

MSP
#8**RETURN PREPARER FRAUD: The IRS Still Refuses to Issue Refunds to Victims of Return Preparer Misconduct Despite Ample Guidance Allowing the Payment of Such Refunds****RESPONSIBLE OFFICIAL**

John Koskinen, Commissioner of Internal Revenue

DEFINITION OF PROBLEM

While most tax return preparers treat their clients with honesty and integrity, some unscrupulous preparers prey on unsuspecting taxpayers by altering return information without their clients' knowledge or divert refunds for their personal benefit. This type of fraud creates significant challenges for the IRS, harms innocent taxpayers, and undermines trust in our tax system.

In 2012, the IRS developed interim guidance¹ that addresses in a taxpayer-favorable manner the type of fraud where the preparer inflates the refund without the taxpayer's knowledge, provides the taxpayer with the accurate refund amount, and pockets the difference.² Yet in cases where the preparer alters return information without the taxpayer's consent and directs the entire refund to an account under his or her control, the IRS has refused to make these victims whole — namely, by issuing the refunds claimed on their legitimate returns.

On October 17, 2012, the National Taxpayer Advocate issued a proposed Taxpayer Advocate Directive (TAD) directing the Commissioner of Wage and Investment (W&I) to, among other things, develop procedures to issue refunds to victims of return preparer fraud who are due a refund after they file a correct original return. After receiving an unsatisfactory response, the National Taxpayer Advocate included return preparer fraud as a most serious problem faced by taxpayers in her 2012 Annual Report to Congress.

The National Taxpayer Advocate has elevated 25 preparer fraud Taxpayer Assistance Orders (TAOs) to the Acting Commissioner. *These taxpayers have been waiting an average of more than two years to receive their refunds.* Some of these victims have been waiting for refunds ever since they filed 2008 tax returns.³ These victims are typically low income taxpayers, with a median adjusted gross income of \$17,548; the median refund amount is \$2,511. In at least 14 cases, the taxpayer reported the refund fraud to the local police.

1 See Director, Accounts Management, *Interim Guidance on Return Preparer Misconduct (For Memphis Accounts Management ONLY)*, WI-21-0812-02 (Sept. 6, 2012), superseded by Director, Accounts Management, *Interim Guidance on Return Preparer Misconduct (For Memphis Accounts Management ONLY)*, WI-21-0813-02 (Aug. 5, 2013).

2 In such cases, the taxpayer has a copy of the legitimate return, receives the refund he or she was expecting, and has no reason to suspect fraud. Only when the IRS ultimately discovers the taxpayer's return is incorrect and attempts to recover the excess refund through levies, liens, and other enforcement actions does the taxpayer learn of the preparer's fraud.

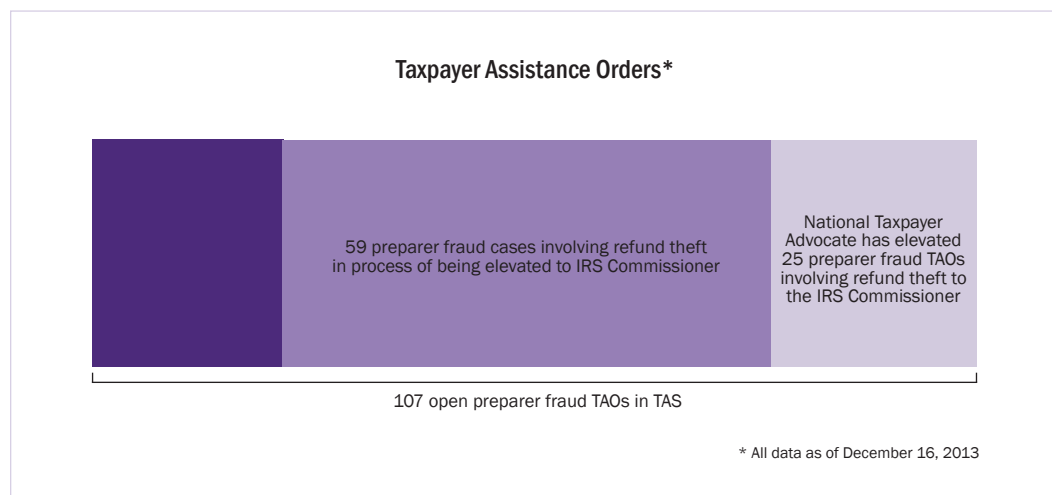
3 See, e.g., Taxpayer Advocate Management Information System (TAMIS) case numbers 4757753, 5269873, and 5361465.

