

TOP 15-71

**Tax Information Reported by Taxpayers Using
an Individual Taxpayer Identification Number Is
Vulnerable to Fraud and Abuse**

June 2004

Reference Number: 2004-30-105

TOP 15-71



INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

June 29, 2004

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND
ENFORCEMENT

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Tax Information Reported by Taxpayers
Using an Individual Taxpayer Identification Number Is Vulnerable
to Fraud and Abuse (Audit # 200330018)

This report presents the results of our review to determine if employers submitted Wage and Tax Statement (Form W-2) information to the Social Security Administration (SSA) that matched information on tax returns¹ filed with an Individual Taxpayer Identification Number (ITIN). We previously reported² on and made recommendations to address a growing risk for identity theft,³ perjury,⁴ and fraud⁵ on the part of unauthorized resident aliens⁶ using an ITIN to file their United States (U.S.) Individual Income Tax Return (Form 1040) and attaching one or more Forms W-2 with incorrect Social Security Numbers (SSN). This review supplements the information we reported in the prior audit.

In summary, Federal, social security, state, and local taxes reported as withheld by employers from these individuals may also be vulnerable to fraud and abuse by employers. For example, in Tax Year (TY) 2000, the Internal Revenue Service (IRS)

¹ For the purpose of this report, tax return refers to United States (U.S.) Individual Income Tax Return (Form 1040).

² *The Internal Revenue Service's Individual Taxpayer Identification Number Creates Significant Challenges for Tax Administration* (Reference Number 2004-30-023, dated January 2004).

³ Identity Theft and Assumption Deterrence Act of 1998, Pub. L. No. 105-318, 112 Stat. 3007 (1998).

⁴ 26 U.S.C. § 6065 (2004).

⁵ 26 U.S.C. § 7206 (2004).

⁶ See Appendix IV for an explanation of the term *unauthorized resident alien*.

processed an estimated 309,000 paper Forms 1040⁷ that were filed under an ITIN and had 1 or more Forms W-2 attached with an incorrect SSN. The individuals filing these 309,000 returns reported wages of an estimated \$6.2 billion and received an estimated \$273 million in refunds.⁸ To determine the amount of reported wages and the associated withholdings that are potentially at risk, we used the same statistical sample of 309 individual income tax returns, out of these 309,000 returns, that we analyzed in the prior review. We found that 6.6 percent (34 of 514) of the Forms W-2 attached to these tax returns could not be located on the IRS' Wage Information Retrieval System (WIRS).⁹ Overall, as many as 34,171 Forms W-2 containing an estimated \$332.7 million of wages¹⁰ may be missing from the IRS' WIRS for TY 2000.

We believe that the percentage of missing Forms W-2 is significant¹¹ for tax returns filed with an ITIN as the primary identification number. (b)(7)(E)

(b)(7)(E)

(b)(7)(E)

While IRS officials have taken steps to address some of the challenges presented with the use of the ITIN, they have not fully considered the risks associated with the Forms W-2. When areas are at risk for fraud and abuse, the General Accounting Office's *Standards for Internal Control in the Federal Government*¹³ recommends that agency managers conduct a comprehensive review of the area to determine the nature

⁷ Electronically filed returns were not included in this audit because the original Forms W-2 are not filed with the return.

⁸ The precision for wages is +/- \$511 million and for refunds is +/- \$30 million.

⁹ The WIRS program provides access to copies of Forms W-2. Forms W-2 filed via magnetic media and paper are microfilmed by the SSA and provided to the IRS to use for Federal tax-related purposes.

¹⁰ The precision of the 34,178 Forms W-2 is +/- 14,178. The precision of the \$332.7 million of wages is +/- \$164.5 million.

¹¹ We were unable to compare the rate we identified to a comparable one from general return processing because at the time of our review the IRS had not developed any data on this type of risk.

¹² If the employer did submit the Forms W-2 in a prior year there is a possibility that, as part of the SSA's SSN verification process, both the employee and employer would have been notified of the mismatch. This process could alert the employer of an undocumented worker, and the employer may then not submit Forms W-2 for the undocumented worker in subsequent years.

¹³ *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1).

and extent of the risk. Commonly referred to as a risk assessment, the purpose of the review is to decide how to manage the risk and to determine what actions to take in identifying cost-effective controls.

To reduce the potential for fraud and abuse in the withholding taxes reported by ITIN users, we recommended that the Commissioners, Wage and Investment and Small Business/Self-Employed (SB/SE) Divisions undertake a risk assessment to determine how best to ensure accountability for the tax information reported by ITIN users. We also recommended that if the risk assessment identifies the need for additional cost-effective controls, the necessary controls be implemented accordingly.

Management's Response: Management disagreed with the recommendation to conduct a risk assessment. They stated that the Treasury Inspector General for Tax Administration's (TIGTA) review was limited to a specific group and that their assessment does not support the TIGTA's premise.

