

**A Corporate Strategy Is Key to Addressing the
Growing Challenge of Identity Theft**

July 2005

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

July 22, 2005

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND
ENFORCEMENT

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT Final Audit Report - A Corporate Strategy Is Key to
Addressing the Growing Challenge of Identity Theft
(Audit # 200440043)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) has an effective process to educate and assist taxpayers that are victims of identity theft.

Identity theft is one of the fastest growing crimes in the United States (U.S.). It occurs when someone uses another individual's personal information, such as his or her name, Social Security Number (SSN), credit card number, or other identifying information, without permission, to commit fraud or other crimes. People whose identities have been stolen can spend months or years and considerable money repairing the harm identity thieves have done to their good names and credit records. The reports of fraudulent tax returns as a percentage of the type of fraud committed by identity thieves almost doubled from Calendar Years 2002 (1.9 percent) to 2003 (3.7 percent).¹

There are two primary types of identity theft that relate to tax administration. The first type involves an individual using another person's identity (name and SSN) to file a fraudulent tax return to steal a tax refund. The second type involves using another person's identity (name, SSN, or both) to obtain employment. This frequently involves undocumented workers.²

¹ Information reported on the Federal Trade Commission web site at consumer.gov/idtheft/.

² For purposes of this report, the term undocumented workers includes (1) workers that legally reside in the U.S. but do not have authorization to work in the U.S. and (2) workers that reside in the U.S. without authorization to either work or reside in the U.S.

The IRS recognizes the growing challenge of identity theft and its effect on tax administration. Existing processes and functions already deal with aspects of identity theft. For example, the IRS conducts routine verifications when processing tax returns and conducting compliance checks that may identify instances of potential identity theft. In addition, depending on the specifics of a potential identity theft issue, the tax return/case may be forwarded to various IRS functions for additional actions. Furthermore, the IRS has recently designated a senior executive to head an Identity Theft Task Force, a key goal of which is to develop an Enterprise Identity Theft Strategy. During the course of this review, we discussed various concerns with IRS management. In response, the IRS has begun to address some of these concerns as part of its Identity Theft Task Force.

However, the IRS currently has no corporate strategy to address identity theft issues. It does not have a consistent process to educate and assist taxpayers and does not always take additional actions to deal with the individuals that have used another's name and/or SSN to file fraudulent tax returns or obtain employment. In addition, the IRS does not have comprehensive or centralized data on identity theft and as a result is unable to determine the effect identity theft has on tax administration. Until the IRS develops an agency-wide strategy, it will be unable to help taxpayers and the Federal Government combat the growing threat of identity theft and assist criminal law enforcement's efforts to prosecute offenders.

We recognize that identity theft presents significant challenges to Federal and State Governments. We understand the unique and significant challenges the IRS faces when dealing with issues of identity theft and tax administration. To meet these challenges and balance customer service with enforcement, we recommended the Deputy Commissioner for Services and Enforcement (1) ensure agency-wide communication tools are updated to include information about identity theft, (2) ensure information provided by the IRS to taxpayers or for use by other Federal Government agencies when referring individuals to the IRS is complete and accurate, (3) develop agency-wide standards to ensure consistency when requiring taxpayers to substantiate claims and when allowing taxpayers future exemptions and credits, (4) develop specific closing codes for cases involving identity theft, and (5) develop an Enterprise Identity Theft Strategy that includes processes to proactively identify instances of identity theft and to resolve identification number discrepancies, while protecting tax revenue and enforcing the law.

Management's Response: The IRS agreed with our recommendations and has developed an Enterprise Identity Theft Strategy. A primary component of this Strategy is outreach, and the IRS has made substantial progress in developing communication vehicles and making them available to the public. Specifically, the IRS has established a web site on IRS.gov and provided updated information and contacts to the Federal Trade Commission. It has also updated correspondence used to communicate with identity theft victims, finalized a plan to update major publications, and updated correspondence used to provide information to taxpayers who have duplicate returns.

The IRS has established the Multi-Agency Identity Theft Working Group and initiated a multiagency panel discussion with representatives from the Social Security Administration and the Department of the Treasury. A key feature of its Victim Assistance Strategy is to develop consistency among processes to ensure taxpayers receive equitable treatment. The IRS has modernized its process to dramatically reduce the time needed to resolve cases, thus reducing the need to suspend refunds or credits while cases are being resolved.

The IRS developed standards for documentation to be used to validate the identity of the taxpayer, the taxpayer's address, and the fact of the theft in cases of identity theft. The documentation required by the IRS is consistent with that required by the Federal Trade Commission and the Social Security Administration.

The IRS has refined its closing codes to include identity theft. The Identity Theft Program Office will accumulate these data from the IRS and other sources, such as the Federal Trade Commission, to determine trends. These trends will be used to develop or enhance outreach activities and communication vehicles and to focus resources on enforcement initiatives.

Prevention is the final part of the IRS Enterprise Identity Theft Strategy. The Strategy outlines several options for initiatives targeted at preventing or deterring identity theft. These activities will be monitored and coordinated through the Identity Theft Program Office.

The IRS did not agree with the amount of the first outcome measure (a potential \$8.5 million in inefficient use of resources), stating it should be revised from \$8.5 million to \$676,000 because the IRS believes we made an incorrect assumption. The IRS also did not agree with the second outcome measure (a potential \$9 billion in increased revenue over 5 years), stating it was based on a recommendation in the report to expand a current IRS tax withholding compliance program. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment: We disagree with the IRS' assertion that the outcome measure should be revised from \$8.5 million to \$676,000. In addition, we did not recommend the IRS expand a current tax withholding compliance project; therefore, the second outcome measure is not directly related to the IRS' current tax withholding compliance program.

Outcome Measure One: Management stated that, in five of eight cases we reviewed, the IRS Individual Taxpayer Identification Number (ITIN) on the tax return was also used as the Taxpayer Identification Number (TIN) on the associated Wage and Tax Statement (Form W-2). We agree that for the five cases there was a match between the ITIN used on the tax return and the TIN used on the Form W-2 and, in the situation where an ITIN was used on both the tax return and the Form W-2, no identity theft victim would result. However, for the remaining three cases, the ITINs on the tax returns did not match the TINs on the associated Forms W-2. For these three cases, the associated Forms W-2 contained SSNs.

The figures supporting our outcome measure did not include situations relating to the five cases. The figures included in our report involved only those occurrences in which an ITIN was used to file a tax return that claimed wages and no corresponding Form W-2 was located with this ITIN. Therefore, the assumption is wages were earned and reported under another TIN. If the characteristics relative to the underreporting meet the Automated Underreporter (AUR) Program criteria, these cases could be selected and ultimately closed as identity theft. This would result in the inefficient use of resources. The IRS has the ability to proactively eliminate these cases from AUR Program inventory if it captured this information. Taking this action would be in line with its Enterprise Identity Theft Strategy of balancing service with enforcement by focusing on victim assistance, outreach, and prevention.

Outcome Measure Two: Although our outcome measure is calculated using the same withholding rate used in the IRS' tax withholding compliance program, in neither our report nor discussions with management did we recommend the IRS expand its current tax withholding compliance project [W-4 withholding compliance program]. As our report states, we believe Form W-2 mismatches provide yet another data source for the IRS to analyze and begin to measure the impact that identity theft has on tax administration. The mismatch file could be used by the IRS to develop compliance initiatives to address the identification number mismatches and to protect any tax revenue associated. We recognize that working these cases on a case-by-case basis is probably not cost effective. However, analyzing the data to develop initiatives may result in both resolving the mismatches and protecting tax revenue.

Further, management indicates that the recommendation focuses limited compliance resources on a low-income population and that the outcome measure calculates tax withholding, not tax liability. Management indicated it is likely that the \$9 billion withheld on low-income taxpayers would be refunded. We have recognized (as footnoted in Appendix IV) that individuals' actual tax liabilities could be different once they file tax returns. The actual tax liabilities could be more or less than the amounts withheld based on the exemptions, credits, and deductions the individuals claim on their tax returns. However, until the individuals file tax returns, the actual tax liabilities are unknown to us as well as to the IRS.

We continue to recommend the IRS Enterprise Identity Theft Strategy include processes to begin to resolve the identification number discrepancies that totaled 7.9 million for Forms W-2 in Tax Year 2002. The IRS does not currently have a program that attempts to resolve the 7.9 million identification number mismatches or enforce tax laws relating to withholding and filing issues.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

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A Corporate Strategy Is Key to Addressing the Growing Challenge of Identity Theft

Background

The Social Security Administration (SSA) and law enforcement officials cite identity theft as one of the fastest growing crimes in the United States (U.S.). The 1990s spawned a new variety of criminal called identity thieves. Identity theft occurs when someone uses another individual's personal information, such as his or her name, Social Security Number (SSN), credit card number, or other identifying information, without permission, to commit fraud or other crimes. Once identity thieves have an individual's personal information, they can open new credit card accounts. They can also file a fraudulent tax return to obtain an illegal tax credit or refund.

People whose identities have been stolen can spend months or years and considerable money repairing the harm identity thieves have done to their good names and credit records. In the meantime, victims may lose job opportunities; be refused loans, education, housing, or cars; or may even be arrested for crimes they did not commit.

