

## Area of Focus #4 High False Detection Rates Associated With Fraud Detection and Identity Theft Filters Unnecessarily Burden Legitimate Taxpayers

### TAXPAYER RIGHTS IMPACTED<sup>1</sup>

- *The Right to Quality Service*
- *The Right to Finality*
- *The Right to a Fair and Just Tax System*

### DISCUSSION

Tax refund fraud remains a significant concern for the IRS and taxpayers. In calendar year 2016, tax refund fraud cost the government approximately \$1.6 billion.<sup>2</sup>

Although not all tax refund fraud involves identity theft, and not all identity theft involves tax refund fraud (*e.g.*, employment-related identity theft does not involve the theft of tax refunds), there are enough similarities between the two that it is appropriate to discuss them together. As the nature of tax refund fraud schemes evolves, it becomes even more important for the IRS to design and implement targeted filters, rules, and data mining models<sup>3</sup> to combat increasingly sophisticated refund fraud schemes while minimizing the rate at which the IRS incorrectly treats legitimate taxpayers as participants in those schemes (*i.e.*, the false detection rate).<sup>4</sup>

#### Pre-Refund Wage Verification

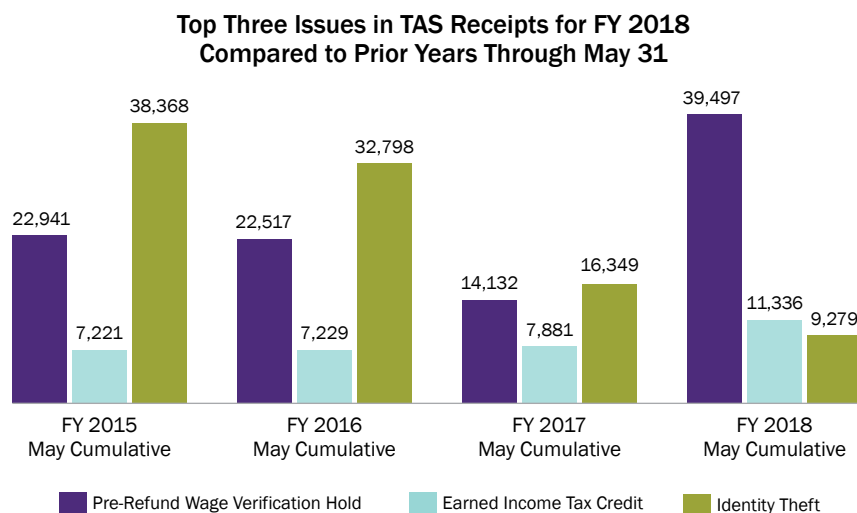
The IRS runs all tax returns claiming refunds through a variety of fraud filters. Depending upon the characteristics of the return, the IRS may select the return for screening and then attempt to match the information on the return with third-party information it has available. One filter that is used to select returns for screening looks for false reporting of income or tax withholding. For example, a taxpayer may file a return that understates income or overstates the amount of tax withheld by the employer to generate an inflated refund. Under the IRS's Pre-Refund Wage Verification Program, the IRS can freeze a claimed refund that has suspicious amounts of income or withholding until the amounts can be verified.

- 1 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).
- 2 Government Accountability Office, GAO-18-224, *Tax Fraud and Noncompliance: IRS Can Strengthen Pre-Refund Verification and Explore More Uses 1* (Jan. 30, 2018); Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2017-40-017, *Efforts Continue to Result in Improved Identification of Fraudulent Tax Returns Involving Identity Theft; However, Accuracy of Measures Needs Improvement 7* (Feb. 7, 2017).
- 3 The IRS uses various filters to screen returns for either possible identity theft (IDT) or non-IDT refund fraud. These filters consist of both *rules* and *models*. Rules are binary in nature – *i.e.*, the rule is broken and the return will be selected for further analysis, or the rule is not broken and the return will continue through normal processing. Models, on the other hand, evaluate characteristics of the return and a total score is given to the return. If the score is above a prescribed threshold, a return will be selected for further analysis for either IDT or non-IDT refund fraud. Internal Revenue Manual (IRM) 25.25.2.1(1), *Program Scope and Objectives* (Mar. 29, 2017).
- 4 See IRS response to TAS recommendations from the IRS Responses and National Taxpayer Advocate's Comments Regarding Most Serious Problems Identified in the 2017 Annual Report to Congress: *Fraud Detection: The IRS Has Made Improvements to Its Fraud Detection Systems, but a Significant Number of Legitimate Taxpayers Are Still Being Improperly Selected by These Systems, Resulting in Refund Delays, infra*.