ANALYSIS OF PROBLEM

Background

The IRS has developed interim guidance and procedures to address situations where a victim of return preparer fraud has received the full refund that he or she expected.⁴ However, the IRS response is insufficient in cases where the victim of the preparer has not received the full refund to which he or she is entitled because the preparer has stolen it. The guidance falls short of instructing IRS employees to issue refunds to victims of preparer fraud, which from the victim's perspective is likely the most important aspect of the case. Instead, the procedures instruct employees to suspend action on such cases pending further guidance.

TAS began keeping track of preparer fraud TAOs in fiscal year 2012; there are 107 open preparer fraud TAOs within TAS as of December 16, 2013.⁵ Of these, the National Taxpayer Advocate has elevated 25 preparer fraud TAOs involving refund theft to the Acting Commissioner of Internal Revenue, with another 59 in the process of being elevated to that level.



Some of the victims who have come to TAS for help have been waiting for refunds ever since they filed 2008 tax returns.⁶ In the 25 preparer fraud TAOs elevated to the Acting Commissioner, *the taxpayers have been waiting an average of more than two years to receive their refunds!* These victims are typically low income taxpayers, with a median adjusted gross income of \$17,548. In at least 14 cases, the taxpayer reported the refund fraud to the local police, resulting in at least five arrests.

4 See Director, Accounts Management, *Interim Guidance on Return Preparer Misconduct (For Memphis Accounts Management ONLY)*, WI-21-0813-02 (Aug. 5, 2013); Director, Collection Policy, *Interim Guidance Memorandum on Return Preparer Fraud or Misconduct*, SBSE-05-0613-0034 (June 3, 2013).

5 See email from Director, TAS Technical Analysis & Guidance (Dec. 19, 2013).

6 See, e.g., TAMIS case numbers 4757753, 5269873, and 5361465.

FIGURE 1.8.1, Statistical Snapshot of the 25 Preparer Fraud TAOs elevated to the Acting Commissioner

Median AGI	Median Refund	Average Days Waiting ⁷
\$17,548	\$2,511	745

On December 20, 2013, the Deputy Commissioner for Services and Enforcement responded to the 25 TAOs that had been elevated to the Acting Commissioner level. For victims who did not receive the full amount of refund he or she was expecting, the IRS will not issue any further refunds. The rationale given was that it would be difficult for the IRS to detect collusion between the preparer and the victim.⁸

The National Taxpayer Advocate is not naïve and recognizes that collusion is a legitimate area of concern. However, there are ways to deal with that possibility without harming a whole class of taxpayers. Some taxpayers that have come to TAS have filed police reports (taxpayers did so in 14 of the 25 TAO cases) and even assisted law enforcement personnel in having the preparer arrested for fraud. In such cases, any suspicion of collusion should be allayed. Instead of trying to develop workable documentation requirements to address this concern of collusion, the IRS made a blanket decision to deny payment to all victims of preparer fraud who have not received the full amount of their refund (unless they can show that the return filed was completely unauthorized; the IRS may try to resolve those cases using identity theft procedures).⁹

It Is Permissible for the IRS to Reissue Refunds to Victims of Preparer Fraud, When the Return Preparer Has Absconded with the First Refund.