However, IRS management agreed that a reevaluation of the efforts to enforce compliance with the employment tax requirements, in general, is needed. Management stated that they are concerned about noncompliance with the reporting, filing, and paying of employment taxes. (b)(7)(E)

and that this is an ongoing concern. To decrease the opportunity for employers to engage in such activities, they have developed initiatives to combat employers that abuse the tax system.

Further, the IRS stated that addressing noncompliance is an operational priority for the SB/SE Division in Fiscal Year 2004. They have emphasized expanding trust fund programs with special attention to taxpayers who are pyramiding their employment tax liabilities. In a related strategy, they are committed to improving the accuracy of SSN reporting. The IRS conducted a compliance check of 78 employers with the highest volume and/or highest percentage of Forms W-2 with mismatched Taxpayer Identification Numbers. The IRS determined that despite the appearance of a high number of errors, the employers had acted with the due diligence required by law.

The IRS stated that the initiatives underway would allow the IRS to target its resources by addressing vulnerabilities in the reporting of employment taxes across all employers. They advised that their experience is that employers generally stop paying withheld taxes for their entire payroll. Thus, the IRS believes that it would be rare for an employer to pick and choose amongst employees when making the willful decision to stop remitting withheld taxes to the IRS. Also, employers are not required to validate names and SSNs provided to them.

Lastly, management stated their research indicated that up to 75 percent of the ITINs issued by the IRS have shown up on tax returns. Based on this research, the IRS has determined that ITIN holders are a highly compliant group of taxpayers.

Office of Audit Comment: We continue to have concerns with the potential tax compliance risk identified by the evidence gathered in our audit. The bases of

management's disagreement are that taxpayers filing a tax return with an ITIN are highly compliant as a group, employers treat all employees the same, and issues in the report are not unique to ITIN holders and their employers. We remain concerned because, at the time of our review, the IRS had not developed any data regarding this specific risk or any data on the risk for the overall population of all returns filed. The IRS' response did not include any details in support of their assessment that we could analyze.

In contrast, other studies support the TIGTA's position. For example, a study by the SSA Office of the Inspector General¹⁴ reported that "SSA suspects that employers in certain high turnover industries . . . may knowingly hire illegal aliens with fraudulent identification . . ." Also, a study by the University of Illinois at Chicago¹⁵ concluded that many employers are aware that employees are undocumented or become aware of the employees' status through the SSA's SSN verification process.

Regarding employers' compliance, the IRS does agree that there are employers who retain withholding taxes instead of remitting all applicable taxes. Our concern is that this position does not recognize the fact that a new risk specific to ITIN taxpayers may be evolving. We are encouraged that the IRS also stated that it is developing strategies to enhance the accuracy of SSN reporting.

While our review was limited to ITIN filers, we believe the data we developed have identified a tax administration risk. When the risks associated with fraud and abuse are identified, agency managers should conduct a risk assessment to determine the significance of this risk. We limited our recommendation to conducting a risk assessment because of the scope of our review and to determine if this risk can be mitigated by cost-effective actions to resolve this potential problem.

The IRS has stated that it plans new strategies that will address employment tax issues, including addressing the accuracy of the SSN. These strategies and actions need to be specifically evaluated to determine if the risk we identified has been addressed.

While we still believe our recommendations are worthwhile, we do not intend to elevate our disagreement concerning them to the Department of the Treasury for resolution.

The TIGTA has designated this report as Limited Official Use (LOU) pursuant to Treasury Directive TD P-71-10, Chapter III, Section 2, "Limited Official Use Information and Other Legends" of the Department of Treasury Security Manual. Because this document has been designated LOU, it may only be made available to those officials who have a need to know the information contained within this report in the performance of their official duties. This report must be safeguarded and protected from

¹⁴ *The Social Security Administration's Earnings Suspense File Tactical Plan and Efforts to Reduce the File's Growth and Size* (SSA: A-03-97-31003, dated February 2000).

¹⁵ *Social Security Administration's No-Match Program: Implications for Immigration Enforcement and Worker's Rights* (University of Illinois at Chicago, dated November 2003).

unauthorized disclosure; therefore, all requests for disclosure of this report must be referred to the Disclosure Unit within the TIGTA's Office of Chief Counsel.

Please contact me at (202) 622-6510 if you have questions or Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs) at (215) 516-2341.

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Background

To efficiently and effectively process tax returns, the Internal Revenue Service (IRS) uses Taxpayer Identification Numbers (TIN). The TIN is a required entry on tax returns to facilitate tax administration needs. For individuals, the required TIN is the Social Security Number (SSN).

The Internal Revenue Code (I.R.C.) provides that any person required to file a return, statement, or other document shall include an identifying number for securing proper identification of that person. The SSN shall be used as the identifying number for such individuals for this purpose, except as otherwise specified under regulations.¹ A United States (U.S.) Individual Income Tax Return (Form 1040) is the primary tax return filed by individuals.

In general, the Social Security Administration (SSA) limits its assignment of SSNs to individuals who are U.S. citizens and alien individuals legally admitted to the U.S. for permanent residence or under other immigration categories authorizing U.S. employment. Consequently, individuals who do not meet these criteria cannot obtain SSNs.