While these filters are necessary to combat the epidemic of refund fraud, this benefit is offset somewhat by the cost – which is the delayed processing of some legitimate returns the filter catches, known as “false positives.”<sup>5</sup> Taxpayers whose legitimate refund claims have been frozen by these filters are further inconvenienced because the Pre-Refund Wage Verification function does not provide a mechanism for the taxpayer to directly contact the function. Further exacerbating their frustration, when taxpayers call to inquire about the delay in processing their refund, the IRS assistor does not have access to the IRS database that shows the status of the review.

In fiscal year (FY) 2018, Pre-Refund Wage Verification is currently the number one issue among TAS case receipts (with a 180 percent increase from the prior year, through May), supplanting identity theft as the top issue for the first time since 2011.

**FIGURE 3.4.1**<sup>6</sup>



### Identity Verification

Some of the IRS’s filters look specifically for characteristics of identity theft. As part of the Taxpayer Protection Program (TPP), which uses a series of filters, the IRS freezes returns flagged as suspicious for identity theft until it can verify the identity of the taxpayer filing the return. As of May 17, 2018, the TPP selected approximately 1.66 million suspicious tax returns, up slightly from approximately 1.64 million returns it selected over the same period in 2017.<sup>7</sup>

If the IRS holds a taxpayer’s refund for identity verification under the TPP, it sends a letter instructing the taxpayer to verify his or her identity by calling the TPP phone line. However, taxpayers may not

<sup>5</sup> In prior reports, TAS has referred to a “false positive rate.” The IRS prefers to use the term “false detection rate;” we will use the terms interchangeably in this report. The false detection rate measures the percentage of returns where the taxpayer is able to verify either his/her identity or the information on their return after having his/her return selected for further scrutiny by one of the IRS’s fraud filters.

<sup>6</sup> Data obtained from Taxpayer Advocate Management Information System (TAMIS) (June 1, 2015; June 1, 2016; June 1, 2017; June 1, 2018).

<sup>7</sup> IRS Return Integrity & Compliance Services (RICS), *Update of the Taxpayer Protection Program (TPP)* (May 23, 2018); IRS RICS, *Update of the Taxpayer Protection Program (TPP)* (May 24, 2017).

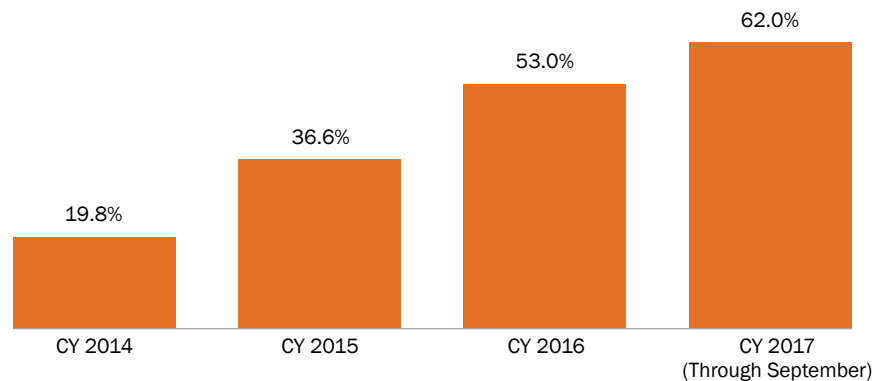
have been able to get through to an assistor, as the level of service on the TPP phone line has dipped as low as 42 percent during the 2018 filing season.<sup>8</sup> If a taxpayer is unable to authenticate over the phone, he or she will be instructed to make an appointment to verify in person at a Taxpayer Assistance Center, which may delay the refund even further.

