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“Real Time Tax System Initiative”

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Thank you for the opportunity to contribute to this panel discussion on a topic which is critical to the future of tax administration. We believe that the Real Time Tax System Initiative has the potential to substantially decrease improper payments, reduce the tax gap, and ease taxpayer burden associated with tax compliance and enforcement.

The timing is right for this initiative. The Internal Revenue Service is putting modernized systems in place that allow for real time processing and data analytics. Notwithstanding, the implementation of this vision presents enormous challenges. Given the complexity of the tax code and the quantity of data that the IRS receives, it will be an intricate process to achieve the goals of this initiative. In Fiscal Year 2010, the IRS received over 2.6 billion information returns. This will further increase with the new merchant card reporting requirements.

The focus of the IRS presentation on this initiative relates primarily to the Automated Underreporter Program and the analysis of income reporting documents such as W-2 statements and Forms 1099. While moving this process to an earlier date could reduce taxpayer burden, an even greater benefit to the taxpayer and the IRS would result if the IRS could provide immediate feedback during the process of transmitting the return, in much the same way the IRS provides error-reject information to taxpayers who file electronically for many conditions such as incorrect Social Security numbers or missing forms. This would help eliminate the need for notices, including soft notices. With such a process, the taxpayer could simply add the correct income information or provide an explanation for the difference and resubmit the return electronically.

As the IRS notes, it will be a substantial challenge to change the timing of the receipt of information needed to perform real time verification. In addition to obtaining the data earlier, the IRS will also need to have processes in place to enable it to make use of the data more promptly. To this end, wage and withholding data are a top priority to help identify fraudulent tax returns and combat identity theft. In September 2010, we recommended that the IRS develop a process to expedite the availability of wage and withholding information received from the Social Security Administration.¹ The IRS agreed and has initiated a pilot project to accelerate its access to this wage data. It is also working with the Social Security Administration to analyze the costs and

¹ TIGTA, Ref. No. 2010-40-129, *Expanded Access to Wage and Withholding Information Can Improve Identification of Fraudulent Tax Returns* (September 2010).

benefits of accelerated transfer, perfection and integration of this data into IRS systems.

Furthermore, both the Department of the Treasury and TIGTA have recommended legislation to expand IRS access to wage information available through the National Directory of New Hires for the purposes of tax administration.² Currently the use of such information is limited by law to just those tax returns with a claim for the Earned Income Tax Credit. Expansion of the availability of such data would not only help the IRS identify fraudulent returns up front, but would also help the IRS use its resources more effectively. For example, some staff time is currently spent on screening tax returns that turn out to have reported valid wages. This time could be used for other compliance efforts.

In addition to obtaining and making use of third-party information earlier in the process, we believe the IRS should assess whether the third-party information is useful for verifying information on tax returns and whether it is requesting enough information from the taxpayer to help facilitate a match with the third-party information.

A recent example relates to Section 6050W of the Internal Revenue Code, which requires payment settlement entities to report payments made to merchants in settlement of payment card transactions. We found that the redesign of Tax Year 2011 income tax forms did not appear to facilitate a direct match between sales reported on *Merchant Card and Third Party Network Payments*, Form 1099-K, and amounts reported on tax returns.³ The design did not provide the IRS the gross and the net merchant card sales, *i.e.* net of cash back. The gross amount would be needed to match the sales information to the 1099-K and the net amount would be needed to calculate income. Based on our finding, the IRS made adjustments to the tax forms to allow the capture and match of the needed information.

Another area we believe illustrates this issue is education credits. *American Opportunity and Lifetime Learning Credits*, Form 8863, requests only one entry for qualified expenses. It does not distinguish between tuition and related expenses. Because related expenses may not be reflected on Form 1098-T and because the educational institutions can report either the amounts billed or the amounts paid to the institution, the information on Form 1098-T and Form 8863 cannot be matched. As such, the IRS did not use Form 1098-T to validate claims for education credits.

Not using this information document to validate claims turned out to be significant. In September 2011, we reported that 1.7 million taxpayers received

² The National Directory of New Hires is a national repository of wage and employment information maintained by the U.S Department of Health and Human Services. It contains quarterly wage information submitted by Federal agencies and State workforce agencies.

³ TIGTA, Ref. No. 2011-40-065, *Plans for the Implementation of Merchant Card Reporting Could Result in Burden for Taxpayers and Problems for the Internal Revenue Service* (July 2011).

\$2.57 billion in education credits⁴ (\$10.3 billion over 4 years) that appear to be erroneous because there was no associated *Tuition Statement*, Form 1098-T, in the IRS's files to validate that the student attended a qualifying educational institution.⁵ The timing of the submission of these forms is not conducive to matching during return processing. Forms 1098-T are required to be provided to students by the beginning of February each year, and to the IRS by the beginning of March (for paper Forms 1098-T) and by the end of March (for electronic Forms 1098-T). Access to the Forms 1098-T at the time tax returns are processed would help the IRS to identify potentially erroneous education claims. Furthermore, revising the Form 8863 to require a taxpayer to provide identifying information for the educational institution, such as their Employer Identification Number, would also help to determine whether the student attended a qualifying institution that for some reason did not submit a Form 1098-T.

To the extent possible, the IRS should design the Real Time Tax System Initiative to verify credits and deductions. However, for many credits and deductions, there is no third party information that can be used to definitively determine taxpayer eligibility. For example, the credit which results in the highest amount of improper payments, the Earned Income Tax Credit, in many cases cannot be adjusted without an examination. The IRS can use third party data via its Dependent Database to identify claims that have a high probability of being improper. Nonetheless, it does not have the resources to audit all of these claims.

For those refundable credit claims that the IRS cannot verify with a reasonable degree of certainty using third party data, we have recommended that the IRS require documentation to verify eligibility. The IRS has taken this action for two refundable credits, namely the First-Time Homebuyer Credit and the Adoption Credit. We believe the IRS should take this action for other refundable credits as well, to the extent practicable. Previously, requesting specific documentation required taxpayers to file a paper tax return. However, with the IRS's replacement of its existing e-file system with its new modernized, Internet-based e-file system, taxpayers will have the ability to provide supplemental information with their tax return, allowing them to participate in electronic filing.

Thank you again for the opportunity to share TIGTA's views on this initiative and on the importance of the use of third-party information at the time tax returns are processed for the purpose of improving tax administration. We will focus on any issues we identify during audit work that will further assist the IRS as it moves forward with the Real Time Tax System initiative.

⁴ Based on tax returns for Tax Year 2009 received and processed as of May 28, 2010.

⁵ TIGTA, Ref. No. 2011-41-083, *Billions of Dollars in Education Credits Appear to Be Erroneous* (September 2011).