Two studies completed in July 2003 by Gartner, Incorporated, and Harris Interactive¹ reported that there



Fraudulent tax returns filed by identity thieves have grown from 1.9 percent in CY 2002 to 3.7 percent in CY 2003.

were approximately 7 million victims of identity theft in the prior 12 months. That equaled an average of 19,178 victims per day. For Calendar Year (CY) 2003, the majority of identity theft victims reported losses due to credit card fraud (33 percent). Although only a small percentage of the total reported identity thefts related to fraudulent tax returns, the Federal

Trade Commission (FTC) reported that the percentage of fraudulent tax returns filed by identity thieves almost doubled from CYs 2002 to 2003.²

¹ Gartner, Incorporated, is a research and advisory firm that helps clients understand technology and drive business growth. Harris Interactive is a worldwide market research and consulting firm best known for The Harris Poll[®] and its pioneering use of the Internet to conduct scientifically accurate market research.

² Information reported on the FTC web site at consumer.gov/idtheft/.

Federal laws have been enacted making identity theft a crime

In October 1998, the Identity Theft and Assumption Deterrence Act³ made identity theft a crime. The law defines identity theft as when someone “knowingly transfers or uses, without lawful authority, a means of identification of another person with the intent to commit, or to aid or abet, any unlawful activity that constitutes a violation of federal law, or that constitutes a felony under any applicable state or local law.” Violations of the law are investigated by Federal law enforcement agencies, including the U.S. Secret Service, the Federal Bureau of Investigation, the U.S. Postal Inspection Service, the SSA Office of the Inspector General, and the Internal Revenue Service (IRS) Criminal Investigation (CI) Division.

Two additional laws reinforce the importance of identity theft. The Fair and Accurate Transactions Act,⁴ signed into law in December 2003, establishes a national system of fraud detection so victims can alert all three major credit bureaus with a single telephone call. The Identity Theft Penalty Enhancement Act⁵ was signed into law in July 2004 and adds an extra 2 years to a prison sentence if a criminal knowingly transfers, possesses, or uses, without lawful authority, a means of identification of another person in addition to committing another offense. An additional 5 years will be added to a sentence related to a terrorism offense if identity theft is involved.

The FTC is the Federal Government agency responsible for compiling identity theft complaint information

The FTC has been established as the Federal Government’s central repository for identity theft complaints. It provides victim assistance and consumer education. Although the FTC does not have the authority to bring criminal cases against identity thieves, it helps victims of identity theft by providing the victims with educational information in print, through its toll-free hotline, and on its web site,

³ Pub. L. No. 105-318, 112 Stat. 3007-3012 (codified in part at 18 U.S.C. § 1028).

⁴ Pub. L. No. 108-159, 111 Stat. 1952.

⁵ Pub. L. No. 108-275, 118 Stat. 831 (codified as amended in scattered sections of 18 U.S.C.).

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consumer.gov/idtheft/. The FTC's goal is to provide information to assist victims in resolving problems that can result from identity theft. The web site and hotline give individuals a single place to report identity theft to the Federal Government and receive helpful information.

Counselors at the FTC take complaints and advise individuals on how to deal with the problems that can result from identity theft. In addition, the FTC, in conjunction with other organizations, has developed the ID Theft Affidavit to help victims of identity theft restore their good names. The Affidavit can be used to report information to many organizations.

The FTC also serves as a central point for law enforcement agencies nationwide to research identity theft cases. The FTC enters complaints into a secure database, the Identity Theft Data Clearinghouse.⁶ The database contains identifying information of the victim, such as name, address, SSN, and date of birth. The database also includes the type of identity theft; a description of the complaint; details of the identity theft (dates and the amount of money involved); other problems incurred by the victim as a result of the identity theft; identifying information on the identity thief, if known; and any companies or credit bureaus creating identity theft problems for the victim.

Access to this database is limited to law enforcement authorities to assist them in their investigations. Complaints may also be shared with some private companies, such as credit bureaus and other appropriate entities, to help them in their investigations and victim assistance.

The SSN is the most widely used identifier for Federal and State Governments and the private sector

An SSN is needed to get a job in the U.S.; to receive Social Security benefits and other Federal Government benefits; and, for most individuals, to file a tax return. Many companies, such as banks and credit card companies, also ask for and use individuals' SSNs to conduct business.

To obtain an SSN for a child at birth, the parent completes an Application for a Social Security Card (Form SS-5). If

⁶ The database is maintained on the FTC Consumer Sentinel Network, a secure, encrypted web site for use by law enforcement agencies.

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SSNs are limited to U.S. citizens or legal aliens admitted to the U.S. for permanent residence under other immigration categories authorizing U.S. employment.

the parent does not apply for the SSN at the same time he or she applies for the birth certificate, the parent will have to provide proof of age, identity, and U.S. citizenship for the child and proof of the parent's identity.

Examples of these documents are a driver's license, passport, employer identification card, school identification card, marriage or divorce record, health insurance card, military

identification card, adoption record, or life insurance policy.

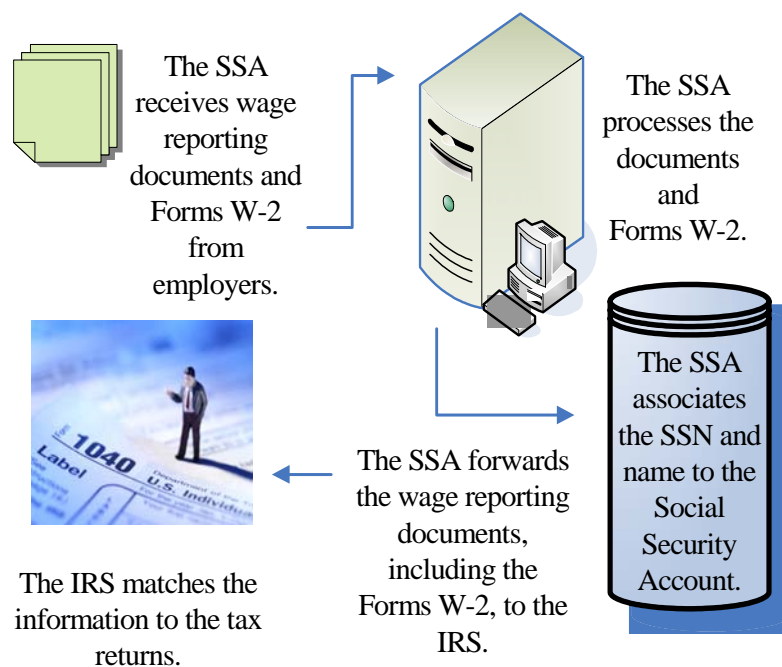
The Internal Revenue Code requires the SSN to be used as an identifying number

The Internal Revenue Code provides that any person filing a tax return, statement, or other document shall include an identifying number for securing proper identification for this purpose. The SSN shall be used as the identifying number for individuals for this purpose, except as otherwise specified under regulations.

In 1996, Treasury Regulations were issued to create an IRS Individual Taxpayer Identification Number (ITIN) that would provide alien individuals an identifying number to use to meet U.S. tax return filing requirements. Treasury Regulations provide that the IRS assign ITINs to resident aliens that 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. or that individual's immigration status (i.e., the ITIN does not authorize a foreign individual to work or live in the U.S.).

Each year, the SSA receives wage reporting information from employers, including income reported on the Wage and Tax Statement (Form W-2). The SSA processes about 240 million Forms W-2 from about 6.5 million employers. These Forms W-2 record the wages earned by about 145 million workers annually.

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The IRS Information Reporting Program (IRP) is used to match taxpayer income and deduction information submitted by third parties to amounts reported on individual income tax returns. The Internal Revenue Code, via the IRP, is the cornerstone of voluntary compliance⁷ and affects compliance and revenue across every taxpayer and market segment. The IRP helps ensure a high level of compliance by requiring third parties, such as employers, banks, brokerage firms, and others, to file information returns reporting taxpayer income and certain deductions to the IRS.

Two primary types of identity theft relate to tax administration

The first type involves an individual using another person's identity (name and SSN) to file a fraudulent tax return to steal a tax refund. The individual committing this type of fraud frequently files the fictitious tax return electronically, early in the filing season.⁸ The individual whose identity was stolen later files his or her tax return and the IRS

⁷ Voluntary compliance is an assumption or principle that taxpayers will comply with tax laws and accurately report their income and deductions.

⁸ The filing season is the period from January through mid-April when most individual income tax returns are filed.

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identifies it as a duplicate tax return. When this happens, the IRS freezes the second tax return, including any tax refunds due, and begins a process of corresponding with the individuals involved in the duplicate filing. This requires considerable time and effort by the legitimate taxpayer to prove he or she is a victim of identity theft. The victim's tax refund, if frozen, will not be issued until the matter is resolved.

The second type of identity theft related to tax administration involves using another person's identity (name, SSN, or both) to obtain employment. This frequently involves undocumented workers.⁹ The wage information is reported to the SSA by the employer (on the Form W-2) under the stolen identification information.

