

**MSP  
#10****TIMING OF REFUNDS: The Speedy Issuance of Tax Refunds Drives Refund Fraud and Identity Theft, As More Research Is Needed on the Costs and Benefits of Holding Refunds Until the End of the Filing Season****RESPONSIBLE OFFICIAL**

Debra Holland, Commissioner, Wage and Investment Division

**TAXPAYER RIGHTS IMPACTED<sup>1</sup>**

- *The Right to Quality Service*

**DEFINITION OF PROBLEM**

The IRS processes in excess of 150 million tax returns each year and issues refunds to taxpayers in about 70 percent of the returns received.<sup>2</sup> Although the IRS prides itself in delivering 90 percent of refunds in less than 21 days,<sup>3</sup> many countries deliver tax refunds more quickly than the IRS is able to do. For example, the Organisation for Economic Co-operation and Development (OECD) found that Estonia processed 100 percent of its tax returns with refunds within five working days and Canada delivered 100 percent of its e-filed refunds within 1.6 weeks.<sup>4</sup>

With the average refund amount being nearly \$2,800,<sup>5</sup> delays in processing the refund can cause significant hardship to taxpayers who rely on this refund. The IRS states that this lag time is needed to fully verify the validity of the items reported on the income tax return against the information returns submitted by employers and other third parties. Even with this 21-day delay, the IRS is still susceptible to identity theft and other refund fraud. In a 2015 report issued by the Treasury Inspector General for Tax Administration (TIGTA), TIGTA found that although the IRS's fraud detection efforts were able to stop between \$22 billion and \$24 billion of false refunds from being issued, identity thieves were still able to successfully defraud the government — and taxpayers, collectively — out of approximately \$5.75 billion in the 2013 filing season.<sup>6</sup>

The speed with which a tax agency issues refunds requires the balancing of two compelling interests. That is, there is an inherent tension between the need to get refunds out to taxpayers quickly and the need to protect against refund fraud. Whether the delay should be a couple of weeks, or whether the IRS should not issue refunds until the filing season officially ends, requires careful consideration.

1 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

2 <https://www.irs.gov/uac/Newsroom/IRS-Ready-to-Start-2016-Tax-Season-Encourages-use-of-IRS-gov-and-e-File-Works-with-States,-Industry-on-Identity-Theft-Refund-Fraud>.

3 <https://www.irs.gov/Refunds/What-to-Expect-for-Refunds-This-Year>.

4 Organisation for Economic Co-operation and Development (OECD), *Tax Administration 2015: Comparative Information on OECD and Other Advanced and Emerging Economies*.

5 <https://www.irs.gov/uac/Newsroom/IRS-Ready-to-Start-2016-Tax-Season-Encourages-use-of-IRS-gov-and-e-File-Works-with-States,-Industry-on-Identity-Theft-Refund-Fraud>.

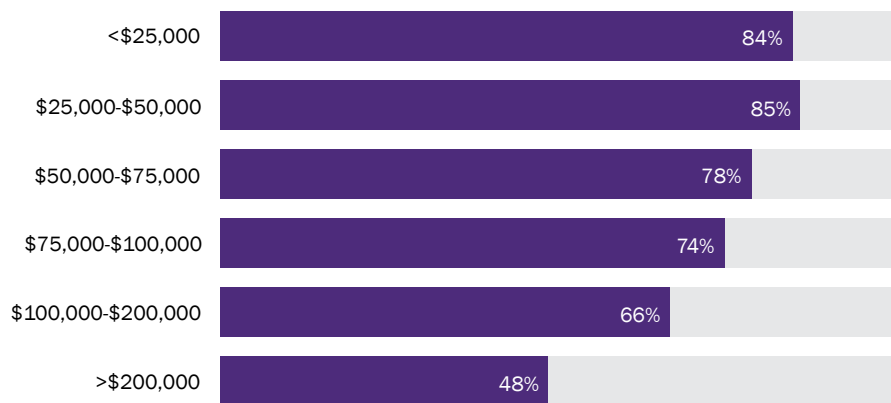
6 Treasury Inspector General for Tax Administration, Ref. 2015-40-026, *Efforts Are Resulting in the Improved Identification of Fraudulent Tax Returns Involving Identity Theft 2* (Apr. 24, 2015).

