

The Rise in State Income Tax Refund Identity Fraud:

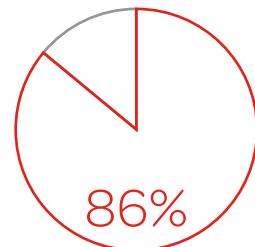
The True Challenges and New Ways to Combat it

Overview

It's fair to say that many people don't enjoy putting together the paperwork and filing their federal income taxes. The task is doubled for taxpayers in the 41 states and the District of Columbia which require taxpayers to file state returns, in addition to their federal return. What many may not realize is that the state agencies processing the tax returns also are faced with a critical burden of their own: combating the rise in identity-based income tax refund fraud.

Identity-based income tax refund fraud is perpetrated in two ways. First, fraudsters use stolen identity data or Personal Identification Information (PII), such as a Social Security number (SSN), date of birth, name, etc. to file for another taxpayer's state income tax refund. Second, fraudsters create synthetic identities—identities comprised of multiple taxpayers' PII and/or fake taxpayer data—to create fake taxpayer identities and file fraudulent returns requesting tax refunds.

A recent survey by the Governing Institute, found that 86 percent of state government tax administration officials view identity fraud as a major problem within the state tax refund process.¹ This should come as no surprise. According to the Federal Trade Commission (FTC), income tax-related identity theft was the number one consumer complaint in 2014—making it the fifth year in a row topping the FTC's annual list of complaints.² What is critical to understand is that the problem is growing—and quickly. One state government official cited in the Governing Institute survey from a Northeast state put it simply: the identity-based fraud "has been growing intensely as criminals become increasingly sophisticated."



Percent of state government tax administration officials that view identity fraud as a **major problem** within the state tax refund process.

¹ 2015 State Income Tax Refund Identity Fraud: Governing Institute and LexisNexis Research Report, June 2015
² Federal Trade Commission Press Release, Tax ID Theft Tops FTC Complaints in 2014; IRS Imposter Complaints Up More Than 2,300 Percent, January 26, 2015

Scope of the Problem

Ascertaining the scope of the problem in the states is a challenge. At the federal level, the Treasury Inspector General for Tax Administration is the U.S. Department of the Treasury's official "watch dog," charged with investigating issues of tax administration, including the level of identity-based income tax refund fraud. No such body exists to investigate and "roll-up" the impact of this type of fraud among the states. Instead, each state manages its own tax refund process, and each state has its own approach to preventing identity-based income tax refund fraud.

What we do know for certain, is that there has been a rise in identity-based tax refund fraud in the states. In fact, according to a recent article, identity-based income tax refund fraud in the states is up 3,700 percent.³ The increase seems to be tied to the recent IRS anti-fraud improvements and to the epidemic of unlinked returns, meaning a taxpayer can file a state return without having to file a federal return at the same time. So when the fraudster files an unlinked return, it then leaves the state at its own disposal to fight this fraud.

In order to understand the breadth and depth of the problem among the states, the Governing Institute surveyed government officials, asking: "What percentage of tax refunds are found as fraudulent?" Twenty-two percent estimated the fraud to be less than five percent of total returns. Eighteen percent estimated it to be between five and ten percent. Thirty percent of states did not know the percentage of tax refunds that were fraudulent, and officials from four states declined to answer the question.

Reasons for the Rise in Identity-based Tax Refund Fraud

There are several reasons for the rise in identity-based income tax refund fraud in the states. First—and this may be tough to hear: your identity has already been stolen. According to the Privacy Rights Clearinghouse, over 816 million PII records have been breached since 2005.⁴ The U.S. Census Bureau notes there are more than 320 million people in the United States today.⁵ It is, therefore, likely that most people have had their PII stolen at least once, if not more than once. Stolen identities are big business. Organized criminal groups—both foreign and domestic—sell them on the "dark web" and in many instances they are used to commit identity-based tax refund fraud.

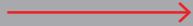
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Over **816 million PII records** have been breached since 2005. Stolen identities are big business.

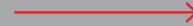
The Digital Trail of Identity-Based Tax Refund Fraud



Criminals Steal Identities



Identities Are Sold On the Dark Web



Organized Criminal Groups Use Identities to Commit Tax Fraud

In addition, most states rely on self-reported data to process tax returns. In the last few years, states have used the Internet to become more customer service-focused. They do not verify that the individual filing the tax return and requesting a refund is in fact the real individual entitled to the return, inadvertently creating a situation that is ripe for identity-based tax refund fraud.

³ Krebs on Security, *The Rise in State Tax Refund Fraud*, February 17, 2015

⁴ Privacy Rights Clearinghouse, *Chronology of Data Breaches: Security Breaches 2005 - Present*, December 31, 2013

⁵ U.S. Census Bureau, *Population Clock*, <http://www.census.gov/poplclock/>

Similarly, there has been an increase in the number of people filing their tax returns online. The IRS noted 125 million people filed their taxes electronically in 2014.⁶ And, taxpayers in the states are following suit. For example, during the 2015 tax season, the state of Oregon reported that 90 percent of its returns this tax season had been filed electronically.⁷ Enabling taxpayers to file online is a critical step for state revenue departments since their own state laws require them to process returns within a designated period of time. The downside, however, is that the ability to file taxes electronically makes it easier for criminals to file fraudulent returns, increasing the scale at which the fraud is being perpetrated.

