

## Many Unhappy Returns: The Need for Increased Tax Penalties for Identity Theft-Based Refund Fraud

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# FLORIDA TAX REVIEW

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## MANY UNHAPPY RETURNS: THE NEED FOR INCREASED TAX PENALTIES FOR IDENTITY THEFT-BASED REFUND FRAUD

by

Pippa Browde\*

### ABSTRACT

*The growing problem of fraudulent tax returns being submitted based on stolen identities is a “tsunami of fraud,” and victims, lawmakers, and law enforcement are struggling with how to deal with the fallout. The issues surrounding identity theft-based tax fraud are complex. Current IRS efforts to stem the tide involve pouring resources into assisting victims, updating IRS processes to detect and prevent refund fraud, and increasing the number of criminal investigations and prosecutions it pursues. The IRS’s approach and pending proposed legislation are not enough to address the problems created by identity theft-based tax fraud. This Article argues the IRS and Congress must use a holistic approach to attack this species of tax fraud. To that end, this Article supports enhanced criminal penalties and proposes new civil tax penalties aimed specifically at identity theft tax fraud.*

*This Article pursues two goals. First, it documents and explains the problem of identity theft-based refund fraud, highlighting particular issues with respect to tax compliance. In so doing, it analyzes existing civil and criminal tax penalties to punish and deter identity thieves, an analysis which reveals that existing criminal penalties are insufficient and that there is no directly applicable existing civil penalty. Second, to address the gaps in existing law, the Article*

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\* Assistant Professor of Law, University of Montana. The author wishes to thank Professors Bryan Camp, Martin Burke and Anthony Johnstone for their thoughtful comments on prior drafts; Professor Jane Bambaur; the University of Utah for the Rocky Mountain Junior Scholars Symposium; the amazing efforts of research assistant Kristin Bannigan; and two anonymous reviewers. All mistakes and errors are solely the author’s.

proposes standards for Congress to use in crafting a comprehensive penalty scheme to apply to identity theft-based refund fraud.

*This Article proceeds in three parts. Part II addresses the nature and scope of identity theft tax fraud, explaining the consequences such fraud has on tax administration, fair enforcement, and public confidence in voluntary compliance, which is the bedrock of our tax system. Part III explores the inadequacy of existing criminal and civil penalties. Part IV then proposes legislative action, evaluates proposed and pending legislation, and makes specific recommendations for enhanced criminal penalties and the creation of a new civil penalty aimed specifically at identity theft-based tax fraud.*

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**I. INTRODUCTION**

The stories are all too familiar. An employee who does data entry or insurance processing at a nursing home or healthcare facility steals the names and social security numbers of hundreds of patients; a criminal in a foreign country purchases a list of personal identity information of American taxpayers; someone at a prison steals the social security numbers and names of prisoners. Once the information is obtained, a perpetrator of tax refund fraud files hundreds of tax returns using the stolen names and social security numbers. The addresses shown on the returns are false; the returns report fictitious income and falsified W-2s. The returns are submitted to the IRS electronically, often hundreds or thousands from the same IP address, but all

of the returns request a refund to be paid to a prepaid debit card or bank account controlled by the perpetrator. The IRS is no dummy. As soon as such a return is submitted, the IRS systems identify and flag the return as having potential identity theft and remove the return from the automatic processing. The IRS inspects the return further and, concluding that it is fraudulent, does not pay the claimed refund.<sup>1</sup>

The consequences to the victims whose identities are stolen are devastating. The victim's tax refund may be delayed, the victim may spend hours on the phone with the IRS and law enforcement, and it can take more than a year to resolve the difficulties.<sup>2</sup> The consequences to the IRS are also serious—the government has to spend millions of dollars on prevention and detection of identity theft to keep its detection techniques current.<sup>3</sup> Even more critical in the long term is that the increase in fraud (or attempts to defraud) erodes public confidence in the tax system, severely undermining the critical purpose of voluntary compliance.<sup>4</sup>

And what about the perpetrator? He did not get a penny in refunds. He committed crimes, but most likely, he walks away without any criminal investigation. No civil penalty directly applies to him. He is free to try again and suffers no consequence.

The growing problem of fraudulent tax returns being submitted based on stolen identities is a “tsunami of fraud,” and victims, lawmakers, and law

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1. These facts, though hypothetical, are based on real identity theft-based refund crimes. “What the identity thieves do is play on volume . . . . So if they file 10 returns and 9 are stopped, the 10th one went through and they got the money,” said Kathryn Keneally, (former) United States assistant attorney general for the tax division. Michael Kranish, *IRS Is Overwhelmed by Identity Theft Fraud*, BOS. GLOBE, Feb. 16, 2014, <http://www.bostonglobe.com/news/nation/2014/02/16/identity-theft-taxpayer-information-major-problem-for-irs/7SC0BarZMDvy07bbhDXwvN/story.html> [hereinafter Kranish, *IRS Is Overwhelmed*]. See also *infra* note 14 for a discussion of common identity theft scams.

2. *Identity Theft-Related Tax Fraud: Hearing Before the Comm. on Oversight & Gov't Reform, & Subcomm. on Gov't Operations*, 113th Cong. 11–12 (Aug. 2, 2013) (written testimony of Nina E. Olson, National Taxpayer Advocate) [hereinafter Olson Testimony, *Hearing on Identity Theft-Related Tax Fraud (2013)*].

3. IRS Commissioner John Koskinen said that keeping up with identity thieves is “a little like ‘Whac-a-Mole,’ knock them down here and they come up over there.” Kranish, *IRS Is Overwhelmed*, *supra* note 1.

4. Rasha Wilson publically declared herself “the queen of IRS tax fraud” on her Facebook page. Kranish, *IRS Is Overwhelmed*, *supra* note 1. See *infra* Part II.B and accompanying notes 45–51 for a full discussion of how the rise of identity theft negatively affects voluntary compliance.

enforcement are struggling with how to deal with the fallout.<sup>5</sup> The issues surrounding identity theft and tax fraud are complex. The IRS has taken a multi-faceted approach, pouring resources into assisting victims, updating its processing systems to detect and prevent refund fraud, and increasing the number of criminal investigations and prosecutions it pursues. The IRS's approach and pending proposed legislation are not enough to address the problems created by identity theft-based tax fraud. This Article argues the IRS and Congress must use a holistic approach to address identity theft. To that end, this Article supports enhanced criminal penalties for identity theft-based tax fraud and proposes new civil tax penalties for identity theft-type situations.<sup>6</sup>

Part II of this Article addresses the nature and scope of identity theft, the consequences identity theft-based refund fraud has on tax administration and voluntary compliance, and the necessity of civil penalties to ensure continued high rates of voluntary compliance. Part III explores the inadequacy of existing law for criminal and civil penalties. Part IV proposes legislative action, evaluates proposed and pending legislation, and makes specific recommendations of standards for enhanced criminal penalties and the creation of a civil penalty for identity theft-based tax fraud.

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5. Lizette Alvarez, *With Personal Data in Hand, Thieves File Early and Often*, N.Y. TIMES, May 26, 2012, [http://www.nytimes.com/2012/05/27/us/id-thieves-loot-tax-checks-filing-early-and-often.html?pagewanted=all&\\_r=1&pagewanted=print](http://www.nytimes.com/2012/05/27/us/id-thieves-loot-tax-checks-filing-early-and-often.html?pagewanted=all&_r=1&pagewanted=print) [hereinafter Alvarez, *Thieves File Early and Often*].

6. In the president's proposed budget of the United States government for fiscal years 2014 and 2015, the administration includes a proposal for imposing a civil penalty on tax identity theft crimes. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2015, at 193 (2014) [hereinafter OMB, BUDGET 2015]; OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2014, at 212 (2013). Neither budget contains any explanation or description of the proposed penalty. The Treasury Department explains that the proposed \$5,000 civil penalty would be imposed on the individual who filed the fraudulent return and would be immediately assessable on each incidence of identity theft. U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS 242 (Mar. 2014); U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS 212 (Apr. 2013). As the "reasons for change," Treasury notes the increase of identity theft-based tax incidents, and that while the IRS already has some tools to combat identity theft based crimes, a civil penalty will serve as an additional efficient deterrent, especially in conjunction with criminal investigations. *Id.* The pending or prior proposed legislation dealing with identity theft-based tax fraud is discussed *infra* at Part IV and accompanying notes 136–141. Only one of the pending or prior proposed bills, the Social Security Identity Defense Act, S. 1323, 114th Cong. § 3(b)(1) (2015), contains a provision proposing a civil tax penalty for identity theft-based fraud.

## II. THE NATURE AND SCOPE OF IDENTITY THEFT-BASED TAX REFUND FRAUD

### A. Background

“Identity theft” is used to refer generally to different types of crimes in which personal or financial data is compromised. The perpetrator of identity theft steals the personal identifying information and transacts business in the name of his victim.<sup>7</sup> Unfortunately, identity theft is pervasive. According to the Bureau of Justice in the Department of Justice, 16.6 million people experienced identity theft in 2012 and suffered financial losses totaling \$24.7 billion.<sup>8</sup>

In the context of tax administration, identity theft crimes arise in two principal ways.<sup>9</sup> First, an identity thief may use a stolen identity to report income and claim deductions for an undocumented worker. This is referred to as “employment-related identity theft”; the person who uses a stolen identity may or may not intend to defraud the victim, but wants the ability to work “legally.”<sup>10</sup> While employment-related tax fraud presents serious problems in

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7. 16 C.F.R. § 603.2 (a), (b) (2015) (defining identity theft as “a fraud committed or attempted using the identifying information of another person without authority”). See generally Fed. Trade Comm’n, Consumer Information: Identity Theft, <http://www.consumer.ftc.gov/features/feature-0014-identity-theft> (last visited Jan. 26, 2015). Perpetrators of identity theft may use the stolen identity for a variety of purposes including to perpetrate medical fraud, credit and loan fraud, and tax fraud. *Id.*

8. ERIKA HARRELL & LYNN LANGTON, BUREAU OF JUSTICE STATISTICS, VICTIMS OF IDENTITY THEFT, 2012, NCJ 243779 (Dec. 2013), <http://www.bjs.gov/content/pub/pdf/vit12.pdf>. These statistics represent all different types of identity theft. *But see* Chris Jay Hoofnagle, *Identity Theft: Making the Known Unknowns Known*, 21 HARV. J.L. & TECH. 97 (2007), for a discussion of the unknowns with respect to statistics on identity theft and a proposal for regulations to require uniform and accurate reporting of identity theft.

9. For an explanation of tax-related identity theft, see Fed. Trade Comm’n, Consumer Information: Tax-Related Identity Theft, <http://www.consumer.ftc.gov/articles/0008-tax-related-identity-theft> (last visited Jan. 26, 2014).

10. Olson Testimony, *Hearing on Identity Theft-Related Tax Fraud* (2013), *supra* note 2, at 1 n.3. John Leland, *Immigrants Stealing U.S. Social Security Numbers for Jobs, Not Profits*, N.Y. TIMES, Sept. 4, 2006, <http://www.nytimes.com/2006/09/04/world/americas/04iht-id.2688618.html?wagewanted=all&r=0>. For a discussion on immigration fraud and employment-related fraud, see Nathaniel J. Stuhmiller, Comment, Flores-Figueroa and the Search for Plain Meaning in Identity Theft Law, 58 BUFF. L. REV. 221, 225–229 (2010).

the context of tax administration, it is outside the scope of this Article.<sup>11</sup>

The second manner in which identity theft crimes arise in the context of tax administration comes when an identity thief seeks a fraudulent tax refund. This Article refers to cases of refund-based identity theft, both where the thief is successful in obtaining a fraudulent refund from the IRS and in cases where the IRS detects the fraud and does not issue the refund.<sup>12</sup> The primary characteristics of these cases are that the perpetrator reports false income and withholding to file a tax return using a stolen identity in order to generate a fraudulent tax refund that the perpetrator collects.<sup>13</sup>

Perpetrators of refund-related identity theft obtain identifying information in a number of ways.<sup>14</sup> Perpetrators purchase social security numbers and names from other criminals, steal the information from employers, or hack into computer systems to obtain the information.<sup>15</sup> Once the information is obtained, the perpetrators file fraudulent tax returns with the

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11. Employment-related identity theft presents the problem of attribution of wages. The perpetrator of identity theft is working under the social security number and name of another taxpayer-victim and the wages are attributed to the taxpayer-victim, not the perpetrator. I.R.M. 10.5.3.1.3.1. This also has the consequence of the perpetrator paying into social security and not receiving credit for such payments. Identity theft is also a threat to cyber security and national security. *See generally* U.S. Dep't of Justice, Identity Theft, <http://www.justice.gov/criminal/fraud/websites/idtheft.html> (last updated June 22, 2015) (resource for general information on identity theft and identity fraud).

12. I.R.M. 10.5.3.1.3.1(4). As discussed *infra* Part II.B. and accompanying notes 45–52, there are costs to the government and tax system whether an identity thief is successful in his attempt to obtain a fraudulent refund or not.

13. The issue of the value of refundable credits compared to the administrative challenges in awarding such credits is the topic of much scholarly debate. *See* Lily L. Batchelder, Fred T. Goldberg, Jr. & Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23 (2006).

14. For a list of examples of identity theft schemes from cases where the perpetrators were prosecuted, see IRS, *Examples of Identity Theft Schemes – Fiscal Year 2014*, <http://www.irs.gov/uac/Examples-of-Identity-Theft-Schemes-Fiscal-Year-2014> (last updated Oct. 20, 2014) [hereinafter IRS, *Examples of Identity Theft Schemes*].