In past years, alien individuals who could not obtain SSNs and who had income that was taxable by the U.S. would file tax returns without identifying numbers. To help these taxpayers comply with the identification requirements of the I.R.C., Treasury Regulations² were issued in 1996 to provide for an IRS Individual Taxpayer Identification Number (ITIN). The purpose of the ITIN was to provide alien individuals, whether or not they reside in the U.S., an identifying number for use in connection with U.S. tax return filing requirements.

Also, the Treasury Regulation provides that the IRS assign the ITINs to resident aliens who cannot obtain an SSN. The ITIN is intended for tax purposes only and creates no inference regarding an alien individual's right to be legally employed in the U.S. and that individual's immigration

¹ 26 U.S.C. § 6109 (2004).

² Treas. Reg. § 301.6109.

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status,³ i.e., the ITIN does not authorize a foreign individual to work or live in the U.S.

At the end of each year, employers send Wage and Tax Statements (Form W-2) to the SSA for each of their employees. The form identifies the employee by name, address, and SSN. It also shows the employee's total wages, wages subject to social security tax, and amount withheld for local, state, and Federal taxes. The SSA uses the Forms W-2 to credit earnings subject to the social security tax to an employee's individual account.

The IRS' processing of Forms W-2 begins with receipt of a microfilm image of the documents from the SSA, which it transfers to its Wage Information Retrieval System (WIRS).⁴ The IRS' Wage and Investment (W&I) Division⁵ and its Small Business/Self-Employed (SB/SE) Division⁶ use the WIRS as a research tool in an effort to provide customer service and ensure the compliance of individual taxpayers and employers.

We performed our review in accordance with *Government Auditing Standards* between March and June 2003 at the SB/SE Division's Headquarters Office in New Carrollton,

³ Treas. Reg. § 301.6109-1. 26 U.S.C. § 7701 (2004) defines a *resident alien* as a resident of the U.S. for any calendar year if that individual was lawfully admitted for permanent residence. A resident alien is also a foreign person in the U.S. who meets the "substantial presence" test, which is based on the number of days that person resides in the U.S.

⁴ The WIRS program provides access to copies of Forms W-2. Forms W-2 filed via magnetic media and paper are microfilmed by the SSA and provided to the IRS to use for Federal tax-related purposes.

⁵ The W&I Division serves about 122 million taxpayers who file a Form 1040 without a Profit or Loss From Business (Sole Proprietorship) (Schedule C); Supplemental Income and Loss (Schedule E); or Profit or Loss From Farming (Schedule F) attached; without an Employee Business Expenses (Form 2106) attached; and without international activity.

⁶ The SB/SE Division serves approximately 45 million taxpayers. These taxpayers include about 33 million full or partially self-employed and 7 million small businesses with assets of less than \$10 million. These taxpayers have some of the most complex issues due to tax law requirements and the number of forms and schedules required.

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Assessing Risks Could Help Reduce Tax Information Vulnerabilities

Maryland, and the WIRS office in Albany, New York. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

We recently reported⁷ and made recommendations to address the growing risk for identity theft,⁸ perjury,⁹ and fraud¹⁰ on the part of unauthorized resident aliens.¹¹ For example, an ITIN holder could file their Form 1040 and attach one or more Forms W-2 with incorrect SSNs.

In Tax Year (TY) 2000, the IRS processed an estimated 309,000 paper Forms 1040 that were filed under an ITIN and had 1 or more Forms W-2^{(b)(7)(E)}

^{(b)(7)(E)}¹² The individuals filing these 309,000 returns reported wages of an estimated \$6.2 billion and received an estimated \$273 million of refunds.¹³

To determine the amount of reported wages and the associated withholding that are potentially at risk, we used the same statistical sample¹⁴ of 309 individual income tax returns, out of these 309,000 returns, that we analyzed in the prior review. We found that 6.6 percent (34 of 514) of the

⁷ *The Internal Revenue Service's Individual Taxpayer Identification Number Creates Significant Challenges for Tax Administration* (Reference Number 2004-30-023, dated January 2004).

⁸ Identity Theft and Assumption Deterrence Act of 1998, Pub. L. No. 105-318, 112 Stat. 3007 (1998).

⁹ 26 U.S.C. § 6065 (2004).

¹⁰ 26 U.S.C. § 7206 (2004).

¹¹ See Appendix IV for an explanation of the term *unauthorized resident alien*.

¹² Electronically filed returns were not included in this audit because the original Forms W-2 are not filed with the return.

¹³ The precision for wages is +/- \$511 million and for refunds is +/- \$30 million.

¹⁴ Audit conclusions about a population of tax returns can be accomplished by examining only a sample of that population. Properly used sampling techniques can provide audit information that is reliable and the results can be accurately projected over the population. For this review, we used a confidence level of 95 percent, a precision of +/- 2.5 percent, and an expected rate of occurrence of not less than 95 percent.