### IRS Fraud Detection Filters Are Overly Broad

The IRS's fraud detection systems have a history of high false detection rates. In calendar year (CY) 2017 (through September), the false detection rate for TPP identity theft filters was 62 percent, meaning that of all returns flagged as potentially fraudulent, nearly two-thirds were legitimate.<sup>9</sup> There has been a significant upward trend in false detection rates for the TPP filters in recent years.

**FIGURE 3.4.2**<sup>10</sup>

**Taxpayer Protection Program: False Detection Rates, Calendar Years 2014-2017**



The IRS's non-IDT fraud filters are also overly broad, with a false detection rate of 66 percent for CY 2017 (through September).<sup>11</sup>

In the 2018 filing season, the IRS added two new filters designed to detect improper reporting of wages on returns in which the taxpayer claimed the Earned Income Tax Credit (EITC) or Additional Child Tax Credit (ACTC). Because the EITC and the ACTC are phased out when a taxpayer's income reaches a certain threshold, these new filters are, in practice, targeting low income taxpayers. When the release of the refund is delayed for any amount of time past normal timeframes, there is potential to create financial hardship.

<sup>8</sup> Joint Operations Center, *Weekly Taxpayer Protection Program (TPP) Report* (week ending Mar. 17, 2018).

<sup>9</sup> IRS response to TAS information request (Nov. 6, 2017). As of June 21, 2018, the IRS was unable to provide updated data on false detection rates for the full calendar year 2017.

<sup>10</sup> IRS Wage & Investment Division, *Business Performance Review* (May 5, 2016; May 11, 2017); IRS response to TAS information request (Nov. 6, 2017).

<sup>11</sup> IRS response to TAS information request (Oct. 19, 2017). The false detection rate measures the percentage of returns where the taxpayer is able to verify either his/her identity or the information on their return after having his/her return selected for further scrutiny by one of the IRS's fraud filters.

For the 2018 filing season, the IRS has a fraud filter that contains a rule that applies “tolerance” amounts for mismatches between income and withholding reported by third parties and taxpayers. If any of these or other rules and risk factors are triggered, the taxpayer’s return is more likely to be selected for further scrutiny. The design of these filters has contributed to a 500 percent increase of cases selected into the Integrity & Verification Office (IVO).<sup>12</sup>

The National Taxpayer Advocate understands the IRS’s desire to curb refund fraud by relying on systemic fraud filters using data analytics. However, when such filters routinely have false detection rates above 50 percent, causing legitimate taxpayers to wait additional weeks to receive their tax refunds, the IRS has a responsibility to review and adjust these filters.<sup>13</sup> The IRS has the capability to adjust its fraud filters in real time during the filing season, but told TAS that it has not exercised this capability for its non-identity theft fraud filters.<sup>14</sup>

Other tax administration agencies have demonstrated that it is possible to have low false detection rates while still effectively stopping fraudulent returns.<sup>15</sup> For example, rather than relying on rules, the IRS can build sophisticated models using data mining and “machine learning” to minimize the false detections without impairing its ability to stop improper payments. Additionally, predictive models could be designed and used to assist the IRS in making intelligent estimations as to how many truly fraudulent returns should be identified during the filing season and the number of false detections that will occur. For the last six months, the National Taxpayer Advocate and her staff have been meeting with experts from the private sector and other tax agencies to learn about current developments in this area and advanced methods to both improve true positive detection and minimize false detections.

In a hearing before the House Committee on Oversight and Government Reform shortly after the 2018 filing season, the acting IRS Commissioner acknowledged the need for the IRS to make improvements in its screening methods. The acting Commissioner agreed to work with the National Taxpayer Advocate to provide a report to this Committee (within 90 days of the April 17, 2018 hearing) detailing how the IRS can lower its false detection rate to below 50 percent for its fraud detection systems.<sup>16</sup>

### High False Detection Rates Can Lead to Significant Downstream Consequences

High false detection rates can lead to significant downstream consequences for taxpayers and for the IRS. When legitimate taxpayers are ensnared by over-reaching IRS fraud detection filters, they may experience protracted delays in receiving their refund as they navigate the authentication processes to prove they are the true tax return filers or provide additional information to the IRS to verify the income or withholding on their returns. During the 2018 filing season, 70 percent of taxpayers received

12 *IDT & IVO Selections Performance Report* (Mar. 21, 2018), slide 2; TIGTA, Ref. No. 2018-40-015, *Employer Noncompliance with Wage Reporting Requirements Significantly Reduces the Ability to Verify Refundable Tax Credit Claims Before Refunds Are Paid* (Feb. 26, 2018).

13 IRS response to TAS information request (Oct. 19, 2017).

14 IRS response to TAS information request (May 23, 2017); IRS response to TAS information request (Oct. 19, 2017). The IRS made no changes to its fraud filters between January 1, 2017 through September 30, 2017. The IRS does have an annual meeting prior to the upcoming filing season in which it reviews prior year filters and discusses possible modifications to the filters for the upcoming filing season.

15 National Taxpayer Advocate 2017 Annual Report to Congress 222. See also National Taxpayer Advocate 2016 Annual Report to Congress 153-157.

16 See *Continued Oversight Over the Internal Revenue Service: Hearing Before the House Oversight and Government Reform Committee, Subcommittee on Healthcare, Benefits and Administrative Rules, and Subcommittee on Government Operations*, 115th Cong. 2018) (statement of David J. Kautter, Acting Commissioner, Internal Revenue Service), available at [https://oversight.house.gov/wp-content/uploads/2018/04/Kautter-IRS\\_Testimony\\_04172018.pdf](https://oversight.house.gov/wp-content/uploads/2018/04/Kautter-IRS_Testimony_04172018.pdf).

refunds, and the average refund amount was more than \$2,780.<sup>17</sup> Many taxpayers, particularly those with low income, depend on timely receipt of their refunds.

For the IRS, it causes additional work for assistors who interact with the taxpayers to unfreeze their refunds and make account adjustments. Many of these victims come to TAS for assistance in unwinding the harm; much of this is rework the IRS could avoid if it set reasonable limits on acceptable false detection rates for its fraud filters. Within the upcoming year, TAS Research will attempt to quantify the downstream consequences of excessively high false detection rates.

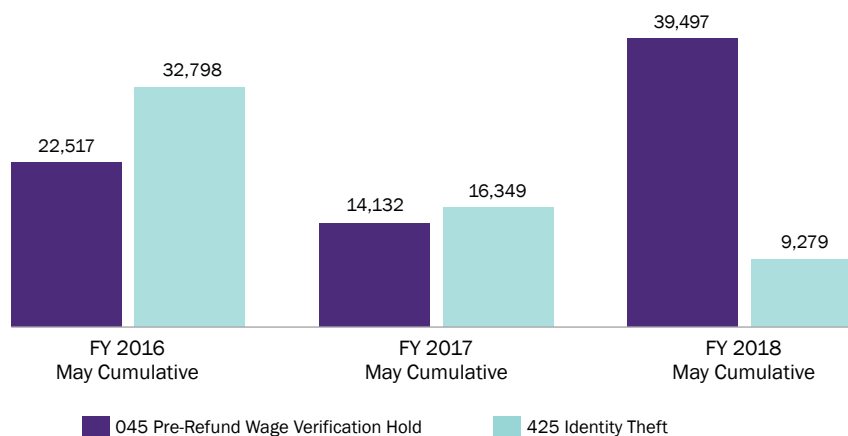
### Identity Theft Case Trends

In recent years, there has been a downward trend in taxpayers reporting that they have been the victims of tax-related identity theft. The number of people who reported to the IRS that they were victims of identity theft declined 65 percent from approximately 699,000 in CY 2015 to 242,000 in CY 2017.<sup>18</sup> As of January 2018, the IRS-wide inventory of unresolved identity theft cases was just over 19,000 – less than half of the inventory three years ago.<sup>19</sup>

TAS is also seeing a decline in identity theft case receipts. However, TAS has experienced an increase in Pre-Refund Wage Verification cases. So while fewer taxpayers may face problems from being victimized by an identity thief, more taxpayers are having their legitimate tax refund claims held up.

**FIGURE 3.4.3**<sup>20</sup>

#### TAS Pre-Refund Wage Verification Hold and Identity Theft Receipts



17 IRS, Filing Season Statistics for Week Ending April 20, 2018, <https://www.irs.gov/uac/newsroom/filing-season-statistics-for-week-ending-april-20-2018>.

18 *The 2017 Tax Filing Season: Internal Revenue Service Operations and the Taxpayer Experience: Hearing Before S. Comm. on Finance, 115th Cong. (2017)* (statement of John A. Koskinen, Commissioner of Internal Revenue). IRS, *ID Theft Report* (Dec. 2017).

19 IRS, *ID Theft Report* (Dec. 2017). Within the Taxpayer Advocate Service, in FY 2017 (through May), there were identity theft case receipts of 16,349 — half the 32,798 identity theft cases it received by the same point in FY 2016. Data obtained from TAMIS (June 1, 2016; June 1, 2017; June 1, 2018).

20 Data obtained from TAMIS (June 1, 2016; June 1, 2017; June 1, 2018).

### Expansion of Identity Protection Personal Identification Numbers

Victims of identity theft whose cases were conclusively resolved by the IRS may be assigned an Identity Protection Personal Identification Number (IP PIN) for use when filing future returns. The IRS implemented IP PINs so it would know a tax return was submitted by the correct Social Security number owner and allow it to pass through its identity theft filters. For taxpayers who have been assigned an IP PIN, the IRS will not process an electronically-filed tax return unless the taxpayer provides the IP PIN when filing. If the IP PIN is provided, the return will be processed without delay. If the tax account contains an identity theft indicator and the tax return lacks an IP PIN or contains an inaccurate IP PIN, the return will be rejected if filed electronically.

The use of IP PINs is an effective way to prevent taxpayers from being repeatedly victimized by identity thieves. For residents of certain states (District of Columbia, Florida, and Georgia), taxpayers may voluntarily opt-in to be assigned an IP PIN. The National Taxpayer Advocate has recommended that the IRS expand the IP PIN program to all taxpayers who wish to protect their accounts. A proposed bill entitled “The Taxpayer First Act” includes a provision that would require the IRS to issue IP PINs to any taxpayer who requests one.<sup>21</sup>

## CONCLUSION

TAS understands and supports the need for a variety of revenue protection strategies. But the IRS must recognize the need for approaches that minimize the burden on legitimate taxpayers. To accomplish this, the IRS needs to take advantage of advanced technologies, including predictive modeling and textual analytics, and build these into their fraud detection practices. In addition, the IRS should design these models in real time, allowing them to be recalibrated easily during the filing season. By doing so, it could simultaneously block more fraudulent returns and reduce the number of legitimate refund claims it flags, thereby reducing inconvenience to taxpayers, avoiding imposing possible financial hardship, and minimizing its own unnecessary rework.

## FOCUS FOR FISCAL YEAR 2019

In fiscal year 2019, TAS will:

- Examine cases selected by the IRS’s Return Review Program to determine if the accelerated third-party reporting has resulted in more accurate selection for the IVO program;
- Work very closely with the IRS to identify the various technologies and strategies that can be used to improve its fraud detection practices;
- Seek inclusion of TAS representatives in the fraud detection model design and planning process;
- Advocate for the IRS to establish definitive maximum acceptable false detection rate goals that are within industry accepted standards; and
- Advocate for the expansion of the IP PIN opt-in process to include all taxpayers.

21 See Taxpayer First Act, H.R. 5444, 115th Cong. § 405 (passed by the House 414-0 on Apr. 18, 2018, and referred to the Senate Committee on Finance on Apr. 19, 2018). The Taxpayer First Act also directs the IRS to assign a single point of contact to victims of identity theft who shall have the ability to work a case across functions to resolve issues involved in the taxpayer’s case until full resolution.