Since 2000, the IRS has received the benefit of several Chief Counsel opinions that address preparer fraud.¹⁰ These opinions, when read together, authorize the IRS to:

1. Deem the first, falsified return a “nullity;”
2. Accept and process the second, true return submitted by the taxpayer after discovering the preparer fraud; and
3. Issue any refund due to the taxpayer under the second, true return (including any amounts previously paid to and stolen by the preparer), plus interest.

Particularly insightful is the Chief Counsel position in Field Service Advice (FSA) 200038005 from June 6, 2000. While FSA are not precedential, they do offer a glimpse into how the IRS may analyze a similar situation. This FSA involved a taxpayer who visited a Volunteer Income Tax Assistance (VITA) site staffed by military volunteers to have her return prepared electronically. The taxpayer received a copy of the return she authorized and was expecting a refund to be direct deposited. When she did not receive the

⁷ Measured from the date the taxpayer came to TAS for assistance through December 2013.

⁸ See Deputy Commissioner for Services and Enforcement response to the National Taxpayer Advocate re: Return Preparer Fraud TAOs (Dec. 20, 2013) (stating “It would be extremely difficult to ensure that the taxpayer and the return preparer are not in collusion in order to obtain an additional refund. If collusion is not present in the current cases, establishing a process whereby IRS issues a second refund could certainly create an incentive for taxpayers and preparers to abuse in order to obtain additional Federal monies.”).

⁹ See Deputy Commissioner for Services and Enforcement response to the National Taxpayer Advocate re: Return Preparer Fraud TAOs (Dec. 20, 2013).

¹⁰ See Field Service Advice 200038005 (June 6, 2000); IRS Office of Chief Counsel Memorandum, *Horse’s Tax Service*, PMTA 2011-13 (May 12, 2003); IRS Office of Chief Counsel Memorandum, *Refunds Improperly Directed to a Preparer*, POSTN-145098-08 (Dec. 17, 2008); IRS Office of Chief Counsel Memorandum, *Tax Return Preparer’s Alteration of a Return*, PMTA 2011-20 (June 27, 2011).

refund at the expected date, she contacted the VITA site, which discovered that someone affiliated with the site altered the taxpayer's return information and directed the refund into another account. The FSA concluded that if the taxpayer can show that the direct deposit was stolen, the IRS may reissue a second refund to the taxpayer since it is clear the taxpayer never received the first one. In other words, there is no legal impediment to the IRS reissuing a refund to make the taxpayer whole in situations of return preparer fraud.

An Unauthorized Tax Return Should Not Be Treated as a Legitimate Return of the Taxpayer.

In *Beard v. Commissioner*,¹¹ involving a taxpayer who altered a Form 1040, *U.S. Individual Income Tax Return*, the Tax Court applied a four-part test to determine whether a document filed with the IRS qualifies as a "return" for tax purposes. Those requirements are that the document:

1. Purport to be a return;
2. Be signed under penalties of perjury;
3. Contain sufficient data to permit a tax to be calculated; and
4. Evince an honest and genuine endeavor to satisfy the requirements of tax law.

The IRS Office of Chief Counsel has routinely referred to the *Beard* analysis in its opinions on preparer fraud as the generally accepted test for determining the validity of a tax return.¹²

Return preparer misconduct occurs when a tax preparer alters return information without their clients' knowledge or consent in an attempt to obtain improperly inflated refunds, or to divert refunds for their personal benefit.

In a typical preparer fraud case scenario, the preparer alters some information on the return after the taxpayer has authorized a prior version. Accordingly, the return submitted by the return preparer was not reviewed, authorized, or signed by the taxpayer under penalties of perjury. It is not a valid return, as it fails the signature requirement of the *Beard* test, and should not be treated as a return of the taxpayer.

Thus, the decision faced by IRS leadership in whether it will pay refunds to victims of preparer fraud is largely one of public policy, rather than a legal question.

Public Policy Concerns Dictate that the IRS Make Victims of Preparer Fraud Whole.