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Forms W-2 attached to these tax returns could not be located on the IRS' WIRS. Overall, as many as 34,171 Forms W-2 containing an estimated \$332.7 million of wages may be missing from the IRS' WIRS for TY 2000.¹⁵

The Federal, social security, state, and local taxes reported as withheld by employers from these individuals may be vulnerable to fraud and abuse by employers. This vulnerability arises because (b)(7)(E)

We believe that the percentage of missing Forms W-2 is significant¹⁶ for tax returns filed with an ITIN as the primary identification number. (b)(7)(E)

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¹⁵ The precision of the 34,178 Forms W-2 is +/- 14,178. The precision of the \$332.7 million of wages is +/- \$164.5 million.

¹⁶ We were unable to compare this rate to a comparable one from general return processing because at the time of our review the IRS had not developed any data on this type of risk.

¹⁷ If the employer did submit the Forms W-2 in a prior year there is a possibility that, as part of the SSA's SSN verification process, both the employee and employer would have been notified of the mismatch. This process could alert the employer of an undocumented worker, and the employer may then not submit Forms W-2 for the undocumented worker in subsequent years.

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(b)(7)(E)

(b)(3), 26 U.S.C. 6103

While IRS officials have taken steps to address some of the challenges presented with the use of the ITINs,¹⁸ they have not fully considered the risks associated with fraudulent Forms W-2. When areas are at risk for fraud and abuse, the General Accounting Office's (GAO) *Standards for Internal Control in the Federal Government* recommends that agency managers conduct a comprehensive review of the area to identify the nature and extent of the risks. Commonly referred to as a risk assessment, the purpose of the review is to decide how to manage the risk and to determine what actions to take in identifying cost-effective controls. To assist agency managers in undertaking such assessments, the GAO has developed various tools¹⁹ that provide a framework for evaluating and establishing controls over areas that can be exploited by unscrupulous individuals.

¹⁸ For example, officials chartered an ITIN Task Force, accepted most of its recommendations, and established an ITIN Project Office that is implementing the accepted recommendations. In addition, the IRS established an ITIN position in the National Taxpayer Advocate Service and is initiating procedures to assist taxpayers who might have been victims of identity theft.

¹⁹ *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1).

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Recommendations

To reduce the potential for fraud and abuse in the submission of Forms W-2 by employers and ITIN users, we recommend that the Commissioners, W&I and SB/SE Divisions:

1. Undertake a risk assessment to determine how best to ensure accountability for the tax information reported by ITIN users.
2. Ensure that if the risk assessment identifies the need for additional cost-effective controls, they be implemented accordingly.

Management's Response: Management disagreed with the recommendation to conduct a risk assessment. They stated that the Treasury Inspector General for Tax Administration's (TIGTA) review was limited to a specific group and their assessment does not support the TIGTA's premise. However, IRS management agreed that a reevaluation of efforts to enforce compliance with the employment tax requirements, in general, is needed.

Also, management stated that they are concerned about noncompliance with the reporting, filing, and paying of employment taxes. (b)(7)(E)

and that this is an ongoing concern. To decrease the opportunity for employers to engage in such activities, they have developed initiatives to combat employers that abuse the tax system.

Further, the IRS stated that addressing noncompliance is an operational priority for the SB/SE Division in Fiscal Year 2004. They have emphasized expanding trust fund programs with special attention to taxpayers who are pyramiding their employment tax liabilities. In a related strategy, they are committed to improving the accuracy of SSN reporting. The IRS conducted a compliance check of 78 employers with the highest volume and/or highest percentage of Forms W-2 with mismatched TINs. They determined that despite the appearance of a high number of

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errors, the employers had acted with the due diligence required by law.

The IRS stated that the initiatives underway would allow the IRS to target its resources by addressing vulnerabilities in the reporting of employment taxes across all employers. They advised that their experience is that employers generally stop paying withheld taxes for their entire payroll. Thus, the IRS believes that it would be rare for an employer to pick and choose amongst employees when making the willful decision to stop remitting withheld taxes to the IRS. Also, employers are not required to validate names and SSNs provided to them.

Lastly, management stated their research indicated that up to 75 percent of the ITINs issued by the IRS have shown up on tax returns. Based on this research, the IRS has determined that ITIN holders are a highly compliant group of taxpayers.

Office of Audit Comment: We continue to have concerns with the potential tax compliance risk identified by the evidence gathered in our audit. The bases of management's disagreement are that taxpayers filing a tax return with an ITIN are highly compliant as a group, employers treat all employees the same, and issues in the report are not unique to ITIN holders and their employers. We remain concerned because, at the time of our review, the IRS had not developed any data regarding this specific risk or any data on this risk for the overall population of all returns filed. The IRS' response to this report did not include any details in support of their assessment that we could analyze.