15. *Id.* A variation on this scenario of refund-related identity theft includes a hybrid of return preparer fraud and identity theft. In those scenarios, a return preparer who was hired and authorized by the taxpayer-victim to prepare an otherwise valid return will increase the refund amount claimed on the taxpayer-victim's return without the taxpayer's knowledge or authorization and the return preparer will divert the increased refund to an account or debit card they control. *See generally* *Identity Theft & Tax Fraud: J. Hearing Before the Subcomm. on Oversight and Soc. Sec. of the H. Comm. on Ways & Means*, 112th Cong. 3 (May 8, 2012) (written testimony of Nina E. Olson, National Taxpayer Advocate) [hereinafter Olson Testimony, *Hearing on Identity Theft & Tax Fraud (2012)*].



IRS, reporting fictitious income and false withholding and claiming fraudulent refunds, usually based upon eligibility for refundable credits.<sup>16</sup> Identity thieves are able to report false income without detection in part because of inconsistent deadlines in the existing administrative system that allow taxpayers to file returns earlier than employers must report wages paid to their employees.<sup>17</sup> Typically, the identity thief submits the return electronically and requests the refund be paid to a bank account or prepaid debit card the thief controls.<sup>18</sup>

The problem of tax refund fraud, including fraud based on identity theft, is widespread. Any taxpayer can be a victim.<sup>19</sup> Often, vulnerable populations such as incarcerated individuals or the deceased or elderly are specifically targeted.<sup>20</sup> There were over 2 million fraudulent returns identified

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16. See IRS, *Examples of Identity Theft Schemes*, *supra*, note 14, for variations of identity theft schemes.

17. Reg. § 31.6071(a)-1(a)(3) (2014) provides that an employer must inform the Social Security Administration of the wages paid to an employee no later than the final day in February of the year following the tax year (Forms W-2 and W-3 transmittal). However, employers must provide employees a statement of the year-end wages no later than January 31 of the year following the tax year. Reg. § 31.6051-1(d) (2014). This has the effect of depriving the IRS of the benefit of verifying a taxpayer's wages when a return is submitted prior to the employer's deadline for reporting. Between January 31 and February 29, the IRS has no way of verifying the wages reported on a taxpayer's return. Proposed legislation pending before Congress identifies this as a problem and seeks to address it. See *infra* note 136, and accompanying text.

18. Regulations require the IRS to verify that tax refunds are deposited into accounts that only the taxpayer controls. 31 C.F.R. § 210.5 (2011). However, the IRS has been criticized for not complying with these legal requirements. TREASURY INSPECTOR GEN. FOR TAX ADMIN., REF. NO. 2008-40-182, PROCESSES ARE NOT SUFFICIENT TO MINIMIZE FRAUD AND ENSURE THE ACCURACY OF TAX REFUND DIRECT DEPOSITS (Sept. 25, 2008) <https://www.treasury.gov/tigta/auditreports/2008-reports/200840182fr.pdf> [hereinafter TIGTA, *Tax Refund Direct Deposits*].

19. For example, an identity thief used the name, social security, and date of birth of then United States Attorney General Eric H. Holder to file a tax return seeking a fraudulent refund. Transcript of Sentencing Proceedings at 5, *United States v. Tadesse*, No. 1:13-CR-0219-1-AT (N.D. Ga.) (March 12, 2014). There was no indication that Attorney General Holder was specifically targeted because of his position.

20. Victims of refund-related identity theft may not have a filing requirement. If this is the case, there is less immediate impact on the victim and the IRS may notify the victim of the incident. See *Identity Theft: Hearing Before the Subcomm. on Fiscal Responsibility & Econ. Growth of Identity Theft of the S. Comm. on Finance*, 112th Cong. 1 (Mar. 20, 2012) (written testimony of Steven T Miller, Deputy Comm'r for Services and Enforcement). For a discussion of elderly taxpayers' particular vulnerabilities to identity theft, see Erin Leigh Sylvester, *Identity Theft: Are the Elderly Targeted?*, 3 CONN. PUB. INT. L.J. 371 (2004). For an explanation of some types of prisoner tax fraud, including identity theft, see TREASURY INSPECTOR GEN.

by the IRS in 2011, 3 million in 2012, and 2 million in 2013, including fraudulent returns based on identity theft-based fraud.<sup>21</sup> These returns claimed fraudulent refunds exceeding \$16 billion in 2011, \$20 billion in 2012, and \$16 billion in 2013.<sup>22</sup> Though the exact number of fraudulent returns that involve claims for a refund based on identity theft is unknown,<sup>23</sup> one estimate is that for 2011, of the 2.2 million tax returns identified as fraudulent, 940,000 involved identity theft claiming fraudulent refunds of \$6.5 billion.<sup>24</sup>

The IRS takes seriously the problems of identity theft and refund fraud; it has allocated resources and staff to victim assistance.<sup>25</sup> In an effort to identify and stop the issuance of potentially fraudulent refunds, the IRS has expanded identity theft filters in its automated return processing system.<sup>26</sup> Once a return is flagged as potentially fraudulent, the IRS reviews the return

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FOR TAX ADMIN., REF. NO. 2014-40-091, PRISONER TAX REFUND FRAUD: DELAYS CONTINUE IN COMPLETING AGREEMENTS TO SHARE INFORMATION WITH PRISONS, AND REPORTS TO CONGRESS ARE NOT TIMELY OR COMPLETE 10–11 (Sept. 25, 2014), <https://www.treasury.gov/tigta/auditreports/2014reports/201440091fr.pdf>.

21. TREASURY INSPECTOR GEN. FOR TAX ADMIN., REF. NO. 2014-40-029, INTERIM RESULTS OF THE 2014 FILING SEASON 11 (Mar. 28, 2014), <https://www.treasury.gov/tigta/auditreports/2014reports/201440029fr.pdf> [hereinafter TIGTA, FILING SEASON REPORT]. These figures include refund fraud based on identity theft and other types of refund fraud.

22. *Id.*

23. *Identity Theft & Tax Fraud: J. Hearing Before the Subcomm. on Oversight and Soc. Sec. of the H. Comm. on Ways & Means*, 112th Cong. 2 (May 8, 2012) (written testimony of Hon. J. Russell George, Treasury Inspector General for Tax Administration) [hereinafter George Testimony, *Hearing on Identity Theft & Tax Fraud (2012)*].

24. *Id.*

25. *IRS Actions to Reduce Improper Payments: Hearing Before the Subcomm. on Gov't Operations of the H. Comm. on Oversight and Gov't Reform*, 113th Cong. 11 (July 9, 2014) (written testimony of John A. Koskinen, Comm'r of IRS) [hereinafter Koskinen Testimony, *Hearing on Improper Payments (2014)*]. Despite the efforts made by the IRS, the National Taxpayer Advocate says victim assistance provided by the IRS to identity theft victims is inadequate. NAT'L TAXPAYER ADVOCATE, IDENTITY THEFT: THE IRS SHOULD ADOPT A NEW APPROACH TO IDENTITY THEFT VICTIM ASSISTANCE THAT MINIMIZES BURDEN AND ANXIETY FOR SUCH TAXPAYERS 77–80 (2013), <http://www.taxpayeradvocate.irs.gov/2013-annual-report/downloads/IDENTITY-THEFT-The-IRS-Should-Adopt-a-New-Approach-to-Identity-Theft.pdf> [hereinafter NAT'L TAXPAYER ADVOCATE, NEW APPROACH].

26. IRS, FS-2014-1, *IRS Combats Identity Theft and Refund Fraud on Many Fronts*, <http://www.irs.gov/uac/Newsroom/IRS-Combats-Identity-Theft-and-Refund-Fraud-on-Many-Fronts-2014> (last updated Dec. 17, 2014). The IRS has expanded the number of identity theft filters in the automated processing system from 80 filters in 2013 to 114 filters in 2014. TIGTA, FILING SEASON REPORT, *supra* note 21, at 12.

to verify the taxpayer's identity.<sup>27</sup> If the taxpayer's identity cannot be confirmed, the IRS will remove the return from processing altogether.<sup>28</sup>

In 2013, the IRS identified 5.7 million tax returns where identity theft was suspected and did not automatically pay the claimed \$17.8 billion in refunds claimed on those returns.<sup>29</sup> This number represented an increase from 2012, when the IRS identified 5 million suspicious returns, and a marked increase from 2011, when the IRS identified 3 million suspicious returns.<sup>30</sup>

The quantity of returns being filed makes the IRS's job of issuing accurate refunds incredibly challenging.<sup>31</sup> Over 135 million individual income tax returns were filed within the first half of the years 2013 and 2014.<sup>32</sup> The vast majority—over 110 million—were filed electronically.<sup>33</sup> Of these returns, 101 million in 2013 and 102 million in 2014 claimed a refund, with total refunds issued of over \$270 billion each year.<sup>34</sup> Because most of these returns are filed electronically, the IRS is receiving tax return information faster and earlier and is, in turn, tasked with issuing refunds more quickly. But because of the prevalence of identity theft tax fraud and refund fraud in general, there is a tension between the need for the IRS to issue refunds quickly and a need for accuracy. The IRS cannot inspect individually all of the 100 million returns claiming a refund.

As the IRS becomes more proficient at identifying fraudulent and potentially fraudulent refund claims, the number of false returns processed may decline. However, that does not mean the number of returns claiming

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27. George Testimony, *Hearing on Identity Theft & Tax Fraud (2012)*, *supra* note 23, at 2.

28. TIGTA, FILING SEASON REPORT, *supra* note 21.

29. Koskinen Testimony, *Hearing on Improper Payments (2014)*, *supra* note 25. These figures are for calendar year periods.

30. *Id.* These figures cited by Commissioner Koskinen are greater than the figures cited by TIGTA. *See supra* notes 21–22 and accompanying text. However, the returns identified by the IRS as suspicious are not the same as the actual number of returns submitted using stolen identities.

31. Another complicating factor in evaluating the accuracy of claimed refunds is that taxpayers are on the move—American taxpayers move to new addresses and change jobs at staggering numbers, making the IRS's job of detecting fraud even more difficult. *Identity Theft in Tax Fraud: Growing Problems in Tax Fraud for the Internal Revenue Service: Hearing Before the Subcomm. on Gov't Org., Efficiency & Fin. Mgmt. of the H. Comm. on Oversight & Gov't Reform*, 112th Cong. 3 (Nov. 4, 2011) (written testimony of Steven T. Miller, Deputy Comm'r for Services and Enforcement).

32. IRS, Filing Season Statistics for Week Ending May 16, 2014, <http://www.irs.gov/uac/Newsroom/Filing-Season-Statistics-for-Week-Ending-May-16,-2014> (last updated Sept. 25, 2014).

33. *Id.*

34. *Id.*

refunds based on identity theft is declining. It does indicate that many perpetrators of tax fraud identity theft are not actually getting refunds. Identity theft-based refund fraud, however, is a problem of increasing proportion that is complicated by the complex and evolving nature of identity theft schemes.<sup>35</sup> As discussed below, when a perpetrator of identity theft-based refund fraud submits a return that is rejected at processing, no civil penalty applies, and it is unlikely that the IRS will conduct a criminal investigation and prosecution.<sup>36</sup>

Identity theft-based refund fraud imposes huge costs on our tax administration system. It affects the individual taxpayers whose identities are stolen as well as the government, and it undermines voluntary compliance.

The immediate effect of refund-related identity theft on the victim is obvious; apart from the emotional toll, a victim likely spends significant time resolving the issue.<sup>37</sup> A taxpayer-victim obligated to file a tax return may be in a situation where an identity thief has filed a fraudulent return for a given tax year before the taxpayer-victim files her return. As a result, a taxpayer-victim's legitimate claim for a refund may be questioned and delayed.<sup>38</sup> Or

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35. See Koskinen Testimony, *Hearing on Improper Payments (2014)*, *supra* note 25, at 1; *Tax Fraud and Tax ID Theft: Moving Forward with Solutions: Hearing Before the S. Fin. Comm.*, 113th Cong. 1 (Apr. 16, 2013) (written testimony of Steven T. Miller, Acting Comm'r of IRS) [hereinafter Miller Testimony, *Hearing on Tax Fraud (2014)*]. Since 2004, the National Taxpayer Advocate has identified tax-related identity theft as one of the "Most Serious Problems" in nearly every report submitted to Congress. NAT'L TAXPAYER ADVOCATE, NEW APPROACH, *supra* note 25, at 75 n.1. Koskinen Testimony, *Hearing on Improper Payments (2014)*, *supra* note 25, at 1 (noting that while the IRS is succeeding at stopping small-scale fraud, the schemes are constantly evolving and the IRS "increasingly face[s] sophisticated large-scale schemes perpetrated by organized criminals").

36. See *infra* Part III.

37. The National Taxpayer Advocate has criticized the IRS for taking too long to assist identity theft victims, citing a recent TIGTA study that the average time for the IRS to resolve identity theft cases was 414 days. Olson Testimony, *Hearing on Identity Theft-Related Tax Fraud (2013)*, *supra* note 2, at 8 (citing TREASURY INSPECTOR GEN. FOR TAX ADMIN., REF. NO. 2014-40-050, MOST TAXPAYERS WHOSE IDENTITIES HAVE BEEN STOLEN TO COMMIT REFUND FRAUD DO NOT RECEIVE QUALITY CUSTOMER SERVICE 11 (May 3, 2014), <https://www.treasury.gov/tigta/auditreports/2012reports/201240050fr.html>). The length of time that it takes the IRS to resolve identity theft cases for victims also contributes to the emotional cost to the victim. "Identity theft is an invasive crime that can have a traumatic emotional impact." NAT'L TAXPAYER ADVOCATE, NEW APPROACH, *supra* note 25, at 76.

