

Problem of Identity Theft and Fraudulent Tax Refunds in the United States: Considering the Possible Developments Following a Future Consumption Tax Increase and Introduction of the Social Security and Tax Number System

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This report discusses the need to design the tax system and considers the possible developments following a future consumption tax increase and introduction of the social security and tax number system (the "My Number" system).

Progress has both favorable and adverse effects, and fraud always occurs to some extent. Recent technological advancements have dramatically increased convenience in our daily lives. At the same time, however, the remote controllability of systems has given rise to such incidents as *furikome* fraud (bank transfer fraud). This report examines the actual status of identity theft and fraudulent tax refunds in the United States. It is little known that a large number of tax returns for refunds are filed in Japan. Every year, more than 20 million income tax returns are filed, of which 50% are returns for refunds. The amount of tax refund payments is equivalent to one-fifth of the total tax revenue. By tax item, consumption tax refunds are overwhelmingly large, standing at ¥3–4 trillion. Tax evasion and fraudulent tax refunds involving consumption tax are also notable. From its inception, the consumption tax collection system has had a structural defect, and if taxes are raised without addressing this defect, the problem is likely to worsen. The launch of the My Number system in 2015 is expected to improve the situation, making it easier for tax authorities to comprehend taxpayers' taxation status. However, when designing the new tax systems important lessons can be learned from the experience of the U.S.

1. Actual status of identity theft and fraudulent tax refunds in the United States

According to a report by the U.S. Treasury Inspector General for Tax Administration (TIGTA), the U.S. Internal Revenue Service (IRS) identified 2.2 million fraudulent tax returns for Processing Year 2011, of which 940,000 tax returns with a value of \$6.5 billion in associated fraudulent tax refunds involved identity theft. This shows that fraudulent tax refunds sometimes result from identity theft. The number of identity theft incidents has been increasing every year, growing from 456,453 incidents (254,079 victims) in 2009 to 1,125,634 incidents (641,052 victims) in 2011 (a 250% increase). In Calendar Year 2011, the IRS identified 1,014,884 incidents of identity theft, of which

110,750 (10%) were incidents in which taxpayers contacted the IRS alleging that they were victims of identity theft. Since identity theft is often carried out before taxpayers file tax returns, most of the victims realize that their identities have been stolen only at the stage when they file a tax return. Some identity thieves steal the identities of former taxpayers who no longer pay taxes or the identities of deceased individuals.

2. Cause of fraudulent tax refunds in the United States and the effect of the globalization trend

The major cause of fraudulent tax refunds in the United States is in the U.S. taxation system. U.S. federal income tax is imposed based on the taxpayer's worldwide income. When a U.S. citizen living overseas files a tax return for a refund, he/she may designate a foreign bank account for receiving the refund, which makes it easy to receive fraudulent tax refunds overseas.

The tax refund methods available in the United States are by paper check or direct deposit, including direct deposit into accounts linked with debit cards. In the case of direct deposit, a taxpayer may file a request in advance to split the refund in up to three accounts.¹ According to TIGTA, approximately \$4.5 billion of the \$5.2 billion in potentially fraudulent tax refunds were issued by direct deposit. Since stolen identities are stolen repeatedly, TIGTA recommended in 2008 that the IRS should limit the amount and frequency of direct deposits. Debit cards are also used frequently for fraudulent refunds, and more than 5,000 debit cards were confiscated in an investigation in Tampa, Florida. A bank associated with those debit cards provided the IRS with a list of 60,000 bank accounts with questionable tax refunds in December 2011, and froze \$164 million worth of questionable refund. As this illustrates, it is also important to strengthen the coordination between the tax authorities and banks.

A study by Cal Mellor on countering fraudulent refunds and identity theft tracked IP addresses involved with such incidents, and detected IP addresses in India, China, Dominican Republic, Kenya, Ghana, Nigeria, Lebanon, and Kuwait. This shows that remote operations are being performed overseas. The identification information used for claiming a tax refund is the taxpayer's name, address, date of birth, and social security number, and this information also needs to be reviewed in future studies.

3. Examples of fraudulent tax refunds in the United States

When investigating fraudulent tax refunds, TIGTA focuses its investigative resources on the following three areas in light of the typical examples of identity theft given below: (1) IRS employees; (2) tax preparers who steal client information; and (3) individuals who impersonate the IRS.