In contrast, other studies support the TIGTA position. For example, a study by the SSA Office of the Inspector General reported that "SSA suspects that employers in certain high turnover industries . . . may knowingly hire illegal aliens with fraudulent identification . . ." ²⁰ Also, a study by the University of Illinois at Chicago concluded that many

²⁰ *The Social Security Administration's Earnings Suspense File Tactical Plan and Efforts to Reduce the File's Growth and Size* (SSA: A-03-97-31003, dated February 2000).

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employers are aware that employees are undocumented or become aware of the employees' status through the SSA's SSN verification process.²¹

Regarding employers' compliance, the IRS does agree that there are employers who retain withholding taxes instead of remitting all applicable taxes. Our concern is that this position does not recognize the fact that a new risk specific to ITIN taxpayers may be evolving. We are encouraged that the IRS also stated that it is developing strategies to enhance the accuracy of SSN reporting.

While our review was limited to ITIN filers, we believe the data we developed have identified a tax administration risk. When the risks associated with fraud and abuse are identified, agency managers should conduct a risk assessment to determine the significance of this risk. We limited our recommendation to conducting a risk assessment because of the scope of our review and to determine if this risk can be mitigated by cost-effective actions to resolve this potential problem.

The IRS has stated that it plans new strategies that will address employment tax issues including addressing the accuracy of the SSN. These strategies and actions need to be specifically evaluated to determine if the risk we identified has been addressed.

²¹ *Social Security Administration's No-Match Program: Implications for Immigration Enforcement and Worker's Rights* (University of Illinois at Chicago, dated November 2003).

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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine if employers submitted Wage and Tax Statement (Form W-2) information to the Social Security Administration (SSA) that matched information on tax returns filed with an Individual Taxpayer Identification Number (ITIN). We initiated this review based on information identified during another Treasury Inspector General for Tax Administration review.¹

To accomplish our objective, we compared information from Forms W-2, associated with selected tax returns, to information in the Internal Revenue Service (IRS) Wage Information Reporting System (WIRS).²

1. The tax returns were selected through the following process:
 - A) Obtained a statistically valid sample of United Status Individual Income Tax Returns (Form 1040) for Tax Year (TY) 2000.
 - 1) Identified from the Returns Transaction File³ Forms 1040 meeting our criteria: filed for TY 2000, identified by an ITIN as the primary identification number, and filed by a resident alien.
 - 2) Selected from the universe of 353,373 (rounded to 309,000 paper returns and 44,000 electronic returns)⁴ tax returns, a statistically valid sample of 353 tax returns (309 paper and 44 electronic) for review using a confidence level of 95 percent, a precision of +/- 2.5 percent, and an expected rate of occurrence of not less than 95 percent.
 - B) Obtained guidance on the validity of the sampling plan from the IRS' Office of Statistics of Income.

¹ *The Internal Revenue Service's Individual Taxpayer Identification Number Creates Significant Challenges for Tax Administration* (Reference Number 2004-30-023, dated January 2004).

² The WIRS program provides access to copies of Forms W-2. Forms W-2 filed via magnetic media and paper are microfilmed by the SSA and provided to the IRS to use for Federal tax-related purposes.

³ The Returns Transaction File contains all edited, transcribed, and error corrected data from the Form 1040 series returns and related forms for the current processing year and 2 prior years.

⁴ Electronically filed returns were not included in this audit because the original Forms W-2 are not filed with the return.

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- C) Obtained (for the sampled returns) the original Forms 1040 and records from the IRS' Master File⁵ and the Integrated Data Retrieval System.⁶
2. Requested that the IRS use the WIRS to research each Social Security Number (SSN) filed with the Forms W-2 from tax returns and provide us with the results of their research. For any information not found for an SSN, we requested the IRS to use the WIRS to research for the corresponding ITIN that was used on the tax return.
 3. Analyzed the results of the WIRS research, conducted an on-site visitation to discuss the results with the manager of the WIRS function, and reviewed the procedures used to assure that in-depth research was performed for each SSN/ITIN.
 4. Discussed the results of our analysis with IRS' Small Business/Self-Employed Division to determine possible causes for why the information on the Form W-2, filed with the tax return, is not included in the WIRS.

⁵ The IRS' database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organization data.

⁶ IRS computer system capable of retrieving or updating stored information; it works in conjunction with taxpayer account records.

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Appendix II

Major Contributors to This Report

Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)
Frank Dunleavy, Audit Manager
Edmond Watt, Audit Manager
Richard Turner, Senior Auditor
Marcus Sloan, Auditor

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner - Attn: Chief of Staff C
Commissioner, Large and Mid-Size Business Division SE:LM
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Wage and Investment Division SE:W
Chief, Criminal Investigation CI
Director, Communications and Liaison, Small Business/Self-Employed Division SE:S:MS:CL
Director, Compliance, Small Business/Self-Employed Division SE:C
Director, Taxpayer Education and Communication, Small Business/Self-Employed Division
SE:S:T
Chief Counsel CC
National Taxpayer Advocate TA
Deputy Chief Financial Officer, Department of the Treasury
Audit Liaison:
 Commissioner, Small Business/Self-Employed Division SE:S

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Appendix IV

Explanation of the Term Unauthorized Resident Alien

This audit report uses the term *unauthorized resident alien* based on the evidence we found during this and a prior analysis of the Internal Revenue Service (IRS) Individual Taxpayer Identification Number (ITIN) process. Our conclusion is that, generally, the individuals who file a United States (U.S.) Individual Income Tax Return (Form 1040) with an ITIN as the identification number and receive wages that are identified with a Social Security Number (SSN) on the attached Wage and Tax Statement (Form W-2) are unauthorized resident aliens. This conclusion is based on the following evidence and assumptions.

