WRITTEN STATEMENT OF

NINA E. OLSON

NATIONAL TAXPAYER ADVOCATE

HEARING ON

IDENTITY THEFT AND INCOME TAX PREPARATION FRAUD

BEFORE THE

SUBCOMMITTEE ON CRIME, TERRORISM, AND HOMELAND SECURITY

COMMITTEE ON THE JUDICIARY

U.S. HOUSE OF REPRESENTATIVES

JUNE 28, 2012

TABLE OF CONTENTS

Chairman Sensenbrenner, Ranking Member Scott, and distinguished Members of the subcommittee:

Thank you for inviting me to testify today about the subject of tax-related identity theft and refund fraud.[1] I have had the opportunity to address the impact of these subjects on taxpayers and to tax administration in three other congressional hearings this spring.[2] Just this week, I submitted my Fiscal Year 2013 Objectives Report to Congress, where I discuss identity theft and refund fraud and describe in detail what my office plans to do to address these concerns.[3]

My first of many experiences with identity theft occurred when I was the founder and Executive Director of The Community Tax Law Project (CTLP), the first independent nonprofit low income taxpayer clinic in the country.[4] CTLP provides pro bono legal representation to low income taxpayers throughout Virginia.[5] In 1993, a legally resident agricultural worker came to CTLP with Internal Revenue Service (IRS) assessments for additional tax purportedly attributable to unreported wages. My client and I spent the next four years proving to the IRS that it was impossible for him to be working and physically present at three different locations at the same instant. Because the identity thieves – several co-workers on one job from years before – continued to work under my client's name and Social Security number (SSN), we had to prove *each year* to the IRS that my client did not earn the unreported income. At that time, the IRS did not

---

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

[2] *See Identity Theft and Tax Fraud*, Hearing Before the H. Comm. on Ways and Means, Subcomm. on Oversight and Social Security, 112th Cong. (May 8, 2012) (statement of Nina E. Olson, National Taxpayer Advocate); *Tax Compliance and Tax-Fraud Prevention*, Hearing Before the H. Comm. on Oversight and Government Reform, Subcomm. on Government Organization, Efficiency, and Financial Management, 112th Cong. (Apr. 19, 2012) (statement of Nina E. Olson, National Taxpayer Advocate); *Tax Fraud by Identity Theft Part 2: Status, Progress, and Potential Solutions*, Hearing Before the S. Comm. on Finance, Subcomm. on Fiscal Responsibility and Economic Growth, 112th Cong. (Mar. 20, 2012) (statement of Nina E. Olson, National Taxpayer Advocate).

[3] *See* National Taxpayer Advocate Fiscal Year 2013 Objectives Report to Congress, at http://www.taxpayeradvocate.irs.gov//userfiles/file/FY13ObjectivesReporttoCongress.pdf.

[4] *See generally* Internal Revenue Code (IRC) § 7526. The Low Income Taxpayer Clinic (LITC) program serves individuals whose incomes are below a certain level and require assistance in dealing with the IRS. LITCs are independent from the IRS and most LITCs can provide representation before the IRS or in court on audits, tax collection disputes, and other issues for free or for a nominal fee. IRC § 7526 authorizes the IRS to award matching grants of up to $100,000 per year to qualifying clinics that represent low income taxpayers involved in controversies with the IRS, or that provide education and outreach on the rights and responsibilities of U.S. taxpayers who speak English as a second language.

[5] *See* www.ctlp.org.

have any system to flag my client's account and avoid tormenting and burdening him each year. Somehow, the fact that my client was the victim did not make any impression on the IRS.

My experiences as a tax lawyer representing clients in identity theft and other cases have served as a guide in my role as the National Taxpayer Advocate, the "voice of the taxpayer" inside the IRS. The Taxpayer Advocate Service (TAS) is unique in the IRS in that we work with our taxpayers' cases from beginning to end. We are also charged, by statute, to make administrative and legislative recommendations to mitigate the problems taxpayers experience with the IRS.[6] As a result, many TAS employees have developed expertise in identity theft and refund fraud-related issues over the years.

To its credit, the IRS has adopted many of my office's recommendations to help victims of identity theft and refund fraud. Certainly, refund-driven tax fraud is not a problem the IRS can fully solve, but I believe that the IRS can do much more to detect questionable returns and assist victims of identity theft or return preparer fraud.

In my testimony today, I will make the following points:

1. When analyzing the impact of refund fraud, a broad perspective is necessary.

2. The IRS and TAS continue to see unprecedented levels of identity theft casework.

3. The IRS should take steps to limit the opportunities for refund fraud, while not unreasonably delaying legitimate refund claims.

4. The IRS has been slow to develop procedures to assist victims of return preparer fraud.

5. The IRS should develop procedures to replace stolen direct deposit refunds.

6. TAS works closely with the Criminal Investigation division to ensure that identity theft victims receive the attention and assistance they require.

7. The Social Security Administration should restrict access to the Death Master File.

8. Creating new exceptions to taxpayer privacy protections poses risks and should be approached carefully, if at all.

9. There is a continuing need for the IRS's identity protection specialized unit to play a centralized role in managing identity theft cases.

---

[6] *See* IRC § 7803(c)(2).

I. When Analyzing the Impact of Refund Fraud, a Broad Perspective Is Necessary.

Tax-related identity theft, refund fraud, and return preparer fraud all have one common theme – the perpetrator is using the tax system to obtain improper refunds. The growth of spending programs that are run through the tax code, as well as overwithholding of income taxes, result in large IRS payments to taxpayers and have made refund fraud more alluring. The IRS has had difficulty verifying the legitimacy of claims for recently-enacted tax benefits such as the Economic Stimulus Payment, First-Time Homebuyer Credit, Work Opportunity Credit, and Making Work Pay Credit. This difficulty, combined with a reduction in IRS funding, has made the IRS's job much harder.

I want to take a moment to put into perspective the IRS's overall mission and the challenges and trade-offs that addressing tax-related identity theft presents. As the nation's tax collection agency, the IRS is responsible for processing over 145 million individual income tax returns annually, including more than 109 million requests for refunds.[7] In 2011, the average refund amount was approximately $2,913, representing a significant lump-sum payment for taxpayers with incomes below the median adjusted gross income of $31,494 for individual taxpayers.[8] At the same time the IRS is being urged to do more to combat refund fraud, taxpayers are clamoring for the IRS to process returns and issue refunds faster. While there is room for the IRS to make marginal improvements in both areas, the two goals are fundamentally at odds. The dual tasks of fraud prevention and timely return processing present challenges in simple tax systems, and ours is far from simple.

In fiscal year (FY) 2011, the IRS's Electronic Fraud Detection System (EFDS) selected over one million questionable returns for screening.[9] While it is important for the IRS to further scrutinize the one million questionable returns, we should not lose sight of the fact that the IRS also has a duty to the other 144 million individual taxpayers in this country. Taxpayers have become accustomed to filing their returns shortly after they receive their Forms W-2 or Forms 1099 (reporting wages and interest, respectively, and available to taxpayers by January 31). Approximately 77 percent of U.S. taxpayers file electronically, meaning the IRS can process most refund requests within a week or two

---

[7] In calendar year 2011, the IRS processed 145,320,000 individual tax returns, with 109,337,000 requests for refunds. IRS, *Filing Season Statistics – Dec. 31, 2011*, *at* http://www.irs.gov/newsroom/article/0,,id=252176,00.html (last visited Mar. 12, 2012).

[8] IRS, *Filing Season Statistics – Dec. 31, 2011*, *at* http://www.irs.gov/newsroom/article/0,,id=252176,00.html (last visited Mar. 12, 2012); Compliance Data Warehouse, Individual Returns Transaction File for CY 2011.

[9] The volume of returns selected to be screened rose from 611,845 in CY 2010 to 1,054,704 in CY 2011 (through Oct. 15, 2011), a 72 percent increase. *See* National Taxpayer Advocate 2011 Annual Report to Congress 28.

of filing.[10] With the introduction of e-filing, combined with the increasing number of refundable credits run through the tax code, our tax system has shifted, for better or worse, to one of instant gratification.

The benefit of enjoying such a tax system is somewhat offset by the increased ability of perpetrators to defraud the government. While the IRS seeks to implement automated filters to screen out as many suspicious refund claims as possible, it is unrealistic to expect the IRS to detect and deny all such claims. Because the fraud detection algorithms are constantly evolving in response to new patterns, there will always be a lag in the filters.