In the case of identity theft, the person who stole the identity may use the SSN of another person but still use his or her own name. When the Form W-2 information is received from the SSA, the IRS performs a match of the SSN and name on the Form W-2 to IRS records. If the SSN and name on the Form W-2 do not match IRS records, the Form W-2 is considered invalid.¹⁰

The IRS uses the Form W-2 information during the IRP process of matching wages to tax returns. In the case of identity theft, the IRS identifies a mismatch or underreporting of income, when in fact the identity theft victim did not underreport his or her income. If a mismatch is identified, the IRS will issue a notice to the individual involved in the mismatch (the victim) and propose an assessment of additional taxes owed relating to the underreported wages. The victim must then work with the IRS to resolve the mismatch of wages, including trying to prove that he or she may be a victim of identity theft.

This review was performed at the IRS National Headquarters in the Wage and Investment Division Compliance and Accounts Management (AM) functions in

⁹ For purposes of this report, the term undocumented workers includes (1) workers that legally reside in the U.S. but do not have authorization to work in the U.S. and (2) workers that reside in the U.S. without authorization to either work or reside in the U.S.

¹⁰ For the purposes of this report, invalid refers to a mismatch between the SSN and name on the Form W-2 and the IRS records.

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Atlanta, Georgia; the CI Division, Taxpayer Advocate Service, and FTC offices in Washington, D.C.; the Andover, Massachusetts, Atlanta, Georgia, and Brookhaven, New York, Campuses;¹¹ and the SSA office in Baltimore, Maryland, during the period June 2004 through January 2005. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Current Processes Help Address Identity Theft Issues

The IRS recognizes the growing challenge of identity theft and its effect on tax administration. Existing processes and functions already deal with certain aspects of identity theft. For example, the IRS conducts routine verifications and checks when processing tax returns and conducting compliance checks that may identify instances of potential identity theft. In addition, depending on the specifics of a potential identity theft issue, the tax return/case may be forwarded to various IRS functions for additional actions.

The IRS uses individuals' names and SSNs as the primary identifiers when performing its routine verifications and checks. For example:

- When processing a tax return, the IRS checks its records to ensure another tax return has not been previously filed for that tax year using the same primary taxpayer's SSN listed on the tax return being processed. This ensures there is not a duplicate tax return situation.

If the IRS identifies that a tax return was previously filed under the same primary SSN, the AM function will attempt to resolve the duplicate tax return situation internally by researching IRS records to determine if the taxpayer or the IRS made an error entering the SSN on the tax return. For example, it might compare the SSN on the tax return to the one on the attached Form W-2.

If the IRS is unsuccessful in resolving the duplicate tax return situation, it sends correspondence to both individuals that used the SSN. This correspondence

¹¹ The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

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advises both individuals that duplicate tax returns have been filed under the same SSN. This might be the first indication of a potential identity theft for both the IRS and the taxpayers. The IRS requests specific identifying documentation from the taxpayers and forwards it to the SSA, which will attempt to resolve the SSN discrepancy (i.e., identify which individual is the rightful owner of the SSN).

- Each year the IRS receives tax documents, called information returns, which are used to conduct compliance checks. Information returns include the Form W-2 as well as other IRS forms used to report, for example, interest income, miscellaneous income, gambling winnings, and pensions. Once the IRS receives the information returns, it performs computer verifications based on the taxpayers' SSNs to match the information reported on the information returns to that reported on the tax returns.

If income (including wages) reported on an information return is not included in the income reported on the tax return, the IRS considers it an underreporter situation. If there is no tax return filed for the income reported, the IRS considers it a nonfiler situation or Taxpayer Delinquency Investigation (TDI).

Depending on specific criteria and resources available, either the IRS Automated Underreporter (AUR) function or TDI function¹² will work selected underreporter and nonfiler cases to determine the correct amount of income that should have been reported. The functions will issue correspondence to the underreporting taxpayer asking him or her to resolve the discrepancy. The taxpayer may respond that the income is not his or her income.

These routine verifications and checks are an integral part of the IRS' tax administration and may serve as a first indication to the IRS and taxpayers of a potential identity

¹² The TDI function falls under filing and payment compliance in the Wage and Investment Division Compliance function. The TDI function deals with individuals that do not file their tax returns and, based on information received by the IRS, the individuals meet the requirements for having to file tax returns.

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theft. However, neither the duplicate tax return nor underreporter process is designed to identify and deal with the issues and challenges of identity theft.

In addition to the IRS functions detailed above, the IRS has a CI Division that deals with tax schemes that could include identity theft issues. The CI Division investigates potential criminal violations of the Internal Revenue Code and related financial crimes. It has investigative authority and usually works tax schemes involving multiple taxpayers or individual cases involving large amounts of taxes/money. The CI Division has developed a Compliance Strategy to assist in identifying, developing, and investigating cases that foster confidence in the tax system and compliance with the law.

The IRS' growing awareness of the effect identity theft has on tax administration has resulted in the IRS recently designating a senior executive to head an Identity Theft Task Force, a key goal of which is to develop an Enterprise Identity Theft Strategy. During the course of this review, we discussed various concerns with IRS management. In response, the IRS has begun to address some of these concerns as part of its Identity Theft Task Force, including meeting with the SSA in an attempt to reduce the time needed to determine the owner of an SSN.

The Internal Revenue Service Does Not Currently Have a Corporate Strategy to Address Identity Theft Issues

The IRS does not have a consistent process to educate and assist taxpayers, and, although the IRS works toward resolving duplicate tax return and underreporting situations, it does not always take additional actions to deal with the individuals that have used another's name or SSN to file fraudulent tax returns or obtain employment. In addition, the IRS does not have comprehensive or centralized data on identity theft to determine the effect identity theft has on tax administration.

This happened because the IRS has not developed a corporate strategy to address the growing significance of identity theft and its effect on tax administration. Until the IRS develops an agency-wide strategy, it will be unable to help taxpayers and the Federal Government combat the growing threat of identity theft and assist criminal law enforcement's efforts to prosecute offenders. Furthermore, one of the IRS' strategic goals is to improve taxpayer service. The IRS will be unable to meet this goal if an

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agency-wide strategy for handling identity theft issues is not developed.

In recent years, the IRS has developed a corporate strategy and agency-wide approach to combat another issue that significantly affects tax administration, the Earned Income Tax Credit (EITC). The IRS recognized that numerous functions dealt with different aspects of the EITC, a credit the IRS had identified as having a significant rate of noncompliance. To better understand the causes and develop solutions, the IRS formed a Project Office to develop policy and procedures in an attempt to consistently deal with the issue. The IRS continues to centralize many of the EITC processes.

The IRS does not have a consistent process to educate taxpayers

Information on identity theft and the problems it presents with tax administration is not available to taxpayers using the communication methods the IRS normally promotes, such as key publications and the IRS Internet site (IRS.gov). Key instructions and publications, including the U.S. Individual Income Tax Return (Form 1040) instruction booklet and *Your Federal Income Tax* (Publication 17), do not provide taxpayers with information on what they should do if they believe they are victims of identity theft. The IRS also does not use its Internet site or its publications to refer taxpayers to the FTC. However, IRS.gov does provide taxpayers with alerts on tax schemes that involve stolen identities.

Information provided by the IRS through its toll-free customer service telephone line, for use by other Federal Government agencies when referring taxpayers to the IRS, and correspondence sent to taxpayers does not adequately provide individuals with the information they need to resolve their issues. For example:

- When taxpayers contact the IRS toll-free telephone line, no general information is available on what they should do if they believe they are victims of identity theft. The information available is limited to only those taxpayers that call and inquire about what to do if someone has filed a tax return using their SSN (duplicate tax return situations). IRS procedures require the telephone

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assistors to advise taxpayers to contact the FTC.

Although the IRS does not have general information available through its toll-free telephone number, referral procedures provided by the IRS to the SSA instruct the SSA to refer individuals that report an identity theft involving a tax matter to the IRS toll-free customer service telephone number.

- When individuals contact the FTC, referral procedures provided by the IRS instruct the FTC to refer these individuals to either the Office of the National Taxpayer Advocate (the IRS Taxpayer Advocate Service (TAS)) or the CI Hotline (the IRS Fraud and Abuse Hotline). However:
 - IRS.gov does not have any general information on what taxpayers should do if they believe they are victims of identity theft.
 - Officials in the TAS stated that the TAS should not be a contact for referral, but if the alternative is to have the taxpayer call the IRS toll-free customer service telephone number, the TAS would rather take the call.
 - Procedures for the Fraud and Abuse Hotline are inconsistent. Both sets of CI Division procedures require that the victim's information be collected. However, the first set of procedures requires the information to be referred to the IRS Exam Identity Theft Unit, which does not exist. The second set of procedures requires the Fraud and Abuse Hotline referrals to be sent to the local CI Division office.

Correspondence sent to taxpayers because of IRS verifications and checks contains incomplete or inaccurate information. For example:

The AM function sends correspondence to taxpayers involved with a duplicate tax return situation. The correspondence states, "The Form [xx] you filed with us for the tax year ended [xx] shows your social security number as [xx]. Our records show the same social security number belongs to another taxpayer."