Of paramount importance is the fact that this crime is being perpetrated by organized criminal groups—both foreign and domestic. Criminals steal identities and sell them on the dark web, where organized criminal groups then use the stolen identities to commit identity-based tax refund fraud in the states and at the federal level.⁸ In fact, the problem is so pervasive the Internal Revenue Service has created a cybercrime unit dedicated to tracking the digital trail involved with identity-based tax refund fraud.⁹

The ability to file taxes online makes it easier for criminals to file fraudulent returns.

Challenges Faced by States in Combating the Problem

States face a number of challenges in combating the problem. According to the Governing Institute survey, state governments have processes and procedures in place to identify state income tax refund fraud. Even so, officials indicated the following key issues are impacting the states' ability to prevent fraud in the state income tax refund process.

The Sheer Magnitude of the Problem

An official from a Western state indicated, "The general nature of combating identity fraud with the tax refund process [is] their primary weakness. In other words, the department is never ahead of the individuals who are committing tax fraud." Similarly, an official from a Northeastern state said, "...it is almost impossible to identify where the next attack is going to come from."

The Lack of Flexibility of the Current System

One Midwestern official noted, "...the Department of Revenue would love to partner with a third-party vendor."

Limited Time and Resources

An official from a Southeastern state indicated, "Simply there is not enough time to thoroughly examine each individual return and guarantee that no more fraudulent activity is taking place." Another Southeastern colleague noted, "The state simply needs more resources. They need more people to speed up the process."

Lack of Predictive Analysis and Faster Resolution

One Northeastern official "...wished that his agency could predict where the next fraud attack will be coming from," while another Northeastern colleague sought "more predictive analysis and faster resolution."

The Inability to Share Information (Intra and Inter-state)

A Western official noted "that a nationwide network could be developed so they could be more in contact with other entities. This network would partially share up-to-date information about fraudulent crimes and practices taking place throughout the nation." Similarly, a Midwestern official noted "more discussions between state agencies are needed to better coordinate which agencies are in charge of covering certain aspects of the issue."

When states are unable to prevent identity-based tax refund fraud, they fall into the "pay and chase" trap, where they pay the criminal requesting the fraudulent tax return and then investigate the case and "chase" the criminal to bring him/her to justice once the fraud is discovered. While post-payment investigation and criminal prosecution are necessary, they are only one component for effective program integrity. Focusing on prevention, as opposed to a "pay and chase" approach, improves efficiencies by enabling members of the tax administration team—from administrators to analysts to investigators—to do what they do best. The agency can focus on quickly paying valid claims while investigators and law enforcement are able to focus their attention on larger, more complex fraud rings.

⁶ Internal Revenue Service, *2014 Filing Season Statistics Report*, December 2014

⁷ My Central Oregon, *Thousands of People in Oregon Still Haven't Filed Taxes*, April 2015

⁸ Herb Weisbaum, *Wave of Fake Federal and State Tax Returns Filed, Experts Say*, NBC News, February 9, 2015

⁹ Aruna Viswanatha, *Internal Revenue Service Joins Cybercrime Hunt with New Investigation Team*, NASDAQ, May 5, 2015

Solving the Problem

While the states do face a number of real challenges, they also are leveraging a number of tactics to prevent identity-based income tax refund fraud. For example, Connecticut's Department of Revenue has found a 150 percent increase in attempts to steal tax refunds using stolen identities, but the state is fighting back with fraud prevention tools.¹⁰

The Governing Institute surveyed state officials about the types of tools they used to prevent this type of fraud. These initiatives fall into two primary categories:

- **In-house tax databases and systems**, such as identity verification, identity theft filters, integrated tax systems, systems designed to identify tax returns with significant signs of negligence, processes to review and validate each refund request before issuance, data warehouses to filter and extrapolate information to verify the necessary information to approve tax returns, internal state programs and rules-based systems.
- **Cross-matching and leveraging external databases and systems**, including identity verification, identity theft filters, the Social Security Administration Death Master File & Index, third-party public records databases with identity-based filters, the Internal Revenue Service, Federal Trade Commission, local/state police forces and the United States Postal Service.

And, states look to each other to find leaders. Respondents in the Governing Institute survey of state officials indicated there were five key states they considered leaders in preventing identity-based income tax refund fraud: California, Indiana, Georgia, Louisiana and New York. Each of these states have policies and procedures in place to prevent this type of fraud and are willing to pursue fraud at a criminal level. Here are some efforts states have undertaken to prevent the problem:

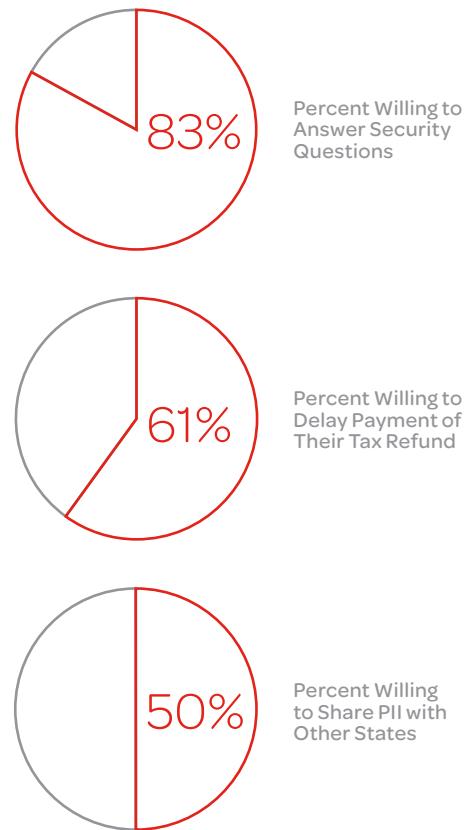
- **Alabama** – In 2013, the Alabama Department of Revenue stopped 19,000 fraudulent returns seeking \$17 million in fraudulent tax refunds.¹¹
- **Indiana** – In 2014, the Indiana Department of Revenue stopped more than \$88 million in fraudulent refunds from being paid to stolen or manufactured identities.¹²
- **Louisiana** – Over the past two years (2013-2014), the Louisiana Department of Revenue has stopped more than \$11 million in fraudulent tax refunds from “going out the door.”¹³
- **Massachusetts** – In 2014, the Massachusetts Department of Revenue stopped \$24 million in fraudulent tax refunds from being paid.¹⁴
- **Ohio** – In 2014, the Ohio Department of Taxation stopped 66,000 fraudulent returns requesting refunds, totaling \$278 million.¹⁵

But, states cannot do the job alone—and the good news is they don't have to. Taxpayers are willing to do their part as well. The Governing Institute survey of consumers' perceptions of the tax refund fraud problem found that taxpayers are willing to help assist in reducing the number of fraudulent tax returns being submitted. For instance, 83 percent would be very supportive of states checking PII by answering a series of unique questions that only the taxpayer would be able to answer to verify their identity. Similarly, 61 percent would be supportive of delaying the payment of their tax refund if it was determined that someone else had already requested a refund using their name, while 50 percent would find it acceptable for the state to share their PII with other states to reduce the risk of someone falsely filing a tax return in more than one state.¹⁶

Five key states considered **leaders** in preventing identity-based income tax refund fraud.



Taxpayers Are Willing to Do Their Part:



¹⁰ Harriet Jones, *Tax Fraud Prevention Up 150 Percent in Connecticut, State Says*, April 20, 2015

¹¹ Phillip Rawls, *Alabama Trying ID Quiz to Catch Tax Fraud*, Washington Times, November 8, 2014

¹² Mike Alley, *Testimony of Mike Alley, Commissioner, Indiana Department of Revenue to the US Senate Committee on Finance*, March 12, 2015

¹³ *State Tax Refunds to Be Delayed*, The Times, February 18, 2015.

¹⁴ Deirdre Fernandes, *Mass. Tax Refunds May Require Quiz*, The Boston Globe, September 20, 2014

¹⁵ Alan Johnson, *Ohio Tax Fraud Cases Could Hit Record This Year, Officials Say*, The Columbus Dispatch, April 6, 2015

¹⁶ *2015 State Income Tax Refund Identity Fraud: Governing Institute and LexisNexis Research Report*, June 2015

Conclusion

Identity-based income tax refund fraud in the states isn't going away anytime soon. As long as it remains a lucrative business for organized criminal groups, they will continue to perpetrate the crime. But, the old method of "pay and chase" is no longer sufficient. The crime is being committed at such scale that the only reasonable approach is to focus on preventing the fraud in the first place. To do so, states must focus on verifying and authenticating the identity of the filer.

The state of Indiana is a prime example of a state utilizing this type of approach. In 2014, Commissioner Mike Alley instituted a Hoosier Identity Protection Program and the results speak for themselves. The program prevented \$88 million in attempted identity-based tax refund fraud and directly attributes \$42 million of that to an identity verification and authentication solution.¹⁷ Taxpayers support these initiatives. In fact, the Governing Institute's survey of consumers found that 83 percent of those surveyed believe the government is responsible for detecting and preventing fraudulent tax returns from being filed.¹⁸

The Indiana Department Of Revenue's Hoosier Identity Protection Program prevented **\$88 million** in attempted identity-based tax refund fraud.



States face a simple choice: continue along the path of "pay and chase," which is rooted in the past and fraught with operational inefficiencies and depletion of already strained resources, or accept that the fraud itself—how it is perpetrated and who is perpetrating it—has changed. The only alternative is to focus on prevention using technology to protect taxpayer identities before criminals have a chance to use them.

To access the full Governing Institute and LexisNexis Research Report on State Income Tax Refund Fraud, visit:

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¹⁷ Mike Alley, Testimony of Mike Alley, Commissioner, Indiana Department of Revenue to the US Senate Committee on Finance, March 12, 2015
¹⁸ 2015 State Income Tax Refund Identity Fraud: Governing Institute and LexisNexis Research Report, June 2015