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IRS FILING SYSTEMS VULNERABLE TO TAX REFUND FRAUD

Y 4. W 36: 103-52

IRS Filing Systems Vulnerable to Ta...

HEARING BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES ONE HUNDRED THIRD CONGRESS

SECOND SESSION

FEBRUARY 10, 1994

Serial 103-52

Printed for the use of the Committee on Ways and Means



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ISBN 0-16-044068-8

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IRS FILING SYSTEMS VULNERABLE TO TAX REFUND FRAUD

THURSDAY, FEBRUARY 10, 1994

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met, pursuant to call, at 10 a.m., in room B-318, Rayburn House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
MONDAY, JANUARY 31, 1994

PRESS RELEASE #19
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1135 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN,
SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A HEARING ON TAX REFUND FRAUD

The Honorable J. J. Pickle (D., Texas), Chairman, Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a hearing on Internal Revenue Service (IRS) efforts to identify and prevent tax refund fraud, particularly with regard to electronically filed returns. The hearing will be held on Thursday, February 10, 1994, beginning at 10:00 a.m., in room B-318 Rayburn House Office Building. IRS Commissioner Margaret Milner Richardson and individuals involved in tax refund schemes will appear as witnesses at the hearing.

In announcing the hearing, Chairman Pickle stated, "IRS continues to be challenged by taxpayer schemes to defraud the tax system for refunds that they are not entitled to. Each year, individuals and tax preparers are becoming more sophisticated in devising ways to cheat the system. While IRS is taking steps to detect fraud, the agency also, to a large degree, is playing "catch-up."

"The Subcommittee needs to assess what IRS is doing up-front to prevent tax refund fraud and what actions are being taken against parties who defraud the tax system. While criminal action against abusers is important, tax refund fraud is not an issue that can be 'prosecuted away.' IRS must be more diligent in implementing procedures to eliminate fraud before refunds are issued. Further, with IRS's goal of having 80 million taxpayers file electronically by year 2000, the agency must deal with this type of growing fraud now, before it's too late. Electronic-filing fraud is a serious enforcement problem for IRS because of the speed with which electronically filed returns are processed and refunds issued."

BACKGROUND:

In 1993, IRS identified about twice as many paper and electronic tax returns involving fraudulent refund claims than were identified in 1992. IRS detected approximately 36,000 fraudulent refund claims on paper returns involving about \$61 million in refunds, and about 25,000 fraudulent refund claims made through electronically filed returns involving about \$53 million in refunds. In 1992, IRS identified about 12,000 fraudulent refund claims on paper returns involving about \$33 million in refunds, and about 15,000 fraudulent refund claims made through electronically filed returns involving about \$34 million in refunds.

In 1993, IRS was able to stop payment of only 86 percent of the \$61 million in fraudulent refunds claimed on paper returns, and only 54 percent of the \$53 million in fraudulent refunds claimed on electronically filed returns. As a result, IRS lost at least \$33 million due to refund fraud. Furthermore, IRS has no way of assessing whether the agency is catching all, most, or only a small amount of tax refund fraud.

In 1994, IRS plans to use a variety of existing and new procedures to detect fraud involving both paper and electronically filed returns. IRS will continue to use: computer criteria to screen potentially fraudulent refund claims; the box known as the "funny box" for flagging paper returns filed at the Service Center that look suspicious; and checks in the electronic filing program such as rejecting returns with invalid Social

(MORE)

Security numbers rejecting returns from first-time filers, and delaying issuance of refunds for certain "high-risk" returns. In addition, several new concepts will be used by IRS, such as: artificial intelligence to detect broad-reaching and sometimes national refund fraud schemes, and "tiger teams," which are groups of IRS experts responsible for developing possible fraud schemes and testing IRS's systems to insure the schemes are detected.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Persons submitting written comments for the printed record of the hearing should submit six (6) copies by the close of business, Wednesday, March 2, 1994, to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D.C. 20515.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

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Chairman PICKLE. We will ask the subcommittee to please come to order and also ask our guests to please take their seats.

I have an opening statement and Mr. Houghton has an opening statement and other members of the committee, as they arrive, may also, but we have a reasonably lengthy session today and we want to get with it.

Today the subcommittee will examine the vulnerability of IRS's filing system to tax refund fraud and what the IRS is doing to address this fraud. The Oversight subcommittee has long been concerned that the IRS is being ripped-off by criminals taking advantage of weaknesses in the IRS' filing system.

In 1991, subcommittee members personally visited the IRS' Questionable Refund Fraud Team at the Memphis Service Center. At that time, we reviewed IRS' process for identifying and prosecuting tax refund fraud, and urged the IRS to do more and tell us what we could do to help. This problem, particularly in the area of EITC, was brought to our attention by members of the Memphis Service Center, who said there was a serious fraud problem involved here.

Over the past several years, the subcommittee has commissioned the U.S. General Accounting Office to review IRS' tax refund fraud problem for which reports were issued to this subcommittee in May 1989 and in December 1993. In both instances, GAO warned us that close attention should be given to tax refund fraud and recommended improvements to IRS' systems. Some of these recommendations have been implemented by the IRS.

Most recently, the subcommittee reviewed several internal IRS reports prepared in 1993 by the IRS Office of Internal Audit and an individual under contract. That is the report of an individual under contract with IRS concerning IRS' fraud detection efforts. I think we will all agree that tax refund fraud is not a new phenomenon nor is it likely to disappear overnight or disappear altogether. However, it is critical that the public know: (1) whether the IRS clearly knows and understands the scope, magnitude and nature of the problem; (2) whether the IRS has a comprehensive fraud control program in place; and (3) whether the IRS is able to effectively adjust its fraud controls as the world changes to quickly deal with criminals' continuing efforts to circumvent the traps.

In my judgment, the IRS has almost perfected the art of using its computers to give out tax refunds quickly without making a corresponding effort in the area of fraud controls. It seems that to some degree the IRS is speeding down the highway at night with its headlights off hoping to avoid oncoming traffic. Perhaps the IRS needs to pull into a rest stop and pull out a map.

The IRS Commissioner today will present detailed testimony concerning the IRS' recent efforts to deal with tax refund fraud and IRS' future plans to be more aggressive. I applaud her for leading the agency in the right direction and commitment to addressing this problem. At the same time, as a result of the subcommittee's investigation and review of IRS reports leading up to this hearing, I have concluded that the situation is worse than originally thought.

The fact of the matter is that fraud exists and it is a serious problem. It is not my intent today to use this hearing to expose

specific IRS weaknesses or to provide a road map for would be crooks. Rather, my goal is to make sure that the IRS is in full gear in stopping fraud, that it is accountable to the public, and where IRS is unable to act because of resources or other restraints, to tell the Congress so that we can act and help.

The tax return filing program is not a Federal Government program that comes and goes depending on priorities of the administration. The tax return filing system is here to stay and affects the pocketbook of every American. Consequently, when it falls short, I think we should know about it.

In conclusion, I expect that the IRS Commissioner will tell it all at today's hearing and in doing so, I believe together we can quickly address any remaining system vulnerabilities during the 1994 filing season and aggressively chart out and implement additional safeguards for the filing seasons to come.

I will ask Mr. Houghton if he wants to make an opening statement.

Mr. HOUGHTON. Thank you, Mr. Chairman. I join you in opening our hearing on the income tax fraud issue. I appreciate your doing it. It is timely and I believe it is important that we understand what is going on, in the light of the IRS statistics and the increase in fraudulent income tax refunds.

The question for us is why is this happening? It seems to me there are two basic issues. One is the refundable nature of the earned income tax credit, and the second is the expansion of electronic filing. We are here to find out. We are here to probe. I hope we will shine a light on something which is of great concern to most American citizens. Thank you.

Chairman PICKLE. Thank you, Mr. Houghton.

Now, we have two witnesses to begin with. One is Frazier B. Todd, Jr. and the other is Barry Becht. Do you gentlemen—first, I want to swear you in as a procedure that the committee always does.

[Witnesses sworn.]

Chairman PICKLE. Let the record show that the witnesses have said, yes.

Do either of you gentlemen want to make an opening statement about your participation in this program or do you want us just to ask questions?

Mr. BECHT. I have an opening statement I have prepared here.

Chairman PICKLE. All right. Do you have a statement to make also, Mr. Todd?

Mr. TODD. Yes, sir, I do.

Mr. BECHT. Good morning.

Chairman PICKLE. Mr. Jefferson, do you have an opening statement?

Mr. JEFFERSON. No, sir.

TESTIMONY OF BARRY BECHT

Mr. BECHT. Good morning, Hon. Chairman Pickle, and members of the Subcommittee on Oversight. It is an honor and a privilege to be able to speak before you on tax refund schemes.

My name is Barry Becht, a Federal inmate, serving an 18-month sentence at Seymour Johnson, a minimum security Federal prison

camp in Goldsboro, N.C. I am charged with aiding and assisting in the preparation of false Federal income tax returns from the eastern district of Virginia in the Alexandria Federal Courthouse.

I have been incarcerated for 7 months, since July 1993, and my release date is scheduled for August of this year. I am 36 years old. I have been married for 10 years with four daughters, ages 8 to 1½ years old. Prior to my incarceration, I have resided in Falls Church, Va. I have considerable experience in all phases of accounting and taxation.

I have generated payroll taxes, issued W-2s, filed W-4s, 940s, 941s, sales tax returns and fixed asset schedules with depreciation. I have had 2 years of college courses primarily in accounting, business and Federal taxation. I have also taken the advanced income tax preparation course offered by the H&R Block Tax Training School.

I began preparing income taxes for friends and relatives of my wife, who is Vietnamese, within the metro D.C. area. Through word of mouth, our business opened in 1987 as T&B Tax Services in Arlington, Va. I felt that I was using my God-given talents in math and working with figures helping these clients get a tax refund.

I charged tax fees based on the forms that I used. The average fee per return was around \$50. In the beginning, I prepared their returns based on information they supplied. However, many clients had not retained receipts. As the business grew and through the clients' greed, as well as my wanting to keep their business, I began inflating deductions, overstating expenses and getting the clients more of a refund than they had a legal right to receive.

I had only a very small percentage of audits, so I continued doing returns this way, from the IRS. I realized the seriousness of my actions when in September 1990 there was a search and seizure done on my office to take all the records out and essentially close the business. I knew that I had made a big mistake in my life for which I am deeply sorry. I thought I was helping clients with their taxes, but I caused hundreds of clients a financial tax burden, and I caused great embarrassment for my wife and family within the community, as well as having a husband and father away in prison.

I also caused the IRS headaches and for all I have done I am deeply sorry and ask forgiveness for that.

Mr. Chairman, I have spent 7 long, difficult months in prison, another 2½ years under investigation from the IRS, and I have tried to think of ways to improve myself. Then, this opportunity came up to assist and perhaps prevent tax fraud schemes. And I feel I can be valuable to help deter preparers from going through what I have.

If tax preparers and individuals know that they will be criminally prosecuted and that they will be detected up front for devising these tax fraud schemes, then we can begin to eliminate the tax refund fraud. There is much work to do as there are so many schemes developed over the years and dangerously so for electronic returns.

I personally have signed and prepared over 4,000 tax returns from 1987 to 1990. Through the 2-year investigation of the IRS, they sampled 475 returns, of which 472 were fraudulent with a tax

deficiency of right around \$750,000. This is what I have personally done and that is what I have been charged with in my case. They found this on concluding the investigation in June 1992. That means refunds were issued to my clients and that those returns passed through their computer criteria and what they call the "funny box" for suspicious or conspicuous fraud.

Briefly, those returns passed because of so many different areas used to reduce tax liabilities, child and dependent care, moving expenses, employee business expenses, rental and common loss, charitable contributions, depreciation, business use of the home, other taxes paid, medical expenses, all of these areas received some attention but spread out so the computer red flag on criteria was able to be passed.

Amended returns I did were done similarly, but only selected areas were explained and used, child care, employee business expenses, Schedule C for self-employment, business expenses, especially depreciation and Section 179 expense. There has to be an implementation to look at supplemental forms within the tax return much more carefully. Schedule C, Schedule E for rental, rental losses claimed through abuses of expenses many times are totally fabricated. Schedule Ks for corporations; that is an extremely abused area to be able to write off personal losses, to be able to transfer those to the taxpayer.

Form 2106, employee business expenses is greatly exaggerated and unsupported without proper records. Form 2441, child and dependent care. Even though they have changed the laws to include the name, address and Social Security number of the recipient, it is still an area that is abused.

Schedule A for itemized deductions, charitable contributions, miscellaneous deductions. These forms have various schemes and I am identifying the problems and the solutions have to come from more selective computer criteria and these "tiger teams" that was mentioned in the press release of experts, to be able to test the system against these schemes.

Mr. Chairman and subcommittee members, in concluding, I would very much like to be a part of this team because it will be a team effort. Of course, as you know I am still incarcerated in prison, on the last 6 months of my sentence. If the remainder of my sentence could be under a home confinement arrangement, I could devote these months to community service. I would devote my time with proper supervision in helping to develop detection of tax refund fraud schemes.

I am here to cooperate and answer any questions that you may have, and I thank you, Mr. Chairman and subcommittee members.

Chairman PICKLE. Thank you for a very forthright statement and it will be a helpful statement, I think, to all of us.

I have some questions, but let me ask, Mr. Todd, do you have a statement to make?

Mr. TODD. Yes, I do.

Chairman PICKLE. Is it a relatively brief statement?

Mr. TODD. Yes.

Chairman PICKLE. Go ahead.

TESTIMONY OF FRAZIER B. TODD, JR.

Mr. TODD. Good morning, Mr. Chairman and members of the Subcommittee on Oversight. My name is Frazier Todd, Jr. I am 35 years of age, divorced, with four children and my home is Atlanta, Ga. I have been incarcerated since April 1, 1992, for the charges of conspiracy to file false claims with the Government.

These charges involved a fraudulent tax refund scheme with electronically filed returns. I was sentenced to 30 months incarceration followed by a period of 3 years supervised release. I am presently serving my sentence at Federal Prison Camp Seymour Johnson, located in Goldsboro, N.C.

I was originally scheduled to be released on February 3, 1994, which was last week, to serve the last 4 months of my sentence in a halfway house, but due to overcrowding of halfway houses my incarceration has been prolonged an additional 2 months and I am now scheduled to be released April 4 of this year to serve the last 2 months of my sentence at a halfway house.

I attended high school in San Francisco, graduated from Woodrow Wilson. I attended the Computer Learning Center and received a computer operations certificate in San Francisco. I moved to Atlanta, Ga., in 1983 and attended Massey Business College and received an associate degree in business administration and later attended St. Leo's College located on the Army Base at Fort McPherson in Atlanta, Ga., and completed my bachelor of science degree there in 1988.

I worked for a CPA firm in Atlanta during the summer months in 1985 and 1986 while attending college. I opened Todd & Associates in 1988 and maintained an office in Atlanta, Ga., for the purposes of providing accounting and tax services.

I remained self-employed up until the time my business was shut down August 16, 1991 by the IRS Criminal Investigation Division pending an investigation of fraudulent activities involving the electronic filing of false income tax returns through that business. The conduct of the scheme involved the recruiting of real persons to provide me with their real names and their correct Social Security numbers.

Criteria for selecting these people recruited were individuals who did not work or were not required to file returns, individuals who were not in default of student loans guaranteed by the U.S. Government, and individuals without child support obligations, individuals without tax liabilities from any previous year. Most of the people recruited for this scheme were women, primarily in low-income housing projects because in most cases, they qualified with the aforementioned criteria.

After an individual was recruited, a wage and tax statement form W-2 was prepared using that individual's real name and correct Social Security number on the W-2 form. The W-2 form would also reflect information with respect to that individual's supposed employment.

Fictitious employer names and addresses were used with real employer identification numbers obtained from the IRS by completing the Form SS-4 application for employer identification number. These employer identification numbers are easy to obtain through the Paperwork Reduction Act. The IRS has a provision whereby

new employer identification numbers can be issued and obtained over the telephone in less than 5 minutes.

The information on the W-2 forms was used to prepare the income tax return and complete the Form 8453 and also complete the refund anticipation loan application. These documents were used to electronically transmit the returns to the Internal Revenue Service.

I want to thank you for this opportunity to testify and I will be happy to answer any questions that you may have. Thank you, Mr. Chairman.

Chairman PICKLE. I thank you also, Mr. Todd, for a very frank statement analysis of how you proceeded. I am sure other members will have a lot of questions.

Let me ask a few questions. Are either of you, are you a CPA? Did you study to be a CPA, Mr. Becht?

Mr. BECHT. No. I took 2 years of college in primarily business and accounting courses.

Chairman PICKLE. Mr. Todd, you did essentially the same thing?

Mr. TODD. Yes.

Chairman PICKLE. When you applied to become an ERO, an electronic refund return, you applied to the IRS?

Mr. BECHT. I am not an electronic—I did not even enroll as a tax preparer.

Chairman PICKLE. Did you have a tax preparer? Did you work through a tax preparer?

Mr. BECHT. I am a tax preparer, but I didn't need to apply for any tax preparer—

Chairman PICKLE. Did you fill out some kind of a form?

Mr. BECHT. No. I filled out 1040s and signed as the preparer of tax returns. That is all that is necessary in the system.

Mr. TODD. I was an ERO, an electronic return originator.

Chairman PICKLE. You were an ERO?

Mr. TODD. Yes.

Chairman PICKLE. Did you apply to IRS?

Mr. TODD. Yes. I completed the application and then there was a suitability check performed and after that—

Chairman PICKLE. By IRS?

Mr. TODD. Yes.

Chairman PICKLE. And you had an office and did they visit you in your office or did they just write you—

Mr. TODD. They wrote me. They didn't visit me. They wrote me and sent me the information that I would need to get online with their commuter system to transmit the returns electronically.

Chairman PICKLE. I think it should be observed that both of you were apprehended, I assume, through the detective or surveillance work of IRS and they caught you?

Mr. BECHT. Yes.

Chairman PICKLE. It ought to be shown that IRS did identify you and now you are in prison so it is not that they are not effective at all or you wouldn't be here now.

Essentially, Mr. Becht you have listed 15 or 20 things that—

Mr. BECHT. There are more.

Chairman PICKLE. That can be puffed up or cut back or changed or altered, and you just did them at random and nobody questioned

you. You filed these returns and the Government paid out some \$750,000?

Mr. BECHT. That was identified in the statement of facts.

Chairman PICKLE. It could have been more, but at least \$750,000?

Mr. BECHT. Yes.

Chairman PICKLE. Was that over a period of 1 year or 2 years?

Mr. BECHT. Between 1987 and 1990. They might have attempted this, but they didn't begin their investigation or conclude the investigation until 1992.

Chairman PICKLE. Can you tell me how you found people? Mr. Todd said he recruited people to file. Did you go out and find these people?

Mr. TODD. Yes, I did.

Chairman PICKLE. How did you find them?

Mr. TODD. Well, I had a person that I hired to select these individuals for me. I gave that individual the criteria that I wanted when he selected the people.

Chairman PICKLE. Who was he? Who was the person you hired to find these people?

Mr. TODD. It was a person who—

Chairman PICKLE. Mr. Todd, I don't want to try to identify the people and have the IRS go after them. You don't have to mention the name.

Mr. TODD. I hired an individual.

Chairman PICKLE. He went down to where poor people lived and he just selected them?

Mr. TODD. Yes.

Chairman PICKLE. And he submitted to you the names. Did you pay him so much?

Mr. TODD. There was a finder's fee.

Chairman PICKLE. In turn, did you pay the people who got the return back? Did you charge them?

Mr. TODD. Well, when the refund check was prepared, the check was payable to that individual.

Chairman PICKLE. Yes.

Mr. TODD. So the check was given to them and they would cash the check and bring my portion—

Chairman PICKLE. And what was your portion?

Mr. TODD. Half of it.

Chairman PICKLE. Mr. Becht, was yours approximately the same thing?

Mr. BECHT. No. I charged by what forms I used and the average fee for a Federal return was \$50. What forms I used was used to base the fees on.

Chairman PICKLE. You did not make them split the check?

Mr. BECHT. I did not take any part of the refund. I charged a percentage. I charged a finder's fee of \$10 to bring in a new client, although that became a headache to keep track of.

Chairman PICKLE. Did the people that gave you the names, did they know this was going to be a fraudulent claim?

Mr. TODD. Yes.

Chairman PICKLE. They would have to be told if they were getting money for nothing?

Mr. TODD. Yes.

Chairman PICKLE. So all those people in one way or another participated in the fraud? That has to be generally understood.

Now, I am going to yield to Mr. Houghton, but Mr. Todd, you said that you would have them fill out a SS-4; is that correct? What is the Form SS-4?

Mr. TODD. The SS-4 is a form that is an application for employer identification number.

Chairman PICKLE. That is all that is required, you said easy to obtain and you could get approval within 5 minutes because of the Government regulations on the Paper Reduction Act?

Mr. TODD. Yes.

Chairman PICKLE. In 5 minutes you could get clearance on it?

Mr. TODD. Yes.

Chairman PICKLE. Mr. Houghton.

Mr. HOUGHTON. Thank you very much. Thank you, gentlemen, for being here. I appreciate your being willing to come here.

As far as I am concerned there are two issues. How big is the problem of tax fraud and what do we do to stop it? Mr. Todd, I would like to ask you the first question, how big is it? Let me give you numbers.

Last year, to the best of my knowledge, the IRS detected about 60 plus thousand individuals who filed fraudulent returns and that amounted to \$115 million. Although you can't necessarily relate to those figures, how big is this thing? Is it bigger than we think it is?

Mr. TODD. I think it is, yes.

Mr. HOUGHTON. Can you break that down a little bit?

Mr. TODD. I think that the IRS is probably detecting maybe 25 percent of the fraud taking place with electronic filing.

Mr. HOUGHTON. Are there particular areas that the IRS should go to look at, people similar to you, or are there other means for fraud?

Mr. TODD. Well, I think a primary way for them to begin to get to the bottom of the problem is to introduce new concepts. Looking over the material, I mentioned the use of tiger teams, which is composed of IRS experts who would develop possible fraud schemes and test them with the IRS to see if they were detected by whatever check system that they have.

I think that this type of team would be a good way for them to approach it. However, I believe that if they were to use individuals who had experience in actually doing these types of schemes to assist them or work along with them, it would help them to—

Mr. HOUGHTON. So you say 25 percent. That is just out of your mind. It could be 10, it could be 50, is that right; or you just feel they are only getting a small portion?

Mr. TODD. I feel that we are only getting a small portion.

Mr. HOUGHTON. Mr. Becht, everything we do in a democracy is based upon trust.

Mr. BECHT. Yes.

Mr. HOUGHTON. You mentioned the fact that if people knew that they would be criminally prosecuted, then this would eliminate the tax refund fraud. Do you really believe that?

Mr. BECHT. If they know that they will be deterred up front and they know——

Mr. HOUGHTON. Didn't you know that you would be——

Mr. BECHT. Criminally prosecuted, no.

Mr. HOUGHTON. You thought this was a good way of doing business?

Mr. BECHT. A small percentage of my returns had been audited through the IRS. I felt that was a formal course of doing business.

Mr. HOUGHTON. I assume that when you fudge a return, that goes all the way back to Al Capone; it is obvious you will get in trouble.