Foreign individuals who received ITINs were residing in the U.S. without apparent authorization by the U.S. Department of Homeland Security

The Treasury Regulation providing for the ITIN states that, "Any individual who is not eligible to obtain a social security number and is required to furnish a taxpayer identifying number must apply for an IRS individual taxpayer identification number on Form W-7, Application for IRS Individual Taxpayer Identification Number . . ." The Form W-7 states, "Do not submit this form if you have, or are eligible to obtain, a U.S. social security number (SSN)." The Form W-7 requires the applicant to provide identity information and support his or her claim of foreign status, i.e., with passport or visa information.

During our prior audits of the ITIN process,² we identified Forms W-7 that were approved by the IRS and showed applicants provided U.S. addresses and claimed to be U.S. resident aliens filing U.S. tax returns. These Forms W-7 did not have passport information or U.S. visa information. The absence of this information indicates the applicant may not have gained lawful entry into the U.S. In fact, Forms W-7 had statements such as, ". . . NO LEGAL STATUS WITH INS"³ and "Entered without a visa" for an indefinite stay in the U.S.

¹ Treas. Reg. § 301.6109. All references to "Treasury Regulation" in this appendix mean Treas. Reg. § 301.6109.

² *The Internal Revenue Service's Individual Taxpayer Identification Number Program Was Not Implemented in Accordance with Internal Revenue Code Regulations* (Reference Number 094505, dated September 1999), and *The Internal Revenue Service's Individual Taxpayer Identification Number Creates Significant Challenges for Tax Administration* (Reference Number 2004-30-023, dated January 2004).

³ The Department of Homeland Security assumed the Immigration and Naturalization Service's responsibilities in 2003. Its U.S. Immigration and Customs Enforcement function is responsible for law enforcement. Its U.S. Citizenship and Immigration Services is responsible for customer service.

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In a related opinion,⁴ the former IRS' Office of the Assistant Commissioner (International) stated, "the Form W-7 is to be used only by individuals who are not eligible to obtain an SSN, and that citizens of the United States thus will not file a Form W-7." The IRS' Office of Chief Counsel determined that, "the group of persons with United States federal tax obligations who are not eligible to obtain an SSN is limited to non-citizens who either do not reside in the United States or who reside here illegally."

The Department of Homeland Security (DHS) is responsible for citizenship, asylum, lawful permanent residency, employment authorization, refugee status, intercountry adoptions, replacement immigration documents, family and employment related immigration, and foreign student authorization. Foreign individuals who received ITINs and declared themselves as residing in the U.S. were apparently not authorized by the DHS to reside in the U.S.

Forms 1040 were filed by resident aliens

The Internal Revenue Code provides that an alien individual shall be treated for tax purposes as a resident of the U.S. with respect to any calendar year if such individual is a lawful permanent resident of the U.S. at any time during that calendar year, meets the substantial presence test, or makes a first-year election.⁵ An individual is a nonresident alien if that individual is neither a citizen of the U.S. nor a resident of the U.S.

An individual who does not reside in the U.S., but who must report income, is required to file a U.S. Nonresident Alien Income Tax Return (Form 1040NR). A resident alien individual is required to file a Form 1040. All of the individuals included in our review filed Forms 1040 identified by ITINs. By filing Forms 1040 with an ITIN, these individuals are declaring themselves as resident aliens rather than nonresident aliens.

Resident aliens were employed

The ITIN is intended for tax purposes only and creates no inference regarding an alien individual's right to be legally employed in the U.S.; i.e., the ITIN does not authorize a foreign individual to work in the U.S. We estimate that \$7.2 billion⁶ was claimed in wages and salaries in Tax Year (TY) 2000 on Forms 1040 identified by an ITIN. In TY 2001, this amount increased to \$10.2 billion. The claimed wages and salaries indicated that these resident aliens were employed.

⁴ Memorandum for Chief Operations Officer, re: *Draft Internal Audit Report – Review of the Individual Taxpayer Identification Number (ITIN) Program*, Internal Audit Project # 960084 (May 27, 1999). This opinion was limited to issues involving individuals under the Privacy Act of 1974, 5 U.S.C. § 552a (2000).

⁵ 26 U.S.C § 7701 (2003). The "substantial presence" test is based on the number of days that an individual resided in the U.S. The "first-year election" is an option for aliens meeting certain criteria to be treated as a U.S. resident.

