

Area of  
Focus #2

## The IRS Agrees It Should Issue Refunds to Victims of Return Preparer Fraud, But It Has Been Slow to Develop Necessary Procedures

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

- *The right to pay no more than the correct amount of tax*
- *The right to a fair and just tax system*

### Victims of Return Preparer Fraud Are Treated Differently Than Victims of Identity Theft

Many taxpayers enlist the aid of tax return preparers<sup>2</sup> to meet their increasingly complex tax return filing obligations. Unfortunately, a small percentage of these preparers betray their clients' trust by inflating income, deductions, credits, or withholding without the clients' knowledge or consent.<sup>3</sup> They then pocket all or part of the taxpayer's direct deposit refund by diverting all or part of the money to a bank account under the preparer's control.

In situations where the preparer diverted the legitimate portion of the refund to his or her own account, victimized taxpayers have little hope of obtaining their refunds from the preparer, who may have closed up shop. While there is no legal impediment to the IRS issuing refunds to victims of preparer fraud, it has been reluctant to do so. Taxpayers who are trying to comply with the law and have demonstrated they were not complicit in the fraud should receive their full refunds, just as victims of identity theft do.

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 procedures that ultimately undo the harm to victims of identity theft. The IRS can "back out" the return filed by the perpetrator, process the legitimate return, and pay the associated refund claim, if applicable, even if the IRS has already paid that refund out to the identity thief.<sup>4</sup>

In contrast, the IRS still has no procedures that fully unwind the harm suffered by victims of preparer fraud. In June 2012, the IRS issued interim guidance to its employees on how to handle certain preparer fraud cases in the form of Servicewide Electronic Research Program (SERP) Alert 12A0417.<sup>5</sup> However, this guidance was not comprehensive, as it failed to provide relief for a large category of victims. For example, the IRS agreed to remove the fraudulent tax return information from the victim's account and

1 See IRS, *Taxpayer Bill of Rights*, available at <http://www.irs.gov/Taxpayer-Bill-of-Rights>.

2 See Internal Revenue Code (IRC) § 7701(a)(36). Approximately 60 percent of individual taxpayers paid a preparer to file their 2013 tax return. IRS Compliance Data Warehouse, Individual Returns Transaction File, (Tax Year 2013 - returns processed as of the end of April 2015).

3 See National Taxpayer Advocate Fiscal Year 2015 Objectives Report to Congress 22 (*Return Preparer Fraud: A Sad Story*).

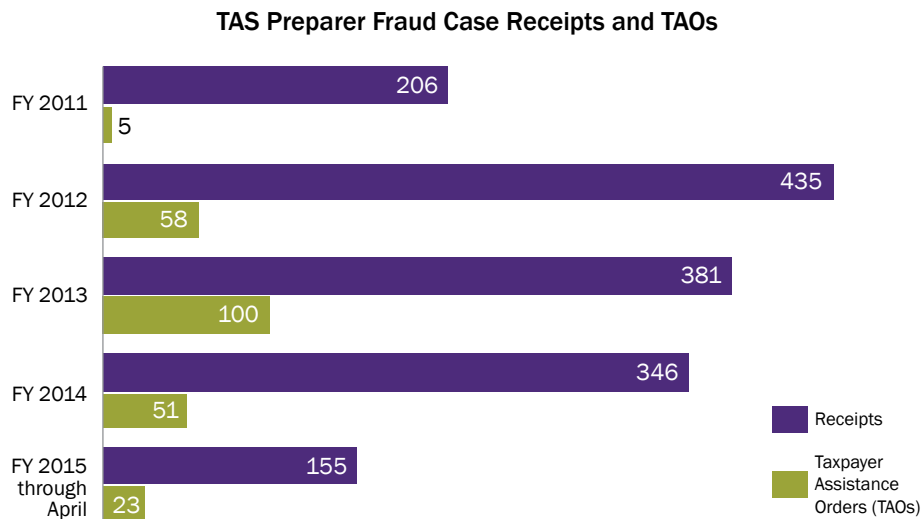
4 See generally Internal Revenue Manual (IRM) 21.6.2, *Individual Tax Returns, Adjusting TIN-Related Problems* (Oct. 1, 2013).

