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May 15, 2013 Joint Committee on Finance Paper #559

# Tax Fraud Enforcement (DOR -- Tax Administration)

[LFB 2013-15 Budget Summary: Page 173, #9, Page 402, #2, and Page 436, #5]

## CURRENT LAW

The Department of Revenue (DOR) conducts ongoing reviews of income tax returns and tax credit claims for errors and fraud. The Department builds business rules and thresholds into computer systems that suspend processing of potential fraudulent returns and credit claims for staff review. Information is shared with the Internal Revenue Service (IRS) and other states on current tax fraud schemes, and based on the schemes that are identified, profiles of tax fraud are built into the tax processing computer systems. DOR also reallocates staff to address possible fraud identified in processing returns. Currently, DOR has one agent reviewing suspicious returns, 49 office auditors trained to review homestead and earned income tax credit (EITC) claims, five criminal investigators, and two fraud analysts. At any time, only 30 office auditors are working on homestead and EITC claims because of other duties.

## GOVERNOR

Provide $4,257,400 in 2013-14 and $3,114,000 in 2014-15, and 10.0 positions in the Audit Bureau and 3.0 infrastructure technology support positions to prevent and reduce fraudulent refund and tax credit claims, under the individual income tax, the EITC, and the homestead tax credit (HTC). The bill also includes statutory provisions that are designed to enhance tax fraud enforcement activities.

## DISCUSSION POINTS

1. DOR processed approximately three million individual income tax returns, 200,000 homestead tax credit claims, and 280,000 earned income tax credit claims in 2011-12. Table 1

shows the number of returns filed, total individual income tax refunds, and the amount of homestead and earned income tax credit claims for 2008-09 to 2011-12. The table shows that individual income tax refunds are around $1.7 billion each year, while annual HTC and EITC claims total ranged between $230 and $260 million.

**TABLE 1**

**Individual Income Tax, Earned Income Tax Credit, and Homestead Tax Credit Returns and Refunds -- 2008-09 to 2011-12**

| | 2008-09 | | 2009-10 | | 2010-11 | | 2011-12 | |
|---|---|---|---|---|---|---|---|---|
| | Returns | Refunds | Returns | Refunds | Returns | Refunds | Returns | Refunds |
| Individual Income Tax | | | | | | | | |
| Electronic | 2,001,400 | | 2,081,000 | | 2,190,700 | | 2,301,700 | |
| All Others | 1,011,800 | | 828,600 | | 738,100 | | 649,200 | |
| Total | 3,013,200 | $1,810,553,200 | 2,909,600 | $1,768,190,800 | 2,928,800 | $1,681,524,500 | 2,950,900 | $1,693,616,400 |
| Earned Income Tax Credit* | 240,600 | $97,949,000 | 276,800 | $129,177,000 | 272,000 | $126,115,000 | 271,900 | $103,251,000 |
| Homestead Tax Credit* | 231,100 | $124,632,000 | 247,000 | $129,197,000 | 250,800 | $133,934,000 | 248,000 | $133,683,000 |

* Also included in individual income tax numbers.

2. DOR conducts annual pre-processing reviews of about 15,000 individual income tax returns based on business rules established to identify fraud. The Department reviews 15% of homestead tax credit claims and 5% of earned income tax credit claims annually, also based on business rules established to identify fraud and errors. The specific rules are confidential but are generally based on known cases of fraud. For example, more returns of first time filers are suspended for review, based on prior experience. The Department also develops characteristics of fraudulent returns and establishes business rules that suspend returns with those characteristics. DOR assigns 26 auditors to homestead tax credits from January to June, and 11 auditors from June through December. Similarly, the Department assigns 32 auditors to earned income tax credits from January to June, and 10 auditors from June through December. (Some auditors work on both EITC and HTC claims.) During the first half of the year, audits typically focus on identifying and preventing the issuance of credit payments that are for incorrect or ineligible credit claims. Auditors working in the period from June through December follow up on work generated during the prior period. Follow-up activities include corresponding with HTC and EITC claimants, adjusting claims, and investigating fraud. The auditors also prepare and test audit systems and train new auditors. The observed error rate for Wisconsin HTC and EITC claims is 9.2%. Table 2 shows individual income tax refund, and HTC and EITC adjustments or denials for 2008-09 to 2011-12. HTC and EITC reductions are substantially larger both in absolute amounts, and proportionally, than income tax refund reductions and denials. The average revenue effect (refund adjustments and collections) per hour of auditing is $1,140 for HTC and $735 for EITC claims.

**TABLE 2**

**Individual Income Tax Refund, and Earned Income and Homestead Tax Credit Reductions and Denials -- 2008-09 to 2011-12**

| | 2008-09 | 2009-10 | 2010-11 | 2011-12 |
|---|---|---|---|---|
| Income Tax Refunds | $2,624,600 | $1,945,700 | $4,075,400 | $6,732,200 |
| Earned Income Credits | 7,055,000 | 5,644,000 | 12,220,000 | 9,341,500 |
| Homestead Credits | 8,760,800 | 10,782,500 | 13,510,200 | 14,694,500 |
| Total Reductions/Denials | $18,440,400 | $18,372,200 | $29,805,600 | $30,768,200 |

3. DOR indicates that it has identified an increasing number of fraudulent income tax returns, homestead tax credit claims, and earned income tax credit claims in the past two years. According to the Department, similar trends have been identified by other states and the IRS. The IRS estimates that 23% to 28% of earned income tax credits are issued improperly each year. In addition, the IRS estimates that it received between $11.5 billion and $16.5 billion in fraudulent refund claims and that attempts to illegally obtain personal information used in identity theft increased 78% from 2011 to 2012. In 2012, the Georgia Department of Revenue stopped over $71 million in fraudulent refunds. New Mexico has identified "refund mill" activity, which is an organization of a small group of individuals claiming fraudulent refunds. The New Mexico Department of Revenue detected and stopped an attempt by one refund mill to fraudulently claim over $3.5 million in refunds.

4. According to the Department, tax fraud usually includes one of the following: (a) stealing another person's identity and filing a false income tax return; (b) using social security numbers of deceased or incarcerated persons to file fraudulent income tax returns and credit claims; (c) creating false wage statements and income tax returns; (d) altering state tax withholding on wage statements; (e) creating false rent certificates for HTC claims; (f) creating false businesses and related false business income to qualify for ETICs; and (g) claiming another person's children for ETICs. Automation of the tax filing system provides opportunities for fraudulent filings. The Department indicates that most fraudulent income tax returns are electronically filed, often providing for automatic online deposit of refunds in a bank. DOR indicates that it is difficult to identify the owner of online bank accounts. Once a refund is deposited into such an account, the funds can be removed at an ATM, and the recipient cannot be easily traced.

5. In 2012, DOR created a cross-functional project team to review the Department's tax enforcement practices for identifying and preventing fraud. The team developed a plan to address fraudulent tax refunds, and EITC and HTC claims. The plan included reallocating resources for 2012 returns and tax credit claims filed in 2013. DOR cross-trained and reassigned more auditors to review HTC and EITC claims. Auditors were reassigned to assist investigators in identifying potential fraud in returns of first-time filers, and in refund deposits into certain online banks. The cross-functional team report also includes confidential compliance information and identifies enforcement activities that require information technology, and fraud detection services and databases that would increase the Department's anti-fraud workload. In order to implement the plan, DOR requests additional funding and audit positions in 2013-14 and 2014-15.

6. In general, the plan includes the following actions: (a) enacting legislation that would allow more data sharing with other state agencies, particularly the Departments of Workforce development (DWD), Transportation (DOT), Children and Families (DCF), and Corrections (DOC); (b) acquiring IRS data on incarcerated persons and incorporating it into the data warehouse; (c) acquiring a nationwide death index file, and incorporating it into the data warehouse; (d) conducting more pre-processing reviews of the income tax returns of first-time filers; (e) developing predictive modeling capabilities to detect anomalies in filing and to prevent identity theft; (f) modifying business rules for pre-processing review, and reviewing a higher percentage of HTC and EITC claims; (g) reviewing all returns filed that have refund deposits into online banks where fraudulent filing schemes have been discovered; (h) reviewing filing patterns from Internet provider addresses to identify suspicious filing activity; (i) acquiring and implementing technology (hardware and software) to enable qualified staff to systematically analyze the data, develop business rules, do queries, and conduct investigations; (j) acquiring additional staff to build analytical systems and conduct analyses and investigations; and (k) considering procuring fraud detection services with prepackaged analytics of nationwide data elements.

7. As noted, DOR would be provided a total of $4,257,400 GPR in 2013-14, $3,114,000 GPR in 2014-15, and 10.0 GPR positions in the Audit Bureau and 3.0 GPR information technology support positions beginning in 2013-14, to increase DOR's fraud enforcement activities. Of the total, $454,700 GPR in 2013-14 and $605,300 GPR in 2014-15 would be appropriated for the 10.0 positions in the Audit Bureau. The 10 positions include a revenue tax specialist criminal investigator, three revenue tax specialist fraud analysts, a revenue agent, and five revenue auditors. The three fraud investigators would review filings that represent cases of potential fraud. Each investigator can review 5,000 cases per year. The office auditors and revenue agent would review wage statements, and HTC and EITC claims. A review typically includes examining a suspended return and supporting documentation to verify or deny the refund being claimed. For HTC and EITC claims, a review often includes corresponding and obtaining additional information. The criminal investigator would develop cases for criminal prosecution.

8. The bill provides DOR with increased supplies and services funding for new technology, IT system upgrades, and data analytics including: (a) $10,000 in 2013-14 and $7,500 in 2014-15 for National Death Index software; (b) $800,000 in 2013-14 and $200,000 in 2014-15 for scanning software upgrades; (c) $750,000 in 2013-14 and $40,000 in 2014-15 for data warehouse software upgrades; and (d) $2,000,000 annually for fraud detection software and analytics. The software and analytics funds would be used by DOR to extract, clean, and standardize data from multiple data sources, both internal and external to the Department, and apply various tools to more effectively analyze and interpret the data in order to identify and prevent fraudulent income tax returns, and HTC, and EITC claims. External data bases would include DWD wage and employer files, and DOT driver's license, vehicle title, and license plate files. New scanning software can be programmed to read many different formats making the information more readily available. The new software and scanner upgrades would enable DOR to capture forms and text, such as W-2s, that have been unavailable to the Department. Data analytics has been used by various industries to improve internal audit functions, including focusing audits on specific areas of risk. Advance Tax Analytics would improve the Departments methods for identifying audit candidates and establish priorities for collection that would result in a higher rate of return on audit fraud activities. DOR would use access to the National Death Index to identify social security numbers of decedents used

by out-of-state refund or tax credit claimants. The Department would be provided $169,600 in 2013-14 and $226,100 in 2014-15 and two four-year project and one permanent information services systems development services specialist position for implementation, maintenance, and support of new software and data analytics.

9. The antifraud activities of the additional Audit Bureau positions, IT hardware and software, and data analytics would reduce GPR expenditures for EITC and HTC claims, and increase state income tax revenues or adjusted. Specifically, annual GPR expenditures would be reduced by an estimated $2.0 million for denied EITC claims, and $1.0 million for HTC claims. Based on prior year collection activities, the Department estimates that income tax revenues would be increased by an estimated $14.0 million from the antifraud activities.

10. The bill would establish civil and criminal penalties for negligent or fraudulent income tax refund or tax credit (including HTC and EITC) claims. A person who negligently filed an incorrect claim for refund of tax or credits would be subject to a penalty of 25 % of the difference between the amount claimed and the amount that should have been claimed. A person who fraudulently filed an incorrect claim for refund of tax or credits would be subject to a penalty of 100% of the difference between the amount claimed and the amount that should have been claimed. A person who filed a false or fraudulent income tax return to obtain a refund or credit with fraudulent intent would be guilty of a Class H felony, and could be assessed the cost of prosecution. The penalty for a Class H felony is a fine of up to $10,000, imprisonment for up to six years, or both. Under current law, the civil penalties for negligence and fraud only apply if the taxpayer fails to report income or evades taxes that are due. Current criminal penalties only apply if a return is required by law. The current provisions do not apply in many refund fraud cases, because the person filing the false return is not required to file a return, and is not attempting to defeat or evade the tax, since they have no tax liability. DOR indicates that, based on a plain reading of the statutes, individuals who make false credit claims may have no consequences other than having their claim denied. The Department estimates that between 10% and 15% of denied claims are from the same individuals. It should be noted that, as drafted, the effective date provision in the bill for the civil and criminal penalties only applies to tax returns. As a result, the provision would not apply to HTC and EITC claims that are filed separately. The Committee may wish to modify the effective date provision to apply to a claim for refund as well.

11. The bill would establish penalties that would make individuals ineligible for homestead and earned income tax credits based on previous fraudulent or reckless claims. An individual who filed a "fraudulent" homestead or earned income tax credit claim could not file a claim for a credit for 10 successive tax years, starting with the tax year that begins immediately after the tax year for which DOR determined that the individual filed a fraudulent claim. "Fraudulent claim" would mean a claim that was false or excessive and filed with fraudulent intent, as determined by DOR. An individual who filed a "reckless" claim could not file a claim for a homestead or earned income tax credit for two successive tax years, starting with the tax year that begins immediately after the tax year for which the Department determined that the individual filed a reckless claim. "Reckless claim" would mean a claim that was improper, due to reckless or intentional disregard of income tax law provisions, or of DOR rules and regulations. An individual could file a homestead or earned income tax credit, after the ineligibility period, subject to any requirements that DOR imposes on the individual to demonstrate he or she was eligible to claim the

credit.

12. There are no current state law provisions that make individuals who file fraudulent HTC or EITC claims ineligible to receive future credits. However, the proposed state provisions are modeled after current federal law. Under federal law, a taxpayer who improperly claims a federal EITC may be restricted from claiming the credit during a disallowance period, and may be required to demonstrate eligibility before being allowed to claim the credit after the disallowance period. The length of the disallowance period depends on whether the credit is claimed fraudulently, or with reckless or intentional disregard of the EITC rules or regulations. A taxpayer who fraudulently claims the federal EITC is ineligible to claim the credit for a period of ten tax years after the most recent tax year for which there is a final IRS determination that the taxpayer's final claim of credit was due to fraud. A taxpayer who erroneously claims the EITC due to the reckless or intentional disregard of the EITC rules or regulations is ineligible to claim the credit for a period of two tax years after the most recent year in which there was a final determination that the taxpayer's claim of credit was due to such reckless or intentional disregard of the EITC rules and regulations.

13. DOR indicates that it spends a substantial amount of resources denying EITCs and HTCs that are incorrect, false, or fraudulent. Between 2008-09 and 2011-12, the amount of HTCs and EITCs denied by the Department have increased by 50%. As noted, between 10% and 15% of credit claims that are denied are from the same individuals. Currently, there are no state penalties for filing false HTC and EITC claims. There is little consequence, under state law, in filing false and or fraudulent EITC and HTC claims every year.

14. Concerns have been expressed that the provisions that would make only EITC and HTC claimants ineligible for future credit claims are unfairly targeted on low-income individuals, because the provisions would not apply to any other refundable tax credits under the state income and franchise taxes. The other state refundable tax credits are generally business tax credits that can be claimed under both the individual income and the corporate income/franchise taxes and include the following: (a) enterprise zone credits; (b) jobs credit; (c) dairy manufacturing facility credit; (d) meat processing facility investment credit; (e) food processing plant and food warehouse investment credit; (f) woody biomass harvesting and processing credit; (g) film production credits; (h) beginning farmer and farm asset owner credits; and (i) farmland preservation credit. Typically, these credits require the claimant to hire new or retain existing employees, train employees in new skills, and/or make capital investments. Claimants must be certified as eligible, credits must be allocated, and, in some cases, expenses must be verified by a state agency or the Wisconsin Economic Development Corporation (WEDC). Currently, WEDC certifies businesses as eligible for enterprise zones and jobs tax credits, contracts with the businesses for credit allocations over a period of years, and verifies expenses on which the credits are based. Copies of both the certification and verification must be included with the business', tax return. The Department of Agriculture, Trade and Consumer Protection (DATCP) certifies eligibility for and allocates the dairy manufacturing facility, meat processing facility investment, food processing plant and food warehouse investment, and woody biomass harvesting and processing tax credits. Copies of the certification must be included with the taxpayer's return. DATCP also certifies individuals as eligible for the beginning farmer and farm asset owner tax credits, and the certification must be included with the return. To claim the farmland preservation tax credit, the taxpayer must be subject to a farmland preservation agreement and meet certain household income and acreage requirements. Copies of the agreement

and property tax bills must be included with the return. The Department of Tourism must accredit productions and determine the amount of eligible expenses for film production tax credit claimants. A copy of the commitment letter and a list of approved expenses must be included with the taxpayer's return. DOR indicates that the rate of fraudulent claims in credits other than the HTC and EITC is minimal.

15. In certain cases, agency administration of tax credits may not ensure compliance with tax law provisions. The recent Legislative Audit Bureau Report on WEDC (Report 13-7, May, 2013) found that WEDC did not establish all statutorily required policies for its tax credit programs. For example, the Corporation did not establish policies that define necessary amounts of capital expenditures and supply chain investments for a business to receive enterprise zone tax credits for such expenditures. The audit found that WEDC did not always perform the analysis necessary to determine if the applicant's proposed project was eligible for tax credits. The audit found one case where the Corporation awarded $47,000 more in economic development tax credits than could have been allocated under program policies. WEDC allocated some tax credits in ways that did not comply with the statute or its program policies. One jobs credit award of $250,000 did not require a business to create jobs as statutorily required. The audit also found that WEDC sometimes allocated tax credits for projects that had occurred before the contracts. For example, two enterprise zone tax credits allocated $1.5 million in tax credits for job creation, employee training, and capital investments that had occurred before the contracts were executed.

16. DOR indicates that deleting the provisions prohibiting individuals from claiming future HTCs and EITCs would have a indeterminate fiscal effect. To the extent disallowing future claims prevented individuals from making legitimate HTC and EITC claims, the positive effect of such programs shown in research would be offset. Specifically, empirical studies have shown that the EITC has been an incentive for single parents, particularly mothers, to work, and to move from welfare to work (Eissa and Hoynes, 2005; Grogger, 2003; Ben-Shalom et al , 2011). Research has also found that raising a poor family's income through programs like EITC has positive intergenerational effects. One recent study found that raising a family's income by $3,000 a year, for children between birth and five years old, is associated with a 17% increase in earnings and an average of 135 hours of additional work per year, compared to similarly low-income children whose families not receive an increase in income (Duncan et al, 2010). A separate study found that additional income from the EITC leads to significant increases in younger children's test scores (Chetty et al, 2011). Another study found that additional EITC income raises the combined math and reading scores of students (Dahl and Lochner, 2007). Also, research indicates that the EITC has a stimulative effect on the economy. The EITC is estimated to have a multiplier of 1.24 (Zaudi, Moody's Analytics, 2012). The civil and criminal penalties for negligence and fraud would remain in the bill, if the provisions that disallow future EITC and HTC claims were deleted.

17. The Departments of Children and Families (DCF), Health Services (DHS), Employee Trust Funds (ETF), Transportation (DOT), and Workforce Development (DWD) would be specifically authorized to share certain information with DOR to assist DOR in tax administration activities that address fraud, identity theft, non-filing, and underreporting.

*Department of Children and Families.* DCF would be authorized to disclose information related to kinship care and foster care assistance payments to DOR, including information contained in electronic records, solely for the purpose of administering state taxes, including verifying state tax refunds or refundable credits, and collecting debts owed DOR.

*Departments of Children and Families and Health Services.* DCF and DHS would be authorized to provide information to DOR concerning applicants and recipients of relief funded with block grants, aid to families with dependent children, Wisconsin Works, social services, child and spousal support, and establishment of paternity and medical support liability services or the state SSI supplement, including by transmitting or granting access to electronic data, including social security numbers, for the purposes of administering state taxes, including verifying refundable individual income tax credits, and collecting debts owed to DOR. Any information obtained by DOR would be subject to statutory confidentiality provisions.

*Department of Employee Trust Funds.* ETF would be authorized upon request of DOR, to disclose information to DOR, including social security numbers, concerning an annuity, only for the following purposes: (a) administering the payment of state taxes: (b) to aid in collecting debts owed DOR; (c) to locate participants, or the assets of participants, who have failed to file tax returns, underreported their taxable income, or who are delinquent debtors; (d) to identify fraudulent tax returns; and (e) to provide information for tax-related prosecutions.

*Disclosure of Vital Records.* Upon request, the state or a local registrar, would be authorized to disclose information on vital records, including social security numbers, to DOR only for the following purposes related to administering state taxes, and collection of debts referred to DOR: (a) locating persons, or the assets of persons, who have failed to file tax returns, who have underreported their taxable income, or who are delinquent debtors; (b) identifying fraudulent tax returns and credit claims; or (c) providing information for tax-related prosecutions.

*Department of Transportation.* DOT would be authorized upon request, to provide to DOR any applicant information maintained by DOT related to identification cards, including social security numbers. This would include DOT providing electronic access to the information. Any information obtained by DOR would be subject to statutory confidentiality provisions.

*Workforce Development.* DWD would be authorized upon request, to provide information, including social security numbers, to DOR concerning a claimant of unemployment compensation, for the purpose of: (a) administering state taxes; (b) identifying fraudulent tax returns; (c) providing information for tax-related prosecutions; or (d) locating persons, or the assets of persons, who have failed to file tax returns, who have underreported their taxable income or who are delinquent debtors. DOR would be subject confidentiality and inspection and disclosure limits.

18. Under current law, state agencies are authorized to disclose certain information, such as social security numbers, addresses, driver's license numbers, and information from state license, certificates, permits, registrations and similar items to DOR for the administration of state tax laws. DOR indicates that the information from other agencies is a valuable resource that can help the Department in preventing identity theft, and identifying fraudulent refunds. However, the useful information is dispersed among different agencies that are often uncertain as to whether current law permits them to share certain information with DOR. The provisions in the bill specify, for various

agencies, information that could be shared with DOR for administering state taxes and refundable credits.

The Department would also be authorized to obtain information from professional licenses issued by agencies other than Safety and Professional Services (DOR currently receives this information from DSPS) and vital records from the state or local governments. The Department did not provide a specific estimate of the additional tax revenue that could be generated by using the information authorized under these provisions, but estimates that it would be a significant amount. In prior years, DOR has used data from ETF to generate $800,000 in addition tax revenue.

## ALTERNATIVES

1. Approve the Governor's recommendation.

2. Approve the Governor's recommendation and modify the effective date provision for civil and criminal penalties for negligence and fraud to apply to claims for refund, as well as the tax return.

3. Delete provisions that would disallow individuals that file reckless or fraudulent EITC and HTC claims from claiming the credit in future years.

4. Delete provision.

| **ALT 4** | **Change to Bill** | |
|---|---|---|
| | Funding | Positions |
| GPR | - $7,371,400 | - 13.00 |
| GPR-Tax | - $28,000,000 | |

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