In 2012, the National Taxpayer Advocate has designated the complexity of the Internal Revenue Code (IRC) as one of the most serious problems facing taxpayers.¹³ The existing code, by our count, has reached nearly four million words and imposes unconscionable burden on taxpayers.¹⁴ Our analysis of IRS data indicates

¹¹ 82 T.C. 766, 777-78 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986).

¹² See IRS Office of Chief Counsel Memorandum, *Horse's Tax Service*, PMTA 2011-13 (May 12, 2003); IRS Office of Chief Counsel Memorandum, *Tax Return Preparer's Alteration of a Return*, PMTA 2011-20 (June 27, 2011). In discussions with IRS Executives, the Office of Chief Counsel recently advised that the IRS, as an innocent third party, would not be required to pay out these refunds under agency law. Specifically, the IRS could rely on the fraudulent representation of the return preparer (the agent) who filed a return he or she fraudulently altered; thus, any refunds issued by the IRS to the return preparer would satisfy the IRS's obligation to pay a refund to the taxpayer (the principal). The Office of Chief Counsel has not adopted or advanced this position in any of its opinions pertaining to return preparer fraud. Indeed, this theory contradicts all prior opinions on the matter and would result in treating taxpayers who are similarly situated, but for the issuance of a refund, being treated disparately.

¹³ See, e.g., National Taxpayer Advocate 2012 Annual Report to Congress 3-23 (Most Serious Problem: *The Complexity of the Tax Code*).

¹⁴ See *Id.* at 6.

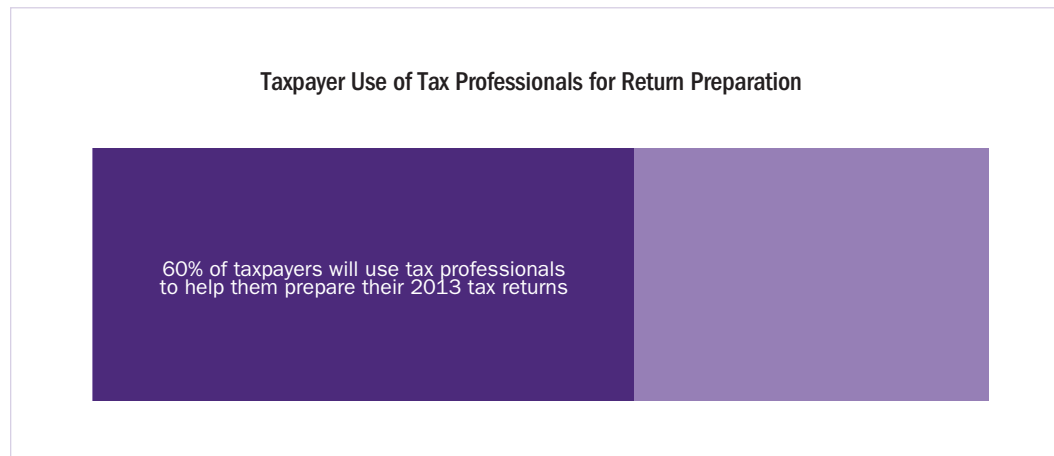
that individuals and businesses spend about 6.1 billion hours a year complying with tax-filing requirements.¹⁵

Even as tax compliance becomes more complex, the IRS provides fewer resources to help taxpayers file their returns. For example, IRS Taxpayer Assistance Center staff will no longer help customers with return preparation.¹⁶ Many taxpayers, particularly low-income ones who are eligible for various refundable credits, feel pressure to hire a preparer to meet their statutorily-mandated tax filing requirement.