Mr. BECHT. Yes, you should.

Mr. HOUGHTON. So it is not only the fact that they know, but there is evidence of people being incarcerated; is that right?

Mr. BECHT. Yes. The idea would be for tax preparers, if they could oversee them better. I am not an enrolled tax preparer with the IRS. I can go ahead and sign someone's return. Anyone in this room could sign another person's tax return as information supplied to them to the best of their knowledge and sign a return as a preparer.

Mr. HOUGHTON. Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Jefferson.

Mr. JEFFERSON. Thank you, Mr. Chairman. Mr. Todd or Mr. Becht—Mr. Becht said he didn't think he was going to be detected. Did you have any fear of detection, Mr. Todd?

Mr. TODD. No, I didn't.

Mr. JEFFERSON. Why is that?

Mr. TODD. I don't think that the IRS detected the system. I believe that it was—they were tipped off by a confidential informant. I believe that if they never would have gotten the confidential informants or anyone to—if they hadn't been tipped off, I don't believe that it would have been detected.

Mr. JEFFERSON. It wouldn't have been caught by the system itself?

Mr. TODD. Yes.

Mr. JEFFERSON. Someone from the outside tipped them off?

Mr. TODD. Yes.

Mr. JEFFERSON. I suppose when you got involved with this you operated on the assumption that you wouldn't be detected so it was a good enterprise, as far as you were concerned, to make money. How much money did you make in this enterprise?

Mr. TODD. Pursuant to the plea agreement, \$511,000.

Mr. JEFFERSON. \$511,000.

Mr. TODD. Yes.

Mr. JEFFERSON. Over what period of time?

Mr. TODD. Over a period of 2 years.

Mr. JEFFERSON. Were you ever audited on these returns? Did you ever have to explain to the Service what was happening with any of these returns?

Mr. TODD. No.

Mr. JEFFERSON. You never did. So it is possible that there are people out there now who are doing exactly what you were doing and as far as you know they operate without detection because the system doesn't pick them up?

Mr. TODD. Yes.

Mr. JEFFERSON. I think Mr. Houghton asked you this, but in your particular case, when you were dealing with this electronic filing, what could the IRS have done to detect what you were doing earlier?

Mr. TODD. I don't know what they could have done to detect it up front. One small suggestion, perhaps, would be to put more stringent requirements on authorizing the employer identification numbers without making it possible for those numbers to be obtained within 5 minutes over the telephone. That is one step.

Mr. JEFFERSON. It was necessary to have this fraudulent employer in order for the scheme to work. That was an essential part of the scheme, right?

Mr. TODD. Yes.

Mr. JEFFERSON. How many different employer ID numbers did you have to use to make this thing work over 2 years?

Mr. TODD. Well, it is hard to say. You can do this type of thing with 10 employer ID numbers or you can do it with 50 employer ID numbers. It would depend on how comfortable a person felt or how safe he wanted to be.

In other words, what I am saying, if an individual doing something like this, if he felt that maybe an employer identification number with more than 20 employees would give a red flag, then he might cut it off at that point and get a new employer ID number to run—to do other people under that particular employer.

Mr. JEFFERSON. So you would incorporate these entities or were they corporations or partnerships or something else?

Mr. TODD. Combinations of proprietorships, partnerships and corporations.

Mr. JEFFERSON. And you filed income tax returns for these entities as well to make this thing operate?

Mr. TODD. Well, no.

Mr. JEFFERSON. You did not?

Mr. TODD. These companies did not physically exist. They had no physical location. These companies that were used in the employer section were purely fictitious. However, the employer identification number was a real number that can be used in the electronic system of the Internal Revenue Service.

Mr. JEFFERSON. I understand that. I guess my question is, is there an employer identification number which is real, but which exists for a fictitious taxpayer or tax-paying entity.

Mr. TODD. Yes.

Mr. JEFFERSON. This tax-paying entity, however, did not file a return itself. You did not file a return for it?

Mr. TODD. Correct.

Mr. JEFFERSON. You simply filed a W-2 form for an employee of that company?

Mr. TODD. Yes.

Mr. JEFFERSON. The system doesn't pick up the fact that the employer never filed a tax return?

Mr. TODD. Well, when an employer identification number is obtained in that method over the telephone, if an application SS-4 form is not received within 10 to 14 days, I believe, then the employer identification number will go off the system. So, in other

words, the employer ID number would be good for at least 10 days and if it went off the system after that, then I don't think there is any method to prompt IRS to even look for an income tax return from that employer.

Mr. JEFFERSON. Did you ever use some real employer numbers?

Mr. TODD. Occasionally, yes.

Mr. JEFFERSON. But your primary practice was to use fictitious employer numbers?

Mr. TODD. Yes.

Mr. JEFFERSON. One other question, Mr. Chairman. Is there a network of folks who talk about this sort of thing—did you work with anybody else, talk to anybody else about developing these schemes? Is there some kind of a regular way that this gets developed or was it something of your own creation?

Mr. TODD. I didn't network with anyone or talk about developing this with anyone. It is just an idea that came up.

Mr. JEFFERSON. I don't have any other questions, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Jefferson. It came up—what motivated you to get into this thing? Was it easy money? Are others out there doing the same thing?

Mr. TODD. I saw an opportunity, I saw it as—I saw an opening and I tried something and it worked. But there was no—nobody else who I had observed doing it where I got an idea from.

Chairman PICKLE. You got involved in this and I assume you have examined it and said it was easy and I want to go after it. Are people in the accounting field generally saying this is an easy way to get quick money? Do they talk about it?

Mr. TODD. Not to my knowledge. I have never heard anyone talk about it.

Chairman PICKLE. Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

You indicated in previous testimony that you had realized about \$511,000 over a 2-year period. I am assuming that when these checks came back that your clients brought you cash money; is that correct?

Mr. TODD. That is correct.

Mr. HANCOCK. In other words, you didn't file any type of an income tax return?

Mr. TODD. I didn't.

Mr. HANCOCK. You are serving time for fraud for the scheme or for failure to file?

Mr. TODD. Could you ask your previous question? You said I didn't file an income tax return. I didn't quite understand that.

Mr. HANCOCK. You realized \$511,000. Did you file an income tax return on that \$511,000?

Mr. TODD. No, I didn't.

Mr. HANCOCK. So my question is, are you incarcerated now as a result of the fraud under the scheme that you put together or are you serving time for failure to file?

Mr. TODD. No. I am serving time as a result of the scheme.

Mr. HANCOCK. You have never been charged with failure to file an income tax return?

Mr. TODD. No, I haven't.

Mr. HANCOCK. There are all kinds of billboard type schemes now on the computers that people can get into—for instance, credit card fraud, telephone usage, long distance telephone calls. Is there any possibility of any type—or is there a possibility that similar type things are being billboarded now through computer networks? Have you heard of anything going on like that?

Mr. TODD. I have never heard of anything like that going on, but I believe that it is very possible that it can exist.

Mr. HANCOCK. It wouldn't be very difficult to do?

Mr. TODD. No.

Mr. HANCOCK. If somebody would attempt to pattern themselves after you, but say they are not quite as entrepreneurial as you were in the amount of money and only decided to pick up an extra \$25,000 a year, it would be extremely difficult to detect that?

Mr. TODD. Yes.

Mr. HANCOCK. In other words, if there were a lot of people out there that said I only want to pick up extra money, not get rich, pick up \$10,000 or \$15,000, just file half a dozen fraudulent tax returns. But you have to get a number to file an electronic return; isn't that correct?

Mr. TODD. To be a return originator, yes. In other words, to offer that service to other individuals, then you have to have an electronic filer identification number.

Mr. HANCOCK. How do you go about getting that number?

Mr. TODD. You apply for it through filling out, completing an application to the Internal Revenue Service and passing the suitability check.

Mr. HANCOCK. In other words, they are supposed to investigate what you put on there?

Mr. TODD. Yes.

Mr. HANCOCK. Is there any bonding requirement?

Mr. TODD. No, there isn't.

Mr. HANCOCK. What would happen if when you filled out the return you were required to put up a \$100,000 bond, what would happen?

Mr. TODD. If you were required to pay \$100,000—

Mr. HANCOCK. To buy, say, a \$10,000 bond similar to what you have to buy if you become a notary public. Just to get a notary public in most States, you have to buy or post a \$10,000 bond.

Mr. TODD. To get the electronic filer number?

Mr. HANCOCK. Yes.

Mr. TODD. That might help a little. It might eliminate people who are not in business, who just saw an opportunity to get into this type of scheme to earn money. I think it would eliminate those.

Mr. HANCOCK. When you first started in this scheme, would you have been in a position to have bought a \$50,000 bond through some insurance bonding company? I don't know what your financial background is, but if in fact you had made an application for, say, a \$25,000 bond would you have been able to obtain that bond, do you think?

Mr. TODD. I would have given serious consideration to obtaining it.

Mr. HANCOCK. You think you would have qualified to be able to get the bonds?

Mr. TODD. Yes.

Mr. HANCOCK. Would you say there is a lot of people that might consider doing what you were doing that might be unable to get a bond?

Mr. TODD. It is two sides to it. If a person was, an individual was in business, in the tax preparation business, he would probably spend the money necessary to do what he had to do to make money.

On the other hand, an individual not in business, but just considering getting into the scheme, he might not make that investment.

Mr. HANCOCK. Mr. Becht, I understand that you completed about 4,000 returns?

Mr. BECHT. Yes, over 4,000.

Mr. HANCOCK. You were just charging people \$50 to complete a return?

Mr. BECHT. That is an average based on the forms that I used, yes.

Mr. HANCOCK. You put the forms together—

Mr. BECHT. Yes.

Mr. HANCOCK. And added and subtracted so people would get the refunds they said they might want?

Mr. BECHT. Yes.

Mr. HANCOCK. I understand that after you were detected, they investigated and checked 472 returns, you said 472 and IRS said 475?

Mr. BECHT. They had 33 returns listed in the charges that I was charged with and as a relevant conduct, they also had 432 returns that they sampled, audited, of which 439 of those additional to the 33 listed in the charges also had a tax deficiency of over \$700,000.

In addition to the first three listed in the charges, that adds up to over \$750,000 charges of tax deficiency.

Mr. HANCOCK. What happened to the other 90 percent?

Mr. BECHT. They said that virtually all of my returns had refunds. In fact, the percentage they gave was 98 percent.

Mr. HANCOCK. Would you say that virtually all were misrepresentations, that they were fraudulent?

Mr. BECHT. Virtually, all of them—in the plea agreement, which you have a copy of, that virtually all, 98 percent had refunds. They did not go on to say that all were fraudulent and all were not fraudulent, but there was a good percentage as sampled by the 442 that they picked up.

Mr. HANCOCK. What percentage would you say of the total were actually—

Mr. BECHT. Fraudulent. There is a good number.

Mr. HANCOCK. Give me a figure; 75 percent?

Mr. BECHT. Not that many.

Mr. HANCOCK. Fifty percent?

Mr. BECHT. I would go with half.

Mr. HANCOCK. I understand that if I sign the return that I am the one that is in trouble if it is fraudulent, not necessarily the person who prepares it. Do you know what happened to the ones that

they didn't investigate? You say there is \$711,000. Do you know whether any action was taken on that?

Mr. BECHT. I believe that because of what I did, I created a tax burden for them. I believe that they had to then pay tax back that they owed.

Mr. HANCOCK. The ones that they came back and audited?

Mr. BECHT. Yes.

Mr. HANCOCK. But you don't know whether they audited all of them or part of them or 20 percent—

Mr. BECHT. As of June 1992, they had concluded their investigation and of those sampled, those were the numbers that were given to me. I don't know what they have done since or if they have audited more than that, but all of my clients did receive refunds, with the exception of a few; but like I say, I did over 4,000 returns and I also noted—in a question earlier you asked Mr. Todd what percentage do you think they were able to detect, and just based on the returns that one preparer did, me, based on the number of returns that I did and looking at the figures that were listed for 1992 and 1993, in 17—I believe there is a figure issued of 12.3 million of electronic returns that were submitted, and of those 25,000 were detected as fraudulent.

When you do the math on that, that is less than 0.2 percent. In other words, 2 out of 1,000 returns that were submitted electronically were detected as fraudulent. To me that is extremely small.

Mr. HANCOCK. That is true.

Chairman PICKLE. We will come back. I want to recognize other members.

Mr. Brewster.

Mr. BREWSTER. Thank you, Mr. Chairman.

Mr. Becht, did your clients themselves know that you were inflating things to make a fraudulent return?

Mr. BECHT. Some did, some did not.

Mr. BREWSTER. So some of your clients didn't know that the returns were fraudulent but only thought that you were legally able to get them back more money than another preparer could?

Mr. BECHT. Yes. That is why they came to me. They came through word of mouth because they knew I was doing this kind of work, getting back the refund, and many did not have knowledge of the tax laws so they relied on my expertise to be able to get the best refund that they could get.

Mr. BREWSTER. Your main advertising, then, was that you had a very satisfied customer because he felt he was legitimately getting back more than another preparer would have gotten for him, so he told his friends to come to you?

Mr. BECHT. That is right.

Mr. BREWSTER. Some also did know it was fraudulent and participated in the program?

Mr. BECHT. As well as myself, they wanted to have more. As one year got to the next year and I had done them previously, they would say can you get me back as much as I got last year or can you do better than that? There was pressure there, as well, from the clients, but it is mostly my fault and I take the blame for doing something that I should not have done.

Mr. BREWSTER. You operated a pretty cheap advertising scheme, didn't you?

Mr. BECHT. Yes.

Mr. BREWSTER. You only operated with paper products; is that right?

Mr. BECHT. Yes.

Mr. BREWSTER. You did nothing electronically?

Mr. BECHT. No. But those schemes done electronically are easier to do than paper. With respect to SS-4s and sham companies set up, there is a problem there.

Mr. BREWSTER. Mr. Todd, how long were you involved in preparing electronic claims before you decided to see if you could do the fraudulent claims, or did you go into that to start with?

Mr. TODD. I was preparing them electronically for maybe one month before I decided to try it.

Mr. BREWSTER. Then after you tried and saw that you got by with the first one or two, then more followed?

Mr. TODD. Yes.

Mr. BREWSTER. And you were operating principally in Atlanta to start with; is that correct?

Mr. TODD. That is correct.

Mr. BREWSTER. You feel that you were detected not by something the IRS did, but from a tip by a confidential informant?

Mr. TODD. That is correct.

Mr. BREWSTER. After you were detected in Atlanta, what did you do then; did you cease and desist?

Mr. TODD. No, I didn't. In January—the IRS did a search and seizure, put my business out of operation on August 16, 1991. In January 1992, I traveled to the city of Baltimore and employed the services of an ERO to transmit by electronic transmission income tax returns prepared on people who were recruited similar to the way they were recruited in Atlanta, Ga.

Mr. BREWSTER. You were using an ERO in Atlanta as well; right?

Mr. TODD. No, I was an ERO in Atlanta.

Mr. BREWSTER. But in Baltimore you utilized someone else that was an ERO?

Mr. TODD. Yes.

Mr. BREWSTER. You were in Baltimore how long?

Mr. TODD. Off and on going back and forth 6 to 8 weeks.

Mr. BREWSTER. Then somebody tipped the IRS to the fact that you were in Baltimore and filing fraudulent claims so you moved to Cincinnati from there?

Mr. TODD. I moved to Cincinnati.

Mr. BREWSTER. Was there a reason for going to Cincinnati or did you just decide you liked the climate there better?

Mr. TODD. I just decided to move to an area outside of Baltimore.

Mr. BREWSTER. How did you operate in Cincinnati?

Mr. TODD. In Cincinnati I employed the services of another electronic return originator to transmit the returns electronically for me.

Mr. BREWSTER. Did they know what you were doing, that it was fraudulent?

Mr. TODD. No, they didn't.

Mr. BREWSTER. In either case, in Baltimore or Cincinnati?

Mr. TODD. Not in either case, they didn't know.

Mr. BREWSTER. The refunds, did you vary who they were sent to—I take it you had a person, that your finder's fee person found a legitimate person that you filed the claim for and when the refund came back they were to give you half the money.

Did you have any of them not give you your half?

Mr. TODD. When I would employ an ERO it was with the understanding that I was new in town and I prepared income tax returns, but I didn't have a way to transmit them electronically, and as a result of that I was losing business to H&R Block and I needed a way to offer customers the rapid refunds.

Mr. BREWSTER. The rapid refund check though; did it go to the customer?

Mr. TODD. No; it came to me because of the agreement that I had with the ERO.

Mr. BREWSTER. The next thing—did you utilize the RAL system as far as the money was concerned?

Mr. TODD. Yes. The refund anticipation loan, yes. That makes it possible for the check to be received within 24 to 48 hours.

Mr. BREWSTER. I happen to believe the RAL system is a legitimate business and very useful for a lot of Americans. In your particular case, were you going in yourself and getting the refund anticipation loan or were you utilizing your person that you filed the claim on?

Mr. TODD. In Atlanta, I had an agreement with Beneficial Bank through my company, and the checks were printed for my office after being authorized by the IRS and Beneficial Bank.

Mr. BREWSTER. Thank you.

Chairman PICKLE. Thank you.

Now, the Chair recognizes Mr. Lewis, and I hope we can keep our questions limited. We have the Commissioner of the Internal Revenue Service here and the GAO and I want to get to them.

Mr. Lewis.

Mr. LEWIS. Thank you very much, Mr. Chairman. Mr. Chairman, I am sorry that I was late arriving due to another meeting.

Mr. TODD, could you tell me where your business was located in Atlanta?

Mr. TODD. On Forsythe Street.

Mr. LEWIS. What is the address?

Mr. TODD. 157 Forsythe.

Mr. LEWIS. That is on the corner of what street—what is the nearest corner?

Mr. TODD. I can't think of the name of the street right now at that intersection—it is opposite the end of the Martin Luther King train station.

Mr. LEWIS. So you had in Atlanta, at 157 Forsythe Street, you had a ready available audience of low-income people because of the transportation site?

Mr. TODD. True, yes.

Mr. LEWIS. And you recruited people from the public housing projects, Bowen Homes and Martin Street Plaza and Techwood-Clark, several public housing projects?

Mr. TODD. Yes.

Mr. LEWIS. What about Perry Homes?

Mr. TODD. And Perry Homes, too.

Mr. LEWIS. So you really preyed on low-income and poor people in Atlanta?

Mr. TODD. Well, I wouldn't say preyed. The people were selected because they easily fit the criteria in such a way that the refund check would not be intercepted by the IRS.

Mr. LEWIS. Do you know what happened to the people who gave you their Social Security number, their ID number—what happened to these people? Did the IRS bring charges against them?

Mr. TODD. No. None of those people were charged.

Mr. LEWIS. Did the IRS, to the best of your knowledge, to the best of your information and knowledge, ever retrieve any of the money?

Mr. TODD. Not to the best of my knowledge. I am not aware if they did or not.

Mr. LEWIS. What do you plan to do—you are now being detained, right?

Mr. TODD. Yes.

Mr. LEWIS. You are going to be released soon?

Mr. TODD. Yes. As I stated earlier, I was originally supposed to be released on February 3, which was last week, but the halfway houses were overcrowded, so I will be released April 4.

Mr. LEWIS. You plan to go back to Atlanta?

Mr. TODD. Yes.

Mr. LEWIS. Do you plan to open another business on Forsythe Street?

Mr. TODD. No.

Mr. LEWIS. What type of business do you plan to go into?

Mr. TODD. I am uncertain what type of business I will be in. However, I would welcome the opportunity to work with the tiger team that the IRS is in the process of developing to develop possible fraud schemes and help detect them.

Mr. LEWIS. So you are going to become a consultant for the IRS—are you going to be paid by the IRS, too, as a highly paid consultant?

Mr. TODD. That is what I would like to do, yes.

Mr. LEWIS. Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman.

Mr. Becht, how did the IRS discover—

Mr. BECHT. There was an undercover agent that came to the office in the summer of 1990 and I did a tax return, two tax returns for this person. One was an 1989 return and one was an 1988 amended return. He came in with two W-2s which were fake. That was a set-up operation by the IRS and I overstated and fabricated Schedule A altogether to get him to receive a refund. In fact, if I had not done anything, if he had filed a short form, he would have had to pay back \$184, I believe. It was set up that way.

What I did was I set up deductions and that way he was able to receive a refund. That led to the search and seizure then in September 1990.

Mr. HERGER. Thank you, Mr. Becht.

Mr. Todd, if you were doing this over again, what would you have done differently? You felt there were, I believe, informers; is that how you feel you were caught?

Mr. TODD. Yes.

Mr. HERGER. Is there anything you would have done differently? Is there anything we should be aware of that you might—

Mr. TODD. In some cases—

Mr. HERGER. Are there some suggestions you have for us on how we might prevent this from happening again?

Mr. TODD. Yes, that would be—one ready suggestion that I would recommend is to have—to eliminate a person being able to obtain an employer identification number within 5 minutes over the telephone.

Mr. HERGER. Within 5 minutes over the telephone?

Mr. TODD. Yes.

Mr. HERGER. Thank you.

Chairman PICKLE. Mr. Hancock, one additional question.

Mr. HANCOCK. Since I get just one, I have to pick the most important one.

Mr. Becht, you went through a whole litany of various forms that you used, you falsified, and what have you.

Mr. BECHT. Yes.

Mr. HANCOCK. Would you state that if in fact, and I know better than to throw this word out, that if the Income Tax Code was simplified, that it would go a long ways toward preventing people from doing what you were able to do? If we could get it down to where the average Ph.D. could understand the Income Tax Code, do you think that would help us in our problem of collecting the revenue?

Mr. BECHT. Yes. Definitely.

Mr. HANCOCK. Thank you. I am really glad that the Commissioner was here. Thank you.

Chairman PICKLE. Thank you. I want to thank both you witnesses again. We may be back in touch with you. But we appreciate your testimony and we are not happy about what we have heard because it appears that it is very easy to file and get these quick refunds.

I am not going to go further, but we do appreciate your testimony and thank you for attending.

Mr. BECHT. Thank you, Mr. Chairman.

Chairman PICKLE. Now, we will have the next panel please come forward. We just had a vote called. I am going to ask the next panel to take their place at the witness table, Ms. Richardson, and the GAO people and we will stand in recess and go vote and ask the members to come back immediately please.

[Recess.]

Chairman PICKLE. The subcommittee will come to order.

Our next panel consists of Hon. Margaret Milner Richardson, Commissioner of the IRS, accompanied by Michael Dolan, Deputy Commissioner, and Ted Brown, who is the Refund Fraud Executive.

We also have Jennie S. Stathis, Director of Tax Policy for GAO and David Attianese, who is the Assistant Director of Tax Policy, GAO. I am going to, in accordance with our procedure, give the oath to all of you.

[Witnesses sworn.]

Chairman PICKLE. The record should show you all indicated in the affirmative.

I want to proceed because I know we are running at a slower pace than we want. We have valuable testimony to be heard from Ms. Richardson and from the GAO.

Ms. Richardson.