⁶ The margin of error is +/- \$474,000,000.

Tax Information Reported by Taxpayers Using an Individual Taxpayer Identification Number Is Vulnerable to Fraud and Abuse

Resident aliens provided Social Security Numbers to their employers to obtain employment

The ITIN is not valid for work purposes. Employers are responsible for obtaining from new hires their names and SSNs from their Social Security cards. Employers are also responsible for preparing Forms W-2 and submitting them to the Social Security Administration (SSA). We estimate that the 309,000⁷ TY 2000 Forms 1040 that resident aliens filed on paper had 354,000 SSNs on the attached Forms W-2s, indicating that the resident aliens provided to their employers Social Security cards or SSNs for the purpose of obtaining employment.

Resident aliens would not have been able to obtain Social Security cards valid for employment in the United States

The SSA issues three types of Social Security cards. The SSA issues Social Security cards to U.S. citizens or individuals lawfully admitted to the U.S. with permanent work authorization obtained from the DHS. The second type of card has the legend, "Not Valid for Employment." The SSA issues this type of card to individuals from other countries lawfully admitted to the U.S. without work authorization from the DHS and who need a number because of a Federal Government law requiring an SSN to get a benefit or service. The third type of card bears the legend, "Valid for Work only with [DHS] Authorization." The SSA issues these cards to individuals who are lawfully admitted to the U.S. on a temporary basis and with DHS authorization to work. We concluded that the SSA should not issue a Social Security card (and therefore an SSN) to an individual who is not authorized by the DHS for admission into the U.S.

The Treasury Regulation states that, "Any individual who is duly assigned a social security number or who is entitled to a social security number will not be issued an IRS individual taxpayer identification number." Since the IRS assigns ITINs to resident aliens, we concluded that these resident aliens were not entitled to an SSN as assigned by the SSA when they applied for an ITIN. We also concluded that if resident aliens were authorized by the DHS to reside in the U.S., and if that authorization permitted those individuals to work in the U.S., then those individuals would be eligible for a Social Security card valid for working purposes, and the IRS would not have assigned an ITIN.

Resident aliens obtained employment using false Social Security Numbers

The Social Security law states that, "whoever...with intent to deceive, falsely represents a number to be the social security account number assigned by the Commissioner of Social Security to him or to another person, when in fact such number is not the social security account number assigned by the Commissioner of Social Security to him or to such other person . . . shall be guilty of a felony" We estimate that all of the 354,000 SSNs⁸ on Forms W-2 submitted

⁷ The margin of error is +/- 12,385 tax returns.

⁸ The margin of error is +/- 21,348 SSNs.

Tax Information Reported by Taxpayers Using an Individual Taxpayer Identification Number is Vulnerable to Fraud and Abuse

by resident aliens on the 309,000 TY 2000 paper filed Forms 1040 with an ITIN were assigned by the SSA to an individual other than the filer (265,000)⁹ or not assigned by the SSA (89,000).

Furthermore, a joint publication by the IRS and the SSA addresses the use of SSNs by individuals with ITINs. The publication summarized an employer's responsibilities for withholding and reporting of employment taxes on wages paid to "illegal aliens." Under the title "Illegal Use of Social Security Numbers (SSN)," the publication states that, "Since ITINs are for tax purposes only and are by no means a legal identification number for employment, individuals are utilizing erroneous or stolen SSNs when applying for employment."¹⁰

⁹ The margin of error is +/- 17,732 SSNs.

¹⁰ *SSA/IRS Reporter, A Newsletter for Employers, Summer 2003.*

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Appendix V

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

RECEIVED
JUN 01 2004

June 1, 2004

MEMORANDUM FOR ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: 
Mark E. Matthews
Deputy Commissioner for Services and Enforcement

SUBJECT: Draft Audit Report – Tax Information Reported by Taxpayers Using an Individual Taxpayer Identification Number Is Vulnerable to Fraud and Abuse (Audit # 200330018)

Thank you for the opportunity to respond to the captioned draft audit report. Your report identifies systemic weaknesses associated with employers' withholding of tax on employees' wages but focuses on workers with Individual Taxpayer Identification Numbers (ITINs). You identify this specific group as being more vulnerable to such abuse by unscrupulous employers, while providing no evidence that this is more likely the case with regard to ITIN holders as compared to employees working under valid Social Security Numbers (SSNs). The draft audit report's recommendations are based on the premise that ITIN workers are more likely to be abused by employers. Our assessment does not support such a premise. While we cannot agree, under these circumstances, to the risk assessment you recommend, we do agree that the Service needs to reevaluate its efforts to enforce compliance with the employment tax requirements generally.

The Internal Revenue Service created the ITIN in 1996 to facilitate the administration of revenue laws to individuals ineligible to receive an SSN, which most individual taxpayers utilize as their Taxpayer Identification Number. Since the inception of the program, we have issued over 7.7 million ITINs. The use of the number enables the Service to identify and track the reporting and payment of tax obligations by, and the entitlement to refund or other payments to, individuals who otherwise lack Taxpayer Identification Numbers.

