VIEWPOINT
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Identity Theft and Refund Fraud At the IRS: A Partial Solution

By Lawrence B. Gibbs

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In this article, Gibbs discusses the fiscal impact and potential for increased fraud within the socioeconomic programs that the IRS administers through refundable credits, especially the earned income tax credit. He proposes administrative reform of those programs.

Our federal fiscal system depends on the IRS not only to raise revenue to fund government operations but also to administer the funding of Medicare and Social Security, which are our governmental healthcare and retirement entitlement programs, and to administer a variety of other socioeconomic programs that have become part of our tax law in the last 25 years or so. These include affordable healthcare, welfare, education, energy, housing, and economic stimulus programs.[1] The impact of the refundable credits in converting the tax collection system to a tax spending system may be seen by focusing on the earned income tax credit, child tax credit, child care and dependent care assistance exclusion, education tax credits, premium assistance tax credits, low-income housing tax credit, new markets tax credits, work opportunity and empowerment zone tax credits, and tax subsidies for antipoverty organizations, as explained and discussed in a remarkable article by Susannah C. Tahk, titled ''The Tax War on Poverty.''[2]

All of these more recent programs are government spending programs that are being run through our tax system.[3] Treasury has estimated that the tax cost of the major family and education credits for 2016 will approach $145 billion and will benefit almost 56 million families.[4]

The IRS today appears to be viewed by many as a financial intermediary for a growing number of governmental support programs.[5] For example, to politicians and economists, it seems to make more sense for the tax system to administer the funding of certain federal welfare programs than to have the IRS collect taxes and then have the Department of Health and Human Services use a portion of those taxes to administer the welfare programs. The IRS

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[1]For refundable credits, see, e.g., sections 24(d) (child tax credit), 25 (home mortgage interest credit), 25A (HOPE scholarship, lifetime learning, and American opportunity credits), 25B (IRA savings credit), 25C (nonbusiness energy credit), 25D (residential energy efficiency credit), 32 (earned income credit), 35 (health insurance credit), 36 (first-time home buyer credit), and 36B (health insurance premium assistance credit); *see also* the Economic Stimulus Act of 2008, P.L. 110-185. For nonrefundable tax credits, *see, e.g.*, sections 21 (employment-related household and dependent care expenses credit), 23 (adoption expenses), 30B (alternative motor vehicle credit), 30C (alternative fuel vehicle refueling property credit), sections 38 - 52 (34 business and investment-related tax credits), and sections 54 - 54AA (eight bond-related tax credits), all of which represent tax spending to subsidize various business and investment activities by lowering the after-tax cost to invest in each activity.

[2]56 *Ariz. L. Rev.* 791 (2014).

[3]For another excellent article (also by Tahk) that explains the change in the tax area over the last 50 years from revenue raising to spending through the tax code and that describes the role and intended impact of the refundable credits, see ''Everything is Tax: Evaluating the Structural Transformation of U.S. Policymaking,'' 50 *Harv. J. Legis*. 67 (2013); *see also* David Kamin, ''Reducing Poverty, Not Inequality: What Changes in the Tax System Can Achieve,'' 66 *Tax L. Rev.* 593 (2014); *see generally* Edward D. Kleinbard, ''The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes,'' 36 *Ohio N. U. L. Rev.* 1, 18 (2010) (This article is a reprint of Kleinbard's 2009 Woodworth Lecture in which he stated: ''Tax subsidies (that is, tax expenditures in the narrow sense used here) permit a marvelous muddling of budget terminology: they increase government spending in economic terms but can be presented as 'targeted tax cuts.' By relying on tax expenditures, Congress can pander to important constituencies that for the last three decades have agitated for lower taxes and smaller government, while giving us what we actually want — more discretionary spending and, implicitly, larger government'').

[4]*See* Treasury, ''Families Benefiting from Major Family and Education Tax Credits and from Expansion under American Recovery and Reinvestment Act, Tax Year 2016'' (July 23, 2015).

[5]*See* Fred R. Goldberg, ''From FDR to W: The IRS as Financial Intermediary,'' 29 *Ohio N. U. L. Rev.* 1 (2002-2003) (This article is a reprint of former IRS Commissioner Fred Goldberg's 2002 Woodworth Lecture).

does this primarily through the EITC,[6] which is one of many refundable tax credits. In other words, the IRS — not HHS — makes direct payments to welfare recipients and enforces compliance with the requirements of the welfare laws that are now part of the code. This approach makes some sense, because the amount of income of taxpayers who claim to be eligible for the EITC is information that the welfare recipients are required to report annually to the IRS in order to be eligible to claim EITC benefits.

However, this approach has had the following consequences. The prior actions that federal agencies like HHS used to take to initially qualify welfare recipients as eligible to receive welfare benefits have been eliminated. Instead, the dollar amounts of those benefits, like the EITC, are now paid to the recipients if their income tax returns indicate that they are eligible to claim refundable tax credits that provide those benefits. In other words, the monetary benefits are paid out to the recipients before it is determined whether and to what extent they are eligible to receive them. Because of its lack of expertise and particularly its lack of resources, the IRS does not have adequate compliance capabilities to properly administer and enforce these government support programs.

As a result, today's approach of shifting the burden of administering these socioeconomic benefit programs to the IRS has introduced significant, ongoing risks of fraud into our tax revenue system — risks that economists and politicians rationalize on the basis that there would have been fraud even if HHS had continued to administer the welfare programs. The speed of the IRS's refund payments to payees, combined with the fact that the IRS has no capability to determine whether the recipients are entitled to those payments, has proven irresistible to the crooks. One of the fastest growing programs at the IRS is to assist taxpayers whose identities and tax refunds have been stolen.

IRS Commissioner John Koskinen has confirmed that large, sophisticated organized crime syndicates in the United States and around the world have become involved in the identity theft and refund fraud.[7] The fraud has been persistent and growing. Every time there is a hacking incident in the public or private sector involving theft of Social Security numbers, the potential for identity theft and refund fraud increases.

Today, although the IRS is working on a number of ideas about how to detect and deter refund fraud, its systems and processes have thus far been unable to effectively interdict many of the payments of fraudulent refund claims based on bogus refundable credits. Most of the low-income income tax returns claiming refundable EITCs are filed in January and February each year. Traditionally, the payer wage and investment tax information (on forms W-2 and 1099) used by the IRS to verify the accuracy of those returns is not provided to the IRS by the payers in time for it to match that payer information against the filed refund returns until after the filing season. Fraudsters have taken advantage of this by filing returns of identify theft victims before the IRS has the capability to match the payer information with the information shown on the fraudulent returns. The IRS, with recent help from Congress,[8] has been investigating various possible remedies, including an acceleration of the due date for employer and payer information and the IRS's matching capability, and a possible delay in payment of the refunds until a matching capability can be accomplished. However, so far both alternatives have proved problematic for a variety of reasons.

No one knows how big this refund fraud problem really is or may become.[9] Clearly, it is in the multi-billions of dollars each year. It is large enough that the Government Accountability Office last year added tax refund fraud due to identity theft to its government-wide list of "high risk" programs.[10]

[6]Section 32; see Margot L. Crandall-Hollick, "The Earned Income Tax Credit (EITC): Administrative and Compliance Challenges," Congressional Research Service (2015).

[7]*See* Laura Saunders, "Combating Tax Identity Theft," *The Wall Street Journal*, June 20, 2015, at B8 ("The IRS is 'dealing with more and more organized crime syndicates here and around the world,' Mr. Koskinen said in Senate testimony earlier this month").

[8]*See* section 201 of the Protecting Americans from Tax Hikes Act of 2015; division Q of the Consolidated Appropriations Act, 2016, P.L. 114-113 (Dec. 18, 2015) (requiring some payers of income in the form of compensation to file forms W-2, W-3, and 1099 MISC with the IRS before the end of January following the year in which the compensation so reported was earned, and giving the IRS more time to pay refunds attributable to the earned income credit and the child care credit in order to better address identity theft and refund fraud).

[9]*See, e.g.*, Treasury Inspector General for Tax Administration, "There Are Billions of Dollars in Undetected Tax Refund Fraud from Identity Theft," 2012-42-480 (July 19, 2012). The national taxpayer advocate expressed similar concerns about refund fraud in her "2013 Annual Report to Congress," vol. 1, 42-67 (Dec. 31, 2013); and in her "2012 Annual Report to Congress," vol. 1, 173-181 (Dec. 31, 2012). *See also* TIGTA, "Billions of Dollars in Potentially Erroneous Education Credits Continue to Be Claimed for Ineligible Students and Institutions," 2015-40-027 (Mar. 27, 2015) (discussing revenue losses from other misapplications of refundable credits).