## ANALYSIS OF PROBLEM

Because Congress has chosen to deliver many social benefit programs through the tax system, and because the IRS has done a good enough job of delivering the resulting tax refunds timely, a cultural phenomenon has developed — many U.S. taxpayers now have an expectation that they will receive a sizable refund shortly after the beginning of each tax filing season. The IRS expects more than 70 percent of taxpayers to get a tax refund after they file.<sup>7</sup>

**FIGURE 1.10.1<sup>8</sup>**

### Taxpayers Receiving Refunds by Income Level



**FIGURE 1.10.2, Average Refund Issued by Income Level<sup>9</sup>**

	<\$25,000	\$25,000-\$50,000	\$50,000-\$75,000	\$75,000-\$100,000	\$100,000-\$200,000	>\$200,000
Average Refund (of Those Who Got a Refund)	\$2,056	\$2,618	\$2,722	\$3,246	\$4,310	\$15,437
Average Refund/Average Total Positive Income	16%	7%	4%	4%	3%	4%

There are various reasons why one would, in essence, give the government an interest-free loan by choosing to be owed a refund. Some taxpayers have a strong desire to avoid uncertainty or to avoid any chance of underpayment of taxes; others may simply enjoy the psychological benefits of looking forward to getting a large refund each year.<sup>10</sup> One thought is that taxpayers “perceive emotional benefits

7 <https://www.irs.gov/uac/Newsroom/IRS-Ready-to-Start-2016-Tax-Season-Encourages-Ause-of-IRS-gov-and-e-File-Works-with-States,-Industry-on-Identity-Theft-Refund-Fraud>.

8 Total positive income data from tax year (TY) 2015 Forms 1040 was used to create this chart (data compiled Nov. 10, 2016).

9 *Id.*

10 See Donna D. Bobek and Kristin Wentzel, *An Investigation of Why Taxpayers Prefer Refunds: A Theory of Planned Behavior Approach*, JOURNAL OF THE AMERICAN TAXATION ASSOCIATION (Mar. 2008).

(e.g., enjoyment of refund check, reduced anxiety) from over-withholding that equal or offset the financial costs.”<sup>11</sup>

Some taxpayers seem to view the tax system as a “forced savings” mechanism, preferring to overfund their tax withholding to ensure that they receive a lump sum refund when they file their tax return.<sup>12</sup> Researchers have found that as refund timing changes, savings and spending patterns change. In one study, respondents receiving a hypothetical lump-sum tax refund saved more (spent less) than those receiving the same amount, but on a monthly basis.<sup>13</sup>

Other taxpayers receive a significant refund as a result of being eligible for refundable credits, such as the Earned Income Tax Credit (EITC), which are payable only through a lump sum after filing. These taxpayers might not have the opportunity to adjust their withholding enough to eliminate their tax refund.

### The Protecting Americans from Tax Hikes Act (PATH Act) Will Delay Refunds for Certain Taxpayers Starting in 2016

Section 201 of the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) that was enacted December 18, 2015, requires the IRS to hold all refunds that include EITC or the Additional Child Tax Credit (ACTC) until February 15 for calendar year filers to allow the IRS more time to verify the validity of the refunds and detect fraud. This will delay the issuance of refunds to early filers who have EITC and ACTC claims, causing a significant burden on households that rely on tax refunds to pay bills. Delaying the issuance of the EITC or ACTC until February 15 will significantly impact taxpayers whose refunds represent a significant portion of their yearly income (see Figure 1.10.2, above).

The PATH Act also changes the due date for employers and payors to submit wage information (Form W-2) and non-employee compensation (Form 1099-MISC) to the Social Security Administration. The deadline to file these information returns has been moved up to January 31 from the end of February (if filing on paper) or the end of March (if filing electronically). The new accelerated deadline will make it easier for the IRS to spot errors on returns and verify the legitimacy of tax returns before issuing refunds.

### States and Foreign Countries Are Combating Refund Fraud by Delaying Refund Issuance or Accelerating Information Reporting

Some states (including Illinois, Louisiana, and Utah) are beginning to push back the date they issue tax refunds.<sup>14</sup> By delaying the issuance of refunds, these states can enhance their efforts to prevent tax-related refund fraud.

In the United Kingdom, Her Majesty’s Revenue and Customs (HMRC) engaged extensively with employers, software developers, agents, and other interested parties to design a Real Time Information

11 When paid in a lump sum annually, \$243 (81 percent) of the \$300 refund and \$487 (also 81 percent) of \$600 would be saved, vs. \$108 (36 percent) and \$180 (30 percent) saved, respectively, with monthly refunds. See Donna D. Bobek and Kristin Wentzel, An Investigation of Why Taxpayers Prefer Refunds: A Theory of Planned Behavior Approach, *JOURNAL OF THE AMERICAN TAXATION ASSOCIATION* (Mar. 2008).

12 Valerie Chambers & Marilyn Spencer, Does Changing the Timing of a Yearly Individual Tax Refund Change the Amount Spent vs. Saved?, *JOURNAL OF ECONOMIC PSYCHOLOGY* 29 (2008) 856-62.