38. *Identity Theft: Hearing Before the Subcomm. on Gov't Org., Efficiency, & Fin. Mgmt. of the H. Comm. on Oversight & Gov't Reform*, 112th Cong. 2, 8 (Nov. 29, 2012) (written testimony of Beth Tucker, Deputy Comm'r for Operations Support of IRS) [hereinafter Tucker Testimony, *Hearing on Identity Theft (2012)*]. Low-income taxpayers who qualify for the Earned Income Tax Credit (EITC) or other low-income credit may depend on their tax refund as a large portion of their annual income.

worse, a fraudulent filing may cause the IRS to initiate enforcement action against the taxpayer-victim, such as attempts to collect an erroneously paid refund.<sup>39</sup> There has been significant political interest in how the IRS resolves cases of identity theft for taxpayer-victims, and the IRS appears to be working hard to assist victims and improve its procedures for victim assistance.<sup>40</sup>

Identity theft-based refund fraud also has significant deleterious effects on the United States government.<sup>41</sup> The cost to the government includes the cost of paying erroneous refunds to identity thieves and the increased cost of enforcement for the IRS. The amount of fraudulent refunds that are actually paid is unknown, but estimates are that billions of dollars of potentially fraudulent refunds are paid each year.<sup>42</sup> The additional costs to the IRS for enforcement include costs to improve prevention of refund and identity theft fraud, provide services to taxpayer-victims, and investigate and prosecute perpetrators.<sup>43</sup> In 2012, the IRS spent \$328 million on refund fraud and identity theft efforts.<sup>44</sup>

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Delay in receiving their refund may cause significant hardship. Olson Testimony, *Hearing on Identity Theft-Related Tax Fraud (2013)*, *supra* note 2, at 1–2.

39. Tucker Testimony, *Hearing on Identity Theft (2012)*, *supra* note 38, at 1.

40. Proposed legislation would require the IRS to process and resolve identity theft cases within an average of ninety days; establish a single point of contact within the IRS for each victim; issue special personal identification numbers to victims; and allow victims to prevent electronic filing of any federal tax return by a person purporting to be the victim. Identity Theft and Tax Fraud Prevention Act of 2013, S. 676, 113th Cong. §§ 101–104 (2013). Another proposed bill would require the IRS to expedite an evaluation of identity theft victim's returns; amend the Code in response to identity theft; impose a criminal penalty for using a false identity to commit tax fraud; and increase the penalty applied to return preparers who either improperly use or disclose taxpayer information. Tax Crimes and Identity Theft Prevention Act, H.R. 3482, 112th Cong. §§ 2–5 (2011). For an explanation of IRS efforts to provide and improve victim assistance, see Miller Testimony, *Hearing on Tax Fraud (2014)*, *supra* note 35, at 5–6. Koskinen Testimony, *Hearing on Improper Payments (2014)*, *supra* note 25, at 2–9.

41. The dollar amount of protected refunds discussed does not indicate the dollar amount of erroneous refunds paid. Koskinen Testimony, *Hearing on Improper Payments (2014)*, *supra* note 25.

42. TREASURY INSPECTOR GEN. FOR TAX ADMIN., SEMIANNUAL REPORT TO CONGRESS 27 (Apr. 1–Sept. 30, 2013), [https://www.treasury.gov/tigta/semiannual/semiannual\\_sept2013.pdf](https://www.treasury.gov/tigta/semiannual/semiannual_sept2013.pdf). TIGTA's analysis identified that approximately 1.1 million returns in 2011 were undetected identity theft returns and potentially fraudulent refunds issued totaled approximately \$3.6 billion, compared to \$5.2 billion in potentially fraudulent refunds issued in 2010. *Id.* See also George Testimony, *Hearing on Identity Theft & Tax Fraud (2012)*, *supra* note 23, at 3.

43. Miller Testimony, *Hearing on Tax Fraud (2014)*, *supra* note 35, at 2.

44. *Id.*

B. *Identity Theft and Voluntary Compliance*

In addition to harming victims and depleting government resources, identity theft-based tax fraud also erodes voluntary compliance.<sup>45</sup>

The United States' tax system depends on voluntary compliance by its taxpaying citizens. Voluntary compliance means taxpayers must calculate, report, and pay their taxes rather than the government calculating the taxpayers' liability.<sup>46</sup> Voluntary compliance rates in the United States are particularly high—in the low to mid-80th percentile.<sup>47</sup> Factors contributing to such high compliance include mandatory reporting and matching systems, employer withholding, and the risks of civil penalties or criminal prosecution.<sup>48</sup>

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45. From individual taxpayers personally affected by identity theft to general perceptions by other taxpayers about the fairness of the tax system where fraudulent refunds are paid, public perception of fairness is critical to the functioning of the United States' tax system. See Joel Slemrod, *On Voluntary Compliance, Voluntary Taxes, and Social Capital*, 51 NAT'L TAX J. 485, 487 (Sept. 1998) ("Tax rule obedience thus emerges as one dimension of civil cooperation.") [hereinafter Slemrod, *On Voluntary Compliance*].

46. Taxpayers are free to structure their transactions in a way to minimize their liability, within the construct of the law, but taxpayers must report their taxes, report them accurately, and pay their taxes. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934) ("Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.").

47. U.S. DEP'T. OF THE TREASURY, A COMPREHENSIVE STRATEGY FOR REDUCING THE TAX GAP 5 (Sept. 26, 2006), [http://www.irs.gov/pub/irs-news/comprehensive\\_strategy.pdf](http://www.irs.gov/pub/irs-news/comprehensive_strategy.pdf). These high rates of compliance are curious to scholars and policy makers, especially in light of the low likelihood of enforcement. See Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 KAN. L. REV. 971, 984 n.73 (2003) (analyzing the likelihood of enforcement).

48. There are systems in place to ensure and encourage compliance, including mandatory withholding of tax by employers; mandatory reporting of financial transactions (including wages and compensation); and audits and penalties for evasion. Slemrod, *On Voluntary Compliance*, *supra* note 45, at 485. A common theory to explain taxpayer compliance is based on a traditional economic model—a taxpayer decides whether to comply based on balancing the risks of detection with the cost of compliance. IRS policy to ensure compliance is based on the economic model. See *infra* note 49, for further explanation of the IRS's policy on the use of penalties to further voluntary compliance. Contemporary scholarship argues that compliance is more complex—arguing compliance depends not just on economics or deterrence, but also on social norms, signaling, and demographics. See generally Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1459; Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781 (arguing that tax compliance is because of social, including government, signaling as opposed to norm compliance); Dan M. Kahan, *Signaling or*

Existing IRS policy depends on civil and criminal penalties as deterrence against non-compliance.<sup>49</sup> According to the IRS's stated policy, "[p]enalties encourage voluntary compliance by: (1) demonstrating the fairness of the tax system to compliant taxpayers; and (2) increasing the cost of noncompliance."<sup>50</sup> Furthermore, the IRS's penalty statement states that penalties are particularly important in situations of "abusive taxpayer conduct" that "undermine[s] the fairness and integrity of the federal tax system and undercut[s] voluntary compliance."<sup>51</sup>

As will be explained in Part III, no specific criminal or civil penalties address identity thieves.<sup>52</sup> However, civil penalties and enhanced criminal penalties should apply to identity thieves because identity theft-based refund fraud imposes a burden on taxpayer-victims, jeopardizes the financial well-being of the government, and to the extent the schemes are successful, disrupts the fairness and integrity of the federal tax system.

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*Reciprocating? A Response to Eric Posner's Law and Social Norms*, 36 U. RICH. L. REV. 367, 368 (positing that compliance is because "individuals in collective action settings behave . . . like moral and emotional reciprocators"); Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and Law*, 102 MICH. L. REV. 71 (arguing that tax compliance is explained by emotional and moral reciprocity factors and external incentives or rewards are ineffective at enhancing compliance).

49. I.R.M. 1.2.20.1.1(1) (IRS policy statement). The IRS is tasked with collecting the correct amount of tax in the most efficient manner, and penalties are an important tool for achieving that goal. I.R.M. 1.2.20.1.1(2). IRS activities, including direct enforcement and non-enforcement (such as customer service), impact voluntary compliance. Alan H. Plumley, *The Impact of the IRS on Voluntary Tax Compliance: Preliminary Empirical Results*, Nat'l Tax Assoc. 95th Annual Conference on Taxation, Orlando, FL, Nov. 14–16, 2002. See Bryan T. Camp, *Tax Administration as Inquisitorial Process and the Partial Paradigm Shift in the IRS Restructuring and Reform Act of 1998*, 56 FLA. L. REV. 1, 11 (2004). See *supra* note 48 for a scholarly debate on the efficacy of penalties as a means to enhance voluntary compliance.

50. I.R.M. 1.2.20.1.1(3). Tax penalties essentially work as a carrot for compliant taxpayers, signaling that noncompliant taxpayers will be penalized; and as a stick for noncompliant taxpayers, signaling that the cost of not complying will be an increased financial burden. IRS policy is based on the economic model to explain compliance because the IRS uses penalties as an incentive for compliance and as a disincentive for non-compliance.

51. I.R.M. 1.2.20.1.1(5). "Consistent development and proper application of the accuracy-related and fraud penalties in abusive transaction cases will help curb this activity by imposing tangible economic consequences on taxpayers who engage in those transactions." *Id.* Abusive taxpayer conduct includes "[a]busive transactions," which are defined as ones in which a significant purpose is to avoid or evade tax. *Id.*

52. See *infra* Part III, and corresponding notes 55–135, for a discussion of the inadequacies of existing law.

### III. THE INADEQUACY OF EXISTING CRIMINAL AND CIVIL TAX PENALTIES

The use of criminal and civil penalties is not an either-or proposition; there are numerous times when both a criminal and a civil penalty will apply to the same conduct.<sup>53</sup> Under the Code, when a criminal penalty applies, the IRS often also pursues civil liability in the same case.<sup>54</sup>

#### A. *The Inadequacy of Existing General Federal Criminal Law and Criminal Tax Penalties*

Congress has not enacted any specific statutes that provide for criminal or civil penalties for identity theft-based refund fraud. As a result, the IRS is forced to rely on general civil and criminal statutes in addressing identity thieves. General federal criminal statutes have been applied in the context of identity theft-based refund fraud, and there are some provisions in the Code that could be applied in such cases, but there is no directly applicable federal statute.

The federal criminal code specifically addresses crimes of identity theft. Under section 1028 of Title 18 of the United States Code, a person who “knowingly transfers, possesses, or uses, without lawful authority, a means of identification of another person with the intent to commit, or to aid or abet, or in connection with, any unlawful activity that constitutes a violation of Federal

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53. I.R.M. 38.3.1.8. The only issue when both civil and criminal aspects of a case exist is the extent to which the IRS must balance the civil investigation to prevent prejudice to the criminal case. *Id.* Criminal tax administration is handled by the IRS Criminal Investigations Division (CI) in conjunction with the Department of Justice. I.R.M. 25.1.3.1 (4). CI is responsible for all criminal tax investigations. Reg. § 601.107(b). In criminal tax cases, the government invariably pursues criminal tax penalties and civil restitution of lost tax. *See* 18 U.S.C. §§ 3556, 3663, 3663A (2012). In criminal tax cases, a court order to pay restitution for failure to pay taxes is treated as if it were payment of the tax. I.R.C. § 6201(a)(4). CI’s activities are intended to enhance voluntary compliance. I.R.M. 25.1.3.1(5). CI investigations serve an important role in the detection and prosecution of identity theft-based refund fraud crimes. *See* Koskinen Testimony, *Hearing on Improper Payments (2014)*, *supra* note 25; Miller Testimony, *Hearing on Tax Fraud (2014)*, *supra* note 35.

54. I.R.M. 9.5.13.2.1. Criminal tax violations are charged only for fraudulent conduct, whereas civil tax penalties are imposed on broader types of conduct, including negligence or recklessness. I.R.M. 9.5.13.2.1(1). *Compare* I.R.C. § 6662 (imposing civil penalty for negligence), *with* I.R.C. § 7201 (imposing criminal sanction for tax evasion based on intentional violation of known legal duty). *See infra* note 74 for a discussion of administrative issues arising from the IRS imposing civil and criminal penalties in the same case.



law,” shall be punished by a fine or imprisonment, or both.<sup>55</sup> Though nothing in the language of the statute itself specifies application in cases where the fraud perpetrated by the identity thief pertains to taxes, the government uses this provision to prosecute perpetrators of identity theft in the federal tax context.<sup>56</sup>

Under section 7206 of the Internal Revenue Code, it is a felony to willfully make any tax document that contains a statement made under penalties of perjury, which the person does not believe to be true and correct.<sup>57</sup> To establish a perpetrator’s guilt under this provision, the government must prove (1) the perpetrator believed the statement or document submitted is not true and correct; (2) the perpetrator acted with willfulness; (3) the false statement made was material; and (4) the perpetrator made and subscribed the document under penalty of perjury.<sup>58</sup> The same statute applies also to a person who willfully aids or assists the preparation of any fraudulent tax document.<sup>59</sup> These tax crimes carry a fine of not more than \$100,000 or imprisonment of three years.<sup>60</sup> These statutes are most often used to establish falsity in a tax return or other tax document submitted to the government when the government cannot prove the more serious tax crime of evasion.<sup>61</sup> However, the government has used the penalty for fraud and false statements against perpetrators of identity theft-based tax fraud.<sup>62</sup>

A lesser, included criminal statute applies to any person who willfully

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55. 18 U.S.C. § 1028(a)(7) (2012). The statute carries a sentence of not more than five or fifteen years depending on if the perpetrator obtains anything of value worth more than \$1,000. 18 U.S.C. § 1028(b)(1)(D), (2)(B).

56. See 18 U.S.C. § 1028. See *United States v. Bazile*, 590 Fed. App’x 870 (11th Cir. 2014) and *United States v. Little*, 522 Fed. App’x 937 (11th Cir. 2014) for recent cases where section 1028 was applied to perpetrators of identity theft-based refund fraud. Although not specific to identity theft, federal criminal law also generally criminalizes fraudulent schemes or false pretenses to defraud or obtain money by wire, radio, or television. 18 U.S.C. § 1343 (2012). Wire fraud carries a sentence of not more than twenty years, or a fine, or both. *Id.* Depending on the nature of the identity theft-based refund fraud scheme, these criminal provisions may be applicable.

57. I.R.C. § 7206(1) (referred to as the penalty for “fraud and false statements”).

58. *Id.*

59. I.R.C. § 7206(2).

60. *Id.*

61. See *United States v. Rayor*, 204 F. Supp. 486 (S.D. Cal. 1962), *reh’g denied*, 323 F.2d 519 (9th Cir. 1963).

62. See *United States v. Woods*, 710 F.3d 195 (4th Cir. 2013); *United States v. Mobley*, No. 10-0243-WS-C, 2013 WL 4166553 (S.D. Ala. Aug. 15, 2013); *Campbell v. United States*, No. WMN-13-471, 2013 WL 2903066 (D. Md. June 11 2013).

delivers or discloses any list, return, account, or other document known to be fraudulent or false without requiring that the identity thief submit the document under penalty of perjury.<sup>63</sup> Violation of this statute is punished as a misdemeanor and carries with it a maximum sentence of up to one year or a \$10,000 criminal fine.<sup>64</sup>

The existing criminal penalties are inadequate because identity theft-based refund fraud is such a serious problem that there should be a specific statute addressing it.<sup>65</sup> Furthermore, the foregoing criminal statutes were enacted long before identity theft-based fraud existed. The lack of a specific, targeted criminal provision is a potential problem because penalties are useful as deterrents,<sup>66</sup> but the growing problem of identity theft requires a penalty tailored to effectively deter potential offenders. Increasing penalties, creating a penalty specific to identity theft-based fraud, will likely add a more effective disincentive.<sup>67</sup>

Simply enacting a directly applicable criminal provision addressing identity theft-based refund fraud, however, is not the complete solution. A problem with existing criminal law is in the administration of criminal tax penalties. The IRS has significantly increased the number of identity theft investigations initiated over the past few years.<sup>68</sup> The IRS initiated 276, 898, and 1,492 criminal investigations of identity theft in 2011, 2012, and 2013, respectively.<sup>69</sup> Despite the increase, however, the number of cases investigated and prosecuted is just a fraction of the hundreds of thousands of returns flagged as reflecting the potential for identity theft-based fraud.<sup>70</sup> These numbers of returns do not even include the millions rejected outright for processing.<sup>71</sup>

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63. I.R.C. § 7207 (2002).

64. *Id.*

65. Serious crimes warrant individual statutes to address them. For example, rape and murder may constitute battery, but they are deserving of their own criminal statute to address the particularities and make a policy statement that rape and murder will be treated seriously and are not tolerated under the law.

66. Jeffrey A. Dubin, *Criminal Investigation Enforcement Activities and Taxpayer Noncompliance*, (Cal. Inst. of Tech. Social Science Working Paper 1200, May 2004) at 4, 21, <http://www.irs.gov/pub/irs-soi/04dubin.pdf> (“CI activities have a measurable effect on voluntary compliance.”).

67. Alvarez, *Thieves File Early and Often*, *supra* note 5. Florida Representative Debbie Wasserman Shultz said “[t]here is almost no disincentive, because the penalty is so low for a thief to [commit refund fraud] repeatedly.” *Id.*

68. IRS, Statistical Data – Identity Theft Investigations, <http://www.irs.gov/uac/Statistical-Data-Identity-Theft-Investigations> (last updated Oct. 9, 2014).

69. *Id.*

70. See Olson Testimony, *Hearing on Identity Theft & Tax Fraud* (2012), *supra* note 15, at 1.

71. See Koskinen Testimony, *Hearing on Improper Payments* (2014), *supra* note 25.

Furthermore, the number of fraudulent returns being submitted to the IRS is also on the rise.<sup>72</sup> And as previously discussed, despite the increase in the number of investigations of identity theft-related tax crimes by the IRS's Criminal Investigation Division, in most cases where fraudulent returns are flagged at processing and refunds are unpaid, the identity thief is not prosecuted or penalized and is able to try again.<sup>73</sup>

It seems inconsistent to say that there should be a directly applicable criminal statute addressing identity theft-based refund fraud and that criminal penalties are inadequate in addressing the problem. However, they are two distinct parts to a holistic solution: first, identity theft-based refund fraud as a serious crime that should have a directly applicable criminal statute; second, recognizing that because enforcement of criminal statutes may not always be possible or practical, parallel civil penalties should apply.

*B. The Inadequacy of Civil Tax Penalties Because Most Do Not Work as a Matter of Statutory Definition*

Like criminal penalties, civil tax penalties also implicate voluntary compliance.<sup>74</sup> This subsection examines existing civil penalties and analyzes

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72. *Id.* As the IRS improves its automatic detection filters, the number of potentially fraudulent returns flagged and stopped increases. However, the number of fraudulent or potentially fraudulent submissions continues to increase; therefore, the actual numbers are difficult to measure. It is safe to say that criminal investigations alone are not deterrent enough.

73. Kranish, *IRS Is Overwhelmed*, *supra* note 1. Before April 16 of 2013, the IRS had “suspended and rejected more than 2 million suspicious returns,” but only opened “800 [criminal] investigations.” Miller Testimony, *Hearing on Tax Fraud (2014)*, *supra* note 35, at 41. Criminal tax prosecutions largely depend on tax loss; though not published, the IRS CI division’s policy seems to favor seeking criminal prosecutions where the tax loss involved is substantial. *See, e.g.*, *United States v. Nkansah*, 699 F.3d 743, 746 (2d Cir. 2012) (prosecuting the taxpayer under 18 U.S.C. section 1028(a)(7) for tax loss exceeding \$500,000); *United States v. Hill*, 683 F.3d 867, 869 (7th Cir. 2012) (prosecuting the taxpayer under 18 U.S.C. § 1028(a)(7) for tax loss exceeding \$350,000). Admittedly, these cases do not involve identity theft-based refund fraud. There is no information about IRS policy on minimum tax loss for identity theft-based cases.

74. Civil penalties against individual taxpayers are structured to discourage three types of noncompliance—failure to timely file; failure to timely pay; and failure to determine and report the correct amount of tax. I.R.C. §§ 6651, 6662–6664. In 1989, Congress overhauled the civil tax penalties as part of the Improved Penalty Administration and Compliance Act, in which the penalty structure was reorganized and simplified. Improved Penalty Administration and Compliance Tax Act, Pub. L. No. 101-239, 103 Stat. 2106 (1989). Subsequently, additional penalties have been added to address specific problems. *See, e.g., infra* Part III.B.3 and accompanying notes 112–134 (return preparer penalties, frivolous return penalties, and erroneous

their potential applicability to cases of refund-based identity theft. Specifically, this section will examine three types of civil penalties that are potentially applicable to identity thieves. They are: (1) penalties that apply to taxpayers who fail to accurately calculate and report their taxes; (2) penalties that apply to third parties who in assisting a taxpayer fail to accurately calculate and report taxes on behalf of the taxpayer; and (3) penalties that apply to claims for erroneous refunds and frivolous returns.<sup>75</sup>

1. *Penalties that Apply to Taxpayers Who Fail to Accurately Calculate and Report Their Taxes Cannot Apply to Perpetrators of Identity Theft-Based Refund Fraud*

Civil tax penalties apply if a taxpayer submits an inaccurate return, and the penalties are enhanced if the inaccuracy is based on fraudulent conduct.<sup>76</sup> Specifically, the Code imposes a civil fraud penalty “if any part of any underpayment of tax required to be shown on a return is due to fraud.”<sup>77</sup> The amount of the penalty is 75 percent of the underpayment attributable to fraud.<sup>78</sup> For purposes of the penalty, fraud has been interpreted to mean an

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refund penalty). *See also* I.R.M. 1.2.13.1.11(2) (“The purpose of criminal and civil tax investigations is to enforce the tax laws and to encourage voluntary compliance.”). The usual procedure for parallel criminal and civil investigations is for the criminal investigation to take precedence over the civil because a civil investigation may jeopardize the criminal case. *Id.* However, in parallel criminal and civil investigations of certain types of cases, such as civil promoter penalty cases, IRS procedures do not require delay of the civil investigation pending outcome of the criminal case. I.R.M. 1.2.13.1.11(10). Criminal and civil tax penalties differ in dollar amount and only criminal penalties impose incarceration, but they also differ in terms of burden of proof. To impose civil penalties based on negligence, the burden of proof imposed on the government is a preponderance of the evidence. For civil fraud, the burden of proof is clear and convincing evidence, I.R.C. § 7454(a), and for criminal penalties, the burden is beyond a reasonable doubt. *Webb v. Commissioner*, 394 F.2d 366, 379 (5th Cir. 1968).

75. This organization is for purposes of this Article and does not reflect the structure of civil penalties as provided in the Code. I analyzed all of the civil penalties in view of the problem of identity theft-based refund fraud and determined that these are the only civil penalties that potentially apply.

76. The civil tax penalties apply if the taxpayer caused the inaccuracy on the return by violating a standard of conduct, such as negligence or fraud. *See* I.R.C. §§ 6662–6663.

77. I.R.C. § 6663(a).

78. *See id.* The civil fraud penalty increases with the dollar value amount of the inaccuracy. I.R.C. § 6662(a). The civil accuracy-related penalty that applies for failure to exercise reasonable care is a 20 percent penalty. *Id.* The penalty, commonly referred to as an “accuracy-related penalty,” is imposed on “the portion of an underpayment of tax required to be shown on a return,” that is attributable to one or

“intentional wrongdoing on the part of a taxpayer motivated by a specific purpose to evade a tax known or believed to be owing.”<sup>79</sup>

Although a perpetrator of identity theft-based refund fraud certainly acts in an intentional manner in an attempt to defraud the government, the perpetrator’s actions do not meet the definition of fraud because a perpetrator does not intend to evade tax known to be due and owing, because a perpetrator of identity theft-based fraud submits an entirely fraudulent return based on fabricated income information.<sup>80</sup> The perpetrator fabricates the entire return, including the amount of tax shown on the return, and is therefore not evading a tax “known to be owing.”<sup>81</sup>

The civil penalty also does not apply because it is based on the amount of the “underpayment of tax required to be shown on a *return*.”<sup>82</sup> In cases of identity theft-based refund fraud, however, there is neither an underpayment of tax nor a valid return filed.

An underpayment is generally the difference between the correct amount of tax (as determined by the IRS) and the amount reported on the return by the taxpayer.<sup>83</sup> In cases where the identity thief uses a stolen identity

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more enumerated types of conduct, such as “(1) [n]egligence or disregard of rules or regulations[;] (2) [a]ny substantial understatement of income tax[; or] (3) [a]ny substantial valuation misstatement.” I.R.C. § 6662(a)–(b).

79. *Stoltzfus v. United States*, 398 F.2d 1002, 1004 (3d Cir. 1968) (quoting *Powell v. Granquist*, 252 F.2d 56 (9th Cir. 1958)). *See also Webb*, 394 F.2d at 377 (defining fraud as “actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing”). Fraudulent intent is often proved by circumstantial evidence of fraud. *Meier v. Commissioner*, 91 T.C. 273, 297 (1988). Examples of fraudulent intent are: “(1) [t]he understatement of income; (2) inadequate records; (3) failure to file tax returns; (4) implausible or inconsistent explanations of behavior; (5) concealment of assets; and (6) failure to cooperate with tax authorities,” and “[t]he following are additional indicia of fraud: (1) [e]ngaging in illegal activities; (2) attempting to conceal these activities; (3) dealing in cash; and (4) failing to make estimated tax payments.” *Meier*, 91 T.C. at 297–98 (citing *Bradford v. Commissioner*, 796 F.2d 303, 307–08 (9th Cir. 1986)). These factors are not exhaustive. *Id.* at 297.

80. *Compare* I.R.C. § 6662(a). An identity thief certainly intends to violate the standard of conduct for purposes of the negligence-based accuracy-related penalty because the thief’s actions constitute intentional disregard of tax rules by virtue of the thief’s fraudulent submission.

81. Compare the conduct of a perpetrator of identity theft-based refund fraud fabricating income information with the conduct traditionally constituting civil fraud, such as a taxpayer intentionally underreporting income or overstating deductions to evade tax.

82. I.R.C. §§ 6662–6663 (emphasis added).

83. I.R.C. § 6664(a). This is an oversimplified definition of underpayment, though it is sufficient for purposes of the analysis in this Article. Technically, the statute defines “underpayment” as the amount by which the correct amount of tax

to file a false return claiming a fraudulent refund, there is no correct amount of tax required to be shown; the entire return is fraudulent.

With respect to the meaning of the language of the civil fraud penalty, “required to be shown on a return,” the purported tax return submitted to the IRS by a perpetrator of identity theft-based refund fraud, most commonly a U.S. Individual Income Tax Return, Form 1040, is not a valid tax return.<sup>84</sup> The Code generally requires any person liable for tax under the Code to “make a return or statement according to the forms and regulations” that must contain the information required by the forms and regulations,<sup>85</sup> but the Code does not specifically define what constitutes a return.<sup>86</sup> If a return does not contain the required information, the IRS will not accept the return.<sup>87</sup> The courts have found the following requirements for a valid return: (1) “there must be sufficient data to calculate tax liability;” (2) “the document must purport to be a return;” (3) “there must be an honest and reasonable attempt to satisfy the requirements of the tax law;” and (4) “the taxpayer must execute the return

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exceeds the excess of (1) the sum of the amount shown as tax by the taxpayer on the return, plus amounts not shown but previously assessed or collected without assessment; less (2) amounts of rebates made. *Id.* A “rebate” is defined as “so much of an abatement, credit, refund or other payment, as was made *on the ground* that the tax imposed by law was less than [the excess of] the amount shown on the return.” See *Villa-Ignacio v. Commissioner*, T.C. Summ. Op. 2014-61, 2014 WL 2959502 (June 30, 2014). A refund that is based on over-withholding of tax is not a rebate for purposes of calculating an underpayment. See Reg. § 1.664-2(g) for examples. For a more thorough explanation of underpayments, see Bryan T. Camp, *The Mysteries of Erroneous Refunds*, 114 TAX NOTES 231, 231–45 (Jan. 15, 2007).

84. The IRS takes the position that “[a] return filed by an identity thief, where the thief acquires and uses another taxpayer’s name[,] social security number,” and possibly address, “for purposes of obtaining a fraudulent refund, is not a valid return.” C.C.A. 2012–13 (Apr. 9, 2012). Applying the civil fraud penalty in cases of identity theft-based refund fraud would require the IRS to change the standard with respect to what constitutes a valid tax return. This would have detrimental consequences to victims of tax related identity theft who file a return because there cannot be two valid returns filed for the same period. The return filed by the victim of identity theft must be a valid return and the purported return submitted by the perpetrator of identity theft must therefore be invalid.

85. I.R.C. § 6011(a). Only a taxpayer who is liable for tax must make a return that contains the information required under section 6011(a). An identity thief who submits a fraudulent return is, by definition, excluded from the requirements of section 6011(a).

86. I.R.C. § 6501(a) (“[T]he term ‘return’ means the return required to be filed by the taxpayer.”).

87. Reg. § 1.6011-1(b) (“Each taxpayer should carefully prepare his return and set forth fully and clearly the information required to be included therein. Returns which have not been so prepared will not be accepted as meeting the requirements of the Code.”).

under penalties of perjury.”<sup>88</sup> In cases of identity theft-based refund fraud, the perpetrator of the fraud signs the return unbeknownst to the taxpayer whose identity has been stolen, and the return is invalidated because the taxpayer himself or herself does not sign the return.<sup>89</sup>

Therefore, the civil fraud penalty does not apply to perpetrators of identity theft-based fraud because the perpetrator’s actions do not meet the definition of fraud for the purposes of the penalty; no underpayment exists and no valid return is filed.

2. *Penalties that Apply to People Other Than the Named Taxpayers May Apply in Certain Cases of Identity Theft-Based Refund Fraud*

Another potential avenue for asserting penalties on perpetrators of identity theft-based refund fraud is to apply the penalties that apply to parties other than the taxpayer who violate standards of conduct, such as return preparer penalties or the penalties against third parties who engage in aiding and abetting another’s understatement of tax. Each penalty is addressed in turn.

Return preparer penalties have existed only for the past forty years—prior to 1976, there were no civil penalties for return preparers who improperly prepared a taxpayer’s returns. In response to the growing return preparer industry and increasing cases of abusive practices by return preparers, Congress enacted civil penalties to address improper preparer conduct.<sup>90</sup> At the time that Congress enacted civil penalties, there were criminal penalties available to punish improper return preparer conduct.<sup>91</sup> Congress noted, however, that the existing criminal penalties available to punish abusive return preparers were insufficient to address the problem.<sup>92</sup>

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88. *Beard v. Commissioner*, 82 T.C. 766, 777 (1984). The four-prong test for a valid return articulated in *Beard* is the synthesis of two Supreme Court cases addressing similar issues: *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172, 180 (1934) and *Florsheim Bros. Drygoods Co. v. United States*, 280 U.S. 453 (1930).

89. *See* F.S.A. 1992–178 (Apr. 2, 1992) (return not valid where submission contains taxpayer’s signature, but name and social security number were not those of the taxpayer); C.C.A. 2009–23–028 (June 5, 2009) (return not valid where wife fraudulently filed return on behalf of husband without husband’s knowledge or consent and husband did not actually sign return).

90. S. REP. No. 94-938(I), at 349–51 (1976).

91. At the time of enactment, return preparers were subject to criminal fraud penalties for willfully aiding and assisting in the preparation of a fraudulent return under section 7206. *See supra* notes 59–60 and accompanying text for a discussion of this criminal penalty.

92. S. REP. No. 94-938(I), at 350. Existing criminal penalties, and the lack of civil penalties, addressing the problems with return preparers were inadequate. The

Return preparer penalties impose monetary penalties on return preparers who violate standards of conduct in preparing tax returns or claims for refund.<sup>93</sup> Return preparer penalties are the greater of (1) a flat \$1,000 or \$5,000, depending on the state of mind of the preparer, or (2) 50 percent of the income the preparer derived from preparing the return.<sup>94</sup>

A perpetrator of identity theft-based refund fraud may seem to violate the standard of conduct the return preparer penalties seek to address. As with the civil fraud penalty, however, in identity theft cases, the return preparer penalty does not apply because those cases do not meet the statutory definition. Return preparer penalties apply in cases where a return preparer, defined as any person who prepares a return in exchange for compensation, is paid to assist the taxpayer in the preparation of a return.<sup>95</sup> Perpetrators of identity theft-based refund fraud are not paid by the taxpayer (or taxpayer's representative) to prepare the return or claim for refund. They are perpetrators of a fraud.

Another penalty applies to any person who aids, assists in, or procures in the preparation or presentation of a return, claim, or other document under the tax laws, which the person knows will be used in connection with a material matter arising under the tax laws, and if the document is so used, it will result in an understatement of another person's tax liability (referred to as the penalty for "aiding and abetting").<sup>96</sup> The penalty imposed is a flat \$1,000.<sup>97</sup>

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criminal penalties were identified as "cumbersome and ineffective deterrents" because of the resources required and time it takes for criminal prosecutions. *Id.*

93. I.R.C. §§ 6694, 6695. Return preparers are subject to penalties of \$1,000 for taking "unreasonable positions," and enhanced penalties of \$5,000 for "willful or reckless conduct" that results in an understatement of liability. I.R.C. § 6694.

94. I.R.C. §§ 6694(a)(1), 6695(b).

95. I.R.C. § 7701(a)(36). There are cases where a paid return preparer also engages in identity theft. See IRS, *Examples of Identity Theft Schemes*, *supra* note 14 for a discussion on this hybrid variation of identity theft.

96. I.R.C. § 6701(a). The actual language of the statute is quite broad, imposing a penalty on:

Any person—

(1) who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document,

(2) who knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws, and

(3) who knows that such portion (if so used) would result in an understatement of the liability for tax of another person . . . .

*Id.*

97. I.R.C. § 6701(b)(1). The person who aids or assists is subject to one \$1,000 penalty per taxpayer aided or assisted per period and may be imposed in



This provision was added as part of the Tax Equity and Fiscal Responsibility Act of 1982,<sup>98</sup> which included several additions and changes to the penalty structure of the Code. The penalty for aiding and abetting expanded the types of tax advisors subject to civil penalties for abusive conduct.<sup>99</sup> Congress enacted a civil penalty to address four policy objectives: First, the civil aiding and abetting penalty was intended to provide an effective enforcement mechanism by discouraging those who would aid taxpayers in the fraudulent underpayment of tax.<sup>100</sup> Second, the penalty remedied the disparate treatment where taxpayers were subject to enhanced penalties for civil fraud, but advisors were not.<sup>101</sup> Third, the Committee recognized that some conduct should be penalized, but not necessarily criminally.<sup>102</sup> Fourth, the penalty was intended to protect innocent taxpayers from abusive advisors.<sup>103</sup>

The penalty for aiding and abetting has been applied in a case where a return preparer engaged in identity theft in conjunction with return preparation. It was applied in *United States v. Anderson*,<sup>104</sup> a judgment and order granting a permanent injunction against a tax return preparer, Dorothy Lee Anderson, who filed 451 tax returns as a return preparer in 2008, claiming refunds in excess of \$1.2 million.<sup>105</sup> Of the refunds claimed, the IRS issued refunds of \$480,000 and denied paying the remaining after the IRS determined the taxpayers were not entitled to refunds or credits claimed.<sup>106</sup> Anderson, indicating she was a paid preparer, filed tax returns “on behalf of a significant number of taxpayers” without the taxpayers’ knowledge or consent. And on these fraudulent returns, Anderson requested refunds of income, claimed credits, reported improper withholding allowances, and claimed false dependents.<sup>107</sup> Based on Anderson’s conduct, the District Court granted the government’s request for a permanent injunction preventing Anderson from

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addition to any other penalties provided by law except for the return preparer penalties. I.R.C. § 6701(b)(3), (f).

98. An Act to Provide for Tax Equity and Fiscal Responsibility, and Other Purposes, Pub. L. 97-248, § 306, 96 Stat. 324 (1982).

99. The return preparer penalties apply only to the narrow class of individuals who fit the statutory definition of return preparers. *See* I.R.C. §§ 6694, 7701(a)(36). The aiding and abetting penalty applies to any person who aids or assists in preparation of any portion of a return. I.R.C. § 6701. Prior to enactment of the civil penalty for aiding and abetting, there were only criminal penalties. § 306, 96 Stat. 324.

100. S. REP. No. 97-494(I), at 275 (1982).

101. *Id.*

102. *Id.*

103. *Id.*

104. *United States v. Anderson*, 2010–1 U.S.T.C. ¶50,391, 105 A.F.T.R.2d 2010–2204 (D.S.C. 2010).

105. *Id.*

106. *Id.*

107. *Id.* at 84,367, 105 A.F.T.R.2d at 2010–2205.

preparing tax returns for others. The injunction was based on her conduct subject to return preparer penalties and the penalty for aiding and abetting, as well as for “unlawful interference with enforcement of internal revenue laws.”<sup>108</sup> In the court’s analysis, the factual finding that Anderson filed tax returns without the consent or knowledge of some taxpayers was used to support the injunctive relief for Anderson’s unlawful interference with the enforcement of tax laws and not for Anderson’s violation of conduct subject to penalties under sections 6694 and 6701.<sup>109</sup> *Anderson* suggests that the penalties for aiding and abetting under section 6701 may not be used in cases of pure identity theft-based refund fraud.<sup>110</sup>

Nothing expressly prohibits application of section 6701 against perpetrators of identity theft-based refund fraud where the perpetrator is unknown to the victim, but the issue has not been tested. The statutory language, “[a]ny person—who aids or assists in, procures, or advises,” could be interpreted as requiring the person against whom the penalty is asserted to be acting in concert with the taxpayer.<sup>111</sup> If the statute were so interpreted, the penalty would not apply to identity theft-based refund absent some type of relationship or connection between the perpetrator and the victim.

The return preparer penalties do not apply because identity thieves are not return preparers under the statutory definition. The civil penalty for aiding and abetting, however, offers a possibility for cases of identity theft where the identity thief has some connection to his or her victims, such as a return preparer or other tax professional who files on behalf of clients (or former clients) without their knowledge or consent.

### 3. *The Erroneous Refund and Frivolous Return Penalties Do Not Exactly Fit the Case of Identity Theft-Based Refund Fraud*

Congress created additional civil penalties to address specific situations, such as taxpayers who make frivolous submissions or request erroneous refunds. It is a stretch to apply these penalties to identity theft-based refund fraud.

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108. *Id.* at 84,369, 105 A.F.T.R.2d at 2010–2208. The conduct was in violation of sections 6694 and 6701.

109. *Id.* at 84,369, 105 A.F.T.R.2d at 2010–2207. The court cited Anderson’s conduct as an unscrupulous tax return preparer only to support the injunction for violations of sections 6694 and 6701. *Id.*

110. Anderson was both subject to return preparer penalties for her abusive conduct in preparing returns for clients and engaged in identity theft-based refund fraud by filing returns on behalf of clients without their knowledge. *Id.*

111. I.R.C. § 6701(a)(1).

The Code imposes a civil penalty for “[f]rivolous tax submissions.”<sup>112</sup> Added to the Code in 1982, at the same time as the penalty for aiding and abetting, the purpose of a civil penalty for frivolous tax submissions is to deter deliberate defiance of tax laws by “tax protestors.”<sup>113</sup> The penalty is a flat \$5,000 and applies to a person who submits a purported tax return that either appears on its face to be incorrect or lacks the necessary information for the IRS to determine whether the purported return is correct, and the person is either taking a position that is identified as frivolous or reflects a desire to impede or impair tax administration.<sup>114</sup> The IRS regularly publishes a list of frivolous positions, ranging from arguments that the income tax is unconstitutional or voluntary to assertions that wages are not taxable or the taxpayer is exempt from the internal revenue laws.<sup>115</sup>

The first part of the penalty requires the purported return to either appear facially incorrect or lack the information necessary to determine whether the return is correct.<sup>116</sup> In cases of identity theft, the perpetrator usually intends the return to appear valid in order to obtain the fraudulent refund, but depending on the IRS’s processing systems, the IRS may detect that the false return is potentially based on identity theft. Whether this satisfies the first part of the frivolous submissions penalty has not been analyzed by the IRS or the courts.

Even if an identity theft-based return appears facially incorrect or lacks the necessary information to determine whether the return is correct, the conduct of the perpetrator would also have to be based on a frivolous position or reflect a desire to delay or impede tax administration for the frivolous submission penalty to apply.<sup>117</sup> The IRS does not designate fraudulent returns submitted by a perpetrator of identity theft as frivolous in nature.<sup>118</sup> An

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112. I.R.C. § 6702.

113. STAFF OF J. COMM. ON TAXATION, 97TH CONG., GEN. EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 223 (Comm. Print 1982). The IRS is prohibited from designating taxpayers as “illegal tax protestors.” Reorganization of Structure and Management of the Internal Revenue Service, Pub. L. No. 105-206, § 3707, 112 Stat. 778 (1998).

