRS initially stated that

---

<sup>56</sup> Intuit Press Release, *Intuit Apologizes to Lacerte, ProSeries and TurboTax Customers* (Apr. 19, 2007).

<sup>57</sup> I-CAN! E-FILE can be used to prepare and file federal and state returns of low income taxpayers who lived and worked in one of the following states: California, Michigan, New York, Pennsylvania or Montana. The program can also add the Permanent Fund Dividend to federal returns of Alaska residents. For the 2006 tax year, the program returned more than \$18,370,000 in tax refunds to 13,438 low-income taxpayers. Letter from Robert J. Cohen, Executive Director, Legal Aid Society of Orange County, to David R. Williams, Director, Electronic Tax Administration and Refundable Credits (Jan. 18, 2008) (on file with the Taxpayer Advocate Service); Letter from Robert J. Cohen, Executive Director, Legal Aid Society of Orange County, to Tim Hugo, Free File Alliance (Aug. 3, 2007) (on file with the Taxpayer Advocate Service). For more information about this product, see <http://www.icanefile.org>.

<sup>58</sup> E-mail from Robert J. Cohen, Executive Director, Legal Aid Society of Orange County, to Taxpayer Advocate Service (Feb. 29, 2008) (on file with the Taxpayer Advocate Service).

the LASOC product cannot be listed as an IRS e-file partner if the corresponding description advertises both free preparation and free filing services.<sup>59</sup>

When a seemingly reputable program run by a nonprofit organization has trouble obtaining a listing on the IRS website as either a Free File participant or an e-file partner merely because it is run by a nonprofit organization and wants to advertise free preparation *and* filing services in its listing description, I am concerned that the IRS's electronic filing policies have gone astray.<sup>60</sup> These determinations are presumably made to further the IRS e-file program, yet they do not reflect the best interests of taxpayers and do not seem to be grounded in any legitimate tax administration purpose.

I believe that the IRS should take a more proactive role in the electronic filing arena by setting the policies and standards for participation in the IRS e-file program. Such policies and procedures should align with the needs of both taxpayers and tax administration. All high quality return preparation and filing products should have equal access to the market, reflect the latest tax law changes, and be compatible with filing season peaks in demand as well as IRS's computer and processing needs. Moreover, all programs should meet IRS established minimum standards for data and identity security, and these standards should apply to both for-profit and free tax preparation offerings.<sup>61</sup> Unless the IRS takes corrective action, the IRS remains in a reactive position at the whim of private industry and is forced to devote scarce resources to address the downstream consequences of potentially avoidable problems. We are encouraged that the IRS is currently evaluating its role in the e-file program as part of the Advancing E-File Study and look forward to lending support to the study as well as to receiving periodic briefings of research findings as the study progresses.

---

<sup>59</sup> Letter from Robert J. Cohen, Executive Director, Legal Aid Society of Orange County, to David R. Williams, Director, Electronic Tax Administration and Refundable Credits (Jan. 18, 2008) (on file with the Taxpayer Advocate Service); e-mail from Robert J. Cohen, Executive Director, Legal Aid Society of Orange County, to Taxpayer Advocate Service (Mar. 5, 2008).

<sup>60</sup> It should be noted that exempt organizations electronically file Form 990-N, or e-postcards, for free through the Urban Institute. See <http://epostcard.form990.org>. In addition, the Urban Institute is listed as a Form 990 e-file partner with a description clearly identifying free e-file and free preparation services at <http://www.irs.gov/efile/lists/0,,id=119598,00.html>.

<sup>61</sup> At the time of this writing, it is not clear how many of the programs listed on the IRS e-file partner webpage would meet IRS-developed data or identity security specifications.