13 *Id.*

14 See <http://www.dontmesswithtaxes.com/2016/01/state-tax-refunds-to-be-delayed-in-illinois-louisiana-utah-because-of-tax-identity-theft-procedures.html> (last visited Nov. 18, 2016); Ann Carrns, *State Tax Refunds May Be Delayed by Security Precautions*, *N.Y. TIMES* (Jan. 15, 2016), [http://www.nytimes.com/2016/01/16/your-money/state-tax-refunds-may-be-delayed-by-security-precautions.html?\\_r=0](http://www.nytimes.com/2016/01/16/your-money/state-tax-refunds-may-be-delayed-by-security-precautions.html?_r=0).

reporting of income tax information from employers, starting in 2013.<sup>15</sup> Such an arrangement gives HMRC an early start in examining “Pay-As-You-Earn”<sup>16</sup> income tax information in real time, well ahead of the filing season.

### Do the Benefits of Reducing Improper Payments Outweigh the Costs of Delaying Refunds?

With tax refund fraud becoming a significant problem, costing taxpayers billions of dollars each year, it may make sense for the IRS to delay the issuance of tax refunds while it verifies taxpayer-reported data. If the IRS held off issuing refunds until the end of the filing season, it would have an opportunity to validate return information using Form W-2 data, check for duplicate dependency exemption claims, reconcile child support and alimony reporting, and conduct Automated Underreporter matching, enabling it to process error-free returns and deliver accurate refunds.<sup>17</sup> The IRS should quantify the compliance impact of administering these programs in real time. Once it does, the IRS would be much better positioned to determine whether delaying the issuance of refunds by a couple of months will be justified, after balancing it against the very real financial impact of the delay on taxpayers, particularly low income taxpayers.

Participants in the 2016 IRS Nationwide Tax Forum focus groups cautioned that changing their clients’ mindsets and expectations about the timing of refund delivery would be difficult.<sup>18</sup> Focus group participants reported that taxpayers who claim EITC often depend on their tax refunds for utility bill payments, car repair expenses, property taxes, tuition, and other bills they may have been holding off paying until the tax filing season. With their clients’ urgent need for the refunds, practitioners felt it would take quite a bit of time to change behavior. Thus, in conducting its study of the implications of delayed refunds, the IRS should consider a staged approach, rolled out over several years. In that regard, the February 15 refund date for EITC and ACTC returns will provide the IRS valuable information about the effect of delayed refunds on the most vulnerable taxpayer population.

## CONCLUSION

The OECD reminds us that tax refunds “represent a cost to taxpayers in terms of ‘the time value of money’... Any delays in refunding legitimately overpaid taxes may therefore result in significant ‘costs’ to taxpayers, particularly where there are inadequate provisions in tax laws for the payment of interest to taxpayers with respect to delayed refunds.”<sup>19</sup> Accordingly, the IRS should carefully weigh the cost of delaying the issuance of refunds to taxpayers who may have grown reliant on such refunds being issued a few weeks after tax filing.

15 Her Majesty’s Revenue and Customs, *Real Time Information (RTI): Improving the Operation of Pay As You Earn* (Dec. 17, 2014), [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/388103/RTI-TIIN.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/388103/RTI-TIIN.pdf).

16 Under a Pay-As-You-Earn (PAYE) system, such as the one widely used in the United Kingdom, a country collects taxes on items including wages, dividends, and other earnings directly from the payor of that income at the time the income is earned. For more discussion about PAYE systems, see Research Study: *A Conceptual Analysis of Pay-As-You-Earn (PAYE) Withholding Systems as a Mechanism for Simplifying and Improving U.S. Tax Administration*, vol. 2, *infra*.

17 These procedures, however, raise significant taxpayer rights concerns if not properly administered. See Most Serious Problem: *Online Accounts: Research into Taxpayer and Practitioner Needs and Preferences Is Critical As the IRS Develops an Online Taxpayer Account System*, *supra*, for more detailed discussion.

18 TAS, *2016 IRS Nationwide Tax Forums TAS Focus Group Report: Timing of Refunds* (Nov. 2016).

19 Organisation for Economic Cooperation and Development (OECD), *Tax Administration 2015: Comparative Information on OECD and Other Advanced and Emerging Economies*, [http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/tax-administration-2015\\_tax\\_admin-2015-en#.V8iLK7DVzIU#page1](http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/tax-administration-2015_tax_admin-2015-en#.V8iLK7DVzIU#page1).

**RECOMMENDATION**

The National Taxpayer Advocate recommends that the IRS:

1. In collaboration with TAS, initiate a research study on the potential savings to the government from reducing improper payments and the potential impact to taxpayers, particularly low income taxpayers, if refund issuance is delayed until after the filing season.