If we wanted to be absolutely certain that no improper refunds are paid out to identity thieves or other individuals filing bogus returns, we could keep the April 15 filing deadline but push the date for issuing refunds several weeks into the summer, after the return filing due date, as some other tax systems do. Such a shift would allow the IRS sufficient time to review every suspicious return. More importantly, the IRS would have at its disposal nearly the full arsenal of information reporting databases – including complete data on wages and withholding, interest income, dividends, and capital gains – and could better detect and resolve discrepancies and questionable returns *before* issuing refunds.

I recognize that this would be a significant shift and it would take considerable effort to change a culture in which taxpayers have become accustomed to receiving their refunds within a week or two of filing their returns electronically. Delaying the delivery of a $3,000 refund to a family that is relying on these funds to meet basic living expenses may inflict severe financial hardships. Many taxpayers have grown accustomed to the existing cycle and make financial decisions based on the assumption they will receive their refunds in February or March.

Alternatively, if we prefer not to delay the processing of refunds but still insist on greater fraud detection than the IRS can now manage, then Congress must authorize significantly more funding for the IRS so it can expeditiously work cases where returns and associated refunds have been flagged but may be legitimate. In my 2011 Annual Report, I noted that while questionable returns selected by EFDS increased by 72 percent, the staffing of the IRS unit conducting the manual wage and withholding verification grew by less than nine percent.[11] It is unrealistic to expect the IRS to keep up with its increasing workload without either allocating a corresponding increase in resources or extending the timeframe for the necessary wage and withholding verification. Without a fundamental shift in tax administration, honest taxpayers will continue to be harmed and overall taxpayer service and compliance will suffer as the IRS moves resources from other activities to combat fraud and identity theft.

---

[10] IRS, *IRS e-file Launches Today; Most Taxpayers Can File Immediately*, IR-2012-7 (Jan. 17, 2012).

[11] The Accounts Management Taxpayer Assurance Program (AMTAP) staff increased from 336 in FY 2010 to 366 in FY 2011, a gain of nearly nine percent. *See* National Taxpayer Advocate 2011 Annual Report to Congress 29.

II. The IRS and TAS Continue to See Unprecedented Levels of Identity Theft and Refund Fraud Casework.

As I have written in my Annual Reports to Congress since 2004, tax-related identity theft is a serious problem – for its victims, for the IRS and, when Treasury funds are improperly paid to the perpetrators, for all taxpayers.[12] In general, tax-related identity theft occurs when an individual intentionally uses the SSN of another person to file a false tax return with the intention of obtaining an unauthorized refund.[13] Identity theft wreaks havoc on our tax system in many ways. Victims not only must deal with the aftermath of an emotionally draining crime, but may also have to deal with the IRS for years to untangle the resulting tax account problems. Identity theft also impacts the public fisc, as Treasury funds are diverted to pay out improper refunds claimed by opportunistic perpetrators. In addition, identity theft takes a significant toll on the IRS, tying up limited resources that could otherwise go toward improving taxpayer service or compliance initiatives.

Today, identity theft can be an organized, large-scale operation. The most recent IRS data show more than 660,000 identity theft cases in inventory servicewide.[14] The Identity Protection Specialized Unit (IPSU), the centralized IRS organization established in 2008 to assist identity theft victims, is experiencing unprecedented levels of case receipts.[15] As this chart shows, IPSU receipts have increased substantially over the two previous years.

---

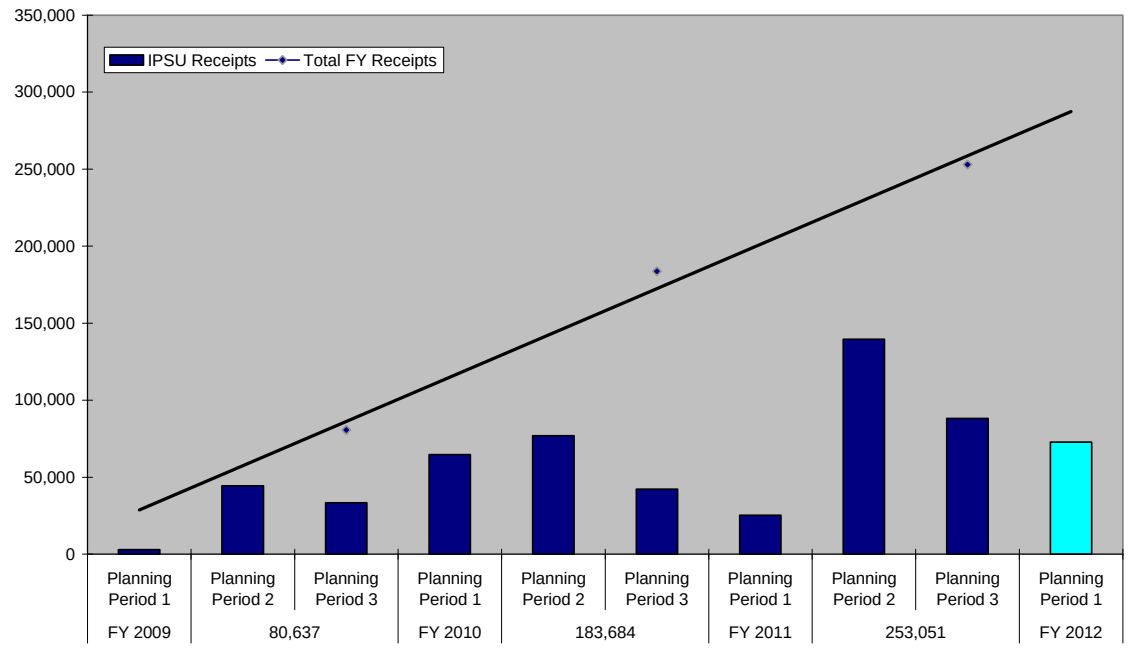
[12] *See* National Taxpayer Advocate 2011 Annual Report to Congress 48-73 (Most Serious Problem: *Tax-Related Identity Theft Continues to Impose Significant Burdens on Taxpayers and the IRS*); National Taxpayer Advocate 2009 Annual Report to Congress 307-317 (Status Update: *IRS's Identity Theft Procedures Require Fine-Tuning*); National Taxpayer Advocate 2008 Annual Report to Congress 79-94 (Most Serious Problem: *IRS Process Improvements to Assist Victims of Identity Theft*); National Taxpayer Advocate 2007 Annual Report to Congress 96-115 (Most Serious Problem: *Identity Theft Procedures*); National Taxpayer Advocate 2005 Annual Report to Congress 180-191 (Most Serious Problem: *Identity Theft*); National Taxpayer Advocate 2004 Annual Report to Congress 133-136 (Most Serious Problem: *Inconsistence Campus Procedures*).

[13] We refer to this type of tax-related identity theft as "refund-related" identity theft. In "employment-related" identity theft, an individual files a tax return using his or her own taxpayer identifying number (usually an Individual Taxpayer Identification Number or ITIN), but uses another individual's SSN in order to obtain employment, and consequently, the wages are reported to the IRS under the SSN. Unlike in 1993, when I first represented a client in an identity theft case, the IRS now has procedures in place to minimize the tax administration impact to the victim in these employment-related identity theft situations. Accordingly, I will focus on refund-related identity theft in this testimony.

[14] IRS, Identity Theft Advisory Council, *Identity Theft Status Update* 14 (June 19, 2012).

[15] With the IRS moving to a specialized approach to assisting identity theft victims, it is unclear what role the IPSU will play in the future. The National Taxpayer Advocate believes it is important for the IPSU to continue to serve as the "traffic cop" and serving as the single point of contact with the identity theft victim, as discussed later in this testimony.

Figure 1, IPSU Paper Inventory Receipts, FY 2009 to FY 2012 by Planning Period (and FY Totals)[16]

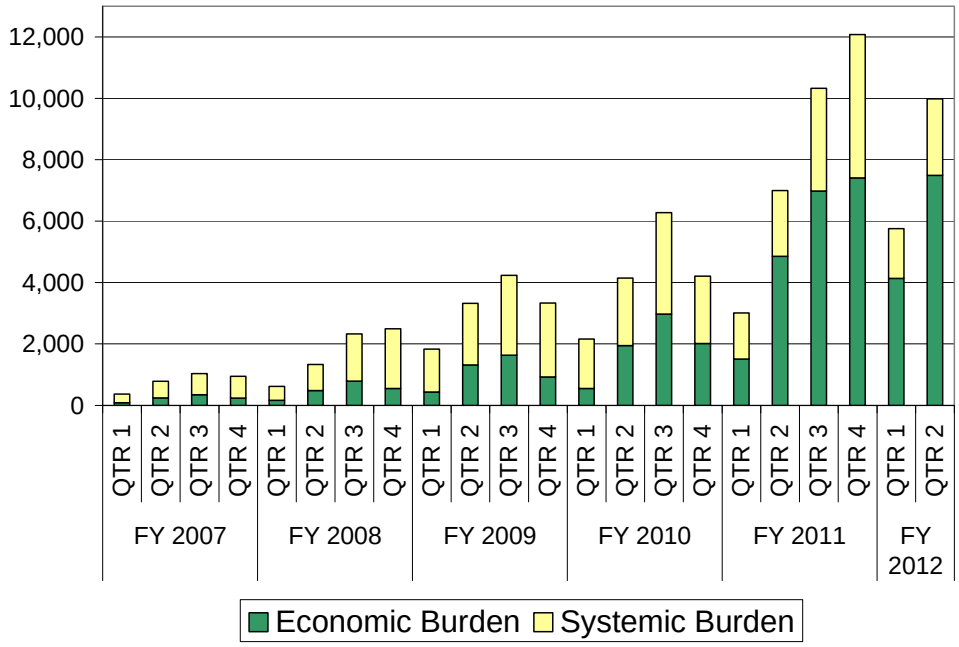


The Taxpayer Advocate Service has experienced a similar surge in cases, as TAS identity theft receipts rose 93 percent in FY 2011 over FY 2010. The upward trend continued in the first two quarters of FY 2012, when TAS received nearly 16,000 identity theft cases, a 57 percent increase over the same period in FY 2011.[17] The growth in casework reflects both the increase in identity theft incidents and the IRS's inability to address the victims' tax issues promptly.

[16] Data obtained from IRS Identity Protection Specialized Unit (Mar. 13, 2012). The IPSU tracks cases by "planning period." Planning Period 1 covers Oct. 1 to Dec. 31, Planning Period 2 covers Jan. 1 to June 30, and Planning Period 3 covers July 1 to Sept. 30. The trend line shows total cases from each FY (not including FY 2012, where we have partial-year data).

[17] There were over 10,000 identity theft cases in TAS during the same period in FY 2011. Data obtained from the Taxpayer Advocate Management Information System (TAMIS) (Apr. 1, 2012; Apr. 1, 2011).

Figure 2, Identify Theft Cases Received Quarterly in TAS, FY 2007 through FY 2011 and Second Quarter of FY 2012[18]



The Accounts Management Taxpayer Assurance Program (AMTAP) selects questionable returns for screening through the EFDS to verify the accuracy of taxpayers' wages and withholding before releasing refunds. As shown below, the number of returns meeting AMTAP criteria has increased 120 percent in FY 2012 (through May 10th) over the same period in FY 2011.

Figure 3, Number of Tax Returns Meeting AMTAP Criteria and TAS Pre-Refund Wage Verification Hold Case Receipts, FY 2011 and FY 2012

	FY 2011	FY 2012	Percent Increase
Number of IRS returns meeting AMTAP criteria through May 10, 2012[19]	572,881	1,260,550	120%
Number of TAS Pre-Refund Wage Verification Hold Case Receipts, through Apr. 30, 2012[20]	4,783	8,059	68.5%

[18] Data obtained from TAMIS. TAS retrieved the data on the first day of the month following the end of each quarter for FY 2007 through second quarter of FY 2012.

[19] EFDS Production Filing Season 2012 Statistics (May 10, 2012).

[20] TAMIS (May 1, 2012).

III. The IRS Should Take Steps to Limit the Opportunities for Refund Fraud, While Not Unreasonably Delaying Legitimate Refund Claims

To better protect the public fisc from a surge of new refund schemes, the IRS has expanded its use of sophisticated fraud detection models based on data mining to filter out questionable refund claims. The IRS estimates that EFDS has an 89 percent accuracy rate – which means the system may still catch upwards of 100,000 legitimate taxpayers.[21] While the IRS can try to screen out as many suspicious refund claims as possible, it is unrealistic to expect the IRS to detect and stop all such claims given its resource and time constraints.

I continue to support the IRS's increased use of data mining and automated screens to identify suspicious refund claims, and commend the IRS's efforts to use every tool at its disposal to combat refund fraud. However, I have cautioned the IRS to not lose sight of the fact that no matter how well-developed a particular filter is, it will inevitably affect legitimate taxpayers. As the IRS creates these filters, it must also create procedures that would allow honest taxpayers to receive their legitimate refunds without unnecessary delay.

For example, if EFDS cannot initially verify wage and withholding information, the IRS applies a "soft freeze" (*i.e.*, the refund will be released systemically) on the account while its employees begin a manual verification process[22] that can take up to 11 weeks.[23] In many cases, the IRS cannot verify the information within this time. Rather than releasing the refunds, the IRS places permanent freezes on these accounts while the wage verification is completed. I am concerned that once a case is placed in a "hard freeze" (*i.e.*, the refund must be manually released), it will lose its urgency in being worked and will languish for weeks, for months, or even indefinitely.[24] Instead of applying hard freezes to these unworked cases, I have advocated that the IRS develop

---

[21] National Taxpayer Advocate 2011 Annual Report to Congress 28. We have not been able to independently verify this accuracy rate.

[22] This includes contacting the taxpayer's employer or if directed by the employer, the payroll processing firm to verify wages and withholding. AMTAP employees will also perform research to ensure they have the employer's current address.

[23] Internal Revenue Manual (IRM) 21.9.1.2.3(1) (Mar. 7, 2011).

[24] For an example of how "questionable" refunds can languish in a "hard freeze" state for months and even years, see National Taxpayer Advocate 2005 Annual Report to Congress 25 (Most Serious Problem: *Criminal Investigation Refund Freezes*) and National Taxpayer Advocate 2005 Annual Report to Congress vol. 2 (*Criminal Investigation Refund Freeze Study*). *See also* National Taxpayer Advocate 2006 Annual Report to Congress 408 (Status Update: *Major Improvements in the Questionable Refund Program and Some Continuing Concerns*). Following a 400 percent increase in TAS cases originating from CI, TAS conducted a research study that found that 80 percent of taxpayers in a statistically representative sample of TAS cases had received at least a partial refund (66 percent had received a full refund) and that taxpayers had to wait about nine months, on average, to receive these refunds. As part of the study, TAS learned that well over 200,000 taxpayers with frozen refunds never received any notice of CI's actions, and CI had taken no action to resolve those disputed refund claims.

the ability to temporarily extend the soft freeze period. Only those returns that have been verified as not legitimate should be placed in a hard freeze.

IV. The IRS Has Been Slow to Develop Procedures to Assist Victims of Return Preparer Fraud

Taxpayers are increasingly becoming victimized by their own tax return preparers. TAS has received a significant number of cases involving preparer refund fraud.[25] Unscrupulous preparers sometimes alter taxpayers' returns by inflating income, deductions, credits, or withholding without their clients' knowledge or consent, and pocket the difference between the revised refund amount and the amount expected by the taxpayer. Here is how a return preparer could commit fraud without the taxpayer's knowledge:

- Provide a copy of the legitimate tax return to the taxpayer.
- Without the taxpayer's knowledge, alter the return to reflect additional withholding, credits, or deductions, resulting in an increased refund.
- File the altered return with the IRS.
- Request that the refund be split among two bank accounts – with the correct amount going to the taxpayer and the inflated portion of the refund going directly into the return preparer's bank account.

In such cases, the taxpayer has a copy of the legitimate return and receives the refund he or she was expecting; there is no reason for the taxpayer to suspect the return preparer had committed fraud. It is only when the IRS ultimately discovers that the taxpayer's return is incorrect and attempts to recover the excess refund from the taxpayer through levies, liens, and other enforcement actions that the taxpayer learns of the return preparer fraud.

One high-profile investigation of a tax return preparation firm has resulted in many TAS cases. On March 14, 2012, the Illinois Attorney General's office sued Mo' Money Taxes, a tax preparation service and lender based in Memphis, Tennessee.[26] The suit accuses the company of filing unauthorized federal income tax returns and charging undisclosed and exorbitant fees for tax preparation services. The Attorney General alleged the returns were riddled with errors and the company failed to provide some customers with their promised refund checks. The Attorney General's office contacted my office for assistance, and we agreed to take the following steps:

- Provide information to alleged victims about seeking assistance from the IRS;
- Ensure the IRS was aware that taxpayers would need assistance; and

[25] Through June 23, 2012, TAS has received 296 return preparer fraud cases in FY 2012. Data obtained from TAMIS.

[26] Illinois Attorney General, Madigan Sues National Tax Preparer Mo' Money, Lawsuit Highlights Need to Crack Down on High Costs, Fees of Refund Anticipation Loans (Mar. 14, 2012), *available at* http://illinoisattorneygeneral.gov/pressroom/2012_03/20120314.html.

- Coordinate actions such as holds on collection activity on the taxpayers' accounts.

To date, TAS has received 76 inquiries related to Mo' Money issues, all of which resulted in new TAS cases. We are able to provide some form of relief to the taxpayer in 56.6 percent of the closed cases.[27]

I issued interim guidance to TAS Case Advocates on recognizing refund theft by preparers and advocating for the taxpayers.[28] However, I am disappointed in the IRS's apparent inability to develop similar procedures to assist victims of return preparer fraud. The IRS has failed to unwind the harm done to these taxpayers – even when it had plenty of time to establish procedures. Recently, in response to continued delays by the Wage and Investment division (W&I) in developing such procedures, I instructed my employees to elevate all cases involving return preparer fraud adjustments to their Local Taxpayer Advocates (LTAs), who will issue Taxpayer Assistance Orders (TAOs)[29] rather than first submit the request to adjust the case through our normal channels.[30]

In one egregious instance involving several returns prepared by the same preparer – and despite the IRS's concurrence that the returns it processed were not the returns signed by the taxpayers – the IRS refused to adjust the taxpayers' accounts to remove the fabricated income or credits because it did not have procedures in place to do so. In these cases, the LTA issued TAOs to the IRS in December 2010. After the IRS refused to comply, I elevated these TAOs to the Commissioner of W&I in July 2011. After receiving no response, I further elevated the TAOs in August 2011 to the Deputy Commissioner for Services and Enforcement, who agreed that the IRS needed to correct the victims' accounts. It was not until the end of March 2012 that the IRS finally made the adjustments – over 18 months after the taxpayers first came to TAS for help.

The IRS response to these cases is particularly disturbing because the IRS has been aware of the issue of unscrupulous preparers altering returns in this manner for at least eight years. In March 2003, the Refund Crimes section of the IRS's Criminal Investigation (CI) division identified a scheme in which a preparer had altered several hundred of his clients' returns without their knowledge to increase each refund and then diverted the excess refunds into his own bank account. CI sought advice from the IRS Office of Chief Counsel, which issued an opinion concluding that a return altered by a

---

[27] Data obtained from TAMIS (June 17, 2012).

[28] *See* TAS Interim Guidance Memorandum TAS-13-0212-008, *Interim Guidance on Advocating for Taxpayers When a Return Preparer Appears to Have Committed Fraud* (Feb. 7, 2012), *available at* http://www.irs.gov/pub/foia/ig/tas/tas-13-0212-008.pdf.

[29] Internal Revenue Code (IRC) § 7811 authorizes the National Taxpayer Advocate to "issue a Taxpayer Assistance Order upon a determination that a taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered by the Secretary." *See* IRC § 7811(a)(1).

[30] *See* IGM TAS-13-0512-017, *Interim Guidance for Preparing Taxpayer Assistance Orders (TAOs) Involving Return Preparer Fraud* (May 22, 2012), http://www.irs.gov/pub/foia/ig/tas/tas-13-0512-017.pdf.

tax return preparer *after* the taxpayer has verified the accuracy of the return is a nullity (*i.e.*, not a valid return).[31] Counsel also advised that the taxpayer's account should be corrected by having the taxpayer file an accurate return and then adjusting the account to reflect the correct information reported on that return.[32] The Office of Chief Counsel issued an additional opinion in 2008, concluding that the IRS *can and should* adjust each taxpayer's account to remove any entries attributable to the invalid return filed by the preparer.[33] And in 2011, shortly after I issued a Proposed Taxpayer Advocate Directive (TAD) (discussed below), Counsel reaffirmed the conclusion that such altered returns were not valid.[34]

Because this was a systemic issue that required guidance to W&I employees, I issued a Proposed TAD to the Commissioner of W&I on June 13, 2011.[35] This Proposed TAD directed W&I to establish procedures for adjusting the taxpayer accounts in instances where a tax return preparer alters the return without the taxpayer's knowledge or consent in order to obtain a fraudulent refund. After receiving an unsatisfactory response to concerns raised about this matter in the Proposed TAD and my 2011 Annual Report to Congress,[36] I issued a TAD to the W&I and Small Business/Self-Employed (SB/SE) Operating Division Commissioners on January 12, 2012.[37] This TAD included suggestions for how the IRS could unwind the victims' accounts. While both officials have acknowledged their intent to comply with the substance of the TAD, they appealed the TAD solely in an effort to extend the time allowed to comply with the actions, *notwithstanding that the IRS already had over eight years to develop procedures to assist these victims of fraud*.

My staff is currently working with the IRS to develop procedures to address return preparer fraud. But frankly, I find it unacceptable that the IRS needs to be constantly

---

[31] *See* IRS Office of Chief Counsel Memorandum, *Horse's Tax Service*, PMTA 2011-13 (May 12, 2003), *available at* http://www.irs.gov/pub/lanoa/pmta-2011-013.pdf. A copy of this memorandum is attached.

[32] *See* IRS Office of Chief Counsel Memorandum, *Horse's Tax Service*, PMTA 2011-13 (May 12, 2003), *available at* http://www.irs.gov/pub/lanoa/pmta-2011-013.pdf.

[33] IRS Office of Chief Counsel Memorandum, *Refunds Improperly Directed to a Preparer*, POSTN-145098-08 (Dec. 17, 2008).

[34] IRS Office of Chief Counsel Memorandum, *Tax Return Preparer's Alteration of a Return*, PMTA 2011-20 (June 27, 2011).

[35] Pursuant to Delegation Order No. 13-3, the National Taxpayer Advocate has the authority to issue a TAD "to mandate administrative or procedural changes to improve the operation of a functional process or to grant relief to groups of taxpayers (or all taxpayers) when implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment, or provide an essential service to taxpayers." IRM 1.2.50.4, Delegation Order 13-3 (formerly DO-250, Rev. 1), *Authority to Issue Taxpayer Advocate Directives* (Jan. 17, 2001). *See also* IRM 13.2.1.6, *Taxpayer Advocate Directives* (July 16, 2009).

[36] *See* National Taxpayer Advocate 2011 Annual Report to Congress 59-60.

[37] *See* Taxpayer Advocate Directive 2012-1 (*Establish procedures for adjusting the taxpayer's account in instances where a tax return preparer altered the return without the taxpayer's knowledge or consent, and the preparer obtained a fraudulent refund*) (Jan. 12, 2012).

nudged to develop guidance for its employees about a type of return preparer fraud that it has known about for more than eight years, is growing, and is potentially very harmful to the impacted taxpayers. The taxpayers are the victims here, and the IRS should act with all due haste to correct their accounts and eliminate the risk of unlawful collection. Between Taxpayer Assistance Orders, Taxpayer Advocate Directives, the Annual Report to Congress, and now today's testimony, I am using every tool in my toolbox to try to get the IRS to help these victims of tax fraud. It is astonishing to me that it has taken the IRS this long to act.

V. The IRS Should Develop Procedures to Replace Stolen Direct Deposit Refunds

Unscrupulous tax return preparers, without the taxpayer's authorization, sometimes change the routing number on a return in an attempt to misappropriate the refund. When this occurs, the IRS's position is that because it paid out the refund according to the instructions it received, the taxpayer's sole recourse is to pursue the matter in a civil lawsuit against the return preparer. According to the IRS, it does not matter that the taxpayer did not actually sign the return that the preparer filed.

I do not believe this is the right answer, especially considering that if the taxpayer had requested a paper refund check (as opposed to a direct deposit), the Treasury Department could have issued a replacement check once it verified that the original refund check was lost or stolen and therefore uncashed by the taxpayer.[38] Despite the growth of electronic banking and its own efforts to get taxpayers to e-file returns, the IRS has insufficient procedures for replacing stolen direct deposit refunds. This causes disparate treatment of taxpayers who elect to receive their refunds electronically compared to those who choose to receive paper checks, and creates a disincentive for taxpayers to e-file.[39]

When a paper refund is stolen, the Financial Management System (FMS) verifies that no person negotiated the check and issues a new one to the taxpayer.[40] If FMS finds that the paper check has been negotiated, it conducts additional research, and if it determines the taxpayer was not involved in negotiation of the check, FMS issues a replacement to the taxpayer and charges the Check Forgery Insurance Fund (CFIF).[41] The CFIF is a revolving fund established to settle claims of non-receipt and make sure innocent payees receive timely settlement checks where a third party fraudulently

---

[38] *See* 31 U.S.C. § 3343; 31 C.F.R. § 235.4. *See also* FMS Form 1133, *Claim Against the United States for the Proceeds of a Government Check*.

[39] *See* National Taxpayer Advocate 2011 Annual Report to Congress 420-426 (Most Serious Problem: *The IRS Procedures for Replacing Stolen Direct Deposit Refunds Are Not Adequate*).

[40] The negotiation of a check is the process of conversion into cash or the equivalent value. http://www.merriam-webster.com/dictionary/negotiate.

[41] A settlement check is a replacement check based on the Form 1133 claim issued by FMS to replace the original check. IRM 21.4.2.4.13 (Dec. 20, 2010).

negotiated the original check.[42] The CFIF was created (long before electronic banking) by a statute that specifically refers to a "check," with longstanding rules and regulations that do not contemplate electronic payments.[43]

FMS guidelines state in part, "If the taxpayer or the taxpayer's agent gave incorrect account information, neither FMS nor IRS will assist the taxpayer with recovering the funds, and the taxpayer is free to pursue civil actions."[44] The IRS interprets this guideline as relief from further obligation as long as the account is the one listed on the return.[45] The IRS's interpretation of FMS guidelines leaves taxpayers with little recourse to recover their stolen direct deposit tax refunds.

I encourage Congress to modify the statute to expressly include direct deposits and other electronic transactions. However, I believe that even in the absence of legislation, the IRS can do more to help taxpayers whose direct deposit refunds have been stolen.

In my view, an unauthorized third party who wrongfully inserts an inaccurate bank account number on a return is not truly "the taxpayer's agent," leaving the IRS obliged to pay the taxpayer. For that reason, I believe the IRS can and should establish a process by which a taxpayer can show that whoever wrongfully altered the bank account number on a return was not an authorized agent, and upon confirmation of these facts, the IRS should pay the refund to the taxpayer.[46]

In case of a stolen direct deposit, the IRS Office of Chief Counsel previously has advised that, "the Service is legally permitted to reissue the refund to the taxpayer."[47] The Office of Chief Counsel has also advised that a return with tax data wrongfully altered by a preparer is not valid.[48] Therefore, I do not think it is too much of a stretch for the IRS to treat a return with an account number wrongfully altered by a preparer as invalid.

---

[42] *See* 31 U.S.C. § 3343.

[43] Congress established the CFIF by law in 1941, before the advent of electronic checks. Pub. L. No. 77-310, 55 Stat. 777 (Nov. 21, 1941). While unrelated regulations provide for electronic checks, the CFIF regulations and rules contemplate forgery of signatures on paper. *Compare* 31 C.F.R. § 240.3 (relating to electronic Treasury checks) *with* §§ 235.1 *ff*. (governing CFIF); *see also* Treas. Fin. Man. vol. 1, pt. 4, § 7055.

[44] Green Book, *Federal Government Participation in the Automated Clearing House* 1-9, *available at* www.fms.treas.gov/greenbook/index.html.

[45] *Cf*. IRM 21.4.1.4.7.5 (Oct. 1, 2011).

[46] As indicated above, it is unclear whether the CFIF could reimburse these payments since the applicable statute refers to "forged endorsement" of paper checks. 31 U.S.C. § 3343.

[47] FSA 200038005 (June 6, 2000); *see also* 31 C.F.R. § 210.4(a)(1) (indicating that an agency that accepts an ACH authorization shall verify "the validity of the recipient's signature").

[48] *See* IRS Office of Chief Counsel Memorandum, *Tax Return Preparer's Alteration of a Return*, PMTA 2011-20 (June 27, 2011); IRS Office of Chief Counsel Memorandum, *Horse's Tax Service*, PMTA 2011-13 (May 12, 2003). *See also Beard v. Comm'r*, 82 T.C. 766 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986).

In the case of a return fraudulently altered by a preparer, the IRS should have even more reason to assist the taxpayer than in fraud cases involving non-preparers. While a non-preparer third party who alters a return may be a mere thief, an errant preparer is not only a thief but is also violating his or her fiduciary duty to the taxpayer and the tax system. Not long ago, an IRS report stated that, "tax return preparers and the associated industry play a pivotal role in our system of tax administration and they must be a part of any strategy to strengthen the integrity of the tax system."[49] To protect the integrity of tax administration, the IRS must develop procedures that address the 21st-century version of return preparers' misappropriation of their clients' federal tax refunds.

VI. TAS Works Closely with the Criminal Investigation Division to Ensure Identity Theft Victims Receive the Attention and Assistance They Require

For many, tax return fraud may be viewed as a low-risk, high-reward venture. News reports suggest some very organized groups have chosen tax-related identity theft as the crime du jour.[50] Identity theft has become a large-scale operation, with "boiler room" operations involving the theft of massive lists of SSNs. Apparently, there are networks of criminals who not only share stolen personal information, but even present seminars about how to use this information to file bogus returns.[51] Such brazen behavior suggests that identity thieves are not worried about criminal prosecution.

In April of this year, Representative Wasserman Shultz introduced a bill that encouraged the Attorney General to use all existing resources to bring perpetrators of identity theft to justice.[52] I am pleased to report that the IRS's Criminal Investigation division (CI) doubled the number of convictions against identity thieves in FY 2011. CI initiated 276 fraud cases related to identity theft, with 81 convictions – up from 224 investigations and 40 convictions in FY 2010.[53] To respond more nimbly to identity theft situations, CI now has a designated liaison for identity theft in each of its major offices, but more action is required.

---

[49] IRS Pub. 4832, *Return Preparer Review*, at 32 (Dec. 2009).

[50] According to one report, suspects are teaching classes of 50 to 100 people at a time on how to file fraudulent returns. *See* Tampa Bay Times, "49 Accused of Tax Fraud and Identity Theft" (Sept. 2, 2011), *available at* http://www.tampabay.com/news/publicsafety/crime/49-accused-of-tax-fraud-and-identity-theft/1189406; Tampa Bay Online, "Police: Tampa Street Criminals Steal Millions Filing Fraudulent Tax Returns," *at* http://www2.tbo.com/news/politics/2011/sep/01/11/police-tampa-street-criminals-steal-millions-filin-ar-254724/.

[51] *See, e.g.*, Tampa Bay Times, "49 Accused of Tax Fraud and Identity Theft," (Sept. 2, 2011), *available at* http://www.tampabay.com/news/publicsafety/crime/49-accused-of-tax-fraud-and-identity-theft/1189406; Tampa Bay Online, "Police: Tampa Street Criminals Steal Millions Filing Fraudulent Tax Returns," *at* http://www2.tbo.com/news/politics/2011/sep/01/11/police-tampa-street-criminals-steal-millions-filin-ar-254724/.

[52] *See* H.R. 4362, *Stopping Tax Offenders and Prosecuting Identity Theft Act of 2012*.

[53] Data obtained from the IRS Criminal Investigation division's research function (Mar. 13, 2012).

My office has worked closely with CI over the last few years to make sure that where CI has identified a scheme and has lists of victims' SSNs, this information is quickly transferred to the civil component of the IRS so that the victims are notified and identity theft markers are placed on their accounts. We have coordinated with CI and the Department of Justice on certain cases to ensure victims receive notification and are informed about avenues for assistance at the IRS. Only through detection, prosecution, and victim assistance will we be able to comprehensively address the rise of tax-related identity theft.

VII. The Social Security Administration (SSA) Should Restrict Access to the Death Master File.

I am concerned that the federal government continues to facilitate tax-related identity theft by making public the Death Master File (DMF), a list of recently deceased individuals that includes their full name, SSN, date of birth, date of death, and the county, state, and ZIP code of the last address on record.[54] The SSA characterizes release of this information as "legally mandated,"[55] but the extent to which courts currently would require dissemination of death data under the Freedom of Information Act (FOIA)[56] has not been tested. To eliminate uncertainty, I have recommended that Congress pass legislation to clarify that public access to the DMF can and should be limited.[57]

The public availability of the DMF facilitates tax-related identity theft in a variety of ways. For example, a parent generally is entitled to claim a deceased minor child as a dependent on the tax return that covers the child's year of death. If an identity thief obtains information about the child from the DMF and uses it to claim the dependent on a fraudulent return before the legitimate taxpayer files, the IRS will stop the second (legitimate taxpayer's) return and freeze the refund. The legitimate taxpayer then may face an extended delay in obtaining the refund, potentially causing an economic hardship, and will bear the emotionally laden burden of persuading the IRS that the deceased child was really his or hers. As a practical matter, legislation could relieve survivors of this burden by simply delaying release of the information for several years.

In light of the practical difficulties of passing legislation, however, I also urge the SSA to reevaluate whether it has the legal authority to place limits on the disclosure of DMF information administratively. In 1980, the SSA created the DMF, now issued weekly, after an individual filed suit in the U.S. District Court for the District of Columbia seeking

---

[54] *See* Office of the Inspector General, SSA, *Personally Identifiable Information Made Available to the General Public via the Death Master File*, A-06-08-18042 (June 2008).

[55] *Social Security and Death Information* 1, Hearing Before H. Comm. on Ways & Means, Subcomm. on Soc. Security (statement of Michael J. Astrue, Commissioner of Social Security) (Feb. 2, 2012).

[56] FOIA generally provides that any person has a right to obtain access to certain federal agency records. *See* 5 U.S.C. § 552.

[57] *See* National Taxpayer Advocate 2011 Annual Report to Congress 519-523 (Legislative Recommendation: *Restrict Access to the Death Master File*).

certain data fields pursuant to FOIA and the court entered a consent judgment in the case pursuant to an agreement reached by the parties.[58] While the 1980 consent judgment may have seemed reasonable at the time, the factual and legal landscape has changed considerably over the past three decades.

From a factual standpoint, DMF information was sought in 1980 as a way to prevent fraud by enabling pension funds to identify when a beneficiary died so they could stop the payment of benefits. Today, DMF information is used to commit tax fraud, so there is a factual reason for keeping the information out of the public domain.

From a legal standpoint, judicial interpretations of FOIA and its privacy exceptions have evolved in several important respects, including the recognition of privacy rights for decedents and their surviving relatives.

In general, agencies receiving FOIA requests for personal information must balance (1) the public interest served by release of the requested information against (2) the privacy interests of individuals to whom the information pertains.[59]

In 1989, the Supreme Court reiterated that the public's FOIA interest lies in learning "what their government is up to."[60] The Court continued:

> Official information that sheds light on an agency's performance of its statutory duties falls squarely within that statutory purpose. That purpose, however, is not fostered by disclosure of information about private citizens that is accumulated in various governmental files but that reveals little or nothing about an agency's own conduct.[61]

Following the Supreme Court's reasoning, the Court of Appeals for the D.C. Circuit rejected a request for a list of names and addresses of retired or disabled federal employees, concluding that release of the information could "subject the listed

---

[58] *See Perholtz v. Ross*, Civil Action Nos. 78-2385, 78-2386 (D.D.C. Apr. 11, 1980).

[59] *See, e.g.*, *Department of Defense v. Federal Labor Relations Authority*, 510 U.S. 487, 497 (1994); *Department of Justice v. Reporter's Committee for Freedom of the Press*, 489 U.S. 749, 773 (1989). This balancing applies to information described in FOIA Exemption 6, 5 U.S.C. § 552(b)(6) ("personnel and medical files and similar files the disclosure of which would constitute a clearly unwarranted invasion of personal privacy"), which would encompass files like the DMF. *See Department of State v. Washington Post Co*., 456 U.S. 595, 599-603 (1982); *see also Judicial Watch, Inc. v. Food & Drug Administration*, 449 F.3d 141, 152 (D.C. Cir. 2006).

[60] *Department of Justice v. Reporter's Committee for Freedom of the Press*, 489 U.S. at 773 (quotation omitted).

[61] *Id. See also National Archives & Records Administration v. Favish*, 541 U.S. 157, 171 (2004) (quotation omitted) ("FOIA is often explained as a means for citizens to know 'what the Government is up to'").

annuitants 'to an unwanted barrage of mailings and personal solicitations,'" and that such a "fusillade" was more than a *de minimis* assault on privacy.[62]

The courts have increasingly found that privacy rights do not belong only to living persons. In 2001, the D.C. Circuit stated that:

> the death of the subject of personal information does diminish to some extent the privacy interest in that information, though it by no means extinguishes that interest; one's own and one's relations' interests in privacy ordinarily extend beyond one's death.[63]

The courts have reiterated that decedents and their surviving relatives possess privacy rights in numerous cases.[64] In the decided cases, the privacy interest at issue generally has consisted exclusively of emotional trauma. Where there is tax-related identity theft, the privacy interest is much stronger because there is a financial as well as an emotional impact. For example, a parent who has lost a child to Sudden Infant Death Syndrome and then discovers an identity thief has used the DMF to claim his child as a dependent must not only devote time trying to prove to the IRS that he was the legitimate parent, but he must also deal with the financial burden of having his tax return (and refund) frozen.

Consider two legitimate uses of DMF information. One is by pension funds that use the information to terminate benefits as of the date of a beneficiary's death. The other is by genealogists who use DMF information to help them build a family tree. While both uses are reasonable, neither fits within the core purpose of FOIA of alerting the citizenry about "what their government is up to." The D.C. Circuit has held that where disclosure does not serve the core purpose of FOIA, no public interest exists, and any personal privacy interest, however modest, is sufficient to tip the balance in favor of nondisclosure.[65] Even if a court were to decide that the DMF does serve a core FOIA purpose, it would balance the public and privacy interests and could easily conclude that the privacy interests predominate.

---

[62] *National Association of Retired Federal Employees v. Horner*, 879 F.2d 873, 876 (D.C. Cir. 1989) (quotation omitted), *cert. denied*, 494 U.S. 1078 (1990).

[63] *Schrecker v. Department of Justice*, 254 F.3d 162, 166 (D.C. Cir. 2001) (citations omitted), *reiterated on appeal following remand*, 349 F.3d 657, 661 (D.C. Cir. 2003).

[64] *See, e.g., National Archives & Records Administration v. Favish*, 541 U.S. at 170 ("FOIA recognizes surviving family members' right to personal privacy with respect to their close relative's death-scene images."); *Accuracy in Media, Inc. v. National Park Service*, 194 F.3d 120, 123 (D.C. Cir. 1999) (noting that the D.C. Circuit "has squarely rejected the proposition that FOIA's protection of personal privacy ends upon the death of the individual depicted"); *Campbell v. Department of Justice,* 164 F.3d 20, 33 (D.C. Cir. 1998) ("The court must also account for the fact that certain reputational interests and family-related privacy expectations survive death."); *New York Times v. National Aeronautics & Space Administration,* 782 F. Supp. 628 (D.D.C. 1991) (concluding that NASA was not required to release audio tapes of the final minutes aboard the Challenger space shuttle).

[65] *National Association of Retired Federal Employees v. Horner*, 879 F.2d at 879.

Thus, if legislation is not forthcoming, I urge the SSA to reconsider its legal analysis and decide to take steps to restrict access to the DMF.[66]

VIII. Creating New Exceptions to Taxpayer Privacy Protections Poses Risks and Should Be Approached Carefully, If at All.

Taxpayers have the right to expect that any information they provide to the IRS will not be used or disclosed by the IRS unless authorized by the taxpayer or other provision of law. The Internal Revenue Code (IRC) contains significant protections for the confidentiality of returns and return information. IRC § 6103 generally provides that returns and return information shall be confidential and then delineates a number of exceptions to this general rule.

Section 6103(i)(2) authorizes the disclosure of return information in response to requests from federal law enforcement agencies for use in criminal investigations. There is no corresponding exception in IRC § 6103 that allows for the release of identity theft information to *state or local* agencies.[67] However, IRC § 6103(c) provides that a taxpayer may consent to disclosure of returns and return information to any person designated by the taxpayer.

It is my understanding that some have called for the expansion of exceptions to IRC § 6103, ostensibly to help state and local law enforcement combat identity theft. I have significant concerns about loosening taxpayer privacy protections and I do not believe that such an expansion of the statute is appropriate at this time. I believe the current framework of IRC § 6103 includes sufficient exceptions to allow the IRS to share information about identity thieves.

The IRS Office of Chief Counsel has advised that the IRS may share the "bad return" and other return information of an identity thief with other federal law enforcement agencies investigating the identity theft.[68] In light of this advice, the IRS has

---

[66] The SSA may be able to restrict access to the DMF without even asking the court to modify its consent judgment in *Perholtz v. Ross*, Civil Action Nos. 78-2385, 78-2386 (D.D.C. Apr. 11, 1980). By its terms, the consent judgment applies only to requests for updated information submitted by Mr. Perholtz himself, is limited to one request per year, and covers only a decedent's "social security number, surname and (as available) date of death." Our understanding is that Mr. Perholtz has not submitted requests for updated information in recent years, that the SSA is now making DMF information available weekly, and that the SSA is making public considerably more information than the three data fields described.

[67] Note, however, that certain disclosures to state law enforcement are permissible. *See* IRC § 6103(i)(3)(B)(i) (disclosure of return information, including taxpayer return information, can be made to the extent necessary to advise appropriate officers or employees of any state law enforcement agency of the imminent danger of death or physical injury to any individual; disclosure cannot be made to local law enforcement agencies). While identity theft may cause emotional and economic injury, the typical identity theft situation does not pose an imminent danger of death or physical injury.

[68] IRS Office of Chief Counsel Memorandum, *Disclosure Issues Related to Identity Theft, PMTA 2012-05* (Jan. 18, 2012).

implemented a pilot program in the State of Florida to facilitate a consent-based sharing of identity theft information with state and local law enforcement agencies.[69]

I believe this approach strikes an appropriate balance – protecting taxpayer return information while simultaneously giving state and local law enforcement authorities more information to help them investigate and combat identity theft. However, I am concerned that once the information is in the hands of state and local law enforcement, there is no prohibition in the tax code against redisclosure. Therefore, I suggest that Congress consider modifying IRC § 6103(c) to explicitly limit the use of tax return information to the purpose agreed upon by the taxpayer (*i.e.*, to allow state or local law enforcement to use the information solely to enforce state or local laws) and to prohibit the redisclosure of such information.[70]

IX. There Is a Continuing Need for the IRS's Identity Protection Specialized Unit to Play a Centralized Role in Managing Identity Theft Cases.

Commissioner Shulman, in his written response to Senator Baucus's follow-up questions stemming from an April 2008 hearing, described the specialized unit (IPSU) as providing "a central point of contact for the resolution of tax issues caused by identity theft." His response further stated, "This unit will provide end-to-end case resolution. Victims will be able to communicate with one customer service representative to have their questions answered and issues resolved quickly and efficiently."[71] While this description fits the model for which my office advocated, it does not accurately reflect how the IPSU works in practice.

The IPSU does not "work" an identity theft case from beginning to end. Instead, it coordinates with up to 27 other functions within the IRS to obtain relief for the victim.[72] That is, the IPSU is designed to act as the "traffic cop" for identity theft cases, ensuring that cases move along smoothly and timely, and are not stuck in one function or another. In some cases (such as when the victim faces no immediate tax impact), the IPSU simply routes the case to other IRS organizations and "monitors" the account every 60 days.[73] In other cases, the unit uses Identity Theft Assistance Requests (ITARs) to ask other IRS functions to take specific actions.[74]

---

[69] *See* http://www.irs.gov/privacy/article/0,,id=256965,00.html (last visited June 8, 2012).

[70] *See* National Taxpayer Advocate 2011 Annual Report to Congress 505.

[71] *Identity Theft: Who's Got Your Number, Hearing Before the S. Comm. on Finance*, 110th Cong. (Apr. 10, 2008) (response of IRS Commissioner Douglas H. Shulman to questions from Chairman Max Baucus), *available at* http://finance.senate.gov/hearings/hearing/download/?id=f989b16e-5da3-452d-9675-b75d796fe2b4.

[72] IRS, Identity Theft Executive Steering Committee, *Identity Theft Program Enhancements, Challenges and Next Steps* 14 (Oct. 19, 2011).

[73] IRM 21.9.2.4.3(7) (Oct. 1, 2011).

[74] IRM 21.9.2.10.1 (Oct. 1, 2011).

While the procedures call for the receiving functions to give ITARs priority treatment, there are no "teeth" to ensure that this happens.[75] Unlike TAS, which can issue a TAO[76] if an operating division (OD) does not comply with its request for assistance in a timely manner, the IPSU procedures do not specify any consequences for functions that are unresponsive to a case referral or an ITAR. Moreover, TAS has negotiated agreements with the ODs that clearly define when and how the ODs will respond to a TAS request for action. I have urged the IPSU to enter into similar agreements with other IRS ODs and functions that set forth the timeframes for taking the requested actions and to develop tracking procedures to report to heads of office when functions regularly fail to meet these timeframes.

Although the IRS has now shifted gears and plans to take a specialized approach to assisting identity theft victims, I firmly believe there remains a need for a centralized body such as the IPSU to serve as the "traffic cop." Identity theft cases are often complex, requiring adjustments by multiple IRS functions. Without a coordinator, there is a high risk that these cases will get "stuck" or fall through the cracks. The IPSU should continue to play a central role in this process by conducting a global account review and then tracking each identity theft case from start to finish, from one specialized function to another.

X. Conclusion

Identity theft and other refund-related fraud pose significant challenges for the IRS. Opportunistic thieves will always try to game the system. From their perspective, the potential rewards of committing tax-related identity theft may be worth the risk. We can do more both to reduce the rewards (by continuing to implement targeted filters) and to increase the risk (by actively pursuing criminal penalties against those who are caught). But in making the tax system less attractive to such criminal activity, we cannot impose significant burden on taxpayers.

At a fundamental level, we need to make some choices about what we want most from our tax system. If our goal is to process tax returns and deliver tax refunds as quickly as possible, the IRS can continue to operate as it currently does – but that means some perpetrators will get away with refund fraud and some honest taxpayers will suffer harm. If we place a greater value on protecting taxpayers against identity theft and the Treasury against fraudulent refund claims, we may need to make a substantial shift in the way the IRS does business. Specifically, we may need to ask all taxpayers to wait longer to receive their tax refunds, or we may need to increase IRS staffing significantly.

---

[75] IRM 21.9.2.1(4) (Oct. 1, 2011) provides:

> All cases involving identity theft will receive priority treatment. This includes…Form 14027-A *Identity Theft Case Monitoring*, and Form 14027-B, *Identity Theft Case Referral*….Identity Theft Assistance Request (ITAR) referrals are also included.

IRM 21.9.2.10.1(1) (Oct. 1, 2011) provides that "Cases assigned as ITAR will be treated similar to Taxpayer Advocate Service (TAS) process including time frames."

[76] IRC § 7811.

Under current circumstances, it is simply not possible for the IRS both to process legitimate returns rapidly and to combat refund fraud effectively.

Office of Chief Counsel
Internal Revenue Service

memorandum

date: May 12, 2003

to: BETTE M. WHISLER
Management/Program Analyst
CI Refund Crimes
Criminal Investigation
CI:RC

from: James C. Gibbons, Chief
Branch 1
Administrative Provisions and Judicial Practice
CC:PA:APJP:B01

---

subject: Horse's Tax Service, POSTN-123371-03

This Memorandum responds to your e-mail to George Bowden dated March 26, 2003. In accordance with I.R.C. ' 6110(k)(3), this Memorandum is not to be used or cited as precedent.

Issues

1. Is a return a nullity if a return preparer increased the charitable contribution amount on a taxpayer's return to inflate a refund, and the taxpayer was unaware of the increased charitable contribution and did not benefit from that part of the refund?

2. If a return is a nullity but the taxpayer received a refund anticipation loan for the correct amount of his refund (minus normal preparation fees), does the taxpayer receive another refund when his true return is filed?

3. Is a return a nullity if a taxpayer willingly allowed the preparer to add fraudulent expenses to his Schedule C to gain a larger refund, but the preparer also increased the charitable contribution amount on the Schedule A, and the taxpayer was unaware of the inflated charitable contribution amount and doesn't benefit from that part of the refund associated with the inflated charitable contribution?

4. In both situations, should the taxpayer correct his account by filing a new return or an amended return?

5. SBSE has agreed to audit 50-100 of these Schedule C's. Is this the best way to handle these fraudulent returns?

Conclusions

1. The return is a nullity because what was sent to the Internal Revenue Service (Service) is a document unknown and unverified by the taxpayer.

2. Assuming that the taxpayer had received the correct amount based on his withholding and tax liability, there is no overpayment, and the Service should not issue a second refund to the taxpayer. Where the taxpayer sent the refund amount to the financial institution because the Service has frozen the refund, however, there is an overpayment and no unjust enrichment. In this situation, the Service should send the correct amount of refund directly to the taxpayer.

3. As in Issue 1, the return is a nullity because what was sent to the Service is a document unknown and unverified by the taxpayer.