FIGURE 1.8.2, Taxpayers Claiming Refundable Credits, Claim Amounts, and Preparer Usage: Tax Years 2010 and 2011¹⁷

Tax Credit	Tax Year	Number of Taxpayers	Average Claim (dollars)	Total Claims (dollars in thousands)	Preparer Returns (percentage)
EITC	2011	27,362,193	\$2,270	\$62,119,975	59.3%
Additional child tax credit	2011	20,616,435	\$1,347	\$27,771,740	65.0%
First-time home buyer credit	2010	373,880	\$6,893	\$2,577,155	53.8%
Adoption credit	2011	55,794	\$13,474	\$760,365	60.1%
Making work pay credit	2010	106,381,764	\$514	\$54,784,234	53.6%
American opportunity tax credit	2011	12,525,776	\$899	\$11,266,488	55.9%

Overall, approximately 60 percent of taxpayers will use tax professionals to help them navigate the maze of the tax code and prepare their 2013 tax returns.¹⁸



15 See *Id.* at 5.

16 See *Id.* at 302 (Most Serious Problem: *The IRS Lacks a Servicewide Strategy that Identifies Effective and Efficient Means of Delivering Face-to-Face Taxpayer Services*); IRS, W&I Business Performance Review (Nov. 20, 2013); IRS, Wage & Investment Division, Response to TAS information request (email dated Dec. 20, 2013). The IRS will refer taxpayers who visit Taxpayer Assistance Centers for tax preparation to the nearest volunteer site for tax return preparation.

17 IRS Compliance Data Warehouse, Individual Returns Transaction File and Individual Master File, tax year 2010 and 2011 (through Mar. 2013).

18 See IRS, IR-2013-33, IRS Releases the Dirty Dozen Tax Scams for 2013, available at <http://www.irs.gov/uac/Newsroom/IRS-Releases-the-Dirty-Dozen-Tax-Scams-for-2013>; IRS, IR-2008-2, *Treasury and IRS Give Taxpayers Greater Control over Information Held by Tax Preparers, Propose Marketing Restrictions on RALs*, available at <http://www.irs.gov/uac/Treasury-and-IRS-Give-Taxpayers-Greater-Control-over-Information-Held-by-Tax-Preparers;-Propose-Marketing-Restrictions-on-RALs>.

Although the IRS has attempted to test, certify, and regulate return preparers, it has not yet been able to implement such a system.¹⁹ In the absence of a certification program that would differentiate qualified tax return preparers from other individuals or businesses offering the same services, taxpayers may find themselves handing over sensitive tax information to an opportunistic preparer who alters the taxpayer's return without authorization.

When this happens, the IRS response has been underwhelming. While the IRS may eventually untangle the victim's account issues, the IRS's position has been that the taxpayer's sole recourse for any stolen refunds lies with the preparer, not the IRS. Victims of preparer fraud, particularly low income and unsophisticated taxpayers who may not be well-versed in the civil litigation options theoretically available to them, would be right in feeling that the IRS has failed them.

A Victim of Preparer Fraud Is Similar to an Innocent Spouse

Generally, married taxpayers who file jointly are jointly and severally liable for any tax, interest, and penalties due as shown on the return.²⁰ However, innocent spouses may file for relief from joint and several liability under IRC § 6015. In 1998, the IRS was given expanded authority for innocent spouse relief.²¹ Congress wanted the IRS, when it had evidence of misdoing through no fault of the victim, to refund the money to the innocent spouse — even when the other party (the “non-innocent” spouse) was unable to pay.

In the case of preparer fraud, no statutory fix is needed to make the victim whole. A series of Chief Counsel opinions make it clear that the IRS has the legal right to issue refunds to victims of preparer fraud — even in instances where the other party (the preparer) is unable to return the proceeds from the first refund. The Office of Chief Counsel recently reaffirmed that position to the National Taxpayer Advocate and the IRS Commissioner.

Although Preparer Fraud Is Similar to Identity Theft, the IRS Treats Victims Substantially Differently.