114. I.R.C. § 6702(a). An example of a return that appears on its face to be incorrect would be a return that claims immunity from tax or that has altered language indicating that the subscriber is not subject to penalty of perjury. An example of a return that lacks the information necessary for the IRS to determine the tax would be a return that contains all zeros in the boxes for income.

115. Notice 2010-33, 2010-17 I.R.B. 609. Under section 6702(c), Congress requires the IRS to set forth this list.

116. See I.R.C. § 6702(a)(1).

117. See I.R.C. § 6702(a)(2).

118. Notice 2010-33, 2010-17 I.R.B. 609. The IRS could take the position that identity theft is a frivolous position, but it has not done so. There is also no

argument could be made that identity theft impedes or delays tax administration and therefore meets the standard for the penalty.<sup>119</sup> Conduct that “reflects a desire to delay or impede” tax administration, however, has traditionally focused on taxpayers seeking to delay collection or stall the tax assessment process.<sup>120</sup>

Nothing in the legislative history indicates Congress intended the frivolous tax submission penalty to apply to cases of identity theft or that the penalty has ever been applied to such cases. Application of the frivolous return penalty would be a departure from how the penalty has been applied to date, but it remains a possibility depending on the construction of the language of the penalty.<sup>121</sup>

The final civil penalty that could possibly apply in cases of identity theft-based refund fraud is the penalty for erroneous refunds. This penalty is the most recent addition to the civil penalties. If a person claims an excessive refund or credit to which he or she is not entitled with respect to income tax, the Code imposes a penalty of 20 percent of the excessive amount claimed (Erroneous Refund Penalty).<sup>122</sup>

At first glance, the penalty for erroneous refunds seems to address the problem of identity theft-based refund fraud. The Erroneous Refund Penalty lacks the limitations contained in the civil accuracy-related and fraud penalties that there be an underpayment or a return filed, and it addresses the specific situation where a person (not necessarily a taxpayer) claims a refund to which he or she is not entitled.

There are two general limitations to the application of the Erroneous Refund Penalty contained in the statutory language itself. First, the Erroneous Refund Penalty does not apply if the refund claimant has a “reasonable basis” for the excessive claim.<sup>123</sup> An identity thief has no reasonable basis for his or her fraudulent claim, and thus the Erroneous Refund Penalty would otherwise apply. A perpetrator of identity theft-based refund fraud has submitted a

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indication that the IRS is considering this solution. Traditionally, tax protester type arguments are what the IRS has considered frivolous positions.

119. Miller Testimony, *Hearing on Tax Fraud (2014)*, *supra* note 35, at 2. In 2012, the IRS spent roughly \$330 million combatting refund and identity theft fraud. *Id.* at 6.

120. Cases where section 6702 applied traditionally included tax protestor-type arguments or dilatory nature. Notice 2010–33, 2010–17 I.R.B. 609.

121. The frivolous return penalty does not have the technical limitations preventing application to identity theft-based problems, unlike the civil fraud penalty or the return preparer penalty. *See* discussion *supra* Part III.B.1–2.

122. I.R.C. § 6676(a). Section 6676(b) defines “excessive amount” as the difference between the amount of refund allowed over the amount disallowed. This penalty is not strictly applied—if the taxpayer has a reasonable basis for claiming the amount that is determined to be excessive, the penalty does not apply. I.R.C. § 6676(a).

123. I.R.C. § 6676(a).

fraudulent return with false information and therefore has no reasonable basis for the claimed excess refund. The penalty also applies whether the refund was in fact paid, which is critical in application to identity theft-based refund fraud in light of how many returns the IRS is detecting and stopping based on suspected identity theft.

The second limitation poses a more difficult obstacle for the application of the penalty to an identity thief. In the statutory language, if any part of the erroneous claim is based upon a claim for the Earned Income Tax Credit (EITC) under section 32, the penalty does not apply.<sup>124</sup> Many, if not the vast majority, of the fraudulent returns submitted based on identity theft seek refunds based on the EITC.

There is no official legislative history explaining the second limitation.<sup>125</sup> The Senate report to a predecessor version of the bill containing a similar penalty provision indicates Congress was concerned about the gap in the law with respect to erroneous claims for refund that would not be subject to the traditional civil accuracy-related or fraud penalties because the refund claim alone did not generate an underpayment of tax.<sup>126</sup> Congress recognized that erroneous claims for refund by some taxpayers were straining IRS resources and impairing effective tax administration, generally.<sup>127</sup> The Erroneous Refund Penalty was intended to deter such claims.<sup>128</sup> Based on the Treasury Inspector General for Tax Administration's (TIGTA) report to Congress that refund schemes were overwhelming IRS resources, the Staff of the Joint Committee on Taxation analyzed the predecessor version of the bill and noted that erroneous refund claims create burdens on both taxpayers and

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124. I.R.C. § 6676(d). This section specifically excepts cases where the taxpayer has claimed an excessive credit amount under the EITC.

125. U.S. Troops Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007, Pub. L. 110-28, § 8247(a), 121 Stat. 112, 204 (2007). The Erroneous Refund Penalty was enacted as part of an emergency appropriations bill. STAFF OF J. COMM. ON TAXATION, 110TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 110TH CONGRESS 36-37 (Comm. Print 2009) (explaining the provision, but no "Reasons for Change."). See Christine S. Hooks, *Spotlight on the Penalty for Excessive Refund Claims, I.R.C. § 6676*, INSIDE BASIS (Fed. Bar Ass'n Section on Taxation, Arlington, Va.), Spring 2013 at 5, <http://www.fedbar.org/Hidden-Files/2013-Newsletter-Submissions/Section-on-Taxation/InsideBasis%20Spring%202013.pdf.aspx?FT=.pdf>.

126. S. REP. NO. 109-336, at 65-66 (2006). See Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act, S. 1321, 109th Cong. § 413 (2005), <http://www.gpo.gov/fdsys/pkg/BILLS-109s1321rs/pdf/BILLS-109s1321rs.pdf> (predecessor version of bill with proposed Erroneous Refund Penalty).

127. S. REP. NO. 109-336.

128. *Id.*

the IRS.<sup>129</sup> Without a penalty, the Staff of the Joint Committee noted there is little downside to a taxpayer who makes a claim for an erroneous refund.<sup>130</sup>

The only difference—and it is a key difference—between the predecessor version of the Erroneous Refund Penalty and the version of the penalty as enacted is that the predecessor version did not contain the limitation that the penalty does not apply to any portion of erroneous refund based on a claim for the EITC.<sup>131</sup> The refund schemes referred to by TIGTA, and cited as impetus for the penalty in the legislative history of the predecessor version of the penalty, were all based on claims for the EITC.<sup>132</sup> However, there is no official explanation as to why erroneous claims for refunds based on the earned income credit are not subject to the penalty. After the penalty was enacted, TIGTA stated in a published memorandum that Congress exempted claims based on the EITC from being subject to the Erroneous Refund Penalty because the EITC statute already contains specific penalties for taxpayers who improperly claim the EITC.<sup>133</sup> Taxpayers who improperly claim the earned income credit can be banned from receiving the credit for two years for “reckless or intentional disregard” of the rules and regulations or ten years if the claim is based on fraudulent conduct.<sup>134</sup>

The unofficial explanation of the limitation that the Erroneous Refund Penalty does not apply to claims for a refund based upon the EITC is that Congress wanted to avoid double penalties for taxpayers who improperly

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129. STAFF OF J. COMM. ON TAXATION, 110TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2008 BUDGET PROPOSAL 186 (Comm. Print 2007) [hereinafter, JCT, PRESIDENT’S FISCAL YEAR 2008]; *Semiannual Report to Congress: April 1, 2005 through September 30, 2005*, TREASURY INSPECTOR GEN. FOR TAX ADMIN. 15–16 [https://www.treasury.gov/tigta/semiannual/semiannual\\_dec2005.pdf](https://www.treasury.gov/tigta/semiannual/semiannual_dec2005.pdf) [hereinafter TIGTA, *Semiannual Report to Congress*].

130. The Staff of the Joint Committee explained that proponents of the penalty argue that by increasing the cost to taxpayers who claim erroneous refunds, the overall functioning of the tax system will improve because taxpayers will be deterred from claiming erroneous refunds. *Id.*

131. Compare I.R.C. § 6676(a), with S. 1321.

132. TIGTA, *Semiannual Report to Congress*, *supra* note 129. The two schemes that TIGTA refers to are a prisoner refund scheme (incarcerated taxpayers submitting tax returns claiming incorrect filing status, or false income information, or both, to generate the earned income credit) and a fictitious Schedule C income information (taxpayers falsifying income information to generate the earned income credit). *Id.*

133. TREASURY INSPECTOR GEN. FOR TAX ADMIN., REF. NO. 2013-40-123, THE LAW WHICH PENALIZES ERRONEOUS REFUND AND CREDIT CLAIMS WAS NOT PROPERLY IMPLEMENTED 3 (Sept. 26, 2013), <https://www.treasury.gov/tigta/audit/reports/2013reports/201340123fr.pdf>.

134. I.R.C. § 32(k)(1)(B).

claim the EITC. But in cases of identity theft-based refund fraud where the entire return is falsified, the EITC penalty scheme is completely ineffective. The EITC penalty scheme merely prohibits a taxpayer from claiming the credit in the future as opposed to imposing an actual monetary penalty. Therefore, the limitation in the Erroneous Refund Penalty, while noble in purpose to protect economically vulnerable taxpayers, effectively bars the application of the penalty in cases of identity theft-based refund fraud. To the extent that a perpetrator of identity theft-based tax fraud claims a refund based on refundable credits other than the EITC, the Erroneous Refund Penalty is a potential option for recourse.

4. *None of the Existing Civil Penalties Clearly Apply to Identity Theft-Based Refund Fraud*

None of the existing civil penalties are a perfect fit for identity theft-based refund fraud. As discussed above, a few existing civil penalties can be stretched to encompass some types of identity theft-based fraud, but not without difficulty. None of the civil penalties were enacted with the purpose of addressing the problems of identity theft-based refund fraud. Furthermore, there is no avenue for a regulatory or administrative fix for a civil penalty. The IRS's internal policies and procedures do not provide for application of any existing civil penalties in cases of identity theft.<sup>135</sup> There is not a statutory scheme under which the Treasury Department can create regulations to solve the problems created by identity theft-based refund fraud.

Creation of a civil penalty that directly applies to cases of refund-based identity theft is consistent with the overall development of civil tax penalties. Civil tax penalties have been used to address problems where a criminal penalty alone was insufficient to address problem.

#### IV. LEGISLATIVE PROPOSALS

Lawmakers are responding to the problem of identity theft-based refund fraud with a multi-faceted approach. This approach is apparent in a number of proposed bills before Congress that emphasize the objectives of providing assistance to victims of identity theft, enhancing fraud prevention and detection, and allowing for coordination between the IRS and other law enforcement agencies.<sup>136</sup> This Article supports a holistic approach to address

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135. See generally, e.g., I.R.M. 4.32.2 (discussing policies for applying section 6701 in examination of abusive transactions other than identity theft); I.R.M. 20.1.6 (explaining policies for applying section 6701 in cases of abusive tax return preparers, promoters, and material advisors but not in cases of identity theft).

136. S. 1323, 114th Cong. (2015); S. 676, 113th Cong. (2013); S. 2239, 113th Cong. (2013); H.R. 531, 113th Cong. (2013); S. 3432, 112th Cong. (2012); H.R.

the problem of identity theft-based refund fraud. Because existing criminal tax penalties are insufficient to address the problems of identity theft, this Article argues that more than prevention, detection, and victim assistance is necessary. To that end, this Part sets forth standards for Congress to use as a guide in crafting comprehensive civil and criminal tax penalties for identity theft-based refund fraud. Of the prior proposed and pending legislation, several bills contain penalty provisions proposing criminal penalties and one bill contains a provision to create a new civil penalty.<sup>137</sup> Those penalty provisions are

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3482, 112th Cong. (2011); H.R. 3215, 112th Cong. (2011). The pending and proposed legislation seeks to address the problems of identity theft-based tax fraud by increasing assistance available to victims; enhancing fraud prevention and detection; relaxing tax disclosure laws to allow for coordination between the IRS and local law enforcement; requiring the IRS to study and report to Congress; and enhancing criminal penalties and creating a civil penalty for perpetrators of these fraud schemes.

Increasing assistance available to victims: Senate Bill 676, House Bill 531, Senate Bill 3432, House Bill 3482, and House Bill 3215 all include provisions intended to protect victims of identity theft, such as taxpayers whose identifying information is stolen and fraudulent refunds are filed under their name and social security numbers. These bills propose assisting victims in the following ways: expediting proper tax refunds to the victims, using personal identifying numbers instead of social security numbers, and making the process more victim-friendly. S. 676; H.R. 531; S. 3432; H.R. 3482; H.R. 3215.

Enhancing fraud prevention and detection: Senate Bill 676, House Bill 531, Senate Bill 3432, House Bill 3482, and House Bill 3215 include provisions designed to prevent identity theft, such as safeguarding social security numbers to prevent access to identity-related information. These bills suggest controlling the death master file access (and creating criminal and civil penalties for unauthorized access), and controlling the dissemination of social security numbers on Medicare cards to prevent and detect identity theft. S. 676; H.R. 531; S. 3432; H.R. 3482; H.R. 3215.

Relaxing tax disclosure laws to allow for coordination between the IRS and local law enforcement: Currently section 6103 has strict disclosure rules prohibiting IRS personnel from releasing information. Senate Bill 1323, Senate Bill 2239, House Bill 531, Senate Bill 3432, House Bill 3482, and House Bill 3215 all contain provisions to allow for disclosure of return information to federal and state law enforcement to aid in investigation and prosecuting identity theft crimes, specifically to work with prison officials. S. 1323; S. 2239; H.R. 531; S. 3432; H.R. 3482; H.R. 3215.