4. The taxpayer's Master File account should be corrected by having the taxpayer whose return has been fraudulently altered by the return preparer file an accurate Form 1040 or 1040 series return from which Criminal Investigation or the SBSE Division can adjust the Master File account to reflect the correct information. The taxpayer should not file a Form 1040X because the electronic return and Form 8453 filed by the preparer are nullities and no return has been filed by the taxpayer.

5. The assignment of the SBSE division to audit a percentage of the Schedule C returns is a business decision that should be made by the Campus and the Operating Divisions.

Facts

Your e-mail presents the following scenario for analysis. Horse (this name has been changed for confidentiality purposes) is a certified public accountant preparing individual income tax returns. Horse prepared approximately 700 returns for tax year 2002, of which, approximately 450 were filed electronically with the Service. Horse prepared tax returns with the information provided by the client and printed a copy of that return to give to the client. Horse established a refund anticipation loan (RAL) account at a financial institution for that client that allowed him to issue a bank check prior to the refund being received from the IRS. Prior to transmitting the return to the Service, Horse increased the charitable contribution amount on the Schedule A without his clients knowledge in order to increase the refund received from the Service. Horse provided his client with the copy of the return printed earlier, which *did not* contain the inflated charitable contributions, and a bank check for the amount of the refund on that tax return less his $50 preparation fee.

Once the Service received the electronic return, the refund was wired to the financial institution. The financial institution then paid off the client's RAL account, deducted the RAL and bank fees, and as instructed by Horse, placed the remainder of the refund into Horse's preparer account as preparer fees. Once these fees reached Horse's preparer account at the financial institution, the fees were automatically wired to Horse's checking account.

It does not appear that any of Horse's clients were aware that Horse was increasing the charitable contribution amounts on their returns. It also appears that none of Horse's clients knew that RAL accounts were being created in their names at the financial institution.

In some cases, the Service froze the refunds and did not send the refund amounts to the financial institution. In those case, the financial institution made demand to the taxpayers for the refund amounts. Many of these taxpayers paid the financial institution the amount of the check they received, and many paid the entire amount of the RAL including the fraudulent portion that Horse received without their knowledge. The taxpayers were completely unaware that they were receiving RALs and that their refunds were routed through the financial institution.

Evidence obtained from Horse's computer and witnesses' testimony show that Horse also reported fraudulent Schedule C business expenses for several of his clients. Horse reported legal and professional fees paid to him on these Schedule Cs which in fact were never paid, and generated fraudulent invoices for expenses never paid by the Schedule C businesses. It appears that these fraudulent expenses were created *with* the clients knowledge.

Law and Analysis

Issue 1: Is a return a nullity if a return preparer increased the charitable contribution amount on a taxpayer's return to inflate a refund, and the taxpayer was unaware of the increased charitable contribution and did not benefit from that part of the refund?

The return is a nullity because the electronic file submitted to the Service is a document unknown and unverified by the taxpayer. Courts have identified a four-part test for determining whether a defective or incomplete document is a valid return: "First, there must be sufficient data to calculate tax liability; second, the document must purport to be a return; third, there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and fourth, the taxpayer must execute the return under penalties of perjury." *Beard v. Commissioner*, 82 T.C. 766, 777 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986). This generally accepted formulation of the criteria for determining a valid return, known as the *Beard* formulation or the "substantial compliance" standard, derives from a venerable line of Supreme Court cases. *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172, 180 (1934); *Badaracco v.*

Commissioner, 464 U.S. 386 (1984); *Florsheim Bros. Drygoods Co v. United States*, 280 U.S. 453 (1930).

The signature requirement derives from I.R.C. ' 6065 which provides that generally, any return, declaration, statement, or other document required to be made under any provision of the internal revenue laws or regulations shall contain or be verified by a written declaration that it is made under penalties of perjury. The purpose of this requirement is to authenticate the signed document, and to verify its truthfulness.

Line 4 of Part 1 of the Form 8453 reports the amount of a taxpayer's refund. The Jurat portion of Form 8453 provides:

> Under penalties of perjury, I declare that the information I have given my ERO and the amounts in part 1 above agree with the amounts on the corresponding lines of the electronic portion of my [year] Federal income tax return. To the best of my knowledge and belief, my return is true, correct and complete.

In cases where the taxpayer is unaware of fraudulent inflated charitable contribution expenses added by the return preparer, it cannot be said that the taxpayer executed his return under penalties of perjury, because what was submitted to the Service by the preparer is not the document signed by the taxpayer. Here the taxpayer signed and verified a return that was not sent to the Service. Accordingly, the electronic file and Form 8453 fail to meet the signature requirement set forth in *Beard*, fail to meet the substantial compliance standard, and is not a return. Since the document does not constitute a return, it has no status under the Internal Revenue Code and is a nullity. Because no return has been filed, under I.R.C. ' 6664(b), no accuracy related or civil fraud penalties can be imposed against the taxpayer. However, criminal fraud penalties under I.R.C. '7206 may apply.

Issue 2: If a return is a nullity but the taxpayer received a refund anticipation loan for the correct amount of his refund (minus normal preparation fees), does the taxpayer receive another refund when his true return is filed?

The taxpayer should not be entitled to a refund from the Service when he has received through the preparer the amount to which he was in fact entitled. This is because there is no overpayment. No refund can be made unless it has first been determined that the taxpayer has made an overpayment in tax for the year. In *Jones v. Liberty Glass Co.*, 332 U.S. 524, 531 (1947), the Supreme Court defined the term overpayment broadly and colloquially, stating:

> [W]e read the term Aoverpayment@ in its usual sense, as meaning any payment in excess of that which is properly due. Such an excess payment may be traced to an error in mathematics or in judgment or in interpretation of facts or law. And the error may be committed by the

taxpayer or by the revenue agents. Whatever the reason, the payment of more than is rightfully due is what characterizes an overpayment.

Thus, assuming that the taxpayer had received the correct amount based on his withholding and tax liability, there is no overpayment, and the Service should not issue a second refund to the taxpayer. In addition, any second payment to the taxpayer would result in the taxpayer's unjust enrichment. Where the taxpayer sent the refund amount to the financial institution because the Service has frozen the refund, however, there is an overpayment and no unjust enrichment. In this situation, the Service should send the taxpayer the correct amount of refund. Since the taxpayer was completely unaware that he was receiving RALs and that the refunds were routed through the financial institution, the Service should send the refund directly to the taxpayer and not forward the refund through the financial institution.

Issue 3: Is a return a nullity if a taxpayer willingly allowed the preparer to add fraudulent expenses to his Schedule C to gain a larger refund, but the preparer also increased the charitable contribution expense on the Schedule A, and the taxpayer was unaware of the inflated charitable contribution expense and doesn't benefit from that part of the refund associated with the inflated charitable contribution?

Even though the taxpayer was aware of and consented to the fraudulent inflation of the Schedule C expenses, the taxpayer was not aware of the addition of the charitable contribution. Using the same rationale in issue 1, the taxpayer has signed and verified documents that was not sent to the Service. What was sent to the Service is a document unknown and unverified by the taxpayer. Accordingly, the electronic file and Form 8453 fail to meet the signature requirement set forth in *Beard*, fail to meet the substantial compliance standard, and are not returns. As discussed above, although criminal fraud penalties under I.R.C. ' 7206 may apply, no accuracy related or civil fraud penalties can be imposed against the taxpayer pursuant to I.R.C. ' 6664(b) because no return has been filed.

Issue 4. In both situations, should the taxpayers correct their account by filing new returns or amended returns?

The taxpayer's Master File account should be corrected by having the taxpayer whose return has been fraudulently altered by the return preparer file an accurate Form 1040 or 1040 series return from which Criminal Investigation or the SBSE Division can adjust the Master File account to reflect the correct information. The taxpayer should not file a Form 1040X because the electronic return and Form 8453 filed by the preparer are nullities and no return has been filed by the taxpayer.

Issue 5. SBSE has agreed to audit 50-100 of these Schedule C's. Is this the best way to handle these fraudulent returns?

The assignment of the SBSE division to audit a percentage of the Schedule C returns is a business decision that should be made by the Campus and the Operating Divisions. We note, however, that because no return has been filed in these cases, under I.R.C. ' 6664(b), no accuracy related or civil fraud penalties can be imposed against the taxpayer. We also note that IRM section 4.10.6.3.3(2) (05-14-1999) provides that Awhen a potential criminal fraud case is identified, preparation of a timely fraud referral to Criminal Investigation is necessary pursuant to the provisions of IRM 25.1, Fraud.@ See also IRM section 5.1.11.6, Referrals to Criminal Investigation (05-27-1999).

If you have any questions, please contact this office at (202) 622-4910.