¹ See IRS Topic 152. <http://www.irs.gov/taxtopics/tc152.html>.

(1) Example of identity theft by an IRS employee

On April 14, 2011, a female employee was indicted for filing a false income tax return while working as a part-time data entry clerk for the IRS. While working at the IRS, she stole taxpayers' information to file returns for refunds totaling about \$175,000.

(2) Example of identity theft by a public accountant who stole client information

Public accountants are allowed to file tax returns on behalf of clients, and in this case, a public accountant misappropriated her clients' information and changed their direct deposit account information in order to redirect the deposits to her own accounts. On May 24, 2010, she was sentenced to serve 64 months of imprisonment and three years of supervised probation.

(3) Example of identity theft by an individual who impersonated the IRS

In this case, the offender, together with co-conspirators, stole the identities of numerous individuals and defrauded them out of more than \$1 million through Internet solicitations, similar to *furikome* fraud in Japan. The group obtained e-mail distribution lists containing thousands of e-mail addresses, and sent unsolicited e-mails to those addresses. The e-mails falsely informed the targeted victims that they had won a lottery or had inherited money from a distant relative, and telling them that the IRS or the United Nations were currently holding the money since advance payment of taxes was required, instructed them to provide their personal and bank information. On December 19, 2011, the offender was sentenced to 108 months of imprisonment and five years of supervised release.

4. Measures by the IRS

The IRS has created filters to screen for identity theft before a fraudulent tax refund is issued. As a result of using the new filters, the IRS has stopped the issuance of \$1.3 billion in potentially fraudulent tax refunds and investigated potential cases of identity theft (as of April 19, 2012). Since deceased individuals are the main targets, the IRS also began to check the accounts of deceased individuals based on the IRS master file and the social security number database in Processing Year 2011. As of March 1, 2012, the IRS had locked 90,570 tax accounts and prevented approximately \$1.8 million in fraudulent tax refunds.

As another measure to prevent identity theft, the IRS began issuing Identity Protection Personal Identification Numbers (IPPIN) to taxpayers. For the 2012 Filing Season, the IRS issued 252,000 IPPINs.

Using the IRS data for Tax Year 2010, TIGTA made a prediction of the cost of future fraud. It estimated that the IRS would issue about \$26 billion in fraudulent tax refunds resulting from identity theft over the next five years. This would mean an annual \$5.2 billion in refunds for 1.5 million fraudulent tax returns. It would cost \$31.8 million to

screen those 1.5 million tax returns. Although the IRS has faced budget cuts, this issue is unavoidable. In the future, the IRS will need tools that allow it to identify identity thieves more easily. An effective tool currently available is the National Directory of New Hires, which is a Department of Health and Human Services database, but its use is limited to tax returns with a claim for the Earned Income Tax Credit.

TIGTA points out that once an identity is stolen, the taxpayer who is the victim faces great inconvenience. The victim generally has to work together with the IRS for a minimum of nearly one year to resolve the case. Some cases take many years to resolve. In November 2011, the IRS established a Taxpayer Protection Unit, and the Unit received more than 86,000 calls during the 2012 Filing Season. The IRS is still unable to acquire complete information on identity theft. At present, it captures and compiles data on 22 different systems. This is still a new issue, and is expected to be addressed further in the future.

5. Consumption tax refunds command an overwhelming share of national tax refunds in Japan

In contrast to the United States, Japan's tax system has a year-end adjustment system, and is little affected by the globalization trend at present. The amount of tax refunds issued in Fiscal Year 2009 totaled ¥8.5443 trillion. Since the total tax revenue is approximately ¥40 trillion, about 20% of the tax revenue is being refunded. With the introduction of the My Number (National ID) system in 2015, electronic tax return filings are expected to increase more and more in the future. This measure is likely to bring substantial benefits, including the prevention of tax evasion; increasing the convenience of tax payment, and to improve consumption tax collection. However the system could be vulnerable to the problems discussed in respect to the U.S. This might lead to the appearance of the type of cases we have examined from the U.S.

Looking at the status of tax refunds in Japan (Figure 1), the amount of refunds, which stood at about ¥5 trillion in the first half of Fiscal Year 2000, exceeded ¥7 trillion in Fiscal Year 2006, and reached ¥8.5443 trillion in Fiscal Year 2009. The breakdown of the refunds shows that consumption tax refunds are prominent at about ¥3 to 4 trillion (excluding corporation tax refunds in Fiscal Year 2009). This is followed by refunds of withholding income tax at about ¥2 trillion, and corporation tax refunds at ¥1 trillion. Surprisingly, income tax refunds issued after tax returns are very small.

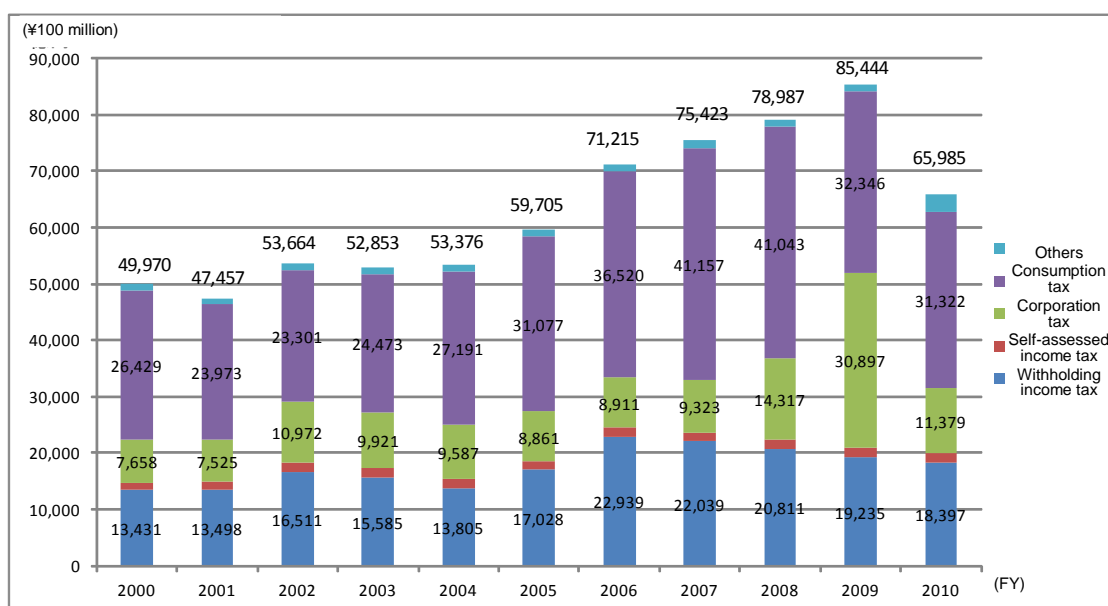
Of the 3.23 million tax returns filed for consumption tax in Fiscal Year 2010, 150,000 (corporations: 114,835; individuals: 36,555) tax returns were filed to claim refunds. Given that the number of taxpayers filing returns for income tax refunds in the same fiscal year was 12.67 million, consumption tax refunds are characteristic in that the number of tax returns filed for refunds is small, but the amount claimed per tax

return is large.

Failure to file and the filing of fraudulent returns for consumption tax are also regarded as problems. The National Tax Agency (NTA), in the 2009 issue and the subsequent issues of *National Tax Agency Report*, has cited "Response to tax returns for fraudulent consumption tax refunds" as one of the "Priority matters addressed in the tax examinations." The NTA has recently been carrying out more than 200,000 consumption tax examinations per year, of which 60% are due to failure to file returns. *National Tax Agency Report* also reports deliberate cases of fraudulent tax refunds.

As discussed above, the system for consumption taxes, which account for a significant number of refunds, already has a defective structure that allows for a considerable amount of failure to file cases and a visible amount of fraudulent tax refunds.² Since a consumption tax hike could lead to a further increase in these incidents, and with the launch of the My Number system likely to induce a higher frequency of electronic tax return filings, the government should appropriately design the tax collection system while taking into account the U.S. case examples referred to in this report.

Figure 1 Status of Tax Refunds in Japan (FY2000–2010)



Source: Compiled based on data from National Tax Agency Tax Statistics (FY2000–2010) <http://www.nta.go.jp/kohyo/tokei/kokuzeicho/tokei.htm>.

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² See Kashiwagi (2011) for indication of the defects in the consumption tax collection system.

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