Requiring the IRS to study and report to Congress: House Bill 531, Senate Bill 3432, House Bill 3482, and House Bill 3215 all contain provisions that would require Treasury to report to Congress on matters of identity theft and tax fraud, including barriers under the disclosure laws and the effects on dealing with identity theft and tax fraud, and to study specific mechanisms and their effect on identity theft. H.R. 531; S. 3432; H.R. 3482; H.R. 3215.

137. Enhancing criminal penalties and creating a civil penalty for perpetrators of these fraud schemes: Senate Bill 1323, Senate Bill 676, House Bill 531, Senate Bill 3432, House Bill 3482, and House Bill 3215 all contain proposals for



discussed and evaluated in light of the standards set forth below.

A. *Legislative Proposals for Enhanced Criminal Penalties for Identity Theft-Based Refund Fraud*

Enhanced criminal penalties are necessary to combat the problem of identity theft-based refund fraud.

To assist Congress in creating an enhanced criminal penalties regime, this Article sets forth the following standards as a guide: (1) the penalty amount should be greater than the penalty that would be imposed if a taxpayer, himself or herself, engaged in comparable fraudulent conduct; (2) the penalty should be flexible so as to apply to the variety of ways taxpayer-identifying information is obtained and used for tax fraud; (3) the penalty should apply regardless of tax loss; and (4) the penalty should apply per instance of identity theft.

Proposed legislation offers two ways to enhance criminal tax penalties for identity theft-based tax fraud. The first is to amend the existing penalty for fraudulent and false statements to include a specific subsection for using a false identity in connection with tax fraud.<sup>138</sup> This proposal would make it a felony, punishable by a fine of up to \$250,000 or up to five years imprisonment, for any person who “willfully misappropriates another person’s taxpayer identity” for the purpose of making any document, return, or list submitted to the IRS.<sup>139</sup>

The second proposal is to amend the penalty for fraudulent returns or other documents.<sup>140</sup> This proposal would impose a fine of up to \$25,000 or

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penalties. Some of the bills provide for criminal penalties within the Code itself (as opposed to just the general federal criminal code) for identity theft; increased penalties for return preparers who improperly disclose or use return information; additional appropriations to the IRS to use for enforcement specific to tax fraud; and the creation of a local law enforcement liaison within the IRS to coordinate investigations and prosecutions of identity theft-related fraud and other tax fraud. S. 1323; S. 676; H.R. 531; S. 3432; H.R. 3482; H.R. 3215. Senate Bill 1323 is the only piece of legislation to propose a civil penalty to identity thieves. S. 1323 § 3(b)(1).

138. S. 676 § 401; S. 3432 § 2. See *supra* Part III.A and accompanying notes 57–64 for an explanation of the existing penalty for fraudulent and false statements.

139. S. 676 § 401(b); S. 3432 § 2. Senate Bill 676 also proposes amending 18 U.S.C. section 1028A, the general federal statute criminalizing identity theft, to make identity theft-based tax crimes an aggravated offense with a heavier penalty. S. 676 § 401.

140. H.R. 531; H.R. 3482; H.R. 3215. See *supra* Part III.A and accompanying notes 63–64 for an explanation of the existing penalty for fraudulent returns or other documents. The key difference between the penalty for fraudulent returns or other documents under section 7207 and the penalty for fraudulent and false

five years' imprisonment for any person who knowingly or willfully misappropriates another person's tax identity number in connection with submitting any document, list, or return to the IRS.<sup>141</sup> These proposed legislative changes reflect Congressional concern about identity theft and are evaluated in the discussion of the standards below.

1. *The Penalty Imposed Against a Perpetrator of Identity Theft-Based Tax Fraud Should be Greater than the Comparable Penalty Imposed on Taxpayers Submitting False or Fraudulent Returns*

Identity thieves should be subject to criminal penalties that are greater than criminal sanctions imposed on taxpayers or their advisors who commit comparable fraudulent crimes.<sup>142</sup>

Identity theft-based refund fraud is conduct of a more serious dimension than where the actual taxpayer submits a fraudulent return, because the attempt to defraud the government is coupled with the crime of identity theft.<sup>143</sup> Furthermore, the penalty should be greater because detection in identity theft cases is so challenging.<sup>144</sup> The corresponding punishments for identity theft and tax fraud combined should therefore be greater than the punishment for tax fraud alone.<sup>145</sup>

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statements under section 7206 is that the former does not require the document submitted to be signed under penalty of perjury. *See* I.R.C. §§ 7206(1), 7207.

141. H.R. 531; H.R. 3482; H.R. 3215. These proposals also both include amendments to existing law for enhanced penalties for return preparers who engage in identity theft-based fraud.

142. The criminal penalties should be greater for identity theft-based fraud in both the monetary penalty and maximum imprisonment sentence.

143. Federal criminal law recognizes that identity theft adds a more serious layer to general crimes. 18 U.S.C. § 1028A(a) (2012) adds additional punishment for identity theft coupled with any other felony.

144. Where a taxpayer himself attempts to defraud the IRS, the IRS first must determine that the return contains fraudulent information. The taxpayer's name and address are provided to the IRS. With identity thieves, the IRS first must identify the fraudulent claim based on identity theft. Second, the IRS must engage in further investigation to determine and locate the identity thief, usually through tracing the IP address or the bank or prepaid debit card to which the refund is directed. *See* TIGTA, *Tax Refund Direct Deposits*, *supra* note 18.

145. Existing criminal sanctions under the Code for making false or fraudulent statements are a fine of up to \$100,000 and up to three years' imprisonment. I.R.C. § 7206. *See supra* notes 57–60 and accompanying text for a discussion of criminal penalties for fraud and false statements. The lesser, included crime of submitting a fraudulent return or other document carries a penalty up to \$10,000 and up to one year's imprisonment. *See supra* notes 63–64 and accompanying text. The pending legislative proposals satisfy the standard proposed in this Article, by

The pending legislation calls for criminal penalties of either \$25,000 or \$250,000, and up to five years' imprisonment for violations. There is a huge disparity between the two proposals with respect to criminal penalty amounts. It is important for criminal punishment to be commensurate with the crime, which suggests that a higher dollar amount for a penalty should apply in the case of identity theft. As will be explained in Part IV.A.4, if criminal penalties are stacked and applied per instance, a lower dollar amount penalty will be increased with the severity of the identity thief's actions if the thief files more than one fraudulent return.

2. *The Criminal Penalty Should Be Broad Enough to Apply in a Variety of Identity Theft-Based Tax Fraud Contexts*

Because identity theft-based refund fraud can take many forms, the criminal sanctions should be flexible enough to apply regardless of how the stolen identities are obtained and used. The pending legislative proposals accomplish this flexibility by applying the sanction to anyone who intentionally "misappropriates" the taxpayer identification information of another and uses the taxpayer information in making a submission to the IRS.<sup>146</sup>

One penalty proposal suggests amending the penalty for fraudulent and false statements, which without amendment, only applies if the fraudulent and false document was submitted under penalty of perjury.<sup>147</sup> The other proposal is to amend the penalty for fraudulent returns or other documents, which without amendment, does not require the document to be signed under penalty of perjury.<sup>148</sup> This distinction may become an issue if there is a question whether a document submitted by an identity thief is submitted under penalty of perjury. For example, the language of the penalty must be carefully drafted to avoid calling the document submitted by the identity thief a "return," since the IRS does not consider the document to meet the technical definition of a return.<sup>149</sup>

As a general proposition, the broad language about intentional misappropriation of a taxpayer's identification information is suitable to

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amending either criminal offense. The pending legislative proposals will add the sanctions against perpetrators convicted of identity theft-based refund fraud of either \$250,000 or \$25,000 and up to five years' imprisonment. S. 676, 114th Cong. § 401(b) (2015); S. 3432, 112th Cong. § 2(b) (2012); H.R. 531 § 4(c); H.R. 3482 § 4(c); H.R. 3215 § 2(c). *See supra* note 137.

146. *See supra* note 137.

147. *See supra* note 140.

148. *See supra* note 140.

149. *See supra* notes 84–89 and accompanying text for a discussion about what the IRS construes to constitute a "return."

address the fact that identity thieves can obtain taxpayer information in a variety of ways. Careful policy considerations should be given, however, to the question whether criminal penalties ought to apply beyond identity theft-based refund fraud, such as in cases of employment-based identity theft. Extending the penalty to other types of identity theft has potential consequences for immigration law, and analysis is necessary to ensure immigration policy objectives are met.<sup>150</sup> The standard suggested in this Article is that criminal penalties for identity theft in the context of tax administration should be limited. Congress should separate the issues that undocumented workers create for tax administration (who may use stolen or “borrowed” taxpayer information to file otherwise legitimate tax returns) from the problems caused by identity thieves (whose sole intention is to defraud the government by claiming false and fraudulent refunds).

### 3. *The Criminal Penalty Should Apply Regardless of Tax Loss*

As the IRS improves its ability to detect identity theft-based refund fraud, it may well be that the IRS is able to stop the issuance of many fraudulent refunds. That a refund is not issued, however, does not mean a crime has not been committed. A criminal tax sanction should be applicable regardless of whether the government has incurred a tax loss.

As a general rule in criminal law, intent alone is not enough to punish; there must also be a criminal act.<sup>151</sup> In identity theft-based refund fraud, the act is complete when the fraudulent return is submitted. It does not depend on the government issuing the fraudulently claimed refund. But just because the IRS is able to detect that a submitted return is based on identity theft and prevent issuance of the refund does not mean that no harm has occurred. There are costs to the government, the victim, and the entire tax administration system whether a refund is paid or not.<sup>152</sup>

### 4. *The Criminal Penalty Should Apply per Instance of Identity Theft*

Finally, a separate criminal penalty should apply to each fraudulent return based on identity theft. This ensures the penalty increases with the number of identity theft-based refund claims submitted.<sup>153</sup>

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150. *See supra* notes 10–11.

151. *United States v. Apfelbaum*, 445 U.S. 114, 131 (1980) (“In the criminal law, both a culpable *mens rea* and a criminal *actus reus* are generally required for an offense to occur.”).

152. *See supra* notes 37–44 and accompanying text.

153. Other ways to accomplish increasing penalties with the severity of the crime include imposing stepped-up penalties for multiple offenses or aggravated levels

Increasing the criminal penalty proportionately with the number of fraudulent submissions is particularly important in the context of identity theft-based refund fraud because the identity thieves are often part of organized criminal activities where multiple returns using multiple stolen identities are submitted at a time.<sup>154</sup>

The pending proposals suggest the penalty amount be either \$25,000 or \$250,000. As discussed in Part IV.A.1, a lower penalty amount may be appropriate so long as the criminal penalties may be stacked in cases where an identity thieves submit more than one fraudulent return.

*B. Legislative Proposal for a New Civil Penalty for Identity Theft-Based Refund Fraud*

A new civil penalty is also necessary to combat identity theft-based refund fraud.<sup>155</sup> The following are standards that should guide Congress as it crafts a new civil penalty: (1) the civil penalty should be a flat penalty of \$5,000; (2) the civil penalty should apply in a variety of identity theft-based tax fraud contexts; (3) the civil penalty should apply regardless of tax loss; (4) the civil penalty should be assessable per instance; (5) the civil penalty should be immediately assessable; (6) the civil penalty should not be subject to the general statute of limitations on assessments; and finally (7) the IRS should have discretion to reduce the penalty imposed if such a reduction would promote compliance.

Whereas many of the proposed bills before Congress address the need for enhanced criminal penalties for identity theft, only one contains a provision for civil penalties.<sup>156</sup> The pending bill with a provision creating a new civil penalty provides for application of a \$5,000 penalty to “any person who knowingly or willfully misappropriates another person’s tax identification number in connection with any list, return, account, statement, or other

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of identity theft crimes. These options are worse because they require arbitrary determinations of how many returns would constitute an aggravated level of offense. Tying the severity of the punishment to the number of fraudulent submissions an identity thief makes ensures that the punishment is commensurate with the crime.

154. Koskinen Testimony, *Hearing on Improper Payments (2014)*, *supra* note 25, at 1. The IRS is “fac[ing] large-scale schemes perpetrated by organized criminals.”

155. See *supra* note 53–54 and accompanying text for an explanation of IRS policies served by having both criminal and civil penalties apply to the same conduct. See *supra* note 73 and accompanying text for a discussion on why civil penalties are a necessary supplement to criminal penalties for identity theft-based refund fraud.

156. See *supra* note 137. The president’s proposed budgets for fiscal years 2014 and 2015 both contained proposals for a civil penalty. See OMB, BUDGET 2015, *supra* note 6.

document submitted to the [IRS].”<sup>157</sup> This provision is discussed and evaluated by the standards set forth below.

*I. The Civil Penalty Should be a Flat Penalty of \$5,000*

Some existing civil penalties are computed as a percentage based on the underpayment of tax reported or the erroneous refund claimed.<sup>158</sup> That computation has the effect of tying the penalty amount proportionately to the magnitude of the error made by the taxpayer. However, civil penalties that apply to types of intentional conduct similar to identity theft-based refund fraud, such as a taxpayer who makes frivolous submissions or return preparers who understate a taxpayer’s tax willfully or intentionally, are a flat \$5,000.<sup>159</sup>

The civil penalty for identity theft-based refund fraud should also be a flat \$5,000 for three reasons.<sup>160</sup> First, many, if not most, of identity theft-based claims for refund are based on fraudulent claims for refundable credits in relatively low dollar amounts.<sup>161</sup> Basing the penalty on a percentage of the fraudulent refund claimed yields a smaller penalty that will be insufficient as an appropriate deterrent.<sup>162</sup>

Second, civil penalties that are computed as a percentage based on the underpayment connect the penalty amount to the dollar cost to the government of the taxpayer’s wrongdoing. Such a connection between the fraudulent refund claimed and the amount of the penalty is inappropriate in identity theft cases because the cost to the government is not just the cost of enforcement.