However, at the time the correspondence is sent, the IRS does not know which taxpayer owns the SSN used to file

both tax returns. In addition, subsequent correspondence sent to these taxpayers does not appropriately inform them of all the ramifications of the duplicate tax return situation, (i.e., that, until the situation is resolved, the taxpayers will be unable to receive certain deductions and credits).

With the percentage of fraudulent tax returns being filed by identity thieves almost doubling and the effect identity theft has on individuals whose information is stolen, the IRS needs to ensure taxpayers have sufficient information to help resolve their issues. In addition, this information should ensure taxpayers understand the actions the IRS takes when trying to resolve the situation and how it affects them when trying to comply with their future tax obligations.

Recommendations

The Deputy Commissioner for Services and Enforcement should ensure:

1. Agency-wide communication tools used to educate and assist taxpayers are updated to include information about identity theft and what to do if taxpayers believe they are victims of identity theft. This should include referring taxpayers to the FTC.

Management's Response: The IRS agreed with this recommendation and has developed an Enterprise Identity Theft Strategy. A primary component of this Strategy is outreach that focuses on updating communication and outreach vehicles. The IRS has documented this Strategy in its Identity Theft Communication Plan and made substantial progress in developing these vehicles and making them available to the public.

Specifically, the IRS has established a web site on IRS.gov and provided updated information and contacts to the FTC. It has also updated correspondence used to communicate with identity theft victims and finalized a plan to update major publications.

Lastly, the IRS has established the Multi-Agency Identity Theft Working Group and initiated a multiagency panel discussion with representatives from the SSA and the Department of the Treasury.

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2. Information provided by the IRS to taxpayers or other Federal Government agencies when referring individuals to the IRS is complete and accurate, including correspondence sent to taxpayers involved in a duplicate tax return situation.

Management's Response: The IRS agreed with this recommendation. It has updated communication vehicles to include references to the FTC and SSA and will continue to collaborate with the FTC and SSA through the Multi-Agency Identity Theft Working Group on communication and outreach. The IRS has also updated the correspondence used to provide more information to taxpayers who have duplicate returns. Lastly, the IRS has reviewed various procedures regarding fraud referral to ensure they are comprehensive and address identity theft cases.

The IRS does not have consistent processes to assist taxpayers that may be victims of identity theft

Procedures and processes of the various IRS functions that assist taxpayers that may be victims of identity theft are not consistent. For example:

- The AM function attempts to resolve duplicate SSN discrepancies (the duplicate tax return situations) to ensure legitimate tax returns are filed with correct SSNs. The function requests that taxpayers submit copies of identifying documents, such as a driver's license, passport, or birth certificate. It also asks taxpayers to provide their place of birth and parents' names. Once it receives this information, the AM function forwards the information to the SSA, which then attempts to determine which taxpayer owns the SSN.

While the SSA is conducting its research, the IRS assigns a taxpayer involved with the duplicate tax return situation a temporary Taxpayer Identification Number (TIN) to use when filing future tax returns. Because temporary TINs are not valid SSNs, certain credits and deductions requiring an SSN will not be allowed, including the EITC and dependent exemptions.

- The CI Division attempts to resolve duplicate tax return situations when there are indications of fraud. In working these cases, the CI Division does not routinely

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assign a taxpayer a temporary SSN, although it does assign a temporary SSN when the fraudulent tax return includes a claim for the EITC. Taxpayers determined to be the rightful owners of the SSNs can continue to file tax returns using their SSNs. The CI Division will place a freeze code on the account of the rightful owner that enables it to monitor the account in subsequent years and prevent the issuance of false refunds in the future.

- The AUR and TDI functions focus on the underreporting or nonreporting of income. Procedures enable taxpayers to provide support that the income is not theirs either verbally or in writing. If the taxpayers claim the income is not theirs, the functions close the cases without any changes.

The National Taxpayer Advocate recognized the inconsistency with which the IRS assists potential victims of identity theft. In the National Taxpayer Advocate 2004 Annual Report to Congress, the Advocate lists the inconsistency of procedures in IRS functions nationwide as one of the most serious problems facing taxpayers. The Advocate cited the assistance the IRS provides to victims of identity theft as an example of these inconsistent procedures.

The function working the cases affects what information taxpayers are required to provide, as well as what credits and deductions taxpayers can claim while their cases are being resolved. However, the information required to substantiate identity theft should be consistent to ensure equal treatment and appropriate resolution of the identity theft cases.

Recommendation

The Deputy Commissioner for Services and Enforcement should:

3. Develop agency-wide standards to ensure the information taxpayers are asked to provide to substantiate claims of identity theft is consistent throughout the IRS. These standards should also ensure taxpayers are consistently allowed applicable future exemptions and credits while identity theft cases are being resolved.

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Management's Response: The IRS agreed with this recommendation. A key feature of its Victim Assistance Strategy is to develop consistency among processes to ensure taxpayers receive equitable treatment. Through process reengineering efforts, the IRS has modernized the process to dramatically reduce the time needed to resolve cases as well as ensure consistency. The substantial reduction in case resolution time will also reduce the need to suspend a taxpayer's refund or credits while the case is being resolved, resulting in treatment consistent with that provided to taxpayer cases in the CI Division.

The IRS also developed standards for documentation to be used to validate the identity of the taxpayer, the taxpayer's address, and the fact of the theft. The documentation required by the IRS is consistent with that required by the FTC and the SSA.

The IRS does not have comprehensive or centralized data to measure the effect identity theft has on tax administration

Identity theft is not specifically recorded as a category when the IRS works cases that involve potential instances of identity theft. Although the multiple functions that assist in these cases have closing codes that record how cases are resolved, the IRS has not developed specific closing codes to use when cases are resolved based on a claim of identity theft. For example, the AUR function closes cases involving a claim of identity theft by using a code that indicates "case closed – complex issue not pursued." The TDI function closes these cases using a closing code that indicates "income below filing requirement."

Although these cases include claims of identity theft, a distinction cannot be made between cases closed because of identity theft and cases closed with "complex issue not pursued" or "income below filing requirements" not due to identity theft. Without a consistent method to capture the cases involving identity theft, the IRS does not know how many taxpayers are affected and the extent of the effect on tax administration.

Although the IRS does not have comprehensive or consolidated data on identity theft, it does have existing data that can be used to begin to measure the effect of identity

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theft. We analyzed selected data and obtained examples of data in which identity theft appears to be a component. We believe these data could be used to begin to compile management information on identity theft. In addition, these data sources could be used to develop compliance initiatives to address identification number discrepancies and to protect tax revenue associated with these discrepancies. For example:

- A computer-matching program developed by the IRS identifies tax returns involved in a duplicate tax return situation with a high probability of being a case in which two individuals are using the same SSN to file a tax return. Currently, this program uses characteristics from the duplicate tax returns. The program identifies mismatches between secondary SSNs and zip codes from both tax returns filed for the same SSN and tax period.
- An analysis of Tax Year (TY) 2002 tax return data showed 378,418 tax returns filed using ITINs had income reported from wages; however, there was no ITIN on a related Form W-2 for these wages. This could indicate that the ITIN filer is using an identity of another individual to gain employment. In addition to the potential burden that may be caused to the individuals whose identities were used by the ITIN filers, the IRS could be inefficiently using its limited compliance resources. For example, if the 378,418 individuals whose SSNs were used were identified by the AUR function as underreporter cases, the IRS would needlessly expend approximately \$8.5 million¹³ in resources to close these cases with no changes.
- An analysis of TY 2002 Forms W-2 showed 7.9 million mismatches for which the SSN and name on the Form W-2 do not match the SSN and name issued by the SSA (considered an invalid Form W-2). For example:

¹³ The figure is based on the 378,418 ITIN tax returns that do not have an associated Form W-2 with the ITIN and the \$22.40 per case it costs the IRS to close an AUR function case.

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- A retired taxpayer's SSN was reported on numerous other individuals' Forms W-2 presumably used to gain employment. The wages earned were reported on Forms W-2 under the SSN of the retired person; however, another name was used. The Forms W-2 contained wage earners' addresses in states different from that of the retired taxpayer. The wages totaled (b)3; (b)(7)(C) with tax withholdings of only (b)3; (b)(7)(C).
- About 9,500 separate companies were identified as each issuing 100 or more of the Forms W-2 on which the names did not match the SSNs and names on file with the SSA. Over 1,000 of the 9,500 companies had discrepancies in 75 percent or more of their Forms W-2.

Further analysis of the data indicates compliance problems similar to those identified in a new IRS tax withholding compliance program initiated in Fiscal Year 2005.¹⁴ Under the guidelines of the new tax withholding compliance program, the IRS will send letters to individuals with low withholding and a tax compliance issue (b)(7)(E)-----

----- proposing to set their withholding rates at the percentage withheld for individuals filing as single with zero exemptions. At the same time, the IRS will send letters to employers advising them to withhold at the rate of single with 0 exemptions on a date specified in the letter (that will be no earlier than 45 days after the date of the letter) if the IRS does not subsequently contact them. At any time after receiving the letter, including before the employer imposes the new withholding rate, the employee (taxpayer) may be able to justify to the IRS a filing status and/or a withholding rate different from that specified in the initial letter.

¹⁴ This program was developed in response to a recommendation made in the Government Accountability Office report entitled, *Reliability of Information on Taxpayers Claiming Many Withholding Allowances or Exemption from Federal Income Tax Withholding* (GAO-03-913R, dated September 2003).

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We analyzed the 7.9 million Forms W-2 using criteria similar to that used in the new IRS tax withholding compliance program. In addition, we eliminated Forms W-2 with wages less than \$7,950, the income threshold required for an individual to file a tax return if filing as single with no dependents.¹⁵ We identified:

- A total of 1,086,195 Forms W-2 on which the SSN was not used to file a TY 2002 tax return.
- A total of \$19.7 billion dollars in income and \$287 million in taxes withheld. The average income and taxes withheld were \$18,165 and \$264, respectively.
- Over 355,500 unique companies that issued the 1,086,195 Forms W-2.

If the IRS required the individuals listed on the 1,086,195 Forms W-2 to withhold at the single withholding rate with 0 exemptions, the potential increase in tax revenue would be about \$9 billion¹⁶ (\$1.8 billion annually over 5 years). This assumes an average wage of \$18,165 and a 10.86 percent withholding rate required for a person filing as single with no dependents.

Identity theft presents significant challenges to Federal and State Governments. We understand the unique and significant challenges the IRS faces when dealing with issues of identity theft and tax administration. To meet these challenges and balance customer service with enforcement, the IRS needs to develop a corporate strategy that will proactively identify instances of identity theft and determine the optimum approach to resolving identification number discrepancies and reducing taxpayer burden, while protecting revenue and enforcing the law.

¹⁵ Based on TY 2004 tax information.

¹⁶ The individuals' actual tax liabilities could be different once they file their tax returns. The actual tax liabilities could be more or less than the amounts withheld based on the exemptions, credits, and deductions the individuals claim on their tax returns.

Recommendations

The Deputy Commissioner for Services and Enforcement should:

4. Develop specific closing codes for cases involving identity theft that will allow the IRS to track and monitor the effect of identity theft on tax administration.

Management's Response: The IRS agreed with this recommendation. The IRS has refined its AUR and TDI function closing codes to include identity theft. The Identity Theft Program Office will accumulate these data from the IRS and other sources, such as the FTC, to determine trends. These trends will be used to develop or enhance outreach activities and communication vehicles and to focus resources on enforcement initiatives.

The IRS did not agree with the amount of the first outcome measure (a potential \$8.5 million in inefficient use of resources), stating it should be revised from \$8.5 million to \$676,000 because the IRS believes we made an incorrect assumption.

Office of Audit Comment: We disagree with the IRS' assertion that the outcome measure should be revised from \$8.5 million to \$676,000. Management stated that, in five of eight cases we reviewed, the ITIN on the tax return was also used as the TIN on the associated Form W-2. We agree that for the five cases there was a match between the ITIN used on the tax return and the TIN used on the Form W-2 and, in the situation where an ITIN was used on both the tax return and the Form W-2, no identity theft victim would result. However, for the remaining three cases, the ITINs on the tax returns did not match the TINs on the associated Forms W-2. For these three cases, the associated Forms W-2 contained SSNs.

The figures supporting our outcome measure did not include situations relating to the five cases. The figures included in our report involved only those occurrences in which an ITIN was used to file a tax return that claimed wages and no corresponding Form W-2 was located with this ITIN. Therefore, the assumption is wages were earned and reported under another TIN. If the characteristics relative to the underreporting meet the AUR Program criteria, these

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cases could be selected and ultimately closed as identity theft. This would result in the inefficient use of resources. The IRS has the ability to proactively eliminate these cases from AUR Program inventory if it captured this information. Taking this action would be in line with its Enterprise Identity Theft Strategy of balancing service with enforcement by focusing on victim assistance, outreach, and prevention.

5. Follow through on the Identity Theft Task Force's goal of developing an Enterprise Identity Theft Strategy. The Strategy should include processes to proactively identify instances of identity theft, resolve identification number discrepancies, and ensure appropriate tax withholding while enforcing the law.

Management's Response: The IRS agreed with this recommendation. Prevention is the final part of the IRS Enterprise Identity Theft Strategy. The Strategy outlines several options for initiatives targeted at preventing or deterring identity theft. These activities will be monitored and coordinated through the Identity Theft Program Office.

For example, the IRS will work with employers through several initiatives to reduce the incidence of theft related to employment, and tax return preparers who promote schemes for clients to make false claims of identity theft to underreport income and maximize refundable credits will face penalties and sanctions.

The IRS did not agree with the second outcome measure (a potential \$9 billion in increased revenue over 5 years), stating it was based on a recommendation in the report to expand a current IRS tax withholding compliance program.

Office of Audit Comment: Although our outcome measure is calculated using the same withholding rate used in the IRS' tax withholding compliance program, in neither our report nor discussions with management did we recommend the IRS expand its current tax withholding compliance program [Form W-4 withholding compliance program]. As our report states, we believe Form W-2 mismatches provide yet another data source for the IRS to analyze and begin to measure the impact that identity theft has on tax administration. The mismatch file could be used by the IRS to develop compliance initiatives to address the

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identification number mismatches and to protect any tax revenue associated. We recognize that working these cases on a case-by-case basis is probably not cost effective. However, analyzing the data to develop initiatives may result in both resolving the mismatches and protecting tax revenue.

Further, management indicates that the recommendation focuses limited compliance resources on a low-income population and that the outcome measure calculates tax withholding, not tax liability. Management indicated it is likely that the \$9 billion withheld on low-income taxpayers would be refunded. We have recognized (as footnoted in Appendix IV) that individuals' actual tax liabilities could be different once they file tax returns. The actual tax liabilities could be more or less than the amounts withheld based on the exemptions, credits, and deductions the individuals claim on their tax returns. However, until the individuals file tax returns, the actual tax liabilities are unknown to us as well as to the IRS.

We continue to recommend the IRS Enterprise Identity Theft Strategy include processes to begin to resolve the identification number discrepancies that totaled 7.9 million for Forms W-2 in TY 2002. The IRS does not currently have a program that attempts to resolve the 7.9 million identification number mismatches or enforce tax laws relating to withholding and filing issues.

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) has an effective process to educate and assist taxpayers that are victims of identity theft. To accomplish this objective, we:

- I. Determined whether the IRS educates taxpayers that are victims of identity theft on the process to resolve their tax accounts.
 - A. Discussed with the appropriate officials how the IRS educates taxpayers on the process to resolve their tax accounts when they are victims of identity theft.
 - B. Obtained and reviewed key communication vehicles to determine how the IRS educates taxpayers about its process for handling identity theft cases.
- II. Determined whether the IRS has an effective process to resolve taxpayer accounts when identity theft has occurred.
 - A. Determined whether the IRS has a process to assist taxpayers whose identities are stolen for the purpose of obtaining employment or filing false tax returns.
 - B. Determined whether State tax agencies may have a process that can be used by the IRS as a best practice when assisting taxpayers that are victims of identity theft.
 - C. Determined whether the IRS has a management information system that captures information on identity theft cases.
 - D. Determined whether the IRS can implement a proactive process to assist taxpayers that are victims of identity theft.
- III. Determined the potential amount of inefficient use of resources and increased revenue.
 - A. Determined the potential amount of inefficient use of resources from identity theft cases not being worked by the Automated Underreporter function. The Automated Underreporter function works cases that show an underreporting of income. The cases are a result of a match of the income reported by taxpayers on their tax returns to third-party information received by the IRS. See methodology in Appendix IV.

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- B. Determined the number of instances with an invalid Wage and Tax Statement (Form W-2) (Social Security Number and name do not match IRS records) for which there is no corresponding tax return for Tax Year 2002,¹ the wages are below what would be included in the IRS Compliance Program and above the filing requirement, and the Form W-2 had a low withholding rate.

¹ Tax Year 2002 is the most recent year for which complete data were available.

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Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Inefficient Use of Resources – Potential; \$8.5 million (see page 9).

Methodology Used to Measure the Reported Benefit:

An analysis of Tax Year (TY) 2002 tax return data¹ showed 378,418 tax returns filed using Internal Revenue Service (IRS) Individual Taxpayer Identification Numbers (ITIN)² had income reported from wages; however, there were no ITINs on a related Wage and Tax Statement (Form W-2) for these wages. This could be an indicator that the ITIN filer is using the identity of another individual to gain employment. In addition to the potential burden that may be caused to an individual whose identity was used by the ITIN filer, the IRS could be inefficiently using its limited compliance resources to unnecessarily work underreporter cases. If the 378,418 individuals whose Social Security Numbers (SSN) were used were identified by the Automated Underreporter (AUR) function³ as underreporter cases, the IRS would needlessly spend approximately \$8.5 million⁴ in resources to close these cases with no changes. This was calculated as follows:

Calculation of Total Salaries for AUR Function Employees for Fiscal Year 2004	
Permanent salaries	\$27,165,343
Temporary salaries	\$11,820,606
Overtime	\$2,066,222
Night differential	\$652,053
Premium dollars	\$784
Total salaries	\$41,705,008

¹ TY 2002 is the most recent year for which complete data were available.

² In 1996, Treasury Regulations were issued to provide IRS identifying numbers for alien individuals to use to meet United States tax return filing requirements. Treasury Regulations provide that the IRS assign ITINs to resident aliens that cannot obtain a Social Security Number.

³ The AUR function works cases that show an underreporting of income. The cases are a result of a match of the income reported by taxpayers on their tax returns to third-party information received by the IRS.

⁴ The figure is based on the 378,418 ITIN tax returns that do not have an associated Form W-2 with the ITIN and the \$22.40 per case it costs the IRS to close an AUR function case.

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Calculation of Average Salary for AUR Function Employees	
Total permanent, temporary, overtime, night differential, and premium dollars	\$41,705,008
Total Full-Time Equivalents (FTE) ⁵	819
Average salary (total salaries/FTEs)	\$50,922

Calculation of Time to Close an AUR Function Case	
Minutes in a work year (2,096 hours x 60 minutes)	125,760
Cases closed in Fiscal Year 2004	2,257
Time to close an AUR function case (minutes in a work year/cases closed)	56 minutes

Calculation of Cost to Close an AUR Function Case	
Average salary	\$50,922
Minutes in a work year	125,760
Cost per minute (average salary/minutes in a work year)	\$.40
Minutes to work/close an AUR function case	56
Cost to close an AUR function case (\$.40 per minute x 56 minutes to work)	\$22.40

Calculation of Inefficient Use of Resources	
Cost to close an AUR function case	\$22.40
ITIN tax returns with wages and no associated Form W-2	378,418
Inefficient use of resources if these cases did not go to the AUR function	\$8.5 million

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$9 billion⁶ (\$1.8 billion annually over 5 years) (see page 9).

Methodology Used to Measure the Reported Benefit:

We analyzed 7.9 million Forms W-2 using criteria similar to that in a new tax withholding compliance program the IRS is initiating in Fiscal Year 2005. We eliminated from our results Forms W-2 that meet the dollar tolerance for inclusion in this new compliance program. We also eliminated the Forms W-2 with earnings less than \$7,950, the income threshold required for an

⁵ An FTE is a measure of labor hours in which 1 FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For the calculation of our outcome, 1 FTE was equal to 2,096 staff hours.

⁶ The individuals' actual tax liabilities could be different once they file their tax returns. The actual tax liabilities could be more or less than the amounts withheld based on the exemptions, credits, and deductions the individuals claim on their tax returns.

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individual if the filing status is single with no dependents.⁷ In addition, we eliminated any individuals who filed a tax return for TY 2002. Our analysis identified:

- A total of 1,086,195 Forms W-2 on which the SSN was not used to file a TY 2002 tax return.
- Wages earned averaged \$18,165, with taxes withheld averaging \$264.
- If the IRS required the individuals in the above population to withhold at the single withholding rate with 0 exemptions,⁸ using the average wages of \$18,165, individuals would be required to have 10.86 percent of their wages withheld. This would result in a potential \$1.8 billion in increased tax being withheld.

The following is the calculation for the increased revenue:

Calculation of Invalid⁹ Forms W-2 (Grouped by the SSN) (b) (7)(E)-----, Wages Between \$7,950 and the IRS Withholding Compliance Program Dollar Tolerance, and No Tax Return Filed	
Total invalid Forms W-2 (wages between \$7,950 and the IRS withholding compliance program dollar tolerance)	1,822,995
Number of SSNs from invalid Forms W-2 used to file a tax return as the Primary taxpayer	391,701
Number of SSNs from invalid Forms W-2 used to file a tax return as the Secondary taxpayer	151,340 ¹⁰
Total invalid Forms W-2 ((b)(7)(E)----- and wages between \$7,950 and the IRS withholding compliance program dollar tolerance)	1,511,220
Number of invalid Forms W-2 on which the SSN was not used to file a TY 2002 tax return	1,086,195
Average wages	\$18,165
Average withholding	\$264
Total wages	\$19.7 billion
Total withholding	\$287 million

⁷ Based on TY 2004 tax information.

⁸ Under the guidelines of the new tax withholding compliance program, the IRS will send letters to the individuals proposing to set their withholding rates at the percentage withheld for individuals filing as single with zero exemptions. At the same time, the IRS will send letters to the employers advising them to withhold at the rate of single with 0 exemptions on a date specified in the letter (that will be no earlier than 45 days after the date of the letter) if the IRS does not subsequently contact them.

⁹ For the purposes of this report, invalid refers to a mismatch between the SSN and name on the Form W-2 and the IRS records.

¹⁰ The 391,701 and 151,340 SSNs are based on a match of the 1.8 million invalid Forms W-2 with wages between \$7,950 and the IRS tax withholding compliance program dollar tolerance and the IRS' 2002 tax return file. These files were then matched to the 1.5 million invalid Forms W-2 that had (b)(7)(E)-----.

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Calculation of Increased Revenue for Invalid Forms W-2 (Grouped by the SSN) (b)(7)(E)-----, Wages Between \$7,950 and the IRS Withholding Compliance Program Dollar Tolerance, and No Tax Return Filed	
Total wages	\$19.7 billion
Single with 0 exemptions withholding rate for average wages of \$18,165	10.86 percent ¹¹
Total withholding for single with zero exemptions withholding rate	\$2.1 billion
Actual withholding on the 1,086,195 invalid Forms W-2 that were not used to file a TY 2002 tax return	\$287 million
Additional withholding for single with zero exemptions withholding rate	\$1.8 billion
Projection over 5 years	\$9 billion

¹¹ Based on the percentage method of withholding for wages paid on a weekly basis through December 2004.

Management's Response to the Draft Report



DEPUTY COMMISSIONER

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

RECEIVED
JUN 27 2005

June 27, 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:


Mark E. Matthews

Deputy Commissioner for Services and Enforcement

SUBJECT

Draft Audit Report - Corporate Strategy Key to Addressing the Growing Challenge of Identity Theft (Audit # 200440043)

Thank you for the opportunity to respond to the referenced draft report. During the course of your audit to determine whether the IRS has an effective process to educate and assist taxpayers that are victims of identity theft¹, we have made substantial progress in executing our Enterprise Identity Theft Strategy.

The IRS, like many other Federal agencies, is faced with the challenge of addressing this growing crime. We have observed identity theft cases arising in several of our processes that were not originally designed to address the needs of identity theft victims. Furthermore, because identity theft impacts many functions and processes in the organization, the IRS designated a senior executive to develop and implement an enterprise approach to address identity theft.

On November 16, 2004, I approved the IRS Enterprise Identity Theft Strategy that is presently in various stages of execution. The strategy includes developing a comprehensive communication plan to provide outreach activities to assist victims and general information to prevent identity theft. The components of the IRS Enterprise Identity Theft Strategy are Outreach, Victim Assistance, and Prevention.

Outreach

The first component of the IRS Enterprise Identity Theft Strategy is outreach, and includes several initiatives to provide information to taxpayers. We have developed a comprehensive communication plan that was approved in early February 2005. The

¹ TIGTA Audit Objective - The overall objective is to determine whether the IRS has an effective process to educate and assist taxpayers that are victims of identity theft. Specifically, we will determine if the IRS educates taxpayers that are victims of identity theft on the process to resolve their tax accounts, and we will assess the effectiveness of the IRS' process to resolve taxpayer accounts after identity theft has occurred.

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plan specifies a variety of outreach vehicles to provide information to taxpayers and tax professionals. The communication plan also targets revisions to some of our most widely used printed documents including the U.S. Individual Income Tax Return (Form 1040) instruction booklet and Your Federal Income Tax (Publication 17).

The IRS launched an identity theft website on IRS.gov in early March 2005 to provide victims with updated information on identity theft and provide links to the Social Security Administration (SSA) and Federal Trade Commission (FTC) sites for further information. Our identity theft website on IRS.gov also provides taxpayers with information about how to contact the Taxpayer Advocate Service. We have also collaborated with the Taxpayer Advocate Service to provide additional information on identity theft to participants in the Low Income Taxpayer Clinics.

IRS.gov directs taxpayers to the FTC for general information about identity theft for those taxpayers who believe their identity may have been stolen but have not received any notices from the IRS indicating that there is an issue with their tax accounts.

This summer at the IRS Nationwide Tax Forums, we are presenting a multi-agency panel discussion on identity theft that includes representatives from the Department of Treasury and SSA. We anticipate reaching over 30,000 tax professionals through the Tax Forums and will also provide information about SSA's new SSN Verification Service and the FTC's brochure on Identity theft.

To distribute updates on the identity theft strategy among our employees, we are using our internal intranet. These updates include information about internal process improvements, answers to frequently asked questions, and updates to our Internal Revenue Manual.

The IRS recognizes that taxpayers must interact with multiple agencies and private industry to resolve issues related to identity theft. To facilitate multi-agency communication, the IRS took the lead to establish a multi-agency working group that includes representatives from the Department of Treasury, FTC, SSA, and the Department of Homeland Security. The purpose of the group is to better enable Federal agencies to provide consistent information and services to victims of identity theft. This group serves as a role model to demonstrate the power that interagency collaboration can bring to communication, outreach activities, and process improvements.

Updated information related to identity theft tax administration issues will be included in the next printing of the FTC publication "Identity Theft – When Bad Things Happen to Your Good Name." The IRS continues to work with the SSA and FTC as they update their major identity theft publications and websites to ensure that IRS' most recent information, phone numbers, and website links are included in each publication. The

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multi-agency working group will continue to explore opportunities to enhance and improve identity theft information made available to taxpayers by each agency.

Victim Assistance

The second component of the IRS Enterprise Identity Theft Strategy is victim assistance. The foundation of that component is the pending IRS identity theft policy statement that "recognizes the need for consistent procedures across its functions to ensure the timely resolution of taxpayer account issues stemming from identity theft." This Policy Statement has been, and will be, used in reengineering our processes and updating IRM's, Handbooks, and Law Enforcement Manuals as appropriate.

One process improvement underway relates to Scramble SSN. When one SSN is used by two different taxpayers, our employees in Accounts Management make every effort to locate a correct SSN for both taxpayers. If Accounts Management is unable to identify the correct number through research and contact with the taxpayer, the common number is "scrambled" and both taxpayers are assigned a temporary number (IRSN) to file future tax returns. This process is called Scramble SSN, and we currently have about 8,000 cases in our nationwide inventory.

The Scramble SSN process was originally intended to resolve cases where the SSA issued the same SSN to two different taxpayers. The IRS collects information to enable the SSA to conduct an investigation to verify the true owner of the SSN.

An IRS-SSA team began working in December 2004 to modernize this process. One of the primary goals of the modernized process is to dramatically reduce the time required to resolve the duplicate SSN usage before the taxpayer is required to use the IRSN to file the next year's returns.

The team has proposed a process improvement with the SSA where the taxpayer can obtain a "numident" or certificate validating their identity from the local SSA office. The IRS will use this certificate to identify the SSN owner and eliminate the need for the IRS to contact the SSA. This process improvement is targeted at reducing the case resolution time to a few months, and will most likely eliminate the need for Scramble SSN taxpayers who are identity theft victims to use the IRSN and for the SSA to conduct a time intensive investigation. The substantial reduction in case resolution time will also reduce the need to suspend the taxpayer's refunds or credits while the case is being resolved.

As part of the Scramble SSN process reengineering, we have also updated the language in the letter sent to taxpayers. The revised correspondence includes information on why we are sending the letter to the taxpayer, how to get a "certified numident" from the SSA, and what may happen to their tax account while the issue is being resolved. Our process has also been updated to provide interim updates to

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taxpayers on the status of the case. To ensure that the new correspondence meets taxpayer needs, we are asking for feedback from practitioner groups.

We also updated our Automated Underreporter (AUR) process and notices to provide assistance to taxpayers whose name and SSN were used by an identity thief for employment purposes. When the IRS matches the identity thief's W-2 information with the taxpayers income tax return, we send the taxpayer a notice regarding this perceived unreported income. This is often the first time a taxpayer is made aware of the identity theft. In processing year 2004, our AUR function processed approximately 30,000 cases where taxpayers claimed they were victims of identity theft.

We have also developed standards for documentation to be used to validate the identity of the taxpayer, the taxpayer's address, and the fact of the theft. The documentation required by the IRS is consistent with documentation required by the FTC and SSA. Many victims of identity theft are often unaware that there is any problem with their tax accounts until they are contacted by the IRS and do not have a police report to verify the fact of the theft. For this reason, we have added the FTC's identity theft affidavit document as an additional way for taxpayers to validate the fact of identity theft to the IRS.

The Identity Theft Program office will continue to look for opportunities to update our internal processes that are impacted by identity theft, reduce taxpayer burden, and provide consistent treatment among taxpayers.

Prevention

Prevention is the final component of the IRS Enterprise Identity Theft Strategy and includes several enforcement initiatives targeted at deterring or preventing this crime. Different enforcement activities, and the resources available to apply to those activities, are tailored to the type of crime resulting from the theft.

We have noted three types of identity theft crimes in tax administration - - Refund Crimes, Employment, and Income Diversion. Refund crimes are perpetrated by identity theft criminals who use another person's tax information to fabricate a tax return and steal a tax refund. The Refund Crimes Unit, of our Criminal Investigation (CI) Division, applies several processes to identify and refer unlawful tax refund schemes through the Questionable Refund Program at the Fraud Detection Centers. Special Agents located in the CI field offices also investigate identity theft associated with other substantive tax crimes. The IRS will continue to identify and recommend criminal prosecution as appropriate. Media coverage of the criminal prosecutions is a successful deterrent to those thinking about committing this crime.

We are in the preliminary stages of developing several initiatives to reduce the incidence of theft related to employment. We are also committed to improving the

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accuracy of SSN reporting and have worked with the SSA to explore options and initiatives that might improve accuracy.

For purposes of income diversion, perpetrators who make false claims of identity theft to underreport income and maximize refundable credits will face additional tax and penalties. Tax return preparers who promote such schemes will be subject to penalties and sanctions.

To prevent identity theft in the first instance, we release fraud alerts on IRS.gov. For example, the IRS warned taxpayers of an identity theft scheme that involved bogus e-mail and a bogus website. In this ploy, unsuspecting consumers receive an e-mail that claims they are under investigation for tax fraud and are subject to prosecution. The e-mail informs recipients they can "help" the investigation by providing "real" information and directs them to an official-looking website.

We have also initiated several research projects to identify trends in identity theft related to tax administration. For example, one research initiative explored the impact of identity theft on e-commerce and e-file.

These prevention activities will be monitored and coordinated through the Identity Theft Program Office.

RECOMMENDATION 1

Agency-wide communication tools used to educate and assist taxpayers are updated to include information about identity theft and what to do if taxpayers believe they are victims of identity theft. This should include referring taxpayers to the FTC.

CORRECTIVE ACTION

We agree with this recommendation. A primary component of the IRS Enterprise Identity Theft Strategy is Outreach, which focuses on updating our communication and outreach vehicles. We have documented this strategy in our Identity Theft Communication Plan and made substantial progress in developing these vehicles and making them available to the public.

By executing the Outreach component of the strategy, we have addressed all of the issues identified in this report. We have established a website on IRS.gov and provided updated information and contacts to the FTC. We have also updated our correspondence used to communicate with identity theft victims and have finalized a plan to update our major publications.

In addition, we have established the Multi-Agency Identity Theft Working Group, initiated a multi-agency panel discussion with representatives from the SSA and Treasury Department at the Tax Forums, and provided updates on our progress for implementing the strategy through the Congressional Quarterly.

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IMPLEMENTATION DATE

February 2005

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 2

Information provided by the IRS to taxpayers or other Federal government agencies when referring individuals to the IRS is complete and accurate, including correspondence sent to taxpayers involved in a duplicate tax return situation.

CORRECTIVE ACTION

We agree with this recommendation. Through our communication and outreach activities, we have updated our communication vehicles to include references to the FTC and SSA and addressed the concerns identified in this report. We will continue to collaborate with the FTC and SSA through the multi-agency working group on communication and outreach. We have also updated the correspondence used in the "Scramble SSN" process to provide more information to taxpayers who have duplicate returns.

We also reviewed our W&I procedures for the Informant Referral Hotline or "Fraud and Abuse Hotline" and the local desk guide for one of our CI Lead Development Centers. Our review concluded that the W&I Informant Referral Hotline procedures are comprehensive, address identity theft cases, and route the referrals to the appropriate treatment based upon the type of crime and level of detailed information.

Our review of the CI Lead Development desk guide indicated that the procedures are also comprehensive and route the referrals to the appropriate treatment stream. The local desk guide included a reference to our Compliance, Planning & Special Programs unit as an "Identity Theft Unit". We have updated the guide to change this reference.

IMPLEMENTATION DATE

May 2005

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

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RECOMMENDATION 3

Develop agency-wide standards to ensure the information taxpayers are asked to provide to substantiate claims of identity theft is consistent throughout the IRS. These standards should also ensure taxpayers are consistently allowed applicable future exemptions and credits while identity theft cases are being resolved.

CORRECTIVE ACTION

We agree with this recommendation. A key feature of our Victim Assistance strategy is to develop consistency among our processes to ensure that taxpayers receive equitable treatment. Through our process reengineering efforts for "Scramble SSN," we have modernized the process to dramatically reduce the time to resolve cases as well as ensure consistency in how this process is administered across our campuses. The substantial reduction in case resolution time will also reduce the need to suspend the taxpayer's refunds or credits while the case is being resolved, resulting in consistent treatment with those taxpayer cases in CI.

We have also developed standards for documentation to be used to validate the identity of the taxpayer, the taxpayer's address, and the fact of the theft. The documentation required by the IRS is consistent with documentation required by the FTC and SSA. Many victims of identity theft are often unaware that there is any problem with their tax accounts until they are contacted by the IRS and do not have a police report to verify the fact of the theft. For this reason, we have added the FTC's identity theft affidavit document as an additional way for taxpayers to validate the fact of identity theft to the IRS.

The pending IRS policy statement and standards for documentation were used to update our AUR and TDI process to provide consistency in the information we request from our taxpayers to validate the theft.

IMPLEMENTATION DATE

June 2005

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 4

Develop specific closing codes for cases involving identity theft that will allow the IRS to track and monitor the effect of identity theft on tax administration.

CORRECTIVE ACTION

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We agree with this recommendation. The IRS has closing codes in place for the majority of the taxpayer cases impacted by identity theft. These codes differentiate identity theft cases in CI, Taxpayer Advocate Service, and the AUR program. We have refined our AUR and TDI closing codes to include identity theft.

The multi-agency Scramble SSN process reengineering includes the development of a category code and systemic control of cases that still require routing to SSA. Unfortunately, it is not possible to distinguish a true Scramble SSN case from an identity theft case. In the near term, the Identity Theft Program Office will periodically consolidate the information from these cases when closed. Future plans include incorporating the case tracking codes for Scramble SSN cases in the Correspondence Imaging System.

The Identity Theft Program Office will accumulate this data from the IRS as well as other sources, such as the FTC, to determine trends. These trends will be used to develop or enhance outreach activities, communication vehicles, and focus resources on enforcement initiatives.

IMPLEMENTATION DATE

June 2005

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 5

Follow through on the Identity Theft Task Force's goal of developing an identity theft enterprise strategy. The strategy should include processes to proactively identify instances of identity theft, resolve identification number discrepancies, and ensure appropriate tax withholding while enforcing the law.

CORRECTIVE ACTION

We agree with this recommendation. Prevention is the final part of the IRS Enterprise Identity Theft Strategy. The strategy outlines several options for enforcement initiatives targeted at preventing or deterring identity theft. These activities will be monitored and coordinated through the Identity Theft Program Office. Different enforcement activities and the resources available to apply to those activities are tailored to the type of crime resulting from the theft. For example, perpetrators of refund crimes will face criminal or civil prosecution. Perpetrators who make false claims of identity theft to underreport income and maximize refundable credits will face additional tax and penalties. We will work with employers through several initiatives to reduce the incidence of theft related to employment. Finally, tax return preparers who promote schemes for clients to make

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false claims of identity theft to underreport income and maximize refundable credits will face penalties and sanctions.

The Identity Theft Program Office will use data from our operations as well as the tax filing data to further refine our prevention activities.

IMPLEMENTATION DATE

June 2005

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

OUTCOME MEASURE ONE

This outcome measure is based on a recommendation that the IRS exclude Wage and Tax Statements (Form W-2) earned by ITIN holders from the AUR program. This recommendation will reduce the potential burden to taxpayers whose identity is used by the ITIN filer for employment.

We have noted three types of wage and earnings statements used by ITIN filers to report earnings from employment. Only one of the three types of Form W-2 Name/ITIN combinations will create an identity theft victim and an AUR case.

Identity theft related to employment may create an identity theft victim and an associated AUR case when an ITIN filer uses a taxpayer's name and the taxpayer's SSN. The wage information is reported to the SSA by the employer (on the Form W-2) using the stolen identification information. The taxpayer is contacted through the AUR program to report this additional income earned by the ITIN filer. In processing year 2004, our AUR program worked approximately 30,000 of these cases that were closed with no change as a result of identity theft.

Some ITIN filers steal the SSN of a real taxpayer, but still use his or her own name for employment. When the Form W-2 information is received from the SSA, the IRS performs a match of the SSN and name on the Form W-2 to IRS records. If the SSN and name on the Form W-2 do not match IRS records, the Form W-2 is not included in the AUR program.

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We have also noted that ITIN filers who earn wages may also receive a Form W-2 with their real name and their ITIN instead of an SSN². This Form W-2 will also not be included in the AUR program. These three types of W-2's and the impact on the AUR program are summarized in the following table.

Tax Return Identifier	W-2 Name	W-2 Tax Identifier	Impact on AUR Program
ITIN	Stolen Name	Stolen SSN	Included
ITIN	Real Name	Stolen SSN	Excluded
ITIN	Real Name	ITIN	Excluded

The TIGTA recommendation and resulting outcome measure assumes that all 378,418 tax returns filed by ITIN filers with income from wages used a W-2 with both the name and SSN of another taxpayer.

During the course of the audit, TIGTA reviewed a sample of paper ITIN returns with wages to review the name and tax identifying number on the attached Form W-2. Where paper Forms W-2 were available, TIGTA found that all reviewed tax returns included the same name on the W-2 as the name on the tax return. Furthermore, TIGTA noted that in five of the eight cases reviewed, the ITIN on the tax return was also used as the tax identification number on the associated Form W-2. In this sample, none of these cases would create an identity theft victim or an automated underreported case.

This observation from the TIGTA review is consistent with our experience in the number of AUR cases closed with no change as a result of identity theft. During processing year 2004, we closed 30,000 cases attributable to identity theft. The number of identity theft cases in processing year 2005 has decreased, and we have closed approximately 7,000 cases as of May 2005. Approximately 20,000 cases were closed with no change at the same time last year in May 2004. This substantial decrease may be attributable to our updated AUR procedures where we request validation of the taxpayer's identity as well as the fact of the theft before we close the case with no changes.

REVISED RESOURCES SAVINGS

Based upon the information collected by TIGTA and the experience of identity theft cases in the AUR program, the total number of cases is most likely to be around 30,000 revising the amount of resource savings from \$8.5 Million to \$676,000.

² Section 6051, of the Internal Revenue Code, which requires the filing of Forms W-2, requires the use of the employee's social security number (SSN).

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Revised Calculation of Cost Savings	
Cost to close an AUR case	\$22.55
ITIN tax returns with both stolen SSN and stolen name on associated form W-2	30,000
Cost savings if these cases did not go to AUR function	\$676,000

Furthermore, there are substantial discrepancies between the information on ITIN data with wages developed by our research staff and those numbers developed by TIGTA. These differences are potentially due to complex data perfection processes.

OUTCOME MEASURE TWO

This outcome measure is based on a recommendation that the IRS subject the over 1 million individuals that had an SSN mismatch on the Wage and Tax Statement (Form W-2) to withholding requirements similar to those to be used in the new Form W-4 compliance program the IRS initiated in Fiscal Year 2005 (i.e., withhold at the single withholding rate with 0 exemptions).

The IRS Enterprise Identity Theft Strategy balances services with enforcement by focusing on Victim Assistance, Outreach and Prevention. The component of the strategy dedicated to prevention focuses on deterring identity theft to decrease the number of victims. The strategy outlines several options for enforcement initiatives targeted at preventing or deterring identity theft. Enforcement initiatives and the resources available to apply to those initiatives are tailored to the type of tax administration crime perpetrated as a result of the theft.

The tax administration issue noted in the recommendation is related to identity theft from employment where undocumented workers use their real name and a stolen SSN to gain employment. This combination of information results in a SSN/Name mismatch on the W-2.

The following is an extract from the IRS Commissioner's Testimony on March 10, 2004, on Individual Identification Numbers and Social Security Number Matching³.

³ Prepared Testimony of Mark W. Everson Commissioner of Internal Revenue before the House Ways and Means Subcommittee on Oversight and Subcommittee on Social Security on Individual Taxpayer Identification Numbers (ITINS) and Social Security Number Matching March 10, 2004.

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“IRS agrees with the importance of accurate W-2 form and Social Security number reporting. We are committed to improving the accuracy of SSN reporting and have worked with the SSA to explore options and initiatives that might improve accuracy.”

Initiatives to improve accuracy of Forms W-2 include strengthening employer penalties associated with SSN mismatches.

“The current penalty regime is not an effective means to address the problem of SSN mismatches. We would, of course, work to execute any changes Congress determines to bring into effect. We would point out, however, that any potential changes would need to address two issues in particular. First, any significant change to the current regime could only be implemented following amendment to Section 6103 of the Code to allow for further information sharing, either interagency or with employers, beyond that which is currently permitted by law.

Second, any requirement to increase our compliance activities in this area, including assessing penalties, would involve an increased demand on our resources. These activities would require a significant rededication of IRS resources to increase compliance in an area that is already, in general, compliant. Absent added funding for such activities, this would likely come at the expense of other compliance activities and with the attendant risk of a decrease in tax revenue from those other compliance activities.”

We do not agree with the recommendation to expand the W-4 withholding compliance program to address Name/SSN mismatches for the following reasons.

- This recommendation focuses limited compliance resources on a low income population, most of whom will have neither a filing requirement nor tax liability. We conducted extensive analysis of the W-2 data to develop the income and withholding levels for the current W-4 withholding program. The program currently focuses on taxpayers that have both a filing requirement and serious under-withholding.
- TIGTA's outcome measure calculates tax withholding, not tax liability. It is likely that the \$9 billion withheld on lower income taxpayers would be refunded. The report recognizes this and stated in a footnote, “The individuals' actual tax liabilities could be different once they file a tax return. The actual tax liabilities could be more or less than the amounts withheld based on the exemptions, credits, and deductions the individuals claim on their tax returns.”