[10]*See* GAO, "High-Risk Series: An Update," GAO-15-290 (Feb. 11, 2015).

Congress has held hearings,[11] criticized the IRS for failing to halt refund fraud, and developed proposed legislation[12] to ameliorate some aspects of the fraud. Most recently, the IRS announced an ongoing, collaborative effort with state tax administrators, return preparation and software firms, and payroll and financial product processors to try to combat refund fraud.[13] It remains to be seen how effective the new efforts will be in detecting and deterring identity theft and refund fraud.

Proposed Solution

At least a partial[14] potential solution to the identity theft and refund fraud problem at the IRS would be for HHS to initially screen and qualify applicants for welfare assistance under the EITC program. Once applicants were so qualified, their names and identifying information could then be forwarded to the IRS by HHS. If a taxpayer claimed an EITC and he had not been certified by HHS as eligible to become a welfare recipient, the IRS would be able to stop any refund payment to that person before it was made. Further, anyone wishing to become a welfare recipient would have to surface in some manner in dealing with HHS before being able to claim an EITC on an income tax return, which itself would be a likely deterrent. The additional HHS cost could be offset by the present revenue loss attributable to fraudulent refunds as well as the cost savings to the IRS of not having to continue to administer its entire identity theft and refund fraud programs as they exist today.

The point is that the welfare program we refer to as the EITC does not have to be administered by the IRS, and certainly not in its entirety. Indeed, before 1975, HHS administered the program. The Ford White House proposed that the program be moved from HHS to the IRS, at the urging of HHS officials and with the support of economists who contended that it would be more "efficient" for the IRS to administer the program.[15] Little thought about the potential for identity theft and refund fraud in the magnitude present today was ever raised and or considered.[16] The adverse fiscal impact of the EITC and other socioeconomic programs that now make well over $100 billion payments annually — and the bipartisan pressure to continually increase the number of these types of programs and the dollar amounts to be paid by each such program — before verifying that recipient-payees are the intended beneficiaries of the programs are significant and growing. It therefore would seem appropriate to reconsider how these programs should be administered and what agency or agencies should be involved in their administration.

[11] *See, e.g.*, Tax-Related Identity Theft and Fraudulent Tax Returns Tax, Hearing Before Senate Budget Committee, 113th Cong. (Aug. 26, 2015); Fraud and Tax ID Theft: Moving Forward with Solutions, Hearing before Senate Finance Committee, 112th Cong. (2013); Identity Theft and Income Tax Preparation Fraud, Hearing Before Subcommittee on Crime, Terrorism, and Homeland Security, House Committee on Judiciary, 112th Cong. (2012); and Hearing on Identity Theft and Tax Fraud, Joint Hearing Before the Subcommittee on Oversight and Subcommittee on Social Security, House Committee on Ways & Means, 112th Cong. (2012).

[12] *See* S. 676, "Identity Theft and Fraud Prevention Act of 2015," introduced by Sen. Bill Nelson, D-Fla., Mar. 9, 2015, now pending in the Senate Finance Committee.

[13] IR-2015-87, "IRS, Industry Take New Steps Together to Fight Identity Theft, Protect Taxpayers" (June 2015).

[14] The growth of identity theft and refund fraud has been exacerbated by some unlicensed, unregulated commercial tax return preparers who are deliberately and repeatedly preparing and filing fraudulent income tax returns claiming excessive EITCs and other tax benefits to which they know their clientele are not entitled. If the taxpayer for whom the commercial tax return preparer is preparing a fraudulent return has been certified by HHS as an eligible welfare recipient, any intentionally overstated EITC would not be caught under my proposal. Proposed legislation that would enable the IRS to regulate commercial tax return preparers in an attempt to better detect and deter refund fraud appears to be stalled in the Senate Finance Committee. *See* Luca Gattoni-Celli, "Return Preparer Bill Stalled Despite AICPA Dropping Objections," *Tax Notes*, Jan. 25, 2016, p. 402.

[15] *See* section 204 of the Tax Reduction Act of 1975, P.L. 94-12 (adding the EITC to the Internal Revenue Code of 1954, as amended).

[16] I was the assistant commissioner (technical) of the IRS at the time. I recall discussions with then-IRS Commissioner Donald C. Alexander, who unsuccessfully opposed the transfer of responsibility for the welfare program from HHS to the IRS, in part because it assigned the IRS the responsibility to administer a program for which the IRS had no background, expertise, capability, or resources.