TESTIMONY OF HON. MARGARET MILNER RICHARDSON, COMMISSIONER, INTERNAL REVENUE SERVICE, ACCOMPANIED BY MICHAEL DOLAN, DEPUTY COMMISSIONER; AND TED F. BROWN, REFUND FRAUD EXECUTIVE (FORMERLY, ASSISTANT REGIONAL COMMISSIONER, CRIMINAL INVESTIGATIONS, CENTRAL REGION)

Ms. RICHARDSON. Mr. Chairman and distinguished members of the subcommittee, as you know, Mike Dolan, the deputy commissioner, is here with me today, also Ted Brown our refund fraud executive, formerly the assistant regional commissioner of criminal investigation in our Central Region and Gary Bell, our chief inspector.

We appreciate the opportunity to be here today to discuss the IRS efforts to detect and prevent fraudulent refund claims. The IRS is committed to detecting and preventing attempts to undermine our tax system of voluntary compliance by those who are unwilling to comply with the tax laws. Our goal is to maintain a balanced enforcement program that ensures compliance among all groups of taxpayers.

Today, we would like to share with you our current activities and long-term strategies for addressing tax refund fraud—one element of tax fraud. This is a very timely topic, as you noted earlier, since the 1994 filing season has just gotten underway.

Even though we are only 6 weeks into the filing season and have processed 6.9 million personal income tax returns, we have already detected approximately 200 schemes involving approximately 3,000 attempts to file fraudulent claims on returns. I would like to assure the subcommittee that we are aggressively pursuing these cases.

We have already suspended several unscrupulous return preparers from the electronic system. We have initiated numerous criminal investigations, and we have executed search warrants to obtain evidence. While it is early to state any trends that are developing, we have confirmed that the fraud artists are continuing to design schemes to bypass new “filters” added for this year.

By way of background, Mr. Chairman, for a number of years the IRS has addressed tax refund fraud through its Questionable Refund Program, which began formally in 1977. The program was conducted in each of the 10 service centers where teams of trained personnel reviewed pre-refund tax returns which had been selected manually or based on computer criteria.

Generally, these claims involved individuals who tried to file more than one return by using another person’s Social Security number or by simply creating a Social Security number and other fictitious supporting documents. In response to a number of factors and emerging trends, we recognize the need to refocus our efforts to better prevent fraud and detect fraud.

Our efforts from 1990 through 1993 resulted in significantly more fraud being identified and stopped. Although we are still finding the "traditional" and I put that in quotes, refund fraud schemes, a number of new schemes have also been identified.

Many of those involve perpetrators who set up pyramid schemes whereby they recruit individuals to file false claims. I think you have heard about some here today.

There are also a significant number of schemes involving a few unscrupulous return preparers and electronic return originators, the EROs discussed earlier, who are responsible for filing many false claims. Based on our internal reviews assessing the vulnerability of our systems—and we have, as you know, reported through the FMFIA process as a material weakness in 1992 and 1993 to Congress—and based on analysis by GAO at the behest of this subcommittee, we have designed a new multifunctional approach to control refund fraud.

In designing this approach, we recognize the need to enhance our processing system safeguards for both paper and electronically filed returns. At the same time, we have sought to balance our fraud prevention efforts with our overall responsibilities to process returns, payments and refunds in a timely and efficient manner.

Our fraud reduction strategy encompasses the understanding of fraud as well as prevention, detection and enforcement. Before detailing that strategy, though, I would like to talk briefly about the extent of refund fraud.

In any fraud control situation, the statistics most readily available to management have limited value because they are taken from existing fraud detection operations and obviously do not include undetected fraud. Although the level of detected fraud has increased, it is uncertain how much is attributable to increased fraud attempts and how much to better detection capabilities.

Without more sophisticated forms of analysis, which are difficult and expensive to do with our current systems, our efforts to measure overall fraud lack some precision. Our current statistical indicators such as the volume of fraudulent claims detected, the corresponding dollar value, and the volume of fraudulent refunds stopped, assist in determining the gross nature of the problem. However, as our expertise increases, we also know there are a variety of other hallmarks of fraud that must be evaluated as part of our overall strategy.

Even before I was confirmed as Commissioner, based on what was happening during last filing season, I recognized the need to step up our efforts to detect and ultimately prevent refund fraud. I responded in two significant ways. First, by engaging the services of Los Alamos National Laboratory, and second, by asking Ted Brown to spearhead a dramatically new approach to how the Service should prevent and detect fraud.

Ted has 21 years of experience in our criminal investigation function and a strong background in fraud detection. He is a senior executive and I mentioned he was serving as the assistant regional commissioner for criminal investigation when I selected him for the job. Prior to that, he had served as an assistant district director in New Orleans and the chief of the Criminal Investigation Division in Dallas.

In his new role, Ted has responsibility for developing and overseeing all of IRS' efforts to detect and prevent not only refund fraud but also all filing fraud. Under Mr. Brown's direction, in order to ascertain the extent of fraud, we have initiated three studies this filing season to analyze internal and external factors to determine the totality of refund fraud.

The first study is already underway and it involves selecting and reviewing a statistically valid sample of about a thousand returns filed electronically during the month of January to help us identify specific elements of refund fraud. IRS employees are contacting taxpayers who file the selected returns and validating the information on the returns.

Our second study involves selecting a moderately large statistically valid sample of returns that are transmitted by EROs to determine the extent of fraud perpetrated by them.

In the third phase of our study, we will be selecting and reviewing a large statistically valid sample of refund returns that are filed throughout the filing season. Included will be returns filed electronically and on paper. Field work for this last effort will begin early this spring.

The findings of these three studies, when combined with other filing season data, should enable us to better identify the extent of fraud, including the accuracy of return information, and to pinpoint types of abuses or errors. Since our concerns go beyond merely prosecuting refund fraud, we recognize that our fraud reduction strategy must cross our traditional functional lines.

Our strategy has four components and it is going to use our new technology and our multifunctional resources to understand fraud, to prevent fraud, to detect fraud, and to use enforcement tools wherever necessary. As the experts will tell you, financial fraud control, whether in the public or the private sector, is dynamic; it is not static. Fraud control is directed against those who think creatively and adapt continuously, who relish devising complex strategies and who have no single profile.

This means that a set of fraud controls which is perfectly satisfactory today may be of no use tomorrow. Maintaining effective fraud controls demands continuous assessment of emerging trends and constant revision of controls.

Most of the more sophisticated financial fraud schemes are devised by persons who are skilled in computer programs and techniques. They assume the existence of transaction level filters and therefore they design their fraud schemes so that the returns for whatever the transaction is can pass through the system unchallenged.

The individuals who devise such schemes seem to accept the constraints imposed by the system. The smarter ones test the system from time to time to make sure they roughly understand the parameters being used and then they may increasingly generate multiple transactions and incorporate sufficient randomness or variation to minimize the risk of detection. It is very important, and I think all of us here today should remember, that fraud claim attempts are not unique to the IRS.

For instance, the banking, credit card, telephone and health insurance industries, as well as other Federal, State and local gov-

ernment agencies are victims of individual and organized group attempts to fraudulently obtain payments or services.

Prevention is a critical element of our strategy. Although detection and prosecution are important, we have no illusion that we can prosecute every instance of fraud. Recognizing this, we will continue to build higher barriers to fraud so that the IRS is viewed by criminals as an unattractive target.

Our goal is to make our system impregnable, to stop fraudulent returns from entering it. We are instituting short and long-term systemic changes that would prevent fraudulent returns from entering our systems. Other prevention measures include an outreach and publicity program.

For instance, at the same time we increase our publicity efforts to educate taxpayers and practitioners about the benefits of electronic filing, we have a responsibility to make the public, including the practitioner and ERO communities, aware of the need to combat fraud. We believe that the vast majority of taxpayers, tax practitioners and even EROs are interested in maintaining the integrity of our tax system.

They recognize their responsibility to prepare, file or transmit correct information to the IRS, and we appreciate their efforts in working with us. However, we want to make it very clear that when we identify those unscrupulous taxpayers, practitioners, and EROs who are committing fraud, we intend to pursue criminal enforcement to the fullest extent.

In order to better our fraud prevention techniques, my staff and I are in complete agreement that we must also have a very strong detection component to our fraud reduction strategy. To that end, we are improving our current screening and detection systems with the use of more sophisticated and automated techniques.

I have long recognized and valued seeking expert advice to address problems. Toward that end, I have explored seeking experts to assist us with all of our fraud concerns. Key members of my staff and I visited Los Alamos National Laboratory last spring to explore how the creative use of the laboratory's artificial intelligence capability could assist us in detecting refund fraud. The laboratory's 7,500 employees have a reputation for applying world class scientific and technical talent to the solution of problems of national importance.

Their greatest strength as it applies to issues of concern to the IRS is the ability to assemble teams of diverse multidisciplined technical staff to tackle all aspects of a complicated problem. Their team is experienced in the challenge of collecting large quantities of data, like tax returns, identifying the subset of information that would be useful for fraud detection, and integrating this information into existing or planned IRS systems.

Through a contract we have with Los Alamos' advanced computing lab, we are placing the resources of the world's most powerful high performance computers to work on fraud detection with us. The laboratory's research in nuclear weapons is widely known, but in more recent years they have been called upon by other government agencies and private companies to lend their technical abilities to solving other important problems.

They have assisted many agencies in improving computer security and designing software to detect anomalies in match patterns in large data sets. It is this, the anomaly detection and pattern matching achieved through the use of artificial intelligence algorithms, neural networks, and other advanced types of machine learning, that we hope to take advantage of. This skill set offers potential to assist the IRS in improving many areas, including fraud detection, audit selection, computer security, and market segmentation.

Specifically, though, we believe this assistance will improve our ability to identify fraudulent refund claims and to reduce expensive manual screening procedures. As we continue to identify the items on returns that are predictive of fraud, we will move these filters to the front of our processing system. Returns with these patterns can then be removed from normal processing and carefully scrutinized. This year we are already piloting a new electronic fraud detection system which will serve as a platform for the Los Alamos Laboratory systems.

Our chief inspector, who is here with me today, also views refund fraud as a priority and he has made it a significant piece of our internal audit work plans. Indeed, many of the enhancements we have installed this year have come from the excellent work of our internal audit function.

As I mentioned, our current detection program depends upon pre-refund review of millions of returns by manual or computer criteria. Those returns having substantive indications of fraud are referred to field offices for possible criminal investigation.

Returns which do not merit criminal investigation are referred to other functions for civil action or processing. The principal source of returns selected for review by the QRP teams is computer runs that apply weighted criteria against every refund return that is processed.

The criteria are developed and refined based upon previously identified false claim schemes as well as potential abuses that are identified by IRS personnel. They are capable of being modified so that data can be inserted when additional schemes or potential abuses are identified to allow cataloguing of the total scope of fraudulent trends.

In addition, the normal return processing routines have built in checks and balances that assist us in the identification of suspected fraudulent claims. All service center personnel are given fraud awareness briefings during their training so that they can be alert to the indicators of fraud, and throughout the returns processing pipeline any service center employee can designate suspicious returns for review by the QRP teams. With the additional staffing we have allocated this year, we expect to review about 6 million suspect returns.

A fourth component of our fraud reduction strategy involves the use of enforcement tools such as prosecution to deter criminal violations of the tax law. Public confidence in our tax system can only be maintained if tax refund fraud perpetrators know that they risk going to jail when they are caught. I think we heard confirmation of that earlier this morning.

The IRS, working with the Department of Justice and U.S. attorneys, will continue to actively pursue cases of criminal violations of the tax laws with every intention of prosecuting where appropriate. We have been very successful in the area of criminal enforcement, and I have recently met with the Attorney General, the Assistant Attorney General and head of the tax division, and the U.S. attorneys, and we have each renewed our commitment to work closely toward the effective prosecution of fraudulent refund cases, both in the paper and in the electronic area.

Approximately 98 percent of our indictments involving refund fraud result in conviction, and the average incarceration time is 17 months. But despite this success, we recognize that we cannot prosecute the problem of fraud away and that we need the broader multifunctional fraud reduction strategy.

In some situations, we have been able to combine criminal prosecution with some of our other compliance initiatives. For example, we found one return preparer in a remote county in northern Florida who was preparing fraudulent refund returns by claiming tax credits. The traditional method of handling such a situation would have been to audit all the preparer's clients, but in this case we notified the unsuspecting taxpayers that they could have a potential problem with their tax returns.

We set up taxpayer assistance sites at convenient times and locations and invited the taxpayers to come up for tax assistance and to do self-audits on their returns. Over 200 taxpayers corrected their returns and received some tax assistance to hopefully prevent the situation from ever happening again.

I would like to turn for a moment to our initiatives for 1994. In continuing to reduce tax refund fraud, numerous systemic and procedural changes have been implemented for the 1994 filing season. These include additional comparisons of IRS data to confirm the identify of the taxpayers and the validity of their claims. However, to disclose the specific nature of those checks here would reduce their effectiveness in protecting our system.

Another systemic test is being performed by a cross-functional group of special agents, questionable refund detection team members, internal auditors and electronic filing specialists. Although recently formed, the group's mission is to creatively challenge the system by developing schemes in which they believe they can file fraudulent returns and avoid detection. In this way, we can test our current detection systems and devise ways to change them, if necessary.

Many of the limitations on our past ability to apply sophisticated fraud detection techniques have been caused by a lack of adequate computer resources. The increases in access to information and increases in computing power and capacity that we are now realizing as a result of tax systems modernization (TSM) are critical to implementing our techniques.

Without modern equipment and software, methods of applying expert systems analysis to large databases would be very difficult. So TSM is already having a positive effect on our fraud detection. In the future, however, we envision that the technology we will acquire under TSM will significantly improve our detection capabilities.

Systems we will install this year and in the next few years will permit us to capture and use all information contained on tax returns, and this will improve our ability to perform more validity checks and data analysis work.

New storage devices will permit us to store enough data online that we will have the ability to check multiple years of information much more extensively than in the past. This storage and the increased telecommunications envisioned in the National Performance Review will make it easier to match data between agencies so we will be able to ensure that our data and that of the Social Security Administration is timely and accurate.

Our electronic management system will offer a means for employers to provide data more quickly and more accurately, allowing us to cross check tax return data more quickly. This should significantly improve our ability to validate employer withholding information, and it will make it much more difficult for anyone to falsify W-2 information.

Mr. Chairman, we appreciate the strong support that this subcommittee has given to our Tax Systems Modernization Program. Your willingness has made and will make our fraud detection capability more sophisticated. But it is important that we continue the progress already started so that we can implement the plans we have made. To do that we would appreciate your continued support for tax system modernization.

In conclusion, I think it is fair to say that prevention and deterrence are clearly the keys to refund fraud control. Prosecutions are an important component of our strategy and we are going to continue to emphasize enforcement. Our detection and deterrence programs are working, but they need to be enhanced as we detect new schemes.

Mr. Chairman, this concludes my prepared remarks. We appreciate your offer to assist us with legislative recommendations for preventing refund fraud and for improving enforcement. When we have concluded the filing season, we would like to review the results of our three studies I described with you and your staff and discuss those and possible recommendations that we might have.

My colleagues and I would now be more than happy to answer questions that you might have and would appreciate any suggestions you have for improvement. Thank you.

Chairman PICKLE. Thank you for your thorough testimony. We appreciate your frankness and your plans that you have for the agency.

[The prepared statement follows:]

**STATEMENT OF MARGARET MILNER RICHARDSON
COMMISSIONER OF INTERNAL REVENUE**

BEFORE THE

**SUBCOMMITTEE ON OVERSIGHT
HOUSE COMMITTEE ON WAYS AND MEANS**

FEBRUARY 10, 1994

Mr. Chairman and Members of the Subcommittee:

With me today are Mike Dolan, my Deputy Commissioner, and Ted Brown, our Refund Fraud Executive, formerly the Assistant Regional Commissioner, Criminal Investigation, Central Region.

We appreciate the opportunity to be here today to discuss the Internal Revenue Service's (IRS) efforts to detect and prevent fraudulent refund claims. The IRS is committed to detecting and preventing attempts to undermine our tax system of voluntary compliance by those who are unwilling to comply with the tax laws. Our goal is to maintain a balanced enforcement program that ensures compliance among all groups of taxpayers.

Traditionally we have accomplished this goal through a broad-based enforcement of the tax laws, the Bank Secrecy Act and money laundering statutes by our Criminal Investigation Division (CID), the criminal tax investigative arm of the IRS. Our special agents are widely recognized experts in investigating financial fraud. White collar financial crimes, such as tax fraud, bankruptcy fraud, and motor fuel excise tax crimes are among CID's top enforcement priorities.

Today, we would like to share with you our current activities and long-term strategies for addressing tax refund fraud -- one element of tax fraud. This is a very timely topic, since the 1994 filing season has just gotten underway. Even though we are only six weeks into the filing season and have processed 6.9 million personal income tax returns, we have already detected approximately 200 schemes involving approximately 3,000 attempts to file fraudulent claims on returns. I would like to assure the Committee that we are progressively pursuing these cases. We have already suspended several unscrupulous return preparers from the electronic system, initiated numerous criminal investigations, and executed search warrants to obtain evidence. While it is early to state any trends that are developing, we have confirmed that the fraud artists are designing schemes to bypass new "filters" added for this year.

I. INTRODUCTION

For a number of years, IRS has addressed tax refund fraud through its Questionable Refund Program (QRP), which began formally in 1977 in response to perceived abuses of the system. In 1977, the CID had the primary responsibility for QRP. The program was conducted in each of the ten service centers, where teams of trained personnel reviewed pre-refund tax returns which had been selected manually or based on computer criteria. During the thirteen years 1977 to 1990, IRS identified a relatively modest number of fraudulent refund claims per year. Generally, these claims involved individuals who tried to file more than one return by using another person's Social Security Number (SSN) or by simply creating SSNs and other fictitious supporting documents. We also pursued, through our Collection Division, fraudulent refunds which had been issued prior to detection.

In response to a number of factors and emerging trends, we began, over the last several years, to step up our efforts to identify fraud. These increased efforts from 1990 through 1993 resulted in significantly more fraud identified and stopped by the IRS. Although we are still finding the "traditional" refund fraud schemes, a number of new

schemes have also been identified. Many of these involve perpetrators who set up pyramid schemes, whereby they recruit individuals to file false claims. Another significant number of schemes involves a few unscrupulous return preparers and Electronic Return Originators (EROs) who are responsible for many false claims.

To arrest this trend, IRS reviewed its systems and designed a new multi-functional approach to control refund fraud utilizing new technologies for fraud prevention and detection. In designing this approach, we recognized the need to enhance our processing system safeguards for returns filed on paper and electronically while, at the same time, we are balancing our fraud prevention efforts with our overall responsibilities to process returns, payments, and refunds in a timely and efficient manner.

Our fraud reduction strategy encompasses the understanding of fraud, as well as prevention, detection, and enforcement. All four elements are essential for effective fraud control. Before detailing that strategy, I want to discuss the extent of refund fraud and provide you with some examples of actual schemes.

II. EXTENT OF FRAUD

In any fraud control situation, the statistics most readily available to management have limited value because they are taken from existing fraud detection operations and obviously do not include undetected fraud. Although the level of detected fraud has increased, it is uncertain how much is attributable to increased fraud attempts and how much to better detection capabilities. Without more sophisticated forms of analysis, which are difficult and expensive to do with our current systems, our efforts to measure overall fraud will lack some precision. Our current statistical indicators, such as the volume of fraudulent claims detected, the corresponding dollar value, and the volume of fraudulent refunds stopped, assist in determining the gross nature of the problem; however, as our expertise increases, we also know there are a variety of other hallmarks of fraud that must be evaluated as part of our overall strategy.

The known statistical indicators must be cited with caution, since they can be easily misunderstood. For example, from January 1 through October 31, 1993, the number of fraudulent refund returns detected (approximately 61,000 returns) was more than double the number detected in 1992 (25,000 returns for the whole year). The dollar aggregate for fraudulent refunds detected during that ten month period exceeded \$110 million. We are continuing to analyze the statistics along with others to further assess the extent to which these detection figures represent a dramatic increase in the rate of fraud attempts, an improvement in IRS detection capabilities, or a combination of both. We do know that some of the things affecting the detection figures are: increased staffing in the QRP; changes to the QRP reporting by including return preparer schemes previously not included in the QRP; and added enhancements to the QRP selection criteria. We have also begun to identify additional external factors relating to refund fraud.

In order to enable more comprehensive analysis, we initiated three studies this filing season to analyze internal and external factors to determine the totality of refund fraud. Statistically valid samples, including paper and electronically filed returns from all income levels, are being used for these studies.

The first study is already underway and involves selecting and reviewing a small, statistically valid sample of about 1000 returns filed electronically during the month of January. IRS employees are contacting the taxpayers who filed the selected returns and validating the information on the returns. This project will help us identify specific elements of refund fraud. The second study involves selecting a moderately large sample of returns transmitted by EROs to determine the extent of fraud perpetrated by them. Third, we will select and review a large statistical sample of refund returns filed throughout the filing season. This includes returns filed on paper and electronically. Although plans are still being formulated and we would like the precise elements to

remain confidential, we do anticipate using a combination of face-to-face, telephone and correspondence contacts. Field work for this last effort is scheduled to begin this spring. The findings of the three studies, when combined with other filing season data, should enable IRS to better identify the extent of fraud including the accuracy of return information, and to pinpoint types of error or abuse. We will use this information to plan for the FY95 filing season as well as for long term improvements.

III. FRAUDULENT SCHEMES AND INVESTIGATIONS

Fraudulent refund schemes detected by the QRP team consist of tax returns filed that claim fraudulent refunds based on the misrepresentation of federal income taxes withheld or refundable credits. Those perpetrating fraud:

- ◆ use their own names and SSNs;
- ◆ use names and SSNs of unsuspecting legitimate taxpayers; or
- ◆ use totally fictitious names and SSNs.

Some specific examples of detected fraudulent schemes may make the issues involved easier to understand.

A) Unscrupulous return preparers/EROs

Two owners of an income tax return preparation firm in Salinas, California, obtained SSNs and names of area agricultural employees from their clients' payroll records. Unknown to the agricultural workers, the two preparers submitted over 200 tax returns claiming more than \$165,000 in fraudulent refunds. This scheme was discovered when the QRP team detected irregularities on the returns and when the workers began filing legitimate returns of their own. The preparers received substantial sentences of 37 and 18 months for their respective roles in the scheme and were ordered to pay restitution.

B) Individuals who recruit others to file false tax returns.

Two rings operating in Jacksonville and Tampa, Florida, recruited their friends, families and associates to file false tax returns. The scheme involved real people using their own SSNs, but the Forms W-2 had false wage and withholding information. The ring also used non-existent companies or claimed wages from companies where the filers were never employed. This case was identified when similarities among returns were detected by the QRP team. Over \$400,000 in false claims were involved, and 28 people were charged in the conspiracy to perpetrate this refund scheme. Most have pled guilty and have received substantial sentences.

C) Prisoner Schemes

Each year there are prisoners who attempt to defraud the tax system. For example, an inmate in a Colorado prison contrived a refund scheme to file three false claims for refunds totalling \$20,000. The inmate prepared and submitted Forms W-2 and tax returns after obtaining other prisoners' SSNs and names. The other prisoners were paid a commission for allowing these returns to be filed using their names and SSNs. The inmate received 10 more years to serve in prison for this scheme. Through systemic checks we have regarding prisoners, IRS was able to stop all of the refunds.