Return preparer fraud is similar to identity theft in that both crimes delay refunds and cause account problems, but the IRS deals with the victims in substantially different ways. Over the years, the IRS has developed victim assistance procedures that ultimately unwind the harm to a victim of identity theft. Although it may take much longer than an identity theft victim prefers, the IRS has procedures to “back

19 See Most Serious Problem: *Regulation of Return Preparers: Taxpayers and Tax Administration Remain Vulnerable to Incompetent and Unscrupulous Return Preparers While the IRS is Enjoined from Continuing Its Efforts to Effectively Regulate Unenrolled Preparers*, *supra*. In November 2011, the IRS launched a return preparer competency test with a deadline for completion by December 31, 2013. See IRS News Release, IR-2011-111, *IRS Moves to Next Phase of Return Preparer Initiative; New Competency Test to Begin* (Nov. 22, 2011). However, in January 2013, a U.S. District Court judge in *Loving v. Internal Revenue Service* disagreed with the IRS's view that it has the authority to implement these requirements on its own, and invalidated the testing and continuing education requirements. *Loving v. IRS*, 917 F. Supp. 2d 67 (D.D.C. Jan. 18, 2013). The government filed a motion to suspend the injunction pending appeal. The U.S. District Court for the District of Columbia denied the motion but then modified the terms of the injunction. See *Loving v. IRS*, 920 F. Supp. 2d 108 (D.D.C. Feb. 1, 2013). The Justice Department has appealed the District Court's decision. *Loving v. IRS*, No. 1:12-cv-00385 (D.D.C. 2013) (USCA Case No. 13-5061).

20 See IRC § 6013(d)(3).

21 See IRC § 6015. “Innocent spouse relief” is frequently used to describe relief from joint and several liability under IRC § 6015(b). Refunds are also available under IRC 6015(f), called “equitable relief.” See also Joint Committee on Taxation, JCX-6-98, *Present Law and Background Relating to the Treatment of “Innocent Spouses”* (Feb. 9, 1998); *IRS Restructuring (Innocent Spouse Tax Rules): Hearing Before the S. Comm. on Finance*, 105th Cong. (1998).

out” the return filed by the perpetrator, process the true return, and pay out the associated refund claim, if applicable.²²

In contrast, the IRS has not developed procedures that would fully unwind the harm suffered by victims of preparer fraud. For instance, although the IRS is willing to process the correct original return from the taxpayer, the IRS will not provide full relief by issuing a refund to these victims in cases where the preparer absconded with the initial refund that the IRS issued after receiving the falsified return.²³

The IRS has the legal authority to issue such refunds to victims of preparer fraud. The National Taxpayer Advocate urges IRS leadership to make these vulnerable taxpayers whole once it is established that they were not complicit in the crime, just as the IRS works to make identity theft victims whole.

The IRS Should Consider Multiple Factors — Including Mitigation, Restitution, and Substantiation — Before Deciding Whether to Release a Refund to a Victim of Preparer Fraud.

In the absence of any regulation of return preparers, taxpayers have many options when choosing someone to prepare and file their tax returns. Return preparers run the gamut from attorneys and certified public accountants to large, national tax preparation firms to nonprofessionals who have purchased off-the-shelf software and volunteer to prepare a neighbor’s return. Undoubtedly, some taxpayers are swayed by claims made by certain preparers to obtain a refund amount that may seem too good to be true. The IRS, rightfully, must be cognizant of the possibility of collusion between the preparer and the “victim” in an attempt to defraud the government. Moreover, the IRS does not want to serve as the *de facto* insurer of taxpayers who choose a preparer solely based on the size of the refund they were promised. Doing so would create a moral hazard by encouraging taxpayers to engage in high-risk behavior.

With these concerns in mind, the National Taxpayer Advocate proposes a framework of analysis the IRS can undertake when deciding whether to issue refunds to purported victims of preparer fraud. This framework includes mitigation, restitution, and substantiation.

MITIGATION

The IRS should ask the victim what actions were taken to prevent the preparer fraud or to minimize the loss. For example, did the victim request a copy of the return that he or she authorized for filing? If the refund was not received by the expected date, did the victim promptly follow up with the preparer to check on the status? Did the victim contact the IRS to request a refund trace?

If the fraud was committed by an employee of a national, franchised tax preparation firm, did the victim request a settlement from the firm? To take the onus off the victim, the National Taxpayer Advocate suggests that the IRS establish a liaison with the nation’s largest tax preparation firms to present these cases and request that they make the victims whole. TAS could spearhead coordination with the Wage & Investment division, the Criminal Investigation division, Chief Counsel, the Return Preparer Office, and the Office of Professional Responsibility.

²² See generally IRM 21.6.2, *Individual Tax Returns, Adjusting TIN-Related Problems* (Oct. 1, 2013).

²³ See Director, Accounts Management, *Interim Guidance on Return Preparer Misconduct (For Memphis Accounts Management ONLY)*, WI-21-0813-02 (Aug. 5, 2013).

These taxpayers who have been victimized by return preparers are being harmed again by the IRS inaction.

RESTITUTION

The IRS should not be obligated to pay out the full amount of the refund when restitution is available and recovered. If the preparer, whether out of guilt or under a court order, paid the victim a portion of the refund after being confronted or convicted, the IRS should subtract the amount of any money recovered by the victim. In these cases, emphasis should be on restitution *received*. Some preparers may be indigent or incarcerated. Thus, they may be unable to comply with a court order to pay restitution.

SUBSTANTIATION

Victims of preparer fraud should be encouraged to provide the IRS with as much documentary evidence of the claim as possible. In addition to the required forms,²⁴ victims may wish to submit:

- A copy of the unaltered return (if provided by the preparer);
- A business card, flyer, or other advertisement with the preparer's contact information;
- A copy of any refund traces requested;
- A copy of bank statements showing the expected refund was not deposited into the victim's account; and
- Taxpayer statement (signed under penalties of perjury).

The IRS should encourage victims of preparer fraud to contact local law enforcement and file a report or complaint against the preparer. Doing so would ease the IRS's concern that the preparer and taxpayer may have been acting collaboratively to defraud the government. Victims should provide a copy of the police report (and conviction, if applicable). However, some jurisdictions may not be willing to receive a victim's complaint or issue a police report. Thus, the absence of one or more of these documents should not count against the taxpayer's claim. Moreover, none of the factors discussed above need be dispositive of the matter.

CONCLUSION

In many return preparer fraud cases, refunds are directed to an account under the preparer's control, leaving the taxpayer with no monetary benefit from the fraudulent filing and having to deal with the IRS in the aftermath. Although there is no legal impediment to the IRS reissuing refunds to victims of preparer fraud, IRS leadership has refused to make the policy call to do so. These taxpayers, who have been victimized by return preparers, are being harmed again by IRS inaction.

In the case of a return altered by a preparer, the IRS should have even more reason to assist the taxpayer than in refund fraud cases not involving a preparer. While a non-preparer third party who alters a return may be a mere thief, an errant preparer is not only a thief but is violating his or her fiduciary duty to the taxpayer and the tax system.

²⁴ The IRS requires victims of preparer fraud to submit Forms 14157, *Return Preparer Complaint*, and 14157-A, *Tax Return Preparer Fraud or Misconduct Affidavit*, to the Memphis Accounts Management office. See Director, Accounts Management, *Interim Guidance on Return Preparer Misconduct (For Memphis Accounts Management ONLY)*, WI-21-0813-02 (Aug. 5, 2013).

Not long ago, an IRS report stated that, “tax return preparers and the associated industry play a pivotal role in our system of tax administration and they must be a part of any strategy to strengthen the integrity of the tax system.”²⁵ To protect the integrity of tax administration, the IRS must develop procedures that address the 21st-century version of return preparers’ misappropriation of their clients’ federal tax refunds.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Develop comprehensive guidance providing full relief to victims of return preparer fraud, including the issuance of a refund.
2. Direct TAS, W&I, Criminal Investigation, Chief Counsel, the Return Preparer Office, and the Office of Professional Responsibility to develop referral procedures for and establish a liaison to national tax preparation firms, to seek recovery of refunds for taxpayers defrauded by their employees or agents.

²⁵ IRS Pub. 4832, *Return Preparer Review*, at 32 (Dec. 2009).