5 See SERP Alert 12A0417, *Memphis AM ONLY - Return Preparer Misconduct Interim Guidance* (June 26, 2012). The SERP Alert was incorporated into an interim guidance memorandum, which has been reissued multiple times. See *Interim Guidance on Return Preparer Misconduct (For Memphis Accounts Management ONLY)*, WI-21-0812-02 (Sept. 6, 2012); *Interim Guidance on Return Preparer Misconduct (For Memphis Accounts Management ONLY)*, WI-21-0214-02 (Aug. 5, 2013); *Interim Guidance on Return Preparer Misconduct (For Memphis Accounts Management ONLY)*, WI-21-0814-05 (Aug. 4, 2014). Each interim guidance memorandum indicates that the procedures are interim only until IRM 21.9.3, *Assisting Victims of Return Preparer Fraud*, is published. In accordance with IRM 1.11.10.2.1(3), *Interim Guidance Effective Period* (Apr. 25, 2014), when the interim guidance cannot be incorporated into the IRM before the expiration date on the memorandum, the IRS must reissue the interim guidance. To date, the IRS has not published IRM 21.9.3, and the current interim guidance will expire on August 5, 2015.

process the victim's correct return, but it did not instruct its employees to issue a replacement refund – which, from the taxpayer's perspective, is the most important step.

In fiscal year (FY) 2011, TAS started tracking return preparer fraud cases using a special code. As shown below, TAS has continued to work a substantial number of cases in which taxpayers are harmed by return preparer fraud or misconduct.

**FIGURE 3.2.1<sup>6</sup>**



As of April 30, 2015, TAS had 308 return preparer fraud cases in inventory.<sup>7</sup> Some of the victims who have come to TAS for help have been waiting for refunds since they filed their 2008 tax returns.<sup>8</sup>

### Although IRS Leadership Has Agreed It Would Issue Refunds to Victims of Return Preparer Fraud, the IRS Has Not Developed Any Procedures to Date

While working to help these individual taxpayers, TAS has also pursued this issue from a systemic perspective. Since 2011, the National Taxpayer Advocate has raised and discussed this issue with four

<sup>6</sup> Pursuant to IRC § 7811, the National Taxpayer Advocate may issue a Taxpayer Assistance Order ordering the IRS to cease, take, or refrain from taking certain actions as described more fully in the statute. The order may be modified or rescinded only by the Commissioner or Deputy Commissioner or the National Taxpayer Advocate (or her delegate). Data obtained from the Taxpayer Advocate Management Information System (TAMIS) (FY 2011-2013 - Oct. 24, 2013; FY 2014 - May 28, 2015; FY 2015 - May 19, 2015).

<sup>7</sup> Data obtained from TAMIS (May 19, 2015). The current inventory of return preparer fraud cases includes unresolved cases received in prior FYs.

<sup>8</sup> See, e.g., TAMIS case numbers 4757753, 5269873, and 5361465.

Commissioners (two acting), issued two Taxpayer Advocate Directives (TADs),<sup>9</sup> one Proposed TAD,<sup>10</sup> and covered the subject extensively in her Annual Reports to Congress.<sup>11</sup>

What is frustrating is that return preparer fraud is not a novel issue, as the IRS has known for many years about this problem and its severe impact on victims. Since 2000, the IRS has received four legal opinions from its Office of Chief Counsel that, when read together, permit the IRS to:

- Disregard the altered return filed by the preparer;
- Accept an unaltered return signed by the taxpayer; and
- Issue a refund to the victim even if the IRS had already made a payment to the preparer.<sup>12</sup>

In 2014, the Office of Chief Counsel reaffirmed to the National Taxpayer Advocate and to the IRS Commissioner that the IRS is not prohibited from issuing refunds to victims of preparer fraud.

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**Taxpayers who are trying to comply with the law and have demonstrated they were not complicit in the fraud should receive their full refunds, just as victims of identity theft do.**

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The National Taxpayer Advocate has urged the IRS leadership to make these vulnerable taxpayers whole, just as the IRS works to make identity theft victims whole. The 2013 Annual Report to Congress proposed a framework of analysis that takes into account mitigation, restitution, and substantiation the IRS can use in deciding when to issue refunds to purported victims of preparer fraud.<sup>13</sup>

In March 2014, the Commissioner decided the IRS will issue refunds to victims who can show they were not complicit in the preparer's fraud. Under this approach, the victim must provide a copy of an incident report filed with local law enforcement (*i.e.*, a police report) before the IRS issues a replacement refund, to alleviate the IRS's concern about collusion between the preparer and the taxpayer.

It has now been over a year since the Commissioner made this decision and the IRS still has not implemented this policy. On June 15, 2015, the Deputy Commissioner for Services and Enforcement issued a memorandum to the National Taxpayer Advocate stating the Wage and Investment division (W&I) would be sharing draft procedures with TAS within a week. This memo included a decision document outlining the conditions that need to be met for a preparer fraud victim to be eligible for a refund.<sup>14</sup> W&I shared with TAS on June 23, 2015, draft procedures for resolving return preparer misconduct cases. At the time of publication of this report, the National Taxpayer Advocate is conducting a thorough review of these procedures and will provide

9 Pursuant to Delegation Order No. 13-3, the National Taxpayer Advocate has the authority to issue a TAD "to mandate administrative or procedural changes to improve the operation of a functional process or to grant relief to groups of taxpayers (or all taxpayers) when implementation will protect the rights of taxpayers, prevent undue burden, ensure equitable treatment[,] or provide an essential service to taxpayers." IRM 1.2.50.4, Delegation Order 13-3 (formerly DO-250, Rev. 1), *Authority to Issue Taxpayer Advocate Directives* (Jan. 17, 2001). See also IRM 13.2.1.6, *Taxpayer Advocate Directives* (July 16, 2009).

10 See IRM 13.2.1.6.1.2, *Proposed TAD* (July 16, 2009).

11 See, e.g., National Taxpayer Advocate Fiscal Year 2015 Objectives Report to Congress 22-34; National Taxpayer Advocate 2013 Annual Report to Congress 94-102; National Taxpayer Advocate 2012 Annual Report to Congress 68-94.

12 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).

13 National Taxpayer Advocate 2013 Annual Report to Congress 100-101.

14 See Return Preparer Misconduct Decision Document (updated May 26, 2015). W&I shared with TAS on June 23, 2015, draft internal guidance memorandum containing procedures for resolving return preparer misconduct cases. At the time of publication of this report, National Taxpayer Advocate is conducting a thorough review of these procedures and will provide comments to W&I.

comments to W&I. One point the National Taxpayer Advocate will emphasize is the need to build into the procedures the ability for IRS employees to exercise discretion, when appropriate, and analyze the particular facts and circumstances of each preparer fraud case, rather than use a “checklist” approach. We have seen too many cases where the facts may not fit squarely into a box, and it would be grossly unfair for the IRS to deny relief to these taxpayers (many who have been waiting patiently for refunds for upwards of three years) because they did not comply with the precise documentation requirements that have yet to be shared with the public (and thus could not have known they would have to supply to substantiate their claims).

Despite continued requests from TAS to be included in the development of these procedures, neither the Deputy Commissioner for Services and Enforcement nor the Commissioner of W&I shared the draft guidance with the National Taxpayer Advocate before issuance. Many of the concerns being identified now by the National Taxpayer Advocate could have been addressed months ago had discussions been held. This decision to withhold communication until the last minute is particularly disturbing given the National Taxpayer Advocate’s leadership and advocacy in this area, and the IRS’s history in not providing relief for these victims.

## FOCUS FOR FISCAL YEAR 2016

- Provide comments to W&I on the draft procedures for processing return preparer misconduct claims submitted by victims of preparer fraud;
- Issue appropriate guidance to TAS employees on how to advocate for victims of return preparer fraud and what documentation should be submitted to the IRS;
- Continue to refer taxpayers to Low Income Taxpayer Clinics to evaluate options to pursue legal action;<sup>15</sup> and
- If necessary, continue to elevate return preparer fraud TAOs to the highest levels of the IRS.

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<sup>15</sup> In December 2014, the National Taxpayer Advocate personally wrote to each of the taxpayers whose return preparer fraud cases were in TAS’s inventory, encouraging them to obtain representation from a Low Income Taxpayer Clinic and to possibly file a refund suit in a United States district court or the United States Court of Federal Claims to pursue the matter further.