D) Use of False or Nonexistent Documentation

One of the more sophisticated schemes involved an attorney who planned for eight months to perpetrate a multi-million dollar scheme to file false income tax

refund claims with the help of two people. He agreed to pay a friend, who was previously convicted of extortion, a fee of 20% of the proceeds to:

- ◆ obtain the names and SSNs to be placed on the false returns;
- ◆ assist in obtaining false identification for their use;
- ◆ locate mail drops for mailing the refund checks; and
- ◆ retrieve the refund checks when they arrived.

The second person was a payroll clerk of a large company, who helped steal the company's payroll printouts containing employee data. The conspirators mismatched names and SSNs to create married couples and prepared joint tax returns. Other names were used to prepare single returns. They established mail drops along the East and West Coasts using the false identification and also generated fictitious Forms W-2. They then mailed over 900 false returns claiming over \$8 million to three different service centers so the duplicate addresses would not be easily detected.

However, all of their plans failed, because within a short term our QRP identified this scheme. When the conspirators visited the mail drops to pick up refund checks, an employee of the business providing the mail service informed them that they were being watched.

They destroyed all of the physical evidence in their possession, including the few refund checks that had been released by IRS. The attorney was attempting to sell all of his assets and leave the country when our special agents arrested him. He subsequently pled guilty to conspiracy and received a 41 month prison sentence. His friend was sentenced to 5 years and the payroll clerk was sentenced to 1 year in prison, followed by 1 year supervised release.

Our detection systems also have intercepted false claims which reveal the following additional types of abuse:

- ◆ Using fraudulent Schedule Cs with inflated income figures.
- ◆ Using unidentified income, later determined to be welfare payments, as earned income to qualify for an Earned Income Credit-based refund. These funds are included on returns as other income or wages.
- ◆ Recruiting indigent, homeless individuals, as well as college and high school students, to file fraudulent returns. Persons standing in low income housing and welfare lines are also being recruited.
- ◆ Misusing SSNs on EIC schedules by not including a SSN, writing the words "applied for," or using a false SSN that either does not exist or belongs to someone else.
- ◆ Preparers knowingly file incorrect returns, with or without a taxpayer's knowledge, by adding non-qualifying dependents as exemptions or increasing deductions while diverting the refunds from the taxpayers.
- ◆ Individuals acting alone and filing just one fraudulent return using many of the methods already identified.
- ◆ Claiming large amounts of false income and withholding and claiming a refund based on business losses.
- ◆ Obtaining names and SSNs of unsuspecting taxpayers from many sources including payroll records, church records, softball teams, and even obituaries.

IV. FRAUD REDUCTION STRATEGY

A) Overview

Shortly after becoming Commissioner, I recognized the need to step up our efforts to detect refund fraud. I responded by appointing Ted Brown, who is with me here

today, as our Refund Fraud Executive to spearhead our enhanced efforts. Ted has 21 years of experience in our Criminal Investigation function and a strong background in fraud detection. He is a senior executive, who was serving as the Assistant Regional Commissioner (CI), Central Region, when I selected him. Prior to that he was the Assistant District Director in the New Orleans District and the Chief, CID in Dallas. In his new role, he has the responsibility for developing and overseeing all of IRS' efforts to enhance the detection and prevention of not only refund fraud, but also filing fraud in general.

Since our concerns extend beyond just prosecution of refund fraud, we recognize that our fraud reduction strategy must cross our traditional functional lines. The strategy is a four-component plan utilizing new technology and multifunctional resources to:

- ◆ understand fraud;
- ◆ prevent fraud;
- ◆ detect fraud; and
- ◆ use enforcement tools whenever needed.

B) Understanding Fraud

Fraud control is dynamic, not static. Fraud control is directed against those who think creatively and adapt continuously, who relish in devising complex strategies, and who have no single profile. This means that a set of fraud controls, which is perfectly satisfactory today, may be of no use at all tomorrow. Maintaining effective fraud controls demands continuous assessment of emerging trends and constant revision of controls.

Most of the more sophisticated fraud schemes are devised by persons skilled in computer programs and techniques. They assume the existence of transaction-level filters, and therefore design their fraud schemes so that their returns pass through the system unchallenged. These individuals who devise such schemes seem to accept the constraints imposed by the system. The smarter ones test the system from time to time to make sure they roughly understand the parameters being used, and then they may increasingly generate multiple transactions and incorporate sufficient randomness or variation to minimize the risk of detection.

It is very important to recognize that fraud claim attempts are not unique to the IRS. We are all too familiar with the recent reported examples of fraudulent attempts to obtain disaster relief in the Los Angeles earthquake area. Other examples of attempts to defraud government agencies through false claims to obtain food stamps, Medicare/Medicaid payments, welfare assistance or procurement payments have made headlines around the United States. Not only government agencies have been the target of fraud artists; the banking, credit card, telephone and health insurance industries have been victims of individual and organized group attempts to fraudulently obtain payments or services. As government agencies and private companies have moved to automate their systems, the fraudsters have followed.

There are factors commonly found in all fraud control situations and we at the IRS are taking steps to avoid those pitfalls. Private sector companies (credit card and insurance companies, for example) compete with one another on the basis of quality service, which often produces an incentive to pay customers faster than the competition. Efforts to shorten payment cycles and to dispatch electronic payments rapidly must be matched by corresponding safeguards to ensure adequate controls -- whether a private company or the IRS. While we too want to provide quality service that will include prompt payment, and are moving to do so through modernizing our technology, we have to assure improved compliance as well.

C) Prevention

Prevention is the critical element of our strategy. Although detection and prosecution are important, we have no illusion that we can prosecute every instance of fraud. Recognizing this, we will continue to build higher barriers to fraud -- so that the IRS is viewed by criminals as an unattractive target. Our goal is to make our system impregnable -- to stop fraudulent returns from entering it.

We are instituting short-term and long-term systemic changes that would prevent fraudulent returns from entering our systems. One such example implemented this filing season is our elimination of the direct deposit feature on refunds issued to first time filers. These refunds are issued in the form of a paper check. Other prevention measures include an outreach and publicity program. For instance, at the same time we increase our publicity efforts to educate taxpayers and practitioners about the benefits of electronic filing, we have a responsibility to make the public -- including the practitioner and ERO communities -- aware of the need to combat fraud. One example of our fraud awareness efforts is the presentation we make at our electronic filing trade shows and other practitioner events. During this presentation, we provide an overview of the QRP and focus on keeping bad returns out of the system.

We continue to build on our partnership with practitioners and EROs. We provide training to preparers and have designated Electronic Filing Coordinators in each IRS district. The vast majority of taxpayer practitioners and tax EROs are interested in maintaining the integrity of our tax system; they recognize their responsibility to prepare, file, or transmit correct information to the IRS. Several of the major preparers have initiated their own fraud prevention efforts, and we appreciate their efforts in working with us. However, when we identify those few unscrupulous practitioners and EROs abusing the authority of their position by committing fraud, we intend to pursue criminal enforcement to the full extent.

D) Detection

In addition to better prevention techniques, we also have a strong detection component in our fraud reduction strategy. We are improving our current screening and detection systems with the use of more sophisticated and automated techniques. I recognized this as a priority item when I became Commissioner. With key members of my staff, I visited the Los Alamos National Laboratory in Los Alamos, New Mexico, to see first-hand the creative use of competent artificial intelligence systems in detecting fraud.

Los Alamos National Laboratory's 7,500 employees are ready to apply world class, scientific and technical talent to the solution of problems of national importance. The Laboratory's greatest strength, as it applies to the IRS' problems, is the ability to assemble large or small teams of diverse, multi-disciplined technical staff to tackle all aspects of a complicated problem, integrate the solution, and then deliver a final product in a timely fashion that meets requirements. The Information Extraction and Analysis Team is experienced in the challenge of collecting large quantities of data (like tax returns), identifying the sub-set of information that would be useful (for fraud detection) and integrating this information into existing or planned IRS systems. Through Los Alamos' Advanced Computing Lab, we can place the resources of the world's most powerful high-performance computers to work on the problem of fraud detection.

The Laboratory's research in nuclear weapons is widely known. But in more recent years, they have been called upon by other government agencies and private companies to lend their technical abilities to solving other important problems. They have assisted many agencies in improving computer security and designing software to detect anomalies and match patterns in large data sets. This anomaly detection and pattern matching is achieved through the use of artificial intelligence algorithms, neural

networks and other advanced types of machine learning. This skill set offers potential to assist the IRS in improving many areas including fraud detection, audit selection, computer security and market segmentation. Specifically, we believe this assistance will improve our ability to identify fraudulent refund claims and to reduce expensive manual screening procedures. As we continue to identify the items on returns that are predictive of fraud, we will move these "filters" to the front of our processing system. Returns with these patterns can then be removed from normal processing and carefully scrutinized. This year, we are already piloting a new electronic fraud detection system which will serve as a platform for the Los Alamos Laboratory systems.

Our Chief Inspector also views refund fraud as a priority and has made it a significant piece of the Internal Audit work plans. Internal Audit continues to provide assistance in enhancing our detection capabilities, as well as evaluating the efficiency and effectiveness of our program.

As I mentioned before, our current detection program depends on a pre-refund review of millions of returns selected by manual or computer criteria. Those returns having substantive indications of fraud are referred to field offices for possible criminal investigation. Returns which do not merit criminal investigation are referred to other functions for civil action or processing.

The principal source of returns selected for review by the QRP teams is computer runs that apply weighted criteria against every refund return that is processed. The criteria are developed and refined yearly based upon previously identified false claim schemes, as well as potential abuses, identified by IRS personnel. They are capable of being modified so that data can be inserted when additional schemes or potential abuses are identified to allow cataloguing of the total scope of fraudulent trends.

In addition, the overall processing of returns by IRS has certain built-in checks and balances that assist us in the identification of suspected fraudulent claims. All service center personnel, including data transcribers, are given fraud awareness briefings during their training so they can be alert to indicators of fraud. Throughout the returns processing pipeline, service center personnel designate suspicious returns for review by the QRP teams. We continually challenge our system, drawing from what we observe and learning from the most sophisticated schemes.

We use many internal as well as external sources of information in order to identify fraudulent returns. With our present staffing levels, we are able to physically review about 6 million suspect returns a year. Each center has a team made up of 20 to 65 members during various times of the filing season. The additional staffing that has been allocated to the QRP teams has allowed them to review more returns and use a more analytical approach in the detection process. The additional staffing has also allowed for more interaction between our field agents and our QRP teams. This interaction facilitates early detection of fraud and stops many schemes. Our Returns Processing and Information Systems functions continue to expand their role in fraud detection, which has contributed to the increase in detection of fraud.

E) Prosecution

A fourth component of our fraud reduction strategy involves the use of enforcement tools, such as prosecution, to deter criminal violations of the tax law. Public confidence in our tax system can only be maintained if tax refund fraud perpetrators know that they risk going to jail when they are caught. The IRS, working with the Department of Justice and the U.S. Attorneys, will continue to actively pursue cases of criminal violations of the tax laws with every intention of prosecuting where appropriate. We have been very successful in the area of criminal enforcement, and we will continue to work closely with the Department of Justice and the U.S. Attorneys to be even more effective in the prosecution of fraudulent refund cases. I have taken two recent opportunities to commend the U.S. Attorneys for their excellent support on those

cases and solicited their continued partnership. Approximately 98% of our indictments involving refund fraud result in conviction, and the average incarceration time is 17 months.

During recent briefings of this Subcommittee's staff, we were asked to review the existing criminal tax statutes to determine whether they are adequate or whether there is a need for additional legislation to address fraud. We believe that at the present time, the existing criminal statutes are effective, but we will continue to evaluate legislative and regulatory proposals to address the evolution of fraud.

Examples of the three basic methods of refund fraud prosecution under current criminal statutes include:

- ◆ A return preparer in the Boston area was recently convicted of violating 18 USC 286, conspiracy to defraud the government with respect to claims. He received a sentence of 57 months in prison and was fined \$492,828.
- ◆ An individual in the Dallas area was convicted of violating 18 USC 287, for submitting false, fictitious, or fraudulent claims. He was recently sentenced to 60 months in prison.
- ◆ An Arkansas return preparer was convicted of 26 USC 7206(2), aiding and assisting in preparing or presenting fraud or false statements. He was sentenced to 30 months in prison for preparing 1090 fraudulent returns with the false claims totaling \$1.3 million.

Despite these successful convictions, we recognize that we cannot prosecute the problem of fraud away and that we need a broader multi-functional fraud reduction strategy. In some situations, we have successfully combined criminal prosecution with other compliance initiatives. For example, in a remote county in northern Florida, there was one return preparer for the county. This preparer was preparing fraudulent refund returns by claiming tax credits. The traditional method of handling such a situation would be to audit all of the preparer's clients. In this case, we notified the unsuspecting taxpayers that they could have a potential problem with their tax returns. We set up taxpayer assistance sites at convenient times and locations and invited the taxpayers to come in for tax assistance and to do self-audits of their returns. Over 200 taxpayers corrected their returns and received some tax assistance to prevent the situation from happening again.

Although this approach is not appropriate in all cases, it worked very well in this situation. Efforts like this, as well as many outreach and educational efforts, are being used throughout the country.

F) Initiatives for 1994

In a continuing effort to reduce tax refund fraud, numerous systemic and procedural changes have been implemented for the 1994 filing season. These include additional comparisons of IRS data to confirm the identity of the taxpayers and the validity of their claims. However, it would not be appropriate to disclose the specific nature of these checks here, since to do so would reduce their effectiveness in protecting our system.

Another systemic test is being performed by a cross-functional group of special agents, questionable refund detection team members, internal auditors, and electronic filing specialists. Although recently formed, the group's mission is to creatively challenge the system by developing schemes in which they believe they can file fraudulent returns and avoid detection. In this way, we can test our current detection systems and devise ways to change them if necessary.

V. LONG-TERM PROPOSED SYSTEMIC CHANGES WITH TSM

Many of the limitations on our past ability to apply sophisticated fraud detection techniques have been caused by a lack of adequate computer resources. The increases in access to information, and increases in computing power and capacity now being realized as a result of Tax Systems Modernization (TSM), are critical to the implementation of these techniques. Without modern equipment and software, methods of applying expert systems analysis to large data bases would be very difficult. So, TSM is already having a positive effect on our fraud detection.

In the future, however, we envision that the technology we will acquire under TSM will significantly improve our detection capabilities. Systems we will install this year and in the next few years will permit us to capture and use all information contained on tax returns. This will improve our ability to perform more validity checks and data analysis work. New storage devices will permit us to store enough data on-line that we will have the ability to check multiple years of information much more extensively than in the past. This storage and the increased telecommunications envisioned in the National Performance Review will make it easier to match data between agencies, so we will be able to ensure that our data, and that of the Social Security Administration, is timely and correct. Our Electronic Management System will offer a means for employers to provide data more quickly and more accurately, allowing us to cross-check tax return data as a tax return is processed instead of after it is processed. This should significantly improve our ability to validate employer withholding information and will make it much more difficult for anyone to falsify W-2 information.

Mr. Chairman, we appreciate the strong support of this Subcommittee for our Tax Systems Modernization program. Your willingness to support this capital investment in our tax system has made our fraud detection capability more sophisticated and promises to significantly improve our future capabilities. But, it is important that we continue the progress already started so that we can implement the plans we have made. To do that we will need your continued support for TSM.

VI. CONCLUSION

In conclusion, prevention and deterrence are clearly the keys to refund fraud control. Prosecutions are an important component of our strategy, and the IRS will continue to emphasize enforcement. Our detection and deterrence programs are working but need to be enhanced as we detect new schemes. All of our partners in tax administration need to recognize that fraud reduction is a joint responsibility. We are pleased that the practitioner community has answered the call for assistance and recognized their responsibility to assist us in detecting fraud.

Mr. Chairman, this concludes my prepared remarks. We would appreciate any suggestions for improvements that you or your colleagues may wish to offer. My colleagues and I would be happy to answer any questions you or other Subcommittee members may have. Mr. Brown will also be available to follow up with your Subcommittee as subsequent filing season data relating to refund fraud becomes available.

Chairman PICKLE. Now, I am going to go to Ms. Stathis for her testimony. Will you proceed?

TESTIMONY OF JENNIE S. STATHIS, DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT DIVISION, ACCOMPANIED BY DAVID J. ATTIANESE, ASSISTANT DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT DIVISION

Ms. STATHIS. Thank you, Mr. Chairman. We are pleased to be here today to participate in your hearing. My statement focuses on recommendations that we have made with respect to electronic filing fraud.

Electronic filing fraud, while an important issue today, will become even more critical as IRS moves toward a goal of 80 million electronic returns by the year 2001. We wholeheartedly support the need to convert IRS in a paper environment to a more modern electronic one, but the conversion must be accompanied by adequate controls against fraud.

In the past, IRS has often appeared more interested in expanding electronic filing than in insuring that it fully understood and adequately addressed the risks. As a result, IRS has been in a reactive posture, adding controls every year in the hope of effectively dealing with a problem that it did not fully understand.

Thus far, the number of electronic returns identified as fraudulent is relatively small. The high rate of growth in that number is of concern, however, because it could reflect an increase in fraudulent activity rather than the result of increased monitoring. More troubling is the uncertainty as to how much fraud might be going undetected.

In 1993, about 12 million returns were filed electronically, 13 percent more than in 1992. By comparison, IRS identified 105 percent more fraudulent electronic returns.

The risk of electronic filing fraud could be reduced through changes in the system's design. The system is not fully electronic. Taxpayers can file tax data electronically, but must still send in paper documents with their handwritten signatures. Those signatures have not been of value in helping control fraud because IRS does not delay issuing a refund until it receives the paper signature.

Electronic signatures would not only make electronic filing more efficient by eliminating paper, but if implemented correctly, could help control fraud, especially if IRS intends to eventually allow taxpayers to file electronically from their own computers. IRS has prepared a legislative proposal that would allow it to use alternatives to paper signatures. A similar proposal was included in H.R. 11, which was passed by Congress in 1992, but vetoed for reasons unrelated to the proposal. As far as we know, that proposal has not yet been resubmitted.

The one aspect of electronic filing that most attracts taxpayers is the speed with which they can get their refunds, but that speed makes it difficult for IRS to effectively identify and stop questionable refunds. One way to deal with that problem is to prevent questionable returns from being filed. Toward that end, IRS has implemented some controls at the front of the filing process. Before ac-

cepting an electronic transmission, for example, IRS first verifies that the name and Social Security number match information in IRS records. If there is a mismatch, IRS will not accept the filing. In 1993, this check resulted in IRS rejecting about 240,000 returns. IRS does not know, however, how many of those returns involve attempted fraud or how many were simply errors.

More up-front checks are needed. In that regard, we recommended that IRS work toward electronically matching employer wage information with electronic return data. That kind of match is currently beyond IRS capabilities. Currently, employer wage information other than that provided by taxpayers is not available to IRS until after it has processed the returns. This is because of the time it takes to verify the information and correct any errors.

Under one component of IRS' systems modernization, IRS expects to electronically receive tax returns, tax information documents like W-2s and correspondence. Electronic transmission of W-2s would enable IRS to more quickly verify and correct the information, thus offering the possibility of having that information available up front to match with data being reported on electronic returns.

Once an electronic return is filed, IRS' primary means of detecting fraud involves manual reviews of electronic return data. After accepting an electronic return, IRS uses computerized screening criteria to identify questionable returns for possible review.

As we have reported, problems with those criteria resulted in more returns being identified as questionable than service center staff could review. Even after IRS revised the criteria, the computer screening manual review process was still labor-intensive and inefficient. For example, of the 3 million potentially fraudulent returns reviewed last year, less than 1 percent were determined to be fraudulent.

Because IRS data showed that many fraudulent electronic returns had been filed by first-time filers who had no history that IRS could check, we recommended that IRS revise its computer screening criteria to allow further investigation of first-time filers. IRS has since done that and has implemented procedures to give itself more time to assess the credibility of a first-time filer's return before releasing the refund. As of April of last year, IRS had identified about 157,000 such returns.

To file electronically, taxpayers can have an IRS-approved practitioner prepare and submit the return or they can take a return that they have prepared to an individual or business that IRS has approved as a transmitter. Because some preparers and transmitters have been involved in schemes involving fraudulent electronic returns, we recommended that IRS do more to check the background of these persons before accepting them into the program.

One step we recommended was that IRS obtain access to the National Crime Information Center database. That national database, maintained by the FBI, contains information on various types of Federal, State and local crime convictions. Internal IRS documents indicate that IRS has consulted with the FBI and that use of this data base for suitability checks would require either an executive order or legislation. We understand that proposed legislation will be drafted.

Because we believe that the many honest providers of electronic filing services also have a responsibility to help protect against fraud, we recommended that IRS require return preparers and transmitters to obtain and retain copies of two forms of identification, one with a photo, from persons wanting to file electronically.

At the time of our report, IRS said that it would revise its procedures to include such a requirement for the 1994 filing season. IRS has since decided not to require but only recommend that two forms of identification be obtained. IRS concluded that it would not have resources to effectively monitor compliance with such a requirement.

We believe that IRS should impose such a requirement even if it is only able to monitor the activities of a small number. IRS should also consider whether an increase in monitoring resources is warranted as a step toward improving fraud control.

In conclusion, electronic filing frauds is a problem that requires urgent IRS attention and IRS has a number of on going efforts. We continue to believe that our open recommendations, which we have listed in an appendix to our statement, have merit and should be implemented as part of those efforts.

In the longer term, it is critical that IRS thoroughly assess its controls and determine what is needed to adequately protect the Government's revenues. With a goal of 80 million electronic returns by 2001, IRS must ensure that fraud control needs like various up-front matching capabilities are fully identified and considered in planning its systems modernization. It is also important that IRS learn from the electronic filing experience by building adequate controls into the design of future systems like TeleFile and assuring that those controls are adequate before nationwide implementation.

Attached to my statement is a listing of the related GAO reports that we have issued on this topic.

With your permission, Mr. Chairman, I would like to add one more which was done for the subcommittee in 1989. You mentioned it earlier. It is entitled ADP Modernization: IRS Needs to Assess Design Alternatives for Its Electronic Filing System. That is the report that discusses the last point I made about the need to work on long-term systems to ensure that controls are in place before the systems are deployed nationwide.

That concludes my statement. We will be pleased to answer your questions.

[The prepared statement and report follow:]

**TESTIMONY OF JENNIE S. STATHIS, DIRECTOR
TAX POLICY AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE**

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to participate in the Subcommittee's inquiry into refund fraud. Our statement focuses on electronic filing fraud, an area on which we have previously reported.¹

Electronic filing fraud, while an important issue today, will become even more critical as IRS moves toward its goal of 80 million electronic returns by 2001. We wholeheartedly support the need to convert IRS from a paper environment to a more modern electronic one. But the conversion must be accompanied by adequate controls against fraud. In the past, IRS has often appeared more interested in expanding electronic filing than in ensuring that it fully understood and adequately addressed the associated risks. As a result, IRS has been in a reactive posture--adding controls every year in the hope of effectively dealing with a problem that it did not fully understand.

Thus far, the number of electronic returns identified as fraudulent is relatively small. The high rate of growth in that number is of concern, however, because it could reflect an increase in fraudulent activity rather than the result of increased IRS monitoring. More troubling is the uncertainty as to how much fraud might be going undetected.

In 1993, IRS received about 115 million individual income tax returns. About 12 million of the returns were filed electronically, or 13 percent more than in 1992. By comparison, IRS identified 105 percent more fraudulent electronic returns--25,633 during the first 10 months of 1993 compared to 12,488 for the same period in 1992. These 25,633 fraudulent returns claimed refunds of about \$53 million, of which IRS reported stopping about \$29 million before checks were mailed or funds were transferred to a bank account. However, a recent IRS internal audit report estimated that about \$3 million of the refunds IRS reported as stopped had actually been issued.

PREVENTING FRAUD THROUGH DESIGN CHANGES

The risk of electronic filing fraud could be reduced through changes in the system's design. The system is not fully electronic. Taxpayers can file tax data electronically but must still send in paper documents with their handwritten signatures. Those signatures have been of little value in helping control fraud because IRS does not delay issuing a refund until it receives the paper signature.

Electronic signatures would not only make electronic filing more efficient by eliminating paper but, if implemented correctly, could help control fraud--especially if IRS intends to eventually allow taxpayers to file electronically from their own computers. IRS has prepared a legislative proposal that would allow it to use alternatives to paper signatures. A similar proposal was included in H.R. 11, which was passed by Congress in 1992 but was vetoed for reasons unrelated to the proposal. The proposal has not yet been resubmitted.

The one aspect of electronic filing that most attracts taxpayers is the speed with which they can get their refunds. That speed makes it difficult for IRS to effectively identify and stop questionable refunds once an electronic return has been filed. One way to deal with that problem is to prevent questionable returns from being filed.

¹Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992) and Tax Administration: Increased Fraud and Poor Taxpayer Access to IRS Cloud 1993 Filing Season (GAO/GGD-94-65, Dec. 22, 1993).

Toward that end, IRS, in the last couple of years, has implemented some controls at the front of the electronic filing process. Before accepting an electronic transmission, for example, IRS first verifies that the taxpayer's name and Social Security number on the electronic transmission matches information in IRS' records. If there is a mismatch, IRS will not accept the filing. In 1993, this computer check resulted in IRS rejecting about 240,000 electronic returns. IRS does not know, however, how many of those returns involved attempted fraud or how many were the result of honest errors by taxpayers or preparers in recording or transcribing names and/or Social Security numbers.

More up-front checks are needed. In that regard, we recommended in 1992 that IRS work toward electronically matching employer wage information with electronic return data.² That kind of match is currently beyond IRS' capabilities. Currently, employer wage information other than that provided by taxpayers is not available to IRS until after it has processed taxpayers' returns. This is because of the time it takes to verify the information and correct any errors.

Under the Electronic Management System--one of many planned components of IRS' multibillion dollar systems modernization effort--IRS expects to electronically receive tax returns, tax information documents (like W-2s), and correspondence. Electronic transmission of W-2s would enable IRS to more quickly verify and correct the information, thus offering the possibility of having that information available to match with data being reported on electronic returns.

BETTER DETECTING FRAUDULENT RETURNS

Once an electronic return is filed, IRS' primary means of detecting fraud involves manual reviews of electronic return data by analysts in IRS' service centers. After accepting an electronic return, IRS uses computerized screening criteria to identify questionable returns for possible review by an analyst. As we reported in December 1992, problems with those criteria resulted in more returns being identified as questionable than service center staff could review.

Even after IRS revised the criteria, as we reported in December 1993 to this Subcommittee, the computer screening/manual review process was still labor intensive and inefficient.³ We noted, for example, that of the approximately 3 million potentially fraudulent returns IRS reviewed in 1993, less than 1 percent were determined to be fraudulent.

Because IRS data showed that many fraudulent electronic returns had been filed by first-time filers (persons who had no filing history that IRS could check names and Social Security numbers against), we recommended in 1992 that IRS revise its computer screening criteria to specifically identify electronic returns from first-time filers as questionable returns for further investigation. IRS has since done that and has implemented procedures to give itself more time to assess the credibility of a first-time filer's return before releasing the refund.

As of April 23, 1993, IRS had identified about 157,000 returns submitted by first-time filers. IRS' Internal Audit recently reported, however, that 44 percent of those returns were mistakenly identified because IRS' computer program did not check

²GAO/GGD-93-27.

³GAO/GGD-94-65.

to see if the person had filed in prior years as a secondary taxpayer on a joint return. As a result, those taxpayers had their refunds delayed unnecessarily.

BETTER SCREENING AND MONITORING OF PREPARERS AND TRANSMITTERS OF ELECTRONIC RETURNS

To file electronically, taxpayers can have an IRS-approved practitioner prepare and submit the return or they can take a return that they have prepared to an individual or business that IRS has approved as a transmitter. Because some preparers and transmitters have been involved in schemes involving fraudulent electronic returns, we recommended in 1992 that IRS do more to check the backgrounds of these persons when they apply to participate in the electronic filing program.

One step we recommended was that IRS obtain access to the National Crime Information Center database. That national database, maintained by the Federal Bureau of Investigation (FBI), contains information on various types of federal, state, and local crime convictions. In a December 1993 memorandum to the Assistant Commissioner for Criminal Investigation, IRS' Assistant Chief Counsel for Criminal Tax noted, after consulting with the FBI, that use of this database for suitability checks would require either an executive order or legislation. We understand that Criminal Investigation will be asking Chief Counsel to draft proposed legislation.

Because we believe that the many honest providers of electronic filing services also have a responsibility to help protect against fraud, we recommended that IRS require return preparers and transmitters to obtain and retain copies of two forms of identification, one with a photo, from persons wanting to file electronically. At the time of our report, IRS said that it would revise its procedures to include such a requirement for the 1994 filing season. IRS has since decided not to require but only recommend that two forms of identification be obtained. IRS concluded that it would not have resources to effectively monitor compliance with such a requirement. We believe that IRS should impose this requirement even if it is only able to monitor the activities of a small number of preparers and transmitters. IRS should also consider whether an increase in monitoring resources is warranted as a step toward improving fraud control.

CONCLUSIONS

Electronic filing fraud is a problem that requires urgent IRS attention, and IRS has a number of ongoing efforts. We continue to believe that our open recommendations, which are listed in the appendix, have merit and should be implemented as part of those efforts.

In the longer term, it is critical that IRS thoroughly assess its controls and determine what is needed to adequately protect the government's revenues. With a goal of 80 million electronic returns by 2001, IRS must ensure that fraud control needs, like various up-front matching capabilities, are fully identified and considered in planning its systems modernization program. It is also important that IRS learn from its electronic filing experience by building adequate controls into the design of future systems, like TeleFile (which allows certain taxpayers to file their returns over the telephone), and assuring that those controls are adequate before nationwide implementation.

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That concludes my statement. We welcome any questions you may have.

STATUS OF GAO RECOMMENDATIONS

In our report entitled Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992), we made several recommendations. A list of the recommendations and our understanding of IRS' status in implementing them follows.

RECOMMENDATION 1

IRS should seek approval to allow Criminal Investigation staff access to National Crime Information Center data for the purpose of checking the background of electronic filing applicants. Until that approval is obtained, district offices should use the National Law Enforcement Telecommunications System to check criminal records maintained by state and local law enforcement authorities.

Status (Open)

In a December 1993 memorandum to the Assistant Commissioner for Criminal Investigation, IRS' Assistant Chief Counsel for Criminal Tax noted, after consulting with the FBI, that use of this database for suitability checks would require either an executive order or legislation. We understand that Criminal Investigation will be asking Chief Counsel to draft proposed legislation. In May 1993, in response to the second part of our recommendation, the Assistant Commissioner for Criminal Investigation sent a memo to all regions telling them that each district office "should determine with their respective states if the information [in the National Law Enforcement Telecommunications System] can be used for the suitability checks." We do not know how many district offices, if any, have contacted the states and/or gotten access to that system.

RECOMMENDATION 2

IRS should identify electronic filing preparers/transmitters on IRS computer files so that past year electronic filing participants who did not pay taxes or file returns or who otherwise failed to meet electronic filing requirements can be included in the annual suitability screening process.

Status (Implemented)

Our recommendation anticipated that IRS would identify electronic filing preparers/transmitters on its Master File so that those who become delinquent in their tax responsibilities after being accepted into the electronic filing program can be automatically identified for follow up. Instead, according to IRS, it is achieving the same end by bumping a separate file of preparers/transmitters against the Master File. What happens to those preparers/transmitters identified by such matching depends on the type and severity of the problem. IRS' actions appear responsive to our recommendation; we have done no audit work to verify it.

RECOMMENDATION 3

IRS should establish rejection standards for preparers and transmitters applying to participate in the electronic filing program who habitually fail to pay their taxes or file their returns on time.

Status (Open)

IRS said that it has standards and will review them with field office staff and emphasize their importance. We are not

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convinced that the standards of which IRS speaks meet the intent of our recommendation.

RECOMMENDATION 4

IRS should establish a procedure to review electronic filing coordinators' suitability decisions.

Status (Open)

According to IRS, regional electronic filing coordinators are reviewing district office electronic filing coordinators' decisions. However, IRS is still developing a specific procedure spelling out just what is to be covered in those reviews. Although having regional coordinators review district office coordinators' decisions is an improvement over the condition that existed at the time of our review, we believe that it would be more appropriate to have the reviews done by persons not involved in promoting the electronic filing program so as to avoid conflicts of interest. That is why we had suggested that the reviews be done by district office quality review staff.

RECOMMENDATION 5

IRS should follow through on plans to develop improved computer checks for identifying questionable electronic returns in time for the 1993 filing season. These checks should be based on analyses of the perpetrators of electronic filing schemes and not restrict service center fraud detection teams from adapting the checks as fraud schemes are identified during the filing season. As it modernizes its computer systems, IRS should also consider electronically matching employer wage information with electronic return data as a means of validating information on electronic returns.

Status (Partially Implemented)

IRS modified the computer checks used in 1993 and planned further changes for 1994, including enabling service center teams to adapt those checks to meet local conditions. It also plans to eventually use artificial intelligence. In the longer term, IRS said it is working with the Social Security Administration to find ways to expedite wage withholding information to match against amounts claimed on tax returns.

RECOMMENDATION 6

IRS should classify electronic returns from first-time filers as questionable returns for further investigation and delay processing those returns until the validity of the filer can be established.

Status (Implemented)

In 1993, IRS implemented special procedures for electronic returns filed by first-time filers that, in effect, provided investigative staff with more time to assess the validity of the filer and/or the return. IRS has implemented additional procedures for 1994 that will preclude first-time filers from getting a direct deposit (and thus a Refund Anticipation Loan). This will give IRS more time to assess the return's validity before issuing the refund.

RECOMMENDATION 7

IRS should require that preparers/transmitters obtain at least two pieces of identification from electronic filers before transmitting their returns and retain the pieces of

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identification with taxpayers' records. One piece of identification should be a picture identification.

Status (Open)

Because it was too late to do anything differently for 1993, IRS only recommended that two pieces of identification be obtained that year. IRS said that it would require this in 1994. IRS has since changed its mind, we are told, because it would not have had resources available to monitor compliance with such a requirement.

RECOMMENDATION 8

Until electronic filing paper documents are no longer required, IRS should (1) follow established procedures for warning and suspending preparers/transmitters who do not submit timely paper documents and (2) discontinue issuing refunds until the associated electronic return can be matched with a corresponding taxpayer signature document.

Status (Partially Implemented)

According to IRS officials in Washington and the field, IRS has been sending out warning notices and suspending some preparers/transmitters. We were told that a notice went out in October 1993 to all preparers/transmitters who had not submitted required documentation for 5 percent or more of the electronic returns they submitted telling them that they are being suspended from the program. Staff at one service center told us that the center has since suspended about 60 preparers and transmitters.

IRS did not agree with the second part of our recommendation, saying it would defeat the purpose of electronic filing.

We also had a recommendation in our December 22, 1993, report to the Oversight Subcommittee (Tax Administration: Increased Fraud and Poor Taxpayer Access to IRS Cloud 1993 Filing Season) that was directed at further enhancing IRS' computer screening criteria.

RECOMMENDATION 9

IRS' Criminal Investigation Division should (1) analyze the fraud cases IRS identified from information provided by banks that provide Refund Anticipation Loans (RALs) to see if those cases involve unique features that should be included in IRS' computer screening criteria and (2) determine which RAL banks were used for fraudulent refunds to see if special attention should be given to banks that do not use the Fraud Service Bureau.

Status (Open)

IRS agreed with our recommendation but has not yet begun these analyses.

RELATED GAO PRODUCTS

Internal Revenue Service: Opportunities to Reduce Taxpayer Burden Through Return-Free Filing (GAO/GGD-92-88BR, May 8, 1992).

Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992).

Tax Administration: Opportunities to Increase the Use of Electronic Filing (GAO/GGD-93-40, Jan. 22, 1993).

Tax Administration: IRS' Test of Tax Return Filing by Telephone (GAO/GGD-93-91BR, Apr. 26, 1993).

Tax Administration: Increased Fraud and Poor Taxpayer Access to IRS Cloud 1993 Filing Season (GAO/GGD-94-65, Dec. 22, 1993).

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Report to the Chairman, Subcommittee on
Oversight, Committee on Ways and
Means, House of Representatives

May 1989

ADP MODERNIZATION

IRS Needs to Assess Design Alternatives for Its Electronic Filing System





United States
General Accounting Office
Washington, D.C. 20548

Information Management and
Technology Division

B-227683

May 5, 1989

The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

As agreed with your office, this report provides the results of our review of the Internal Revenue Service's (IRS) electronic filing system. Electronic filing has the potential to streamline the tax processing system by allowing individual tax returns to be filed using computers instead of traditional paper forms. In a prior report, we summarized IRS' early efforts to develop an electronic filing system.¹ The objectives of our current review were to report on the problems this system encountered during the 1988 and 1989 filing seasons and IRS' approach for expanding electronic filing nationwide in 1990.

IRS has spent about \$13 million through fiscal year 1988 developing an electronic filing system. Although this system processed about 583,000 returns during the 1988 filing season, it experienced problems when a major software component was unable to operate as intended. IRS also experienced contracting problems that resulted in payment for defective software. In December 1988, IRS' electronic filing project office drafted a proposal for enhancing the current system to achieve the agency's 1990 goal of expanding the availability of electronic filing nationwide. The project office estimated that about \$37 million would be required to expand, modify, and maintain this system so that it can handle the projected nationwide volume of about 36 million electronic returns by 1997.

We are concerned about this approach to expand electronic filing because (1) the system was originally developed solely as an interim measure until a nationwide system could be fielded, and (2) IRS has not demonstrated that this approach is the best for achieving the agency's ultimate goals for electronic filing. Before making a major financial commitment to expand the current system, we believe that IRS should clearly define its nationwide needs, analyze alternative approaches for meeting those needs, and resolve its software development problems.

¹ADP Modernization: IRS' Progress on the Electronic Filing System (GAO/IMTEC-88-40, July 13, 1988)

Background

IRS developed a pilot system in 1986 to test the technical feasibility and public acceptance of electronic filing in a small geographical area. On the basis of preliminary test results, IRS began developing a system in 1986 to meet its long-range needs for nationwide electronic filing. IRS expected to field the new system in 1988. A key part of its strategy was to buy mainframe computers to process the electronic returns.

IRS abandoned its development approach for the nationwide system when the Department of the Treasury rejected IRS' plan for purchasing the mainframes in November 1986. According to Treasury and IRS officials, Treasury disapproved IRS's plan to use an existing contract to buy computers because (1) the contract was in danger of going into default, and (2) buying computers for electronic filing was beyond the contract's scope. IRS estimated it would take until 1990 to compete a new contract and begin fielding a nationwide system. Rather than delay expanding the availability of electronic filing until then, IRS chose to develop an interim system at its Cincinnati, Ohio, and Ogden, Utah, service centers for use during the 1988 and 1989 seasons.²

IRS' Interim System Experienced Problems During the 1988 and 1989 Filing Seasons

According to the Assistant Commissioner for Information Systems Development, IRS decided to develop an interim system because it wished to promptly obtain the benefits of electronic filing by making it available in more districts. The pilot system used in 1986 and 1987 could not be used for this purpose because it could not handle the increased work load that expansion would entail. IRS proceeded with this strategy even though its prime contractor believed the interim system might well fail during 1988 because there was not enough time to adequately design and test it. IRS also knew that it would have to replace the software used for storing and retrieving returns because it was not designed to handle the projected 36 million tax returns expected when electronic filing is expanded nationwide. This software cost about \$1.7 million.

In 1988, the agency expanded electronic filing from the seven metropolitan areas covered by the pilot system to 16 IRS districts, including many major metropolitan areas. During the 1988 filing season, the interim system processed about 583,000 returns. The agency believes it has provided faster refunds to taxpayers by eliminating manual preparation

²To file electronic returns using the interim system, taxpayers typically must pay professional tax preparers or others authorized by IRS to transmit the returns. A computer, electronic communications equipment, and related software are required. IRS authorizes only those transmitters who apply and successfully complete IRS tests designed to verify competence in transmitting returns. Tax preparers may also transmit through an authorized intermediary firm which transmits directly to IRS.

and key-entry of data from paper tax returns into IRS' computers. IRS information indicates that electronically filed returns were processed in 1988 with significantly fewer errors than paper returns; as of April 1988, about 5.5 percent of electronically filed returns had errors vs. 20 percent of paper returns. This should save IRS the additional cost of identifying and correcting errors and help taxpayers get correct refunds. However, we are not aware of any published analyses of the costs and benefits of this system.

Although IRS was able to process the returns received electronically in 1988, software for a major system component did not work as intended. The prime contractor responsible for developing the software for storing and retrieving electronic returns could not deliver this software until December 1987, 3 months behind schedule and just 1 month before the 1988 filing season. According to the Chief of IRS' Compliance Systems Testing Branch, this prevented IRS from thoroughly testing the software to ensure that it worked properly before using it. In pursuing an overly optimistic schedule for system development, IRS was driven by project milestones geared to implementing a system in time for the 1988 filing season. According to the Assistant Commissioner for Information Systems Development, IRS accepted the risks of this development approach in order to achieve the expected benefits of the system as soon as possible.

Ultimately, the software never worked correctly. Specifically, an electronic replica or image of the returns could not be stored and retrieved as fast and reliably as needed for processing. As a result, stop-gap manual operations were necessary to correct errors. IRS tax examiners had to print paper copies of returns, annotate their corrections, and store these paper records. IRS decided to replace the defective software prior to the 1989 season and reprocess the returns filed during 1988 using the new software so they could be properly stored and retrieved.

The system experienced similar problems in 1989 because the replacement software was not ready on time. As a result, IRS again had to print paper copies of thousands of electronic returns that contained errors in order to correct them and issue refunds. IRS decided to install portions of the incomplete software in mid-February, to avoid printing more of these returns. According to IRS officials, the replacement software will not be completely installed or fully tested until about mid-April, the end of the 1989 filing season. The replacement software is expected to cost about \$2 million.

Contract Terms for Performance Requirements and Test Periods Were Inadequate

According to electronic filing project office officials, IRS' failure to clearly define system performance requirements or allow enough time to decide whether the deliverables were acceptable contributed to the problems with the defective software in 1988. IRS developed this software by engaging Vanguard Technologies, Incorporated, under a previously awarded support services contract that required the agency to obtain from Vanguard certain automated data processing services, such as the design and installation of software for major projects. IRS issued a task order under this contract containing 80 contract deliverables for a multi-phased design and development effort. Portions of the work under this task order were subcontracted, including the development of the 1988 software discussed above.

In failing to clearly define critical performance requirements for the software in task order documents, IRS did not, for example, specify the volume of returns the software should be able to handle during peak processing periods or the response times acceptable during these periods. According to the project office, the software had to be replaced because it could not meet the response times that would be required for 1989 and beyond.

The Chief of IRS' Capacity Management Branch—which is responsible for providing technical assistance to other IRS offices—stated that his staff could have helped the project office write adequate contract performance requirements. The project office did not take advantage of this opportunity for assistance, in part because IRS procedures do not require project offices to seek technical assistance from the Capacity Management Branch. The project office has been working with the Capacity Management Branch in developing recent contracts for the 1989 filing season. As a result, the contract documents for the 1989 system more explicitly state performance requirements. For example, the contractor is required to develop software that will store 750,000 electronic returns per week. The Branch Chief stated that IRS procedures should be clarified to help ensure that IRS project offices obtain the necessary technical assistance from the Capacity Management Branch in developing systems.

When defining the acceptance period for software to be delivered under the task order for the 1988 system, IRS did not allow enough time for quality assurance testing. The task order issued to Vanguard allowed IRS only 10 days to evaluate each deliverable. According to the IRS testing plan, however, quality assurance testing for the software designed to store and retrieve electronic returns required about 3 months.

IRS paid Vanguard about \$186,000 for subcontractor-developed software that failed to work properly. Of this amount, IRS authorized that Vanguard be paid \$124,606 for the installation of software at IRS' Cincinnati Service Center before testing was completed. IRS authorized payment for the software on January 20, 1988. The Compliance Systems Testing Branch began software testing during the week of January 17, 1988, and terminated testing on April 22, 1988, about 3 months later. According to the final testing report, the software should not have been accepted because of numerous unresolved problems. In addition, IRS took about 4 months to reject the software at the Ogden Service Center because it did not work as intended. Nevertheless, IRS eventually paid Vanguard \$61,315 for the installation of the Ogden software. According to a project official, IRS could not require Vanguard to revise the software because the contract terms had not provided adequate performance criteria to clearly establish the contractor's accountability for these revisions.

For 1989, in an attempt to allow more time for testing task order deliverables while also meeting project milestones, the project office increased the acceptance period to 20 days. According to the Chief of the Compliance Systems Testing Branch, however, 20 days still does not allow sufficient time to perform software quality assurance testing.

IRS Faces a Critical Decision Regarding the Future of Electronic Filing

By 1997, the agency projects that over 36 million of an anticipated total of 123 million returns will be filed electronically. After the 1988 filing season, the electronic filing project office abandoned its earlier plans to replace what began as a 2-year interim system with a new nationwide system in 1990. Instead, in December 1988, the project office proposed enhancing the current system to achieve its 1990 goal of expanding the availability of electronic filing nationwide. In February 1989, the project office estimated that about \$37 million would be required to expand, modify, and maintain the current system and about \$139 million more would be necessary to operate it from fiscal years 1989 through 1999. Through fiscal year 1988, IRS had already spent about \$13 million in developing, prototyping, and operating an electronic filing system.

IRS has yet to clearly identify its needs and evaluate the costs, benefits, and technical feasibility of alternative approaches, as required by federal regulations. Performing this analysis would help IRS determine the best approach. Specifically, IRS has yet to:

- assess whether the current system will meet IRS' nationwide needs, since it was developed as an interim system. IRS has not performed an analysis of these needs;
- decide how to minimize the burgeoning, paper-intensive aspects of the current system. With each electronic return, the tax preparer must submit a signature form and W-2. Responsible IRS officials said that during the 1989 filing season, IRS employed 47 people to receive, review, and file these forms, not including data entry staff who transcribe this information into the computer. IRS is considering the legal implications of eliminating the requirement for original signatures and W-2s. Depending on how this issue is resolved, IRS may eventually modify the system so that signatures and W-2s can be transmitted electronically. This could significantly affect system design and costs; and
- decide how the current system will accommodate the processing of tax due returns (presently planned for 1990). Since the current system now handles only refund returns, it will have to be modified to handle tax payments through electronic transfers, credit cards, or other means.