Noncompliance with the reporting, filing, and paying of employment taxes is a concern of the IRS. We agree that there are employers who retain withholding taxes instead of remitting them to the Government, and this is an ongoing concern. To decrease the

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opportunity for employers to engage in such activities, we have developed initiatives to combat employers that abuse the tax system.

Addressing employment tax noncompliance is an operational priority for the Small Business/Self-Employed Division in FY 2004. We have emphasized expanding trust fund programs with special attention to taxpayers who are pyramiding their employment tax liabilities, and we are implementing related strategies that address this and other issues concerning employment tax noncompliance.

A related strategy is our commitment to improving the accuracy of SSN reporting. We have worked with the Social Security Administration to explore options and initiatives that might improve accuracy of SSNs provided to the Service by employers. For example, the IRS conducted compliance checks on 78 employers with the highest volume and/or highest percentage of W-2s with mismatched Taxpayer Identification Numbers. Despite the appearance of a high number of errors, we found that the employers acted with the due diligence required by law. In addition, there is currently a team reviewing the withholding of taxes by employers. The results of these initiatives, along with the operational data they generate, will be used to formulate the Service's employment tax strategy and priorities for FY 2005 and beyond.

The initiatives underway will allow the Service to target its resources to addressing vulnerabilities in the reporting of employment taxes across all employers. This point is especially relevant given the thrust of your draft audit report. The crux of the justification for your recommendation rests upon the assumption that employers will be able to specifically identify ITIN holders and single them out for exploitation. Our experience is that employers generally stop paying withheld taxes for their entire payroll. Thus, we believe that it would be rare for an employer to pick and choose amongst its employees when making the willful decision to stop remitting withheld taxes to the Service. Furthermore, for tax purposes, employers only obtain names and SSNs of their employees, and are not required to validate the names and SSNs provided to them. Without any specific details of how employers are able to identify which of their employees are ITIN holders, as opposed to those who hold a valid SSN, we cannot agree with your assumption.

You recommend that the Service perform a risk assessment to determine the best means to ensure accountability for the tax information reported by ITIN users. As we noted in our response to a prior audit prepared by your office, which also concerned ITINs, our research has indicated that up to 75% of the ITINs issued by the Service have shown up on tax returns. Based on this research, we have determined that ITIN holders are a highly compliant group of taxpayers. We have no reason to believe that ITIN taxpayers as a group are more likely to manufacture false Forms W-2 in an attempt to procure larger refunds. In addition, the estimated figures for Forms W-2 and wages missing from the Wage Information Reporting System are only a measure of data that is not in IRS' wage reporting system, not necessarily a valid measure of the accuracy of the wages and withholding reported on the individual income tax returns.

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In addition, (b)(3), 26 U.S.C. 6103

While we acknowledge that the ITIN is subject to misuse under these and similar circumstances, we note that the ITIN itself is neither more nor less vulnerable to such misuse than the SSN. That is, manufactured false Forms W-2 are just as likely to show a Social Security Number as an ITIN, if not more so due to the relatively small universe of ITINs.

Finally, employees are not penalized when their employer fails to remit withheld taxes to the Service. That is, the employee is permitted to claim the withholding on their individual income tax return. If a refund is due, IRS is legally required to refund the money regardless of the fact that the employer is noncompliant.

In sum, the issues you have identified in the draft audit report are systemic issues with the reporting of employment taxes and the use of manufactured Forms W-2 in attempts to procure larger refunds. None of these issues is ITIN-specific, and none is more prevalent due to an inherent characteristic of the ITIN. We are addressing the systemic issues through the initiatives described above. We look forward to the audit results and recommendations from your review of In-Business Trust Fund accounts (Audit # 200430019) to assess other actions that can be taken to address employment tax non-compliance.

An itemized response to the specific recommendations made in the draft audit report is attached.

If you have any questions concerning this matter, please contact me, or have a member of your staff contact Jerry Heschel, Director, ITIN Program, at (404) 338-9004.

Attachment

**Tax Information Reported by Taxpayers Using an Individual Taxpayer Identification
Number Is Vulnerable to Fraud and Abuse**

ATTACHMENT

Draft Audit Report – Tax Information Reported by Taxpayers Using an Individual
Taxpayer Identification Number Is Vulnerable to Fraud and Abuse (Audit # 200330018)

RECOMMENDATION 1

Undertake a risk assessment to determine how best to ensure accountability for the tax
information reported by ITIN users.

CORRECTIVE ACTION

This recommendation is based on the premise that ITIN workers are more likely to be
abused by employers. Our assessment does not support such a premise. Thus, we
cannot agree, under these circumstances, to your recommendation,

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 2

Ensure that if the risk assessment identifies the need for additional cost-effective
controls, they be implemented accordingly.

CORRECTIVE ACTION

Because we do not agree to recommendation 1, we also do not agree with this
recommendation.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A