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157. S. 1323, 114th Cong. § 3(b)(1) (2015).

158. See I.R.C. §§ 6662, 6663, 6676 (civil accuracy-related, civil fraud, and erroneous refund penalties are 20 percent, 75 percent, and 20 percent of understatement or erroneous refund amount, respectively). With these penalties, the penalty amount increases proportionally with the amount by which the taxpayer does not comply with the law.

159. I.R.C. §§ 6694(b), 6702. A lower penalty amount of \$1,000 per occurrence applies to return preparers whose conduct is merely negligent. I.R.C. § 6694(a)(1). The penalty amount for aiding and abetting an understatement of tax is a flat \$1,000 (or \$10,000, if the person subject to the penalty assisted with a document for a corporation). I.R.C. § 6701(b)(1)–(2).

160. This is the same amount proposed by Senate Bill 1323 and the president’s proposed budget for both 2014 and 2015. See OMB, BUDGET 2015, *supra* note 6.

161. Many, if not most, identity theft claims for refunds are low dollar amounts because they involve claims based on the EITC. See IRS, *Examples of Identity Theft Schemes*, *supra* note 14. For example, if the fraudulent refund claimed is \$2,000, application of a 75 percent penalty will result in a penalty of \$1,500.

162. If the purpose of the civil penalty is to serve as a deterrent to non-complying taxpayers and as a signal to compliant taxpayers, the penalty must be commensurate with the conduct penalized.

The cost to the government and the tax system includes determining that the return was a fraudulent submission based on identity theft and locating the thief. A flat penalty is more appropriate in identity theft cases because the conduct is reprehensible. Identity theft-based refund fraud is more like the intentional conduct of a taxpayer who makes a frivolous submission or a return preparer who intentionally or willfully understates a client's tax liability.

Third, a flat penalty is simple. It requires no additional calculations or resources once the IRS has identified that the return is based on identity theft and has identified the perpetrator of the fraud.

2. *The Civil Penalty Should Apply in a Variety of Identity Theft-Based Tax Fraud Contexts*

Again, similar to the criminal penalty standard proposed,<sup>163</sup> the civil penalty should be flexible enough to apply regardless of how the stolen identities are obtained and used. The pending legislative proposals accomplish this flexibility by applying the sanction to anyone who intentionally "misappropriates" the taxpayer identification information of another and uses the taxpayer information in making a submission to the IRS. As with the discussion about flexibility of application of criminal penalties, the civil penalty language must be carefully crafted to avoid any exclusions or limitations.<sup>164</sup>

As suggested in the proposed standard for enhanced criminal penalties, Congress should carefully craft the policy, limiting the scope, so as not to encompass individuals who use stolen or "borrowed" taxpayer information in attempt to comply with the tax laws. A distinction should be made between the dilemma that undocumented workers face in attempting to comply with the tax law and identity thieves whose sole intention is to defraud the government by submission of a fictitious return making a claim for refund.

3. *The Civil Penalty Should Apply Regardless of Tax Loss*

Similar to the criminal penalty standard proposed, civil tax penalties should apply to perpetrators of identity theft regardless of tax loss.<sup>165</sup>

In the context of civil penalties, there are none of the requirements of both the affirmative act and the requisite mental state that are requisites for applying criminal penalties.<sup>166</sup> Once a perpetrator submits a false return based on identity theft to the IRS, the perpetrator has attempted to defraud the government. Whether the IRS is able to detect and prevent issuance of the

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163. See *supra* Part IV.A.2.

164. See *supra* Part IV. A.2. and notes 86–89 and accompanying text.

165. See *supra* Part IV.A.3.

166. See *supra* note 151 and accompanying text.

refund, the harm is greater than the dollar amount of the fraudulent refund claimed by the perpetrator.

4. *The Civil Penalty Should Be Assessable per Instance*

The civil penalty for identity theft should be assessable on each fraudulent return claiming a refund submitted by an identity thief. Similar to the criminal penalty standard proposed,<sup>167</sup> the application per instance ensures that more serious identity thieves who submit multiple fraudulent claims will be subject to greater penalties.

The return preparer penalty and penalty for aiding and abetting an understatement of tax also are imposed on each return or submission.<sup>168</sup>

5. *The Civil Penalty Should Be Immediately Assessable*

The general rule is that penalties are assessed and collected in the same manner as taxes.<sup>169</sup> This means that, before assessing a penalty, the IRS generally must issue to a taxpayer a notice of the proposed assessment and afford the taxpayer the opportunity to dispute the proposed assessment in U.S. Tax Court.<sup>170</sup> Some penalties, however, provide for immediate assessment without requiring deficiency procedures.<sup>171</sup>

The civil penalty for identity theft-based refund fraud must be immediately assessable against the perpetrator, and deficiency procedures should not apply. Immediate assessment is critical in cases of identity theft-based refund fraud because deficiency procedures consume valuable time and

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167. See Koskinen Testimony, *Hearing on Improper Payments (2014)*, *supra* note 25, at 1. See *supra* Part IV.A.4.

168. I.R.C. § 6694(a)–(b) (penalty with respect to each return); I.R.C. § 6701(b)(3) (providing that person subject to penalty for aiding and abetting only subject to one penalty per taxpayer per period). Cf. I.R.C. § 6651(a) (failure to file and failure to pay penalties ordering rule).

169. I.R.C. § 6671.

170. I.R.C. § 6212 requires the issuance of a statutory notice of deficiency, a notice in which the IRS sets forth the proposed deficiency and notifies the taxpayer of the right to seek a redetermination by the U.S. Tax Court. The IRS cannot assess for ninety days after the issuance of the notice of deficiency. I.R.C. § 6213(a). The IRS can assess after the taxpayer defaults on the notice of deficiency or after the decision of the United States Tax Court has become final. I.R.C. § 6501.

171. Return preparer penalties are not subject to deficiency procedures. I.R.C. § 6696(b). There are numerous other penalties that are immediately assessable. See I.R.C. §§ 6677, 6679, 6682, 6699. Where a penalty is immediately assessable, the general remedy is that the person subject to the penalty must pay the penalty (or a portion thereof) and sue for a refund. I.R.C. § 7422.



resources and are unnecessary.<sup>172</sup> When the IRS detects identity theft-based fraud, further delay is detrimental to the government, especially because tracing and locating the perpetrator of identity theft is very difficult and may take considerable time. To be an effective deterrent and signal to compliant taxpayers, the penalty has to be immediate.<sup>173</sup>

6. *The Civil Penalty Should Not Be Subject to the General Statute of Limitations on Assessments*

The general rule for the statute of limitations on the assessment of tax is three years.<sup>174</sup> The Code provides, however, that for returns that are false or fraudulent with the intent to evade tax there is no statute of limitations.<sup>175</sup> The assessment of a civil penalty for identity theft-based refund fraud should follow the exception and not be limited by the general three-year statute of limitations on assessments because locating identity thieves can be difficult and time consuming.<sup>176</sup>

The general three-year rule depends on the filing of a return, and as discussed above, submission of a falsified return seeking a fraudulent claim for a refund by a perpetrator of identity theft is not a valid return, and the general rule should therefore not apply.<sup>177</sup> Nonetheless, for the sake of clarity, a civil penalty for identity theft-based refund fraud should contain a statutory exception akin to the exception created for returns based on fraud.

7. *The Civil Penalty Should Apply in a variety of Identity Theft-Based Tax Fraud Contexts.*

Again, similar to the criminal penalty standard proposed,<sup>178</sup> the civil penalty should be flexible so as to apply regardless of how the stolen identities

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172. Deficiency procedures serve policies of due process.

173. A possible middle ground between allowing full deficiency procedures and immediate assessment is to provide limited process to dispute the penalty administratively. *See* I.R.C. § 6672(b). Before the IRS can assess a penalty for failure to collect and pay over tax (Trust Fund Recovery Penalty), the IRS must provide written notice to the party against whom the IRS seeks to assess. The notice gives rights to dispute the penalty administratively. *Id.*

174. I.R.C. § 6501(a) provides for a three-year statute of limitations on assessing a tax.

175. I.R.C. § 6501(c)(1). *See* I.R.C. § 6501(c)(2) (providing for no statute of limitations in cases of willful attempts to defeat or evade).

176. *See supra* notes 18, 143.

177. *See supra* note 84. Furthermore, the language of section 6501(a) defines “return” as “the return required to be filed by the taxpayer,” as opposed to information returns submitted by third parties.

178. *See supra* Part IV.A.2.

are obtained and used. The pending legislative proposals accomplish this flexibility by applying the sanction to anyone who intentionally “misappropriates” the taxpayer identification information of another and uses the taxpayer information in making a submission to the IRS. As with the discussion about flexibility of application of criminal penalties, the civil penalty language must be carefully crafted to avoid any exclusions or limitations.<sup>179</sup>

As suggested in the proposed standard for enhanced criminal penalties, Congress should carefully craft the policy, limiting the scope, so as not to encompass individuals who use stolen or “borrowed” taxpayer information in attempts to comply with the tax laws. A distinction should be made between the dilemma that undocumented workers face in attempting to comply with the tax law and identity thieves whose sole intention is to defraud the government by submission of a fictitious return making a claim for refund.

8. *The IRS Should Have Discretion to Reduce the Penalty Imposed if Such a Reduction Would Promote Compliance*

Although the civil penalty should be used generally in cases of identity theft-based refund fraud, the language of the statute should grant the IRS discretion to reduce the penalty if such reduction “would promote compliance with and administration of the Federal tax laws.”<sup>180</sup> If an identity thief agrees to cooperate to uncover a greater scheme or comes forward through some type of voluntary disclosure efforts to curb identity theft, the IRS should have discretion to reduce the penalty.<sup>181</sup> Though it is difficult to think of a case in which a perpetrator of identity theft-based refund fraud should not be subject to a civil penalty, granting the IRS discretion will ensure that the principles of voluntary compliance will be served.

## V. CONCLUSION

This Article addresses the problem of identity theft-based refund fraud and analyzes the inadequacy of existing law to solve the problem. In light of that vacuum, this Article proposes enhanced criminal penalties and a new civil penalty. To assist Congress in crafting such a penalty scheme, this Article

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179. See *supra* note 86–89 and accompanying text.

180. I.R.C. § 6702(d) (language from the penalty for frivolous tax submissions).

181. For example, the IRS uses voluntary disclosure programs to encourage compliance. See IRS, 2012 Offshore Voluntary Disclosure Program, <http://www.irs.gov/uac/2012-Offshore-Voluntary-Disclosure-Program> (last updated Dec. 22, 2014). Likewise, cooperation with the IRS can lead to reduction or elimination of civil accuracy-related penalties in some cases.

identifies standards. There are concerns with the proposal. The proposed standards would add additional complexity in the law<sup>182</sup> and present some administrative challenges.<sup>183</sup> While recognizing that these challenges exist, the concerns do not outweigh the need for Congress to develop a penalty scheme to address the problem. Implementation of these provisions will require a commitment of funds and resources from the IRS at a time when the IRS's budget is in decline.<sup>184</sup> As with other penalties and collection issues, however, investment in collection yields exponential returns.<sup>185</sup> Creation of directly applicable civil penalties and enhanced criminal penalties that specifically address identity thieves will serve important policy objectives, enabling the IRS to vigorously pursue all perpetrators of identity theft and help promote voluntary compliance.

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182. The proposals in this Article will increase the complexity of the Code by virtue of adding additional language or provisions to the Code. The Code increases in complexity every time Congress responds to new schemes developed by taxpayers and their planners, and there are always calls for simplification of the Code. Policy makers should strive for the balance between increased complexity and the need served by the additional laws. In the case of identity theft-based refund fraud, the evils are documented and the consequences to the United States' tax system are severe. *See supra* notes 37–40 and accompanying text.

183. There are also potential difficulties in administering a civil penalty and enhanced criminal penalties, such as difficulty in locating the perpetrator and jurisdictional issues. Locating perpetrators of identity theft can be an expensive and time-consuming process in assessing both criminal and civil penalties. *See supra* notes 18, 144, 176 and accompanying text. Preventing application of the general statute of limitations on assessments, as suggested in the proposed standards, *see supra* notes 65–67 and accompanying text, will allow the IRS to pursue identity thieves to enforce the proposed penalties. Additionally, the proposed pending legislation also addresses this challenge by allowing for disclosures between the IRS and local law enforcement to coordinate efforts. *See supra*, note 136. A related problem is that perpetrators of identity theft-based tax fraud may be non-United States citizens who perpetrate the fraud from outside the United States. Whether the IRS has personal jurisdiction over these individuals is a question of extraterritorial jurisdiction that has not been addressed directly, but it is likely that when a non-resident perpetrator submits a return to the IRS from an international IP address, he is creating contacts sufficient for the United States to exercise jurisdiction. *See* FED. R. CIV. P. 4(k)(2) (establishing personal jurisdiction in cases arising under federal law over a defendant not subject to jurisdiction in the United States if exercise of jurisdiction is consistent with United States law). A more practical problem with international, non-resident, non-citizen perpetrators submitting returns is the likelihood of collecting on the assessments. Challenges in collection from some thieves are not a reason to not have a penalty.

184. Koskinen Testimony, *Hearing on Improper Payments (2014)*, *supra* note 25, at 2; Miller Testimony, *Hearing on Tax Fraud (2014)*, *supra* note 35, at 2.

185. Koskinen Testimony, *Hearing on Improper Payments (2014)*, *supra* note 25, at 1 (“For every dollar that the IRS spends enterprise wide, the return on investment (ROI) is more than \$4.”).