Treasury officials share our position that IRS needs to define requirements and assess alternatives. In January 1989, Treasury directed IRS to perform the analysis necessary to identify the best approach.

Conclusions

IRS plans to expand electronic filing nationwide in 1990 based on its potential benefits in reducing the costs and errors in processing returns and providing faster refunds to taxpayers. However, the agency will not know whether the current system being proposed by the electronic filing project office is the best approach for accommodating expansion until it clearly defines system requirements and evaluates the costs, benefits, and technical feasibility of other approaches.

In attempting to field the interim system, IRS experienced software development problems with a major system component. IRS also experienced contracting problems that resulted in payment for software that did not work as intended. Specifically, IRS did not (1) clearly define product performance requirements in contract documents, or (2) allow enough time for thorough product testing.

Recommendations

We recommend that the Commissioner of Internal Revenue validate the design approach for the nationwide electronic filing system before selecting and funding a system. At a minimum, IRS should:

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- clearly define system requirements for nationwide implementation. For example, IRS needs to determine how it will (1) minimize the burgeoning, paper-intensive nature of the current system, and (2) accommodate the processing of tax due returns; and
 - identify and analyze the costs and benefits of various alternatives for meeting the requirements for a nationwide system.

We also recommend that the Commissioner ensure better management in contracting for automated data processing support services by:

- revising IRS procedures to require project offices to get technical assistance in writing and negotiating contracts for major automated data processing systems; and
- allowing enough time to thoroughly test deliverables, thereby ensuring product quality.

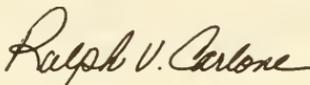
Objectives, Scope, and Methodology

The objectives of our work were to assess the problems encountered during the 1988 and 1989 filing seasons and IRS' approach for developing a nationwide electronic filing system. We conducted audit work between July 1988 and March 1989 at the Office of the Assistant Secretary of the Treasury for Management in Washington, D.C.; IRS' National Office in Washington, D.C.; the IRS service centers in Cincinnati, Ohio, and Ogden, Utah; and the Fairfax and Springfield, Virginia, offices of Vanguard Technologies, Incorporated. We reviewed various planning, contracting, and technical documents for the electronic filing project. We also reviewed the minutes of IRS' executive-level committee meetings dealing with electronic filing and interviewed officials associated with the project. Our work was performed in accordance with generally accepted government auditing standards.

The information contained in this report was discussed with responsible IRS officials, and we have incorporated their comments where appropriate. This report was prepared under the direction of James R. Watts, Associate Director. Other major contributors are listed in appendix I.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution until 30 days from the date of the report. At that time, we will send copies to interested parties, including the Commissioner of Internal Revenue, and make copies available to others upon request.

Sincerely yours,



Ralph V. Carlone
Assistant Comptroller General

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Chairman Pickle. Your appendix will be attached to your testimony and be made a part of the record. I thank you and I thank Ms. Richardson for your testimony.

Overall, the committee recognizes that we have a very difficult problem ahead of us. I am impressed with statements that Ms. Richardson has made about what the plans are at the IRS and with the GAO report. I recognize that we should be careful as we proceed to better understand the problem and to analyze specific steps that should be taken.

Today I don't want to elicit from you specific plans that you have to tighten up on fraud detection. I think both Ms. Richardson and Ms. Stathis have given us a broad picture of what is being done and what is going to be done, so I don't want you to delve into the future about alarming developments. I am going to ask specific questions. I know it is a little late; it is 12 o'clock, but we may take a little more time.

Now, in the first place, Ms. Richardson, you have mentioned in your testimony at the beginning that you had detected some 200 refund schemes during the first month, already, the last 30 days. I want you to submit to our committee the 200 cases. I request that you submit to us the 200 cases, somewhat of a detailed report on these particular schemes to determine whether a refund was issued or whether an identical scheme perpetrated next month would not happen again.

[The information was not received at the time of printing.]

You have 200 cases. We want to examine them. We want to know what has been the action, refunds made, people detected, suits filed, and what is the status of them. I am more concerned in knowing if the same thing will happen in March and in April and in May.

I want to know what is happening and what steps you have taken or can take to see that that doesn't happen again. Our problem overall is to try to correct these problems rather than just publicize them. That is one thing I want to request.

Now, I would say that is the first thing I want to do.

Second, I am going to request that GAO establish another task force on this problem and have a sort of multifunctional task force to conduct a comprehensive analysis of this whole problem. I would like to have this task force make another report to us by September 1.

Ms. Richardson said she would give us a report at the end of the year on their operations. I am not going to wait until the end of the year because Congress may be hot on the campaign trail. But by September 1, I think you are going to have a better picture and so I want a task force formed, multifunctional, GAO, IRS, and on any of your committees and this committee, so we can keep informed what is happening.

I am going to make that as a specific request.

I want to refer to a matter that I think we all recognize has taken place. The GAO report to this committee stated that "IRS had been more interested in expanding the electronic filing than in ensuring that it is fully understood," and I think that is correct and we all admit that.

You made mention in your report, Ms. Stathis, that our committee and you now, GAO, has reviewed a confidential Internal Revenue report prepared by a private contractor for some \$25,000. That has not been made available to the public. So I want to ask first with respect to that particular study, Ms. Richardson, can you tell us what that report says?

Ms. RICHARDSON. I think the report is something that we commissioned because we felt, as I mentioned in my testimony, the need to touch base with outside experts as well as the experts within the Service, and I think that the thrust of the report is that we very much needed to try to put into effect, which we have done for this filing season, the three studies so that we can get a sense of the magnitude of the problem, the types of issues that we are faced with, so that we can go about preventing it.

We need to, as I said in my testimony, analyze the extent of the problem so we can—

Chairman PICKLE. My question is can you tell us what the report says?

Ms. RICHARDSON. Well, not in terms of the specifics of the report. I don't think we would be prepared to discuss those here in the open session. But I think it is fair to say that the drafter of the report has been working with us to help us design filters and systems that we put into place for this filing season and things that we will be doing long term.

Chairman PICKLE. Can you mention whether the study indicated that the losses to IRS has been in the millions or in the billions?

Ms. RICHARDSON. I think the drafter of the report said that based on his guesstimate, and what he knew from what we had done in terms of fraud detection, that it could be possibly in the billions as opposed to in the millions.

Chairman PICKLE. Have you shared this confidential report, if it is, with the Treasury Department?

Ms. RICHARDSON. We have discussed it with them, yes.

Chairman PICKLE. When did you do that?

Ms. RICHARDSON. Over the last few weeks.

Chairman PICKLE. I understood that you had not talked to Treasury and I assume that was yesterday or this morning; is that correct?

Ms. RICHARDSON. No, I don't think that is accurate.

Chairman PICKLE. What is accurate then? When did Treasury know about this?

Ms. RICHARDSON. I am not sure when they first knew about the report.

Chairman PICKLE. Mr. Dolan, how long has Treasury known about this report?

Mr. DOLAN. I am not sure Mr. Chairman. I suspect at the same point in December when the GAO was communicating with this subcommittee that the report was in existence, they knew it then. I also know that they knew in 1992 and 1993 that we had basically declared this whole area in the FMFIA process.

Chairman PICKLE. I am talking about these specific reports.

Mr. DOLAN. I think maybe going back to the GAO date—

Ms. RICHARDSON. Probably in December.

Chairman PICKLE. Then your testimony is that IRS was notified that this report existed as of December last year?

Mr. DOLAN. That is speculation on my part. I would assume at a minimum they knew at that point when the report was released.

Chairman PICKLE. Mr. Brown, do you know when Treasury knew it?

Mr. BROWN. I don't know who might have briefed Treasury officials. All I can tell you is that I personally briefed one person yesterday, but other than that, I don't know what prior conversations had occurred.

Chairman PICKLE. As far as you know, the first time Treasury knew about this was yesterday—

Mr. BROWN. No, sir. The only thing I can say is the first time yesterday that I talked to that person is the first time he knew anything yesterday.

Chairman PICKLE. I hope we will produce this study, because it was a factual study. I assume it was a reliable study. Do you think it was?

Ms. RICHARDSON. I think for the kind of study that it was, I think we certainly believe that the contractor had a significant amount of expertise with financial fraud. I think it was based on a very limited time period and a limited review of documents.

It was done in order to help us short term do things for this filing season and then help us work on long-term issues in the fraud area.

Chairman PICKLE. If you commissioned an individual to conduct a study and it was done, and you paid \$25,000 for it, and you had confidence in him, you say you think he gave a good report, then I think we ought to be able to share it. I am urging you to do that. I am not asking you to do that today, but we are interested in one thing; is the problem as big as we think it is or bigger?

I think it is bigger than we think it is and we better do something about it. Every IRS Commissioner in the past few years has stated that we are going in the direction of electronic filing and each Commissioner has said over the years we will have 80 million of these returns filed by the year 2000. That is a laudable goal and we must go into the electronic age. But as we do that, we have to see that our system is better protected and say how can we fix it, what can we do about it.

I yield to Mr. Houghton.

Ms. RICHARDSON. One thing I would like to say, because I think it would be a mistake for people to assume that there may not have been fraud in the paper process some time ago. I think what the move toward electronic filing and being able to get more data on-line has been able to do for us is allow us to detect patterns and schemes more readily.

Ironically, although the focus has been on concerns about electronic filing, I think that has been the very thing that has helped us uncover fraud, and I hope after this filing season, when we have had a chance to do the three studies, that we will have a better handle—

Chairman PICKLE. I am sure the studies will help. I want to yield to Mr. Houghton.

Mr. HOUGHTON. I would like to thank the Commissioner and Ms. Stathis and the others for being here.

A couple of questions, first a specific one. The IRS authorizes certain individuals, tax practitioners, to become electronic return originators. These individuals are checked out to a degree.

To what degree though does the IRS exercise any control over tax return preparers in the conduct of their business?

Ms. RICHARDSON. Mr. Brown will be in a better position to answer that question.

Mr. BROWN. I think first, and generally, the IRS does not regulate the return preparer industry. Whether they were CPAs or attorneys practicing in the area of tax, they are regulated by State agencies. The only group that we have some control, or passage, is first your enrolled agents; and second the electronic return originators, and that is not a test of tax proficiency, but a suitability to transmit information to us.

When we get an application from a potential electronic return originator, it goes through a suitability test. We look to see what their history is with the IRS, are they already known to us as either a problem, a recalcitrant taxpayer in their own right, or a business problem with us as a questionable return preparer—then we check to see if there are any other things in the background within the organization that might be known.

You have heard about the difficulty from GAO with NCIC checks. Basically, if we don't see anything at that time to alert us of a problem, then they are approved as an ERO and would be assigned the electronic identification number.

The rest of the process is monitoring during the filing season at the district level of EROs to see if they are complying with the requirements of the revenue procedures; basically are they keeping the right kinds of records.

If we identify problems in our process, either as potential fraud, of course, the Criminal Investigation Division gets involved, but even if we identify potential processing problems in terms of timely submission following the rules, the district office is the group that follows up on that and tries to determine if that number should be revoked and their right to transmit to us be revoked.

Mr. HOUGHTON. I don't mean to be flip, but say that in a sentence.

Mr. BROWN. We don't regulate the industry in general. We do a basic suitability check of new applicants to be EROs. We do some monitoring to see that they are conforming to our rules and if they aren't, we throw them out.

Ms. RICHARDSON. One of the things we are looking at closely as we go through this filing season is to see what additional actions, if any, we might need to regulate ERDs.

Mr. HOUGHTON. I understand from what you said this is what you do, but it would seem to me from the testimony of the other two gentlemen earlier that we are moving into Never-Never Land. I just read about this recent glitch in Internet. It is scary. These so-called locks or bridges which you go through can easily be penetrated.

So the question is, is the system which you have now—you can't be the Gestapo—but is the system suitable for doing the types of things you know are potentially out there?

Ms. RICHARDSON. It was clear that you wouldn't necessarily have to have a preparer to sign a return to have a scheme if they could get enough people involved in the process. While I think that we are looking very carefully at what additional authority we would need, I don't think I would view that as a panacea for snuffing out all schemes.

Mr. HOUGHTON. Let me try to summarize what I heard from the gentlemen we had earlier and see if you disagree.

The situation in terms of fraud is very big, a lot bigger than any of us realize. At a minimum, it is four times larger than what you have picked up, meaning half a million dollars could get into the billions.

The electronic filing system which you are moving toward makes it easier rather than less easy to create fraud. The system is not working. For example, if it is so easy to get an employer ID number then it also should be possible to alert people more succinctly that there is a problem out there if they start fiddling around with this, because they are going to go to jail.

Do you agree with those general points?

Ms. RICHARDSON. I am not sure that I do completely.

Number one, I don't know on what basis one of those people has to speculate that the 25 percent number is correct or that there are 4 times as much.

Mr. HOUGHTON. As he said, he doesn't know there is 25 percent. The impression I got and from previous conversations that some of the staff has had is he said you don't really understand the magnitude of what is going on out there, because he knows the people that are doing this and they are not getting caught.

Ms. RICHARDSON. I have no basis for knowing his knowledge. What I do think would be a mistake would be to conclude from his testimony—and I think the other fellow that was here confirmed—is that this is not a problem peculiar to electronic filing.

The electronic filing, I think, has allowed us to recognize that there are vulnerabilities to the processing system and to be able to identify them much more quickly. I personally—and I believe what the chairman said in his opening comments is accurate—I think we should not be emphasizing the rapidity with which you can get your refund, but emphasizing the benefit of electronic filing in terms of reducing paper and in terms of the accuracy, but I clearly support efforts to try to find ways to prevent and detect fraud.

I do understand that it is a serious problem and we are trying very hard to get a handle on it. I look forward to working with GAO and with your subcommittee and subcommittee staff to try to see what we can do because it is nothing peculiar to the IRS.

Banks, credit card companies, insurance companies are constantly fighting this problem. It is not widely discussed, but it is clearly a problem when you have a opportunity for money to be passed out.

Mr. HOUGHTON. If you had a similar report to the one that the chairman has referred to put on your doorstep, would you be willing to share this with the subcommittee right away?

Ms. RICHARDSON. I am not—

Mr. HOUGHTON. If you had a report similar to the one the chairman talked about come to your desk and it showed something that is untoward in the system, would you be showing it to our subcommittee even without a hearing?

Ms. RICHARDSON. I think in the course of discussing the issue, we certainly would. I don't think there is anything in the report that is embarrassing.

I think what is in the report, there are some things that discuss criteria that should be looked at, criteria that have been looked at, what has worked and what hasn't, and I don't think that is something that we would want to make public.

Mr. HOUGHTON. But if there is a report that has an impact on our oversight function and is important to the overall scheme of things that you are involved in in the IRS, you would make such a report available?

Ms. RICHARDSON. Yes.

Mr. HOUGHTON. Let me ask Ms. Stathis two questions in terms of the extent and second about capability. What do you really believe, from the knowledge you have, from the reports you have seen, is the extent of this fraud; and also, does the IRS, even with your recommendations, have the capability to get on top of this issue?

Ms. STATHIS. As we said in our statement, Mr. Houghton, we do not know the true dimensions of this problem. There really are not the kinds of data there to estimate with any great comfort level. It is the type of thing that you look at the system, you try to see what vulnerabilities are there and try to make what recommendations you can to try to shore up those vulnerabilities.

Mr. HOUGHTON. The last accounting was that there were roughly 60,000 people and a little over \$100 million taken in. Is that the order of magnitude you think is there or is there something far greater?

Ms. STATHIS. As we said, the troubling aspect of this is to think about what is not being detected. I suspect that there is an amount of it not being detected, but I have no idea how large that might be.

Mr. HOUGHTON. What about the capability of IRS to get on top of this?

Ms. STATHIS. I think that is a question the Service is going to have to think about as it works on the various scenarios that have been presented to it. I don't believe that we normally as government employees think as though we are fraud perpetrators, so the systems are designed with people in mind who have good intent. We are going to have to step back and think about these systems with a fraud perspective and think about how they might be used to—

Mr. HOUGHTON. Any change would be one of attitude rather than equipment or sort of technical capability?

Ms. STATHIS. I believe that the consultants' report that you have been discussing is a first step in seeking the type of expertise that is needed to understand what possibilities are out there. So I believe that IRS has the capability through its own staff and through contracts with outside people to obtain the expertise that it needs.

Mr. HOUGHTON. Thank you.

Ms. RICHARDSON. One of the things, just to followup, I think it is clear that our voluntary system of compliance is built on trust and reliance in the integrity of the vast majority of people that we have to deal with. It is clear that not everybody has the same kind of mind set.

I think it is fair to say that it hasn't been until very recently that IRS has taken steps to really think about the possibility of the extent of the fraud because we have had a voluntary system. It is not often that people file tax returns—we welcomed all comers, as you can imagine, so it is not often that we would have been looking for returns fraudulent in the—overstated deductions and understated income.

We are clear in our own minds that we have to look at things differently. That is why Mr. Brown is here. That is what our chief inspector and his people have been doing. We are anxious to work with credible, outside consultants to help us in any way to identify the magnitude of the problem and to help us prevent it from occurring in the future.

Chairman PICKLE. Ms. Richardson, our problem is made much more difficult because we are trying to achieve the filing by electronics. But the creation of the EITC is an invitation for a lot of people to try to reach out and get the money and get it quickly. Even though we know that is a problem and we are a compassionate Nation, we know we are going to raise that amount because we want to help people who really need it, and the promise is that we will get it to them immediately.

I think we have to slow down. It normally takes 14 days to process one of these claims. That is pretty much the average you have. I noticed somewhere that the IRS is talking about shortening that time. Do you have any intention of trying to shorten that 14-day period?

Ms. RICHARDSON. I certainly don't until we have a handle on how that is going to impact on the potential for fraud.

Chairman PICKLE. This committee would certainly agree with that.

Ms. RICHARDSON. I think that that is one of the things we have to look at in the context of what we discovered during the filing season. I know there is no reason for speeding up the refund process if that contributes to fraud and we are certainly not going to continue it.

One other thing in terms of the earned income tax credit. We are promoting very heavily the advanced earned income tax credit so that people can actually get their earned income credit as they receive their paychecks over the course of the year as opposed to a lump sum.

Chairman PICKLE. That is another subject to look into later.

Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

I have not read the report and in fact I know very little about it. However, I would like to ask, was there any recommendations made in the report or was this just a statement of fact?

Ms. RICHARDSON. There were a number of statements, some factual and some speculative, and there are a number of recommenda-

tions, some of which we have adopted for this filing season, some of which we will be incorporating longer term.

Mr. Brown might like to address specific things that were in the report that we are doing.

Mr. BROWN. The first recommendation was that we had to take a multifunctional approach. We did have Criminal Investigation and Returns Processing looking at the problem in functional stove pipes. That was one. We had to look at it overarching.

Second, we needed to do some sampling to get more accurate, statistically valid information about the size and scope of the problem. He made some suggestions about how fast we should do that and we have completed the pull of our first sample and, as the Commissioner mentioned in her opening comments, we are doing the confirmation now.

The third was to review our screening, or scoring formula, itself, that GAO described that needs to be enhanced. We have been limited in the past by our computer capacity to do much more advanced statistical scoring.

He suggested we need to take a look at that and if we can't do it in-house, to engage outside experts in the field.

Another area was to watch the commitment to decrease or improve the speed at which we issued refunds, that maybe we shouldn't commit to speeding up refunds until we had the protections in place.

Another was to try to really focus on pre-refund identification of the returns. With this type of fraud, once the refund has gone out, even if when you find it, whether it is 1 week or 6 months later, you have a much tougher problem, either finding the perpetrator or recovering the money and that increases the attraction of it for other fraudsters.

So we have stepped up our pre-refund efforts this year. Those are the kinds of things, specific recommendations, that he made that we are trying to react to.

Mr. HANCOCK. Ms. Richardson, if you recall right after you took over as Commissioner, I came to a reception at your office. I figured if I was ever there, that is the way I wanted to be there.

At that time, you and I discussed the possibility of the Revenue Service itself looking into these areas of compliance cost, change in depreciation schedules every year, first one thing and another about the simplification of the Tax Code.

Frankly, Mr. Chairman, we may be at a point in time that this might be able to be accomplished because of the complications and the fact that we are attempting to do something about it. There wasn't anything in these recommendations about, for instance, getting rid of a whole bunch of schedules? There is no way that we could even have a Tax Code like we have now if it wasn't for computers.

It could not be done. There is not enough people that can do that. Has this even been considered? You and I talked about it. Have you set up a little task force to see if, in fact, we could help reduce compliance costs?

Ms. RICHARDSON. The particular report you are referring to did not address any issues relating to simplification and that sort of thing.

We are working with Treasury. We have sort of an ongoing review of regulations and provisions that are unduly complicated and we also have been working with Treasury to try to come up with simplification measures.

I can't tell you that it is something that is on the front burner and will be here next week, but we are cognizant of the need to simplify the law, particularly the administrative side. It makes our job easier when the law is simpler.

Mr. HANCOCK. One more question. I am going to approach the subject even though I understand it will be a very sensitive question. There have been comments made in various reports and what have you about the possibility that there are some people getting into fraudulent acts that have obtained their information from IRS employees on how to go about doing this.

Ms. RICHARDSON. I don't know that I am aware of that.

Mr. HANCOCK. My question is what type of internal investigation or what type of internal controls do you have aimed at monitoring this? I am a small businessman. We do have bonding, and we have ways that we monitor what our people are doing. I would like to know if, in fact, you do have internal controls and what you are doing in that area?

Ms. RICHARDSON. We do very definitely have internal controls. I think the person to address them is our Chief Inspector who is, in effect, our Inspector General, Gary Bell.

Mr. HANCOCK. The reason I ask the question is because I believe a lot of people ought to know that, yes, in fact you do have this because I know you do.

Mr. BELL. Inspection is comprised of internal security which does investigations of our employees or internal audit. We use computer checks of our data files to determine employee wrongdoing. There are instances where—I don't have the examples with me today—employees have been involved and have been detected through data analysis, file analysis similar to what we do in the questionable refund program and then we investigate and evaluate the areas with our inspection staff.

Mr. HANCOCK. I just wanted the public to know that, yes, these steps are being taken. I know they are being taken and I know some of the other things that you do, too, to work in that area.

Ms. RICHARDSON. I think we have a very strong investigative side and internal audit side and both arms of inspection have done an outstanding job in helping us with some of the issues we are talking about here today.

Mr. HANCOCK. I believe you are right.

Thank you.

Chairman PICKLE. Ms. Richardson and Ms. Stathis both, I believe GAO has recommended to our committee that we not shorten this to 14 days; it ought not go less than that. Ms. Richardson indicated she has no intention of trying to shorten that time and I think our committee would agree with that.

The IRS Taxpayer Ombudsman has criticized the electronic filing process because low-income taxpayers seeking quick refunds incur disproportionate costs to use the electronic filing program. On average, it takes about \$30 to file electronically and it takes another

\$30 on average to obtain an application for a RAL. That is \$60 that the taxpayer is out.

The OMB has indicated to us that they don't know whether that is a good deal or not because the IRS saves about \$1.62 on one of these filings as compared to a \$60 cost to the taxpayer. Miss Stathis, is that basically correct?

Ms. STATHIS. As far as I know those are about the right numbers.

Chairman PICKLE. Is electronic filing a good system, a good deal for the taxpayer?

Ms. STATHIS. From the perspective of the taxpayer, particularly low-income taxpayers, it is quite problematic. A report we did on IRS' marketing strategy for electronic filing talks about who is being served and who isn't and notes that the way the marketing has gone thus far appeals more to low-income people than to higher-income people.

Chairman PICKLE. Someone this morning indicated that you do not issue EROs.

Ms. RICHARDSON. We don't.

Chairman PICKLE. If a tax preparer wants to get an ERO, to whom does he apply?

Mr. BROWN. We do the suitability test. The Service issues approved persons to be EROs.

Chairman PICKLE. Do you issue employer numbers?

Mr. BROWN. Identification numbers, right.

Ms. RICHARDSON. Mr. Chairman, one of the things I would like to say—and I have said this before—I feel very strongly that every person who wants to file electronically should be able to. We have been looking for ways to make it economical for everyone.

We have this year, in a number of our offices, made available opportunities for people to come in and file electronically without cost. I think that is the kind of thing we would like to expand. We have TeleFile, which I think we have had about 100,000 filers already. People can call and punch in their information over the telephone. That is a free service.

It is basically for people with simple fairly straightforward returns, but those are ways that we are trying to move to accommodate the concerns that I know you have had in the past and we do, too, about the cost of the system.

Chairman PICKLE. I think filing electronically is going to be done more and we have to find ways to handle that. We are not going to keep on just handling it just by paper refunds, but I think we need to make a lot of corrections and we better make them quickly or else the public is going to continue to defraud and beat the Government out of money and taxpayers are openly violating the law because they don't figure they will get caught.

We heard this morning that the people who allowed their names or their Social Security numbers to be used knew at the time and in all probability that this was fraudulent, yet they wanted to participate because they wanted to get the money. It is easy as pie, they testified.

Assuming this is correct, or even in the broadest sense it is correct, we have to make big changes. When we have our report again in September, this task force, I hope and believe that at that time

we will have about 100 percent or nearly 100 percent or the big majority of these problems worked out. If not, I am going to recommend that there be a freeze on electronic filing.

I recognize that means that the people would go back to paperwork and we are trying to get away from some of that, but I think we have to correct the problem and I am going to insist it be done. I am going to recommend that the GAO go out next month and investigate some 5500 EROs—that is only 10 percent of the number you have—to see if they exist and what they find.

You have 55,000 of them, take 10 percent of them and give us a report of what you got. I think we need to know exactly what are your standards for an ERO, how easy it is to get an ERO number and identification number. The big question is can you make these corrections by this fall?

Ms. RICHARDSON. I think what we have to do is identify what we need to do and then work with you all to let you know whether we can. There are some things that are long-term systemic issues that I don't think can be done by next year. There are other things that I think we can do.

Chairman PICKLE. This committee ought to support your advocacy of funds for the TSM program and we have to support your budget bigger and better if you need it.

Ms. RICHARDSON. That is clearly the answer to our long-term—

Chairman PICKLE. Every dollar we spend we would get \$3 or \$4 back if we do it right. So this committee, I think, will support you on that.

The question that comes to mind is do you have the equipment to really make these findings or corrections?

Ms. RICHARDSON. I think there are some things that we presumably will identify that we can do for next year and we are bringing online additional equipment over the years, so there may be additional things that we can't do today that we would be able to do.

There are other things that are further into the future.

Mr. BROWN. Many of the ideas and solutions that we have are equipment and capacity and computing power dependent, and we keep rolling out different pieces of TSM so as the new piece comes out, we can implement additional controls.

The question of what we can do by September or January is very much dependent upon the systems.

Second, some of the research being done by Los Alamos, for example, will be iterative. Because of systems limitations, we will add some capability this year, next year and in 1996. It will be an iterative process.

By September, I think we can tell you what we can do short term and what will take a little bit longer and what it depends on.

Ms. RICHARDSON. I think also, Mr. Chairman, when you are visiting the service center in Austin later this month, we will be able to show you things we will be bringing online over the course of the year and where they will lead us.

Chairman PICKLE. You are able to take a lot of these forms filed or kicked back by the computer. What bothers me is you only catch the obvious, as I understand it, and when you get a stack every day 1 foot high, you don't know what to do with it.

Ms. RICHARDSON. That is the significance of our contract with Los Alamos. That is where they can truly help us with that stack of information. They can help us detect patterns, analyze the data, so we are very hopeful that they will be able to help us in that front.

Chairman PICKLE. In making these recommendations from my standpoint, I am trying to see that the emphasis is put on electronic filing and how it affects the system. I think it would be a mistake to say to the country what you are going to do to catch the crooks.

I know from your testimony that you are going out there to make these corrections, and I think we have a right to expect it, but I also think if they are not corrected and corrected soon, we better slow down the process, even having a freeze.

I hope our task force, the three studies you are going to make would give us better insight and you tell us how you are not able to catch these people and what can we in Congress do to improve the situation. We are ready to do it, but we don't want to be kept in the dark when you have a study that shows the situation is worse than it is and we have to find out the hard way.

Let's work together and find a better answer to it and do it as quickly as we can, because I think the whole system is at stake. I will have a specific task force created and I want to work together and I want this committee to be a part of the task force.

Ms. STATHIS, I am going to ask that you give us a bundle of people to help on the continued study of this program.

Ms. STATHIS. I will go back and seek such resources, Mr. Chairman.

Chairman PICKLE. I will not be bashful in our request.

We will conclude unless Mr. Houghton has other questions or comments to make.

Mr. HOUGHTON. No.

Maybe just one. You know I was supposed to go to a Social Security hearing this morning and I didn't because I wanted to be here. But it is the same issue—it is the drug addicts, the alcoholics who milk the Social Security disability system.

We have talked here about people doing the same thing. It is sad that this is happening, but it is happening. So the question to me is not just the specific procedure or set of equipment, but it is an attitude—not that again we want to be policemen totally, but we have to change our attitudes toward what is going on out there because it is really tough on those people who try to be honest. You know that they are surrounded by people who are taking tremendous advantage of it.

I don't know what it is going to look like in 20 years, but it is an attitudinal problem.

Ms. RICHARDSON. One of the saddest things was a lot of people were victimized by the people who testified this morning. I think that is absolutely right.

Chairman PICKLE. What we have heard from these two individuals is happening all across the land. All known crime is not just in Atlanta or Baltimore.

Ms. RICHARDSON. Or at the IRS.

Chairman PICKLE. We know that and better accept that fact and go to work to try to correct it. I don't want to be an alarmist. I want to be able to say we are correcting it.

I hope through your service centers and through the press we can make people understand that if they do participate with a tax preparer or a crook preparer or whatever you call it, they are going to be held responsible and they might end up in jail, the same as the preparer, and that is wrong. It is hurting the system.

I don't know how we can get that word out, but they ought to know that Uncle Sam will come after them and catch them. It may take more time than I think it should because you can't move fast enough yet, but they will probably be caught.

I think we need to make that understood; otherwise the voluntary system is in big trouble. It is still the best system in the world and we got to work fast in this area and that is why I want the task force to continue.

Ms. RICHARDSON. Thank you for your support and we look forward to working with you to solve the problem.

Chairman PICKLE. Thank you.

[Whereupon, at 12:50 p.m., the hearing was adjourned.]

[A submission for the record follows:]

STATEMENT SUBMITTED TO THE SUBCOMMITTEE ON
OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE
OF REPRESENTATIVES, OUTLINING PRIVATE INDUSTRY EFFORTS
TO DETECT AND DETER TAX REFUND FRAUD IN CONNECTION WITH
ELECTRONICALLY FILED TAX RETURNS

Mr. Chairman and members of the Subcommittee, this statement is submitted on behalf of the Electronic Filing Coalition, a group of corporations and associations formed to help combat fraud--through detection and prevention--associated with the filing of individual tax returns. Among the members of the coalition are H&R Block, the National Association of Computerized Tax Processors, the four major financial institutions engaged in Refund Anticipation Loans, i.e., Bank One, Beneficial National Bank, Greenwood Trust and Mellon Bank, and other entities involved with electronic filing of tax returns.

Today's hearing affords us an important opportunity to describe our industry's significant efforts to combat tax refund fraud. As the Subcommittee noted in its release announcing today's hearing, the problem of fraud historically has been endemic to both paper and electronically filed returns. In this regard, we would emphasize at the outset our firm belief that the impetus to commit tax fraud stems not from the availability of refund anticipation loans, for example, but from the belief by some that they can successfully defraud the tax system by manipulation of the tax filing process through whatever countless schemes the criminal mind can devise.

Attempts at fraud generally take two forms: (1) individuals using false social security numbers (SSNs) or other identification, and counterfeit W-2s and other fictitious documentation and (2) taxpayers utilizing erroneous information to enhance their refund claim or to claim statutory credits to which they are not entitled, such as the earned income credit (EIC). Our industry, working with the IRS, has been a potent force for preventing refund fraud at the initial stage of the filing process. Our industry has trained its employees to be aware of suspicious returns, has put into place systems for verification of returns and has implemented routine anti-fraud checks and safeguards. As a result, it has become a powerful partner with the IRS in preventing refund fraud in connection with electronic filing.

The Internal Revenue Service has taken great steps in deterring the first type of fraud mentioned above by implementing the On-line Entity Check which validates taxpayer names and social security numbers as part of the electronic filing acceptance process. This process virtually stops invalid names and social security numbers used to defraud the system.

Some major initiatives undertaken by the industry for preventing, detecting, and deterring tax filing fraud include:

- * Creation and distribution by H&R Block and other major tax preparers of videos to the Electronic Return Originator (ERO) community to raise the awareness of fraud.
- * Extensive training of tax preparers to identify non-standard W-2s and to verify employment in the case of non-standard forms.
- * Development and implementation by H&R Block and other tax preparers of a comprehensive fraud prevention and detection plan (see attached, Fraud Prevention 1994). This plan which focuses on deterring electronic filing fraud before transmission of the return, establishes controls used by tax preparers and return processing

personnel. Controls utilized by the tax preparers include:

Screening taxpayers eligible for an EIC to determine if they filed a return the previous year and, in accordance with criteria established by the lending banks, denying credit to those who do not meet the criteria.

Stringently examining W-2s and identifying those that are determined to be non-standard.

Verifying the accuracy of FICA and Medicare withholding accounts.

Denying credit, in accordance with criteria established by the lending banks, to taxpayers whose only income is from Schedule C.

Requiring a copy of a birth certificate for a child age one or older listed on Schedule EIC if such has been used in lieu of the SSN.

- * Establishment of return processing procedures to verify employment on suspect fraud returns and, when applicable, contacting the Criminal Investigation Division (CID) of the IRS.
- * Creation and implementation of sophisticated diagnostics built into electronic filing software in order to identify criteria that would exclude loan eligibility as well as to alert return processing personnel to conflicting information that may flag potential fraud. An example includes the ability of the diagnostics to compare W-2 withholding with gross wages to determine whether the withholding is reasonable for the amount of wages.
- * Creation of the Fraud Service Bureau (FSB) to review tax return data. This industry-wide cooperative effort links all major lenders and electronic return transmitters, which allows them to compare and cross-check data to verify valid loan applications and identify suspect applications regardless of which lender receives the application.
- * Employment by the FSB of sophisticated fraud detection systems, including the use of statistically based and neural network technology, to create various "scorecards" based upon tax return data which key in on fraudulent refund characteristics.
- * Prompt referral of suspected fraudulent returns to the Criminal Investigation Division at the IRS Service Centers.
- * Thorough screening and background checks of participating EROs by major lenders.
- * Full cooperation with law enforcement in responding to subpoenas and appearing as witnesses in prosecutions for electronic filing refund fraud.

Our industry's strategy is to work closely with the IRS and CID in the development of an ever-evolving, comprehensive program to combat tax filing fraud. The IRS and CID are precluded from sharing their internal anti-fraud strategies with the private sector. All information developed by the industry is treated as confidential in accordance with current law. Consistent with these confidentiality safeguards, our industry's mission is to develop and implement manual and electronic procedures that will deter

and detect fraud while promoting the advancement of electronic filing of tax returns in support of the stated goals of the Congress and the IRS.

Members of our coalition continue to develop and implement a series of "up-front" checks that screen taxpayer data to determine the likelihood of electronic filing fraud. These screenings focus primarily upon verification of the W-2 and tax return information. When evidence is found that a fraudulent scheme is in progress, procedures have been put in place to report the information to the CID as expeditiously as possible. The industry views a close and efficient working relationship with the IRS and CID as a key to success in stopping electronic filing fraud.

While an up-front check of tax returns represents an important first layer of screening for suspect electronically filed tax returns, an equally important second layer of screening is provided through manual and computerized checks of the Fraud Service Bureau FSB created in the fall of 1992 through the joint effort of our industry's four major banks. The FSB is in its second year of operation. It uses various scoring methodologies to screen all the electronically filed tax returns accompanied by loan applications (more than 9 million tax returns during 1993 alone).

The FSB process requires all electronic filers associated with our major lenders to send to the FSB all loan-related tax returns at the same time they send those returns to the IRS. It is important to note that these tax returns reach the FSB before the IRS acknowledges a return and authorizes direct deposit of the taxpayer's refund. It is a primary mission of the FSB to get the scored suspect fraud record to the lender during the loan approval process so that it can be considered prior to approval of the loan application by the RAL bank.

In addition to the FSB's ability to process high volumes of data rapidly, it employs both statistical and neural-based scoring modules that identify typical patterns of data on tax returns associated with prior fraudulent schemes. These modules are re-trained and re-engineered each tax season, updating them with any new fraud patterns that have surfaced. The FSB gathers its fraud information through industry experience and subpoenas issued to our lenders for specific taxpayer data required to aid in a fraud investigation. The actual SSN or identity of a taxpayer is never used in the scoring development. However, certain characteristics and attributes of the actual tax return are used in the scoring process as permitted by law.

Once electronically analyzed, the emerging patterns are scored accordingly and a distribution table of scores is produced. Each lender reviews the tables and sets its own scoring threshold for a suspect loan denial. Typically, our lenders have been denying up to one percent or more of their loan applications as suspect fraud. Each lender has procedures allowing a loan applicant to call an "800" number and discuss a denial. In many cases a loan applicant can provide sufficient information to refute the denial and in such event an approval of the loan application is issued.

If an applicant for a denied loan does not call the lender within five days to refute the loan denial, lenders transmit those filers' SSNs to the appropriate IRS Service Center for further investigation (over 13,000 such SSNs were forwarded to the IRS during the 1993 tax season). Our lenders understand that an honest loan applicant simply may not bother to refute a loan application denial. However, as cited in the December 1993 General Accounting Office (GAO) report assessing the IRS's 1993 filing season performance, the information provided by our industry helped CID Fraud Detection Teams identify fraudulent refunds.

The same GAO report pointed out that our industry often took too long to report and transmit information to the IRS. In response, our lenders in the 1994 season have cut the

reporting time to the IRS from 10 days to 5 days. Last year the data was batched and transmitted to the IRS on a weekly basis. This year, files are transmitted daily. As a result, the IRS receives all information on the evening of the 5th day! In addition, a new file of SSNs containing duplicate (previously filed) SSNs identified by the FSB is being transmitted to the CID in an effort to further assist in identifying suspect fraud situations. The value of this new procedure to both our industry and IRS is as follows:

The FSB stores an identification record for all primary, spouse, and dependent social security numbers on its database. When a return comes in with a previously received SSN, the application is immediately flagged and further inquiries are begun. The system checks to see if the current and previous return were received from the same return originator and the same transmitter. If they have, the SSN is judged to be a correction and the duplicate flag is lifted. If these conditions are not present, the SSN is deemed a duplicate. A file of this information is prepared for same-day transmission to the IRS. Processing for the four major lenders, the FSB receives loan-related tax returns transmitted to all five IRS service centers and is able to check SSNs across each of them. The file sent to IRS contains the duplicate SSN, primary SSN, dependent SSN, and a code indicating the type of duplicate found, i.e., "dup prime, dup spouse, dup dependent." The IRS is then able to investigate the basis for duplication before a refund is issued.

The FSB is operated by Beneficial Data Processing Corporation in Peapack, N.J. To date, the development investment by our industry's members is over \$3 million in direct FSB expenses attributable to hardware, software and maintenance. Another \$1 million is spent annually by each member to cover travel, meetings, high level resource involvement, system testing and the individual member's own fraud investigation department's handling of the thousands of calls made daily. The FSB maintains electronic links to 16 electronic filing transmitters (the largest being CompuServe) and our four major lenders. In 1993, the FSB processed over 9 million loan-related tax returns through its facilities, representing roughly 73% of all tax returns filed electronically.

Based on recent 1993 IRS statistics, the percentage of fraud attempts involving loan applications has decreased significantly from 1992 to 1993. We believe this significant verification was a result of the IRS On-line Entity Check (name and SSN validation process) and the industry's aggressive efforts. In fact, for tax season 1993, there were a comparatively small number of loans subsequently determined to be fraudulent.

These facts lead to the conclusion that the screening methods, including the FSB, now applied by the industry are working well. Nevertheless, the FSB is but a part of a larger process dedicated to identifying and deterring filing fraud. Our industry's front-end vigilance, ongoing IRS/industry dialogue on fraud prevention, the IRS's own internal fraud procedures, CID's follow-up and each lender's own fraud investigation teams have played an important part in the intense focus on this problem. We believe that the electronic filing fraud identified in tax season 1993 establishes the benchmark and that the fraud problem is being addressed.

During the last four years alone, well over 35 million taxpayers have filed their returns electronically and been issued loans. The enormous customer demand for electronic filing accompanied with a loan is clear. Historically, since the inception of the program in 1987, approximately 90% of all electronic filers also have requested a loan. Significantly, seventy-five percent of electronic filing borrowers surveyed have indicated that if they could not obtain a loan with their electronically filed tax return, they would not have filed electronically.* The ongoing

challenge of our industry will be to foster future growth of electronic filing and, at the same time, to continue the deployment of sufficient resources to maximize the reduction of fraud-related losses. Tax season 1994 is only the second year of such an undertaking and to date the results are promising. The efficiencies and resulting tens of millions of tax dollars saved by the U.S. Treasury because of electronic filing are already significant. We firmly believe that the collective efforts of the industry and government will be successful in substantially reducing tax filing fraud as the IRS pursues its goal of 80 million electronically filed tax returns annually by the year 2000.

2/10/94

*Copies of a Roper Survey completed in 1993 involving 500 randomly selected borrowers are available upon request. Inquiries should be directed to Mr. Gary J. Perkinson, Electronic Filing Coalition, 453 New Jersey Avenue, S.E. Washington, D.C. 20003. Tel.202-646-1260

FRAUD PREVENTION

OVERVIEW

Tax fraud is not new. The concept of trying to "beat the government" by filing fraudulent returns has been around since 1913, when income tax systems as we know it today was first introduced.

However, the introduction of electronic filing in 1986 and the refund anticipation loan in 1988, opened new and faster avenues for dishonest taxpayers to defraud the government. Over the past three filing seasons, tax fraud perpetrators have targeted H&R Block offices in various parts of the country as sites for their illegal activities.

During the 1993 tax season, H&R Block and the RAL banks joined forces in an effort to prevent electronic filing fraud. An additional goal was to demonstrate to the IRS that fraudulent returns could be detected before transmission to the IRS in hopes that the IRS would reinstate the direct deposit indicator (commonly know as the "flip" indicator) transmitted as part of the acknowledgement file for electronically filed returns.

Although we were successful in meeting our goals, we must all continue to be diligent in our efforts to control and prevent electronic filing fraud. If fraud gets out of hand again and escalates significantly, the IRS could (and no doubt would) eliminate the "flip" indicator - there would not likely be a second chance.

Based on our continuing concern, we will maintain our action plan to help combat and prevent the filing of fraudulent tax returns. The RAL banks will also continue to operate their fraud detection system. In addition, the IRS has put into place several new fraud prevention safeguards.

H&R BLOCK PLAN

Block's plan is focused in the Quality Control Center, rather than the front office. In addition, the RAL banks have agreed to incorporate several of the items into their criteria for granting refund anticipation loans. While some of the items explained below have some tax office procedures associated with them, these are being presented to preparers as new bank requirements associated with the RAL. It is

important to remember that the filing of fraudulent returns is not to become an issue in the front office. The tax return preparer should never be placed in the position of confronting clients. If a return does not meet the eligibility requirements for a RAL, the preparer will simply tell the client that his or her situation will not meet bank requirements.

#1 - A RAL will not be granted to any taxpayer who is eligible for EIC if the primary taxpayer did not file a return the previous year.

Tax Office Procedures: This requirement has been incorporated by the banks into the Refund Anticipation Loan application. When either a military ID or a Social Security card is presented to validate the primary taxpayer's name and SSN (line 2 of the application), the preparer will ask if he or she filed a 1992 return and check the applicable line 2 box. The preparer will also check the yes or no box that indicates whether the taxpayer is eligible for EIC. For all returns containing Form 8453 and Schedule EIC, TPS will issue a warning diagnostic reminding the preparer that if a RAL was requested, the primary taxpayer must have filed a 1992 return.

Quality Control Center Procedures:

- * All RAL returns for which either the military ID or a social security card was used for the line 2 SSN validation and which contain Schedule EIC will be status 3 returns in Rapid Refund edit.
- * The Rapid Refund checker will issue a warning message stating, "Military or SSN ID. Check paper loan app to be sure TP qualifies for RAL."
- * On all returns on which the warning message is issued, the editor will review the paper copy of the loan application to make sure that the questions regarding filing a 1992 return and EIC eligibility have been answered and that the taxpayer does qualify for a RAL.
- * If the questions regarding last year's return have not been answered, the return is to be sent back to the preparer so that he/she can contact the client for the information to properly complete the application.
- * If the answer to the question regarding last year's return has been answered no, the return is to be sent back to the preparer so that he/she can contact the client, explain that the return is not eligible for a RAL, and offer one of the other electronic filing options

#2 - All W-2s will be subjected to a stringent review process. All electronically filed returns containing a non-standard W-2 will be carefully reviewed in the Quality

Control Center. The FICA and Medicare withholding amounts will be verified for accuracy on all W-2s.

Tax Office Procedures: The IRS requires that we will identify non-standard W-2s on all electronically filed returns. On all returns prepared using TPS, preparers have been instructed to answer no to the standard W-2 question on the W-2 screen if any of the following apply.

- * The information on the W-2 is handwritten.
- * The form is a substitute W-2 (including one prepared by H&R Block).
- * The form appears to have been typewritten rather than computer generated. (Note: stress to preparers that they should not spend time scrutinizing W-2s to determine whether they are typewritten vs. computer generated. Indications that W-2 is typewritten included strike-outs, typeovers, crooked lines, erasures, etc.)
- * The W-2 form has been altered or changed in any way.

In addition, the preparer is to check the non-standard W-2 item on the Blue Ribbon form and attach it to the outside of client envelope.

If Express Filer returns are being entered directly into the Rapid Refund program in the tax office, the individual entering the information will be required to indicate the W-2 type (S=standard, N=non-standard) on the Form W-2 screen.

The TPS program will alert preparers if FICA and/or Medicare withholding amounts do not equal (within a \$5.00 tolerance) the applicable percentage of the FICA and Medicare wages.

Quality Control Center Procedures:

- * For all Express Filer returns entered into the Rapid Refund program in Quality Control, the input operator will be required to indicate the W-2 type (S=standard; N=standard) on the Form W-2 screen.
- * All returns containing one or more W-2s coded non-standard, will be Status 3 returns. Checker will issue a warning message alerting the editor to carefully review the Form W-2 to see if it appears to be fraudulent.
- * When it is suspected that a W-2 is fraudulent, follow one of the procedures listed below, whichever seems applicable to the situation:

1 - A designated individual in quality control will call the client, explain that the Form W-2 contains an irregularity, and that it will be necessary for us to contact the employer to clear up the discrepancy. Obtain the employer's phone number and the supervisor's name. For local employers, before calling the number given by the client, check the phone book listing for the company name to validate the phone number provided by the client is not fictitious.

When contacting the employer, the Block associate should identify him or herself as being with H&R Block and explain that we have the employee's permission to verify employment.

If the employment can be verified, transmit the return in usual manner.

If the employment cannot be verified, **PUT THE RETURN ON HOLD USING REASON CODE 5 (OTHER) - THEN TRANSMIT IT TO THE VAX.** Follow the procedures for sending Pat Nelson letter (#6 below), or

2 - Send the client a copy of the Pat Nelson letter (samples of this letter and procedures for its use may be found later in this chapter.)

#3 - A RAL will not be granted to any taxpayer whose only income is from Schedule C.

Tax Office Procedures: This requirement has been incorporated into the refund anticipation loan application. A client whose only income is from Schedule C is not eligible for a RAL. The TPS program will issue a severe diagnostic to this effect, when applicable, and the client should be offered one of our other electronic filing options.

Quality Control Center Procedures: Returns on which the only income is from Schedule C will be Status 2 returns. If this is the case, the return should be sent back to the preparer so that the client can be notified that the return does not qualify for a RAL and offered one of our other electronic filing options.

#4 - For taxpayers who are eligible for EIC and who are first time users of H&R Block's electronic filing system, a software program will be used to validate the SSN of the qualifying child(ren) if a RAL has been requested. Proof of the SSN will be required if the SSN appears to be invalid.

Tax Office Procedures: Tax office procedures will be implemented only if the return is sent back from Quality Control because of an invalid SSN. In this case, the preparer is to contact the client, explain that the SSN appears to be invalid, and request proof of the SSN. If the number cannot be validated, a RAL will not be

granted. One of the other electronic filing products should be offered to the client.

Quality Control Procedures: The Rapid Refund checker will validate the SSN range for all social security numbers (including dependents) present on the return.

* A return containing an invalid SSN will be a status 2 return. Return it to the preparer who will contact the client and verify the accuracy of a number.

#5 - If a RAL is requested, EIC is present on the return, and Applied has been used in lieu of the SSN for a child age 1 or older listed on Schedule EIC, the banks require that the client must bring in a copy of the birth certificate for the preparer to see in order to validate the existence of the child.

Tax Office Procedures: If this condition exists, the preparer will explain verification of the child's existence is a requirement of the bank. If a birth certificate cannot be provided, the client is not eligible for a RAL. In this case, one of the other electronic filing options should be offered.

Quality Control Procedures: None. If Applied has been used in lieu of an SSN, it is to be assumed the preparer followed the required procedure.

#6 - If fraud is suspected or detected, the client will be sent a Pat Nelson letter.

NOTE: Each district should designate one or more individuals to respond to the "Pat Nelson" calls.

Tax Office Procedures: Preparers and receptionists should be informed that there may be times when a client will receive a Pat Nelson letter in lieu of his or her check. When this occurs, the Block associate should explain that he or she has no information regarding the situation and that the client will have to call the phone number on the letter for information about the status of his or her return.

Quality Control Procedures: When fraud is suspected or detected on a return; **PUT THE RETURN ON HOLD USING REASON CODE 05 (OTHER) - THEN TRANSMIT IT TO THE VAX.**

Follow the procedures outlined below.

* In company-owned locations, notify the quality control supervisor that what appears to be a fraudulent return has been detected. This individual should, in turn, notify the district manager, who will then notify the regional director.

* Satellite owners will notify their satellite director who will then notify the regional director of the situation.

- * Mail a copy of the Pat Nelson letter to the client. Two versions of the letter are at the end of this chapter. Send the one that seems more applicable to the situation.
- * Put a duplicate copy of the Pat Nelson letter in a client envelope and send it to the front office. This will be given to the client when he or she comes in to pick up the check.
- * If the client calls in response to having received the Pat Nelson letter, reiterate that there is a problem with the W-2.

Ask the taxpayer to verify the following information:

- * Street address, city, and ZIP
- * Phone number, including area code
- * Primary (and spouse, if applicable) social security number
- * Children's names and SSNs
- * Employer's name and phone number and supervisor's name

When verifying this information, **DO NOT** read the information on the return and W-2s to the client. Instead, say, "I need to verify some information on your return. What is your complete address?" Repeat this procedure with each of the items listed above.

Unfortunately, there are no hard and fast rules for making a decision as to whether the return is fraudulent or not. It is often a judgement call based on subjective factors. For example, if the client cannot give you the information requested without getting his copy of the return, or gives you information completely different from that appearing on the return, there is a good chance that you may be dealing with a fraud situation.

If you are unable to verify, beyond a shadow of doubt, the client's employment, **PUT THE RETURN ON HOLD USING REASON CODE 05 (OTHER) - THEN TRANSMIT IT TO THE VAX.** In this case, explain to the client that because of the discrepancies that exist, the return cannot be filed electronically.

- * If there is no response from a taxpayer to whom a Pat Nelson letter was sent within 10 days, you should contact the CID regarding the situation. Before contacting the CID, be sure to follow the chain of communications described

on page 7.

#7 - The Rapid Refund checker will compare W-2 withholding with gross wages to determine whether the withholding amount is "reasonable" for the amount of wages.

Tax Office Procedures: None

Quality Control Center Procedures: Returns on which the W-2 withholding is outside of the system tolerance will be Status 3 returns.

- * Editors will carefully review the W-2 form.
- * When it is suspected that a W-2 is fraudulent, follow one of the procedures listed below, whichever seems applicable to the situation:

1 - A designated individual in quality control will call the client, explain that the Form W-2 contains an irregularity, and that it will be necessary for us to contact the employer to clear up the discrepancy. Obtain the employer's phone number and the supervisor's name. For local employers, before calling the number given by the client, check the phone book listing for the company name to validate that the phone number provided by the client is not fictitious.

When contacting the employer, the Block associate should identify him or herself as being with H&R Block and explain that we have the employee's permission to verify employment.

If the employment can be verified, transmit the return in the usual manner. If the employment cannot be verified, **PUT THE RETURN ON HOLD USING REASON CODE 05 (OTHER) - THEN TRANSMIT IT TO THE VAX.** Follow the procedures for sending the Pat Nelson letter (#6 above), or

2 - Send the client a copy of the Pat Nelson letter using the procedures explained in #6 above.

#8 - Conduct a check that verifies that the client's area code is compatible with the ZIP code, and/or the first three digits of the phone numbers are compatible with the area code.

These checks will be routinely performed by the banks on all RAL returns. The RAL may be denied if either of criteria listed above is not met. More information on bank fraud detection plan is presented later in this material.

THE BANK FRAUD DETECTION SYSTEM

The banks will also have a fraud detection system in place during the upcoming tax season. At the same time that the RAL return is being transmitted to IRS, it will also be transmitted to the bank's Fraud Service Bureau (FSB) where various elements contained on it will be scored based on known fraud criteria. It will be run through a credit risk scoring system, including a cross check with all RAL banks for prior bad debt. A RAL will be denied if the return does not pass successfully through the Bank Fraud Detection System.

Quality Control Center Procedures:

- * RALs denied for this reason display on the Loans Denied Report with a bank reject Status Code of 11-04 - Denial is due to condition indicating possible fraud.
- * Complete the Loan Reconsideration Request - Code 11-04, verify the taxpayer's employment, and fax the reconsideration request to the RAL bank.
- * If the employment cannot be verified or the bank denies the reconsideration request, contact the client and explain that the bank has denied the Refund Anticipation Loan request because of discrepancies on the return. Also, send the client a copy of the bank loan denial letter.

Tax Office Procedures: There may be occasions when a client whose loan has been denied because of possible fraud conditions has not been contacted by quality control. In this situation, if a copy of the Client Status Report is available in the tax office for preparer and receptionist use, instruct them not to tell the client the reason for the denial but to simply say that the bank has denied the refund anticipation loan request because of discrepancies on the return and that the client will have to contact the bank for more information.

Returns Transmitted for EROs

Block's Fraud Prevention Action Plan procedures do not apply to returns transmitted for EROs. EROs are responsible for adhering to the bank requirements. Therefore, the checks in the Rapid Refund checker program will not apply to ERO returns.

IRS FRAUD PREVENTION PROGRAM

The IRS has instituted many new checks and balances into their system to detect fraudulent returns that have been filed electronically. Beginning this year, the IRS will:

- * Deny a direct deposit to first-time filers. Refunds for these individuals will be

paid by paper check. A first-time filer is one who has not, at any time during the past 10 years, filed as a primary taxpayer. Details about the preparer's responsibility are discussed in the Tax Office Procedures Handbook.

- * Check the date the SSN was issued with the date of birth for dependents listed on Schedule EIC to validate that the number was issued in a time frame consistent with the birth date.
- * Validate the EIN on Form W-2.
- * Perform validation checks on the spouse's SSN.
- * Suspend from the electronic filing program any ERO who misuses the W-2 Standard/Nonstandard indicator.

COMMUNICATIONS

It is extremely important to keep all levels of field management informed and aware when fraudulent returns are suspected or detected. Call the regional director before contacting the CID.

The following chart illustrates the communication steps to be followed before the CID is contacted.

Position	Contacts
Quality Control Center	Quality Control Supervisor
Quality Control Supervisor	District Manager
District Manager	Regional Manager
Satellite Owner	Satellite Director
Satellite Director	Regional Director

Questions about fraud, fraud prevention procedures, and contacts by CID should be directed to your regional director or to one of the following individuals at Home Office: Rusty Wallower (Ext. 230), Judy Keisling (Ext. 430), or Eddie Feinstein (Ext. 451).

DEALING WITH THE CID

As a general rule, the Criminal Investigation Division of the IRS (CID) should be contacted only when a pattern of fraud is identified. For example, if fraud is

suspected on only one return, you generally would not contact the CID. You should, however, follow the communication steps above so that the regional director is aware of the situation. Perpetrators of electronic filing fraud often target several locations within an area, filing only one or two fraudulent returns in each location. By notifying the regional director about every return that appears fraudulent, he or she will be able to determine whether there is a fraud scheme operating within the region.

On the other hand, if several returns come through the QC center with similar characteristics; e.g., W-2s appear to be nonstandard or fraudulent, taxpayer uses head of household filing status, the EIC is claimed, and the income amounts are similar, the CID should be notified. A listing of the CID Hotline numbers may be found at the end of this chapter.

After contacting the regional director, use the following procedures when you contact the CID:

- * Allow the agent to review the returns in question.
- * If the agent requests to remove the records from the office, you may make and release a copy of the tax return information, including Form 8453, the tax return, and Forms W-2. The originals of any document may not be released unless you receive a summons or subpoena.

Use the following procedures if you are contacted by the CID:

- * Contact Rusty Wallower at Home Office (Ext. 230) and give him details about the situation. Also, contact your regional director.
- * Do not open your office to a CID agent to go on a "fishing expedition" looking through all the records that exist in the office.
- * If the agent is looking for a particular return and knows the name of the taxpayer, comply with the request to see the records.
- * If the agent requests to remove the records from the office, you may make and release a copy of the tax return information, including Form 8453, the tax return, and Forms W-2. The originals of any documents may not be released unless you have a summons or subpoena.

If you receive a summons or subpoena from the CID, contact the legal department at the Home Office for assistance.

SUSPECT FRAUD REPORTS

Home Office will be tracking certain information related to returns that are suspected or detected to be fraudulent. The Fraud Suspect Return Report on 10 has been developed for this purpose.

Completing the Report

Each company-owned district should make a sufficient number of copies of the report for their use during the tax season. The reports will be maintained in the Quality Control Center. All applicable information on the report should be completed for each taxpayer to whom a Pat Nelson letter is sent and for each return which H&R Block generates a call to the CID.

Record the taxpayer's SSN in column a and the last name in column b.

For the Pat Nelson letter, record the date the letter was sent in column c. If, after talking to the client and determining that the return is not fraudulent, record the date the return is transmitted to the IRS in column d. If a check is printed and/or distributed to the client, record the applicable dates in columns e and f.

For CID Contacts, record the date the initial contact with CID was made in column g. In column h record the date the CID responds to the call. If copies of the tax return are released to CID, record that date in column i. Information should not be recorded if subsequent calls are made on return already recorded.

Examples of correct recording are described below:

Situation 1: Pat Nelson letter sent. Return transmitted, check printed and distributed after client called.

Complete columns a through f.

Situation 2: Pat Nelson letter sent. Taxpayer did not respond. CID contacted but has not responded.

Complete columns a through c, and g.

Situation 3: No Pat Nelson letter sent, but CID contacted. Copies of return given to CID after their response.

Complete columns a and b and g and i.

A separate reporting form (of group reporting forms) should be kept for each reporting period, as discussed below. The reporting period is the same period as for volume reports.

Reporting Requirements

Company-owned locations will report the total number of entries in columns c, d, e, f, g, h, i for each reporting period to the regional office each time the volume report is called in. The information will be consolidated at the region level and sent to Home Office.

Franchise Locations. While we encourage all franchises to participate in recording and reporting suspected or detected fraudulent returns, participation is on a voluntary basis.

The reporting periods for franchises are as follows: January 15 through February 28, March 1 through March 31, and April 1 through April 16.

Franchises who chose to participate should send a recap of their column totals to their satellite directors on March 1, April 1, and April 17.

Satellite Directors will consolidate all totals from their franchises and forward the results to the regional. The regional comptroller will consolidate the results for all franchises in the region and MAIL a copy of the consolidated report to Home Office, Attention: Judy Keisling, by March 10, April 10, and April 30.

Conclusion

The H&R Block Fraud Prevention Action Plan primarily focuses on two elements of the tax return --fraudulent W-2s and returns on which EIC is claimed. Our experience, and that of the IRS, has shown that the majority of fraudulent electronically filed returns contain one or both of these elements.

Members of the Tax Operation team at Corporate are very much aware that dealing with the issue of fraud is not a pleasant one -- yet it is an issue that all of us must confront and deal with. We are also aware that some honest taxpayers may be denied a RAL because of the more stringent qualification criteria. We believe that the number of honest taxpayers affected will be small, and believe that making exceptions to our general rules would jeopardize the integrity of a program that we believe will be a strong detriment to perpetrators of electronic filing fraud.

In Tom Block's works, our goal is not to become law enforcement officers. Our goal is to protect our honest clients' right to a quick refund.

H&R BLOCK

Date _____

John Q. Taxpayer
Street Address
City, State, Zip

Dear Mr. Taxpayer:

SSN: _____

We have experienced difficulty in electronically transmitting your 1993 tax return to the Internal Revenue Service. It appears that your 1993 W-2s contain one or more irregularities.

Please call me at (Block Phone Number) to have your W-2s validated.

DO NOT contact the office where you had your return prepared; the office no longer has the information regarding your return.

Sincerely,

Pat Nelson
Customer Service Representative
H&R Block

Fraud Prevention

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H&R BLOCK

Date

John Q. Taxpayer
Street Address
City, State, Zip

Dear Mr. Taxpayer:

SSN: _____

We have experienced difficulty in electronically transmitting your 1993 tax return to the Internal Revenue Service. It appears that your 1993 W-2s contain one or more irregularities.

You will need to call the Criminal Investigation Division of the Internal Revenue Service to have your W-2s validated. The telephone number in City Name of Closest CID Location is CID Phone Number at Location Named.

If you prefer, you may call me at Block Phone Number to be Called.

DO NOT contact the office where you had your return prepared: the office no longer has the information regarding your return.

Sincerely,

Pat Nelson
Customer Service Representative

**CRIMINAL INVESTIGATION HOTLINE NUMBERS
FOR REPORTING SUSPICIOUS ELECTRONIC FILING TRANSACTIONS**

District	Contact	Phone	Beeper/Other
Aberdeen, SD	Greg Pasco	605-226-7221	
Albuquerque, NM	(daytime)	800-829-2872	
Anchorage, AK	Jeff Willert	907-271-6245	
Atlanta, GA	Patsy Tittle	404-454-1713	
Augusta, ME	Bill Kiely	207-622-8316	
Austin, TX	(daytime)	800-829-2872	
Austin, TX	Buddy Adams	512-499-5261	512-480-4236
Austin, TX	Michael Grubich	512-499-5206	800-999-6710
Baltimore, MD	Paul Czarnecki	215-969-2405	
Baltimore, MD	June Mattson	215-969-2373	
Birmingham, AL	Joanne Rinks	901-365-5181	
Boise, ID	Steve Hines	208-534-1000	208-384-2593
Boston, MA	Paul Donnelly	508-559-5200	
Brooklyn, NY	Cathy Steckman	516-366-6458	
Buffalo, NY	Robert Newell	716-846-5525	Buffalo
Buffalo, NY	Frank Perez	716-263-3137	Rochester
Buffalo, NY	Gerald Bradley	518-472-6073	Albany
Buffalo, NY	Jeff Derx	315-423-5026	Syracuse
Burlington, VT	Joe Cross	802-860-2016	
Cheyenne, WY	(daytime)	800-829-2872	
Chicago, IL	George Johnson	312-886-4553	312-308-3720
Chicago, IL	Mark Cohen	312-886-4538	
Chicago, IL	(24 hours)	312-886-4519	
Cincinnati, OH	Reggie McDaniel	513-684-2333	
Cleveland, OH	Ed Salak	216-522-5240	216-273-2193
Columbia, SC	Patsy Tittle	404-454-1713	
Dallas, TX	(24 hours)	214-767-1076	
Dallas, TX	(daytime)	800-829-2872	
Dallas, TX	Darin Wiewel	817-334-3381	214-804-1694
Dallas, TX	Vernon Hampton	817-334-3381	214-804-1642
Denver, CO	(daytime)	800-829-2872	
Denver, CO	Steve Vickers	303-446-1810	
Des Moines, IA	Mary Morlan	515-284-8180	
Des Moines, IA	Marsha Griffith	319-328-2650	
Detroit, MI	Joe Ellery	313-226-7262	
Fargo, ND	Gary Keller	701-239-5143	
Ft. Lauderdale, FL	Patsy Tittle	404-454-1713	
Greensboro, NC	Joanne Rinks	901-365-5181	
Hartford, CT	Rodney Clark	203-845-3377	
Helena, MT	Loretta Rodriguez	406-657-6045	
Honolulu, HI	Malia Beth Dougan	808-541-1150	
Houston, TX	(daytime)	800-829-2872	
Houston, TX	Darryl Smith	713-878-5888	
Houston, TX	Ronald Eatinger	713-653-3620	
Indianapolis, IN	Jan Wigand	317-573-5711	
Jackson, MS	Jackie Collins	601-965-5099	
Jackson, MS	Sarah Davison	601-965-5099	
Jackson, MS	Jose Marrero	601-965-5087	
Jackson, MS	Joanne Rinks	901-365-5181	
Jacksonville, FL	Patsy Tittle	404-454-1713	
Laguna Niguel, CA	Maurice Aquate	714-643-7211	714-587-7060
Laguna Niguel, CA	(24 hours)	714-836-2872	

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District	Contact	Phone	Beeper/Other
Las Vegas, NV	Steve McCullough	702-455-1105	
Las Vegas, NV	Greg Brent	702-784-7001	Reno, NV
Las Vegas, NV	(24 hours)	702-251-2899	
Little Rock, AR	Joanne Rinks	901-365-5181	
Los Angeles, CA	Debra King	213-894-4156	213-991-5524
Los Angeles, CA	Anthony Ruckstuhl	818-904-6271	213-525-6443
Los Angeles, CA	(24 hours)	213-894-4151	
Louisville, KY	Harold Calhoun	502-582-5012	502-478-9743
Manhattan, NY	Christine Mazzella	212-264-0794	
Milwaukee, WI	Tom Waltz	414-297-3916	
Nashville, TN	Joanne Rinks	901-365-5181	
New Orleans, LA	Joanne Rinks	901-365-5181	
Newark, NJ	Ray Hopkins	201-357-4017	
Oklahoma City, OK	(daytime)	800-829-2872	
Oklahoma City, OK	Larry Garner	918-581-7050	918-748-2758
Oklahoma City, OK	Henry Maldonado	405-297-4700	
Omaha, NE	John Nuncz	402-221-3596	
Parkersburg, WV	Barbara Nelson	304-347-5923	
Philadelphia, PA	Paul Czarnecki	215-969-2405	
Philadelphia, PA	June Mattson	215-969-2373	
Phoenix, AZ	(daytime)	800-829-2872	
Phoenix, AZ	Debbie Dotson	602-207-8999	602-239-8475
Phoenix, AZ	Francis Turner	602-207-8902	602-239-8110
Pittsburgh, PA	Paul Czarnecki	215-969-2405	
Pittsburgh, PA	June Mattson	215-969-2373	
Portland, OR	Matthew Dougierty	503-326-3203	
Portland, OR	(24 hours)	503-326-3201	
Portsmouth, NH	William Simoneau	603-433-0561	
Providence, RI	William Sitarkey	401-823-1796	
Reno, NV	Greg Brent	702-784-7001	
Richmond, VA	Paul Czarnecki	215-969-2405	
Richmond, VA	June Mattson	215-969-2373	
Sacramento, CA	Charles Philips	415-479-8424	
Sacramento, CA	Jack McMenimen	415-479-8424	
Salt Lake City, UT	Rebecca Romero	801-524-5990	
San Diego, CA	Maurice Aquate	619-557-6100	
San Francisco, CA	Tammy Williams	510-637-2674	
San Francisco, CA	Jim Carpenter	510-637-2674	
San Francisco, CA	(24 hours)	415-556-0779	
San Jose, CA	Clarissa Coate	408-291-7786	
San Jose, CA	Bridget Marchetta	408-291-7786	
Seattle, WA	Stanley E. Linn	206-220-5852	
Seattle, WA	Dan Barnes	206-220-5852	
Springfield, IL	Debbie Alexander	618-482-9254	
St. Louis, MO	Kathleen Burke	314-425-3147	
St. Paul, MN	Gerald Bucksa	612-373-5137	612-530-5967
Wichita, KS	(daytime)	800-829-2872	
Wichita, KS	Richard Whitburn	316-291-6680	
Wichita, KS	Linda Feuerborn	913-789-1170	
Wilmington, DE	Paul Czarnecki	215-969-2405	
Wilmington, DE	June Mattson	215-969-2373	

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