Testimony of Mike Alley, Commissioner, Indiana Department of Revenue
to the
United States Senate Committee on Finance
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Introduction

Chairman Hatch, Ranking Member Wyden and committee members, thank you for inviting me to discuss this important topic with you today. Senator Coats, thank you for that kind introduction. On behalf of Governor Mike Pence and the citizens of Indiana, it is my honor to appear before you today to address this critical issue that faces everyone in the tax and revenue processing industry.

You have asked me to discuss *Tax Schemes and Scams During the 2015 Filing Season*. Specifically, I would like to illuminate the identity theft and tax refund fraud experiences of Indiana over the last two years and note the extent of this challenge facing all government entities in today's environment. And I can tell you from first-hand experience that this is a problem that must be addressed at multiple levels. This morning I would like to address this issue from three perspectives:

First: The nature of the problem and its overall breadth.

Second: Steps Indiana has taken in an effort to combat the problem and lessons we have learned.

Third: Recommendations from our perspective on additional approaches we must take to more fully and effectively address this epidemic issue nationwide.

The Nature of the problem

Tax refund fraud is one of several lucrative platforms for criminals to monetize the value of stolen identity information. It is being perpetrated by thousands of culprits from the small time individual fraudster to large, sophisticated criminal enterprises. In the past, it has been very easy with negligible risk of apprehension or prosecution. The advent of electronic filing and processing has enhanced the ability of criminals to utilize economies of scale in filing large volumes of fraudulent returns, at a nominal cost, replicating numerous returns with only minor changes in original identity information. The zeal of departments of revenue to speed up the processing of returns and reducing turn-around time for refunds – all in the spirit of good customer service – also has contributed to the problem making it easier for criminals to take advantage of the system. Our systems were designed to process rapidly and efficiently – not to screen for fraud and fabricated identities.

The Identity Theft Resource Center[1], in their 2014 Annual Report, created a diagram that effectively illustrates the interrelationship of the criminal activity and our oftentimes disjointed responses. We must develop a coordinated effort to battle ID theft and mitigate the risks of misuse.

In calendar year 2014, twelve percent of the total tax refund dollars requested from Indiana was found to be fraudulent. We identified more than 78,000 fraudulent tax returns filed using manufactured or stolen identities, and prevented more than $88 million in fraudulent refunds from being issued. This mirrors similar statistical reports from the U. S. Government Accountability Office that reports the IRS lost an estimated $5.8 billion to fraudulent refund claims in 2013 while blocking about $24 billion in attempts. They further reported that suspected identity theft incidents for 2013 were nearly 2 million, an increase of more than 350% from 2010. We hear anecdotally from other states that they also are experiencing comparable fraudulent activity.

Though early in the 2015 filing season, we are already seeing a dramatic increase in the use of valid identities which have been stolen. With the advent of reported successful hacks at many large U. S. companies, we believe the availability of valid stolen identities for tax fraudsters has never been greater. This is particularly concerning because stopping fraud with valid identity information is much more difficult than screening for manufactured identities which was the most common practice of fraudsters in the past. The fraudsters have upped their game and we must respond accordingly.

What are we doing in Indiana?

In Indiana, we knew we were suffering some tax fraud based on identity theft, but we did not have a reliable method to calculate the actual impact. In 2012, we began conducting research and analysis of our processes and statistical filing results. We noted that it appeared Indiana was processing more returns and paying out more money in tax refunds than seemed reasonable based on our estimated population growth. Figure 1 (Return Growth) illustrates the growth of our total returns (Red Line) compared to our total refund returns (Blue Line). The green bars show our overall electronic filing percentage. The growth of two hundred thousand taxpayers in a just a couple of years strained credibility, so we looked for other reasons why we would be getting so many more tax returns.

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[1] http://www.idtheftcenter.org/images/page-docs/2014AnnualReport20150227.pdf
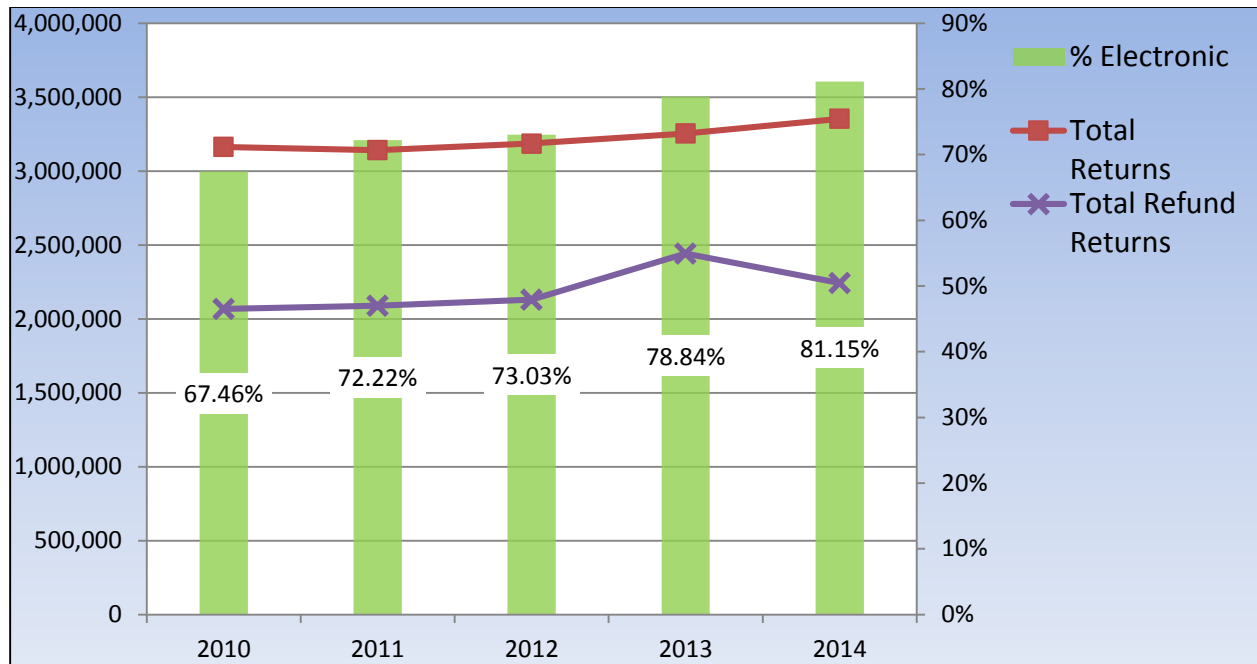
Figure 1: Return Growth

Our analysis determined that identity theft and refund fraud was the most likely explanation for the accelerated growth in returns and refund requests. Once we identified these phenomena, we brought key staff together and worked with the office of Governor Pence and our General Assembly to develop a strategy to define elements of an effective identity fraud program for the Indiana Department of Revenue.

Key objectives of our approach were:

1. Ensure that we do not mistreat legitimate taxpayers because of a small number of dishonest individuals.

2. Protect taxpayer dollars and taxpayer identities.

3. Protect state revenues from issuance of fraudulent refunds.

4. Identify the criminals for deterrence efforts.

5. Ensure fraudulent dollars do not affect our revenue based distributions and financial reporting.

These became the guidelines that our identity protection team would follow. We knew that we needed to make significant systemic modifications and we needed to do it before the next tax season. Staff reached out to our fellow states through the Federation of Tax Administrators (FTA) and our partners at the IRS to see if there were ideas that we could borrow and implement.

The response was very supportive and we were welcomed to view, visit, and exchange ideas with our counterparts across the United States. Many of them had partial solutions or had tried to implement incremental improvements. The time we spent working with other states confirmed that Indiana was less prepared and needed to catch up. On the positive side, we discovered that there were ready-made commercial solutions that we could bring to Indiana that could have a major impact in a short period of time.

Governor Pence reviewed the data we provided and the potential solutions the department suggested. With his support, we initiated a pilot program to screen all returns for suspicious identities. The program used LexisNexis, a third party commercial vendor, to screen the returns and note identity information such as name, address, social security number, or other identifier information that appeared suspicious. Processing of those returns screened as suspicious was suspended and an identity confirmation quiz request was sent to the taxpayer at their filing address. Taxpayers were asked to confirm their identities by completing a short quiz. They could log into a secure website or could call our call center where we had dedicated analysts to handle their quiz. As a result of implementing this pilot effort the department expected to directly reduce fraudulent refunds by $25 million with an investment of $8 million in staffing and technology. Our actual results confirmed more than $88 million of attempted refund fraud identified and stopped with $42 million attributable directly to this identity screening tool.

The identity confirmation quiz is very powerful and made a significant difference. But it is not a panacea. It is only part of a larger process to strategically focus on identity theft and refund fraud which encompassed additional talent, new procedures, and new IT systems. We made it clear in the beginning that the department would need to make systematic changes. We took the following steps:

1. Procured an identity confirmation vendor (LexisNexis)

2. Hired additional staff

3. Conducted a public relations campaign

4. Made agreements with software vendors to begin setting standards

5. Began modernizing infrastructure to specifically confirm identity information and recognize fraud trends

Figure 2 (2014 Indiana Fraud by Source) demonstrates that we stopped more than $88 million in fraudulent refunds being paid to manufactured or stolen identities in the pilot year alone (2014). The identity screening via the identity confirmation quiz was the simplest fraud to stop and we took advantage of that simple process to concentrate on the more sophisticated fraud schemes using our enhanced professional analysts and early analytics.

Source	# of Returns	Description	Total Refunds Stopped
Analyst Review	34,300	Investigation and decision by trained fraud prevention staff	$45,642,625
Identity Confirmation Quiz	43,918	No response to Identity Confirmation Quiz notifications	$42,426,289
		Calendar Year 2014 Total	**$88,068,914**

Figure 2: Indiana 2014 Fraud by Source

In one sense, the $88 million was gratifying − but it was also astonishing. The problem was much larger than we had anticipated. The end-of-year fraud statistics were interesting as well. Almost four percent of returns we processed in 2014 were identity fraud. A surprising data point was that these 78,000 returns represented 12% of the value of all refund requests. While this was higher than expected, it makes sense when we consider that the fraudsters are attempting to maximize their profitability. We also identified that Indiana paid out $4 million in identity fraud refunds that we later identified as fraudulent but were unable to stop. Some fraud gets through before we can identify a new pattern and react. This illustrates that our efforts to identify and stop refund fraud must continue.

We could not have achieved these positive results without additional resources and multiple components to our identity theft and refund fraud program, including an $8 million augmentation to the department's budget. Indiana added 15 call center people to assist our taxpayers with the identity confirmation quiz. We also added eight additional fraud analyst positions, a prosecutor with fraud experience, a public relations professional, and information technology professionals.

Our public relations campaign was critical to our success in educating citizens, rallying market professionals, and explaining the outcomes to stakeholders and media. This allowed us to alert our taxpayers that protecting their identities was a priority for us and though it might slow down the refund process slightly, it would better ensure protection of their identities and avoid a strain on state finances. Further, it provided assurance that if they should receive an identity confirmation quiz, it was legitimate and no cause for alarm.

One quiet, but crucial, key to our success was gaining more control of the interfaces and behavior of our software vendor partners. During the 2014 filing season, we began tracking fraudulent returns submitted by each software vendor. As the Fraud by Software Vendor Table (Figure 3) clearly demonstrates, there was a large variability among software vendors of the incidence of fraud. The data shows that some vendors are taking fraud seriously and implementing protective screening while some are either unaware of, or unable to stop fraud. A few vendors claimed that they were not responsible for doing any fraud prevention at all.

	Fraud by Refund Return Count (%)	Fraud by requested refund amount (%)
Highest	92%	85.0%
Average	22.3%	11.0%
Median	6%	2%
Mode	1%	1%
Lowest	1%	0%

Figure 3: Fraud by Software Vendor

As a result, in 2015 Indiana required that all software vendors wishing to be certified to file Indiana returns sign agreements with the state. The agreements made it clear to vendors that they would be monitored for the fraud they sent along to Indiana. Software vendors that experienced excessive fraud in 2014 were not certified unless they provided evidence of increased fraud screening on their part. We concluded that there is no reason to maintain a business relationship with a vendor that is not playing their part in fraud prevention.

For the 2015 filing season, we have continued to make significant enhancements to our identity theft and refund fraud program. We continue to use the identity theft screening tool contracted with LexisNexis with enhanced elements based upon lessons learned. In addition, we have implemented a new pre-filter processing platform that provides us the ability to run all of our individual returns through an extensive screening prior to being processed in our normal returns processing system. This pre-filter process includes a decision matrix toolset which allows us to establish multiple filter parameters to detect fraudulent returns and unusual activity. This provides dramatically enhanced agility and adaptability during the filing season as we experience various patterns or learn of new issues so that processing rules and parameters can be easily adjusted. This pre-filter platform was built with the assistance of Revenue Solutions, Inc. (RSI), a third party vendor specializing in tax processing.

Lessons Learned

We are still early in battling this problem but the following early lessons are apparent:

1. Strategic priority: identity theft and refund fraud have escalated dramatically over the last two years and in order to effectively combat the problem, it must be a strategic priority. This demands making a fiscal investment in leadership, staff, technology, and third party resources. Priority support must be in place from the top down. Governor Pence has consistently supported our efforts to combat identity theft and refund fraud, which has been crucial in our ability to continue to invest in and improve our program.
2. Collaboration: no one has all of the answers. The perpetrators are sophisticated and agile, moving from one vulnerability to the next. Sharing data, best practices, and experiences among revenue agencies, both state and federal, along with software vendors and support vendors is critical. The Federation of Tax Administrators (FTA) has actively assumed a key role as facilitator but must be strongly supported by all parties involved.

3. Taxpayer Support: Taxpayers are willing to be part of the solution if they understand what you're trying to achieve. We received minimal resistance to the identity confirmation quiz. However, communicating in advance that this is a valid tool and not another scam is critical.

4. Targeted Solutions: There are many types of fraud, fraudsters, and different means for filing returns. It is important to understand the intricacies so that targeted solutions can be developed and applied. We can no longer review returns individually but must identify broad traits so that we can systemically identify suspicious activity and address it collectively. In the past, we treated all fraud the same which is neither efficient nor necessary.

5. Prepaid Debit Cards: Use of prepaid debit cards is the preferred tool of fraudsters in receiving their refunds. They can be purchased with virtually no identification or registration and are readily transferable from the card to gift cards, bank accounts, other debit cards, or even to purchase goods and services.

6. Fraudsters Hide: Sophisticated fraudsters use stolen or invalid identities to open bank accounts, transfer money, and further insulate themselves from the refund once it is received. This makes it even more difficult to apprehend and prosecute the culprits.

7. Manufactured Identity: A "Manufactured Identity" is one where the fraudsters have simply filled out federal or state returns with completely made up identities and tax data. They may use celebrity names or obscure names with bogus addresses and social security numbers and have the refund deposited to a prepaid debit card that requires virtually no purchaser identification. These are often being perpetrated by relatively unsophisticated fraudsters and rely upon tax software vendors that allow filing fees to be deducted from the refund itself thus requiring no cash outlay in advance. Fortunately, our LexisNexis identity confirmation tool is very effective at identifying these fraudulent attempts as the identity information does not match to valid external information.

8. Unlinked Return: An "Unlinked Return" is one that does not have a federal tax return associated with it and is filed directly with a state bypassing many of the IRS fraud safeguards. This unlinked return process is also used by fraudsters to file in multiple states rather than simply one using the same fraudulent identity. Though it is possible to have a valid unlinked return, the rate of fraud is very high and requires additional review.

9. Synthetic Identity: A "Synthetic Identity" is one which has been amalgamated from existing identity information such as children or deceased relatives and contains enough valid identity information to appear to be a valid identity.

10. Stolen Identity: A "Stolen Identity" is one where the fraudsters have obtained valid taxpayer information comprised of names, addresses, social security numbers, and sometimes even dependents, from real taxpayers. These culprits then seek to gain fraudulent refunds in two ways. First, they file a federal return early in the filing season before the real taxpayer submits their valid return. Second, they file directly with a state, or multiple states, that is usually not where the valid taxpayer is actually located.

The Ultimate Approach to Combat this Problem

In order to effectively overcome the problem of identity theft and refund fraud, all parties involved must work collaboratively. We must develop cross-functional teams with significant coordination among the three key players in our tax system. Consider the Three Legged Stool concept depicted in Figure 4 which notes that the states, the IRS, and software vendors each represent an important leg of the stool. Each has unique data, perspectives, and capabilities that the system as a whole requires in order to make better decisions.
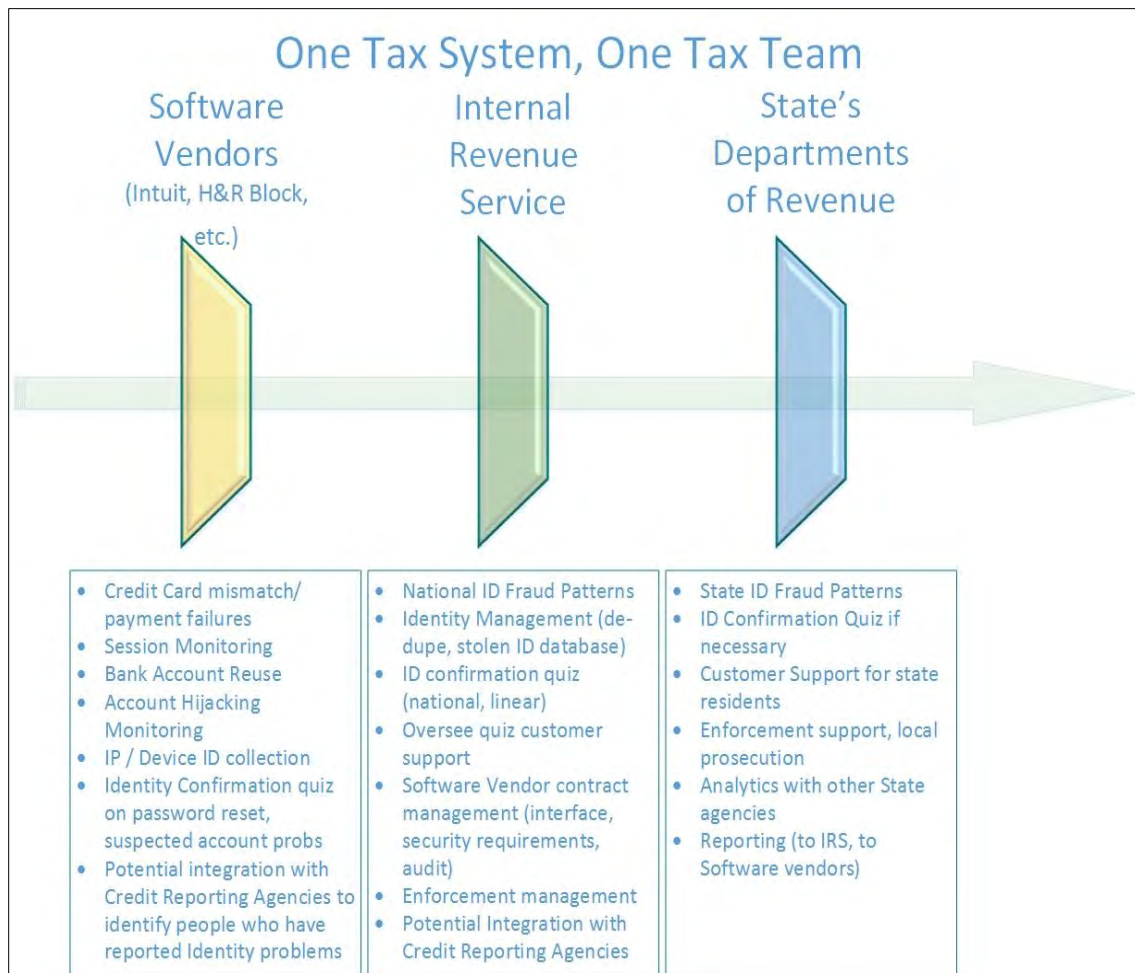
Figure 4: Three Legged Stool

The "three legged stool" concept allows each leg to execute appropriate roles within our present tax system resulting in an effective and collective solution.

Indiana believes that our partners at the IRS are in the best position to centrally manage the highly sophisticated fraud. The IRS can help the states define the expected behavior of the software vendors which could include security requirements, potential fraud reporting, and corrective behavior for vendors

not operating according to the systematic norm. The central location in this process also makes the IRS a better place to accomplish analytics to identify multi-state fraud patterns, manage a shared database, correlate with other data sets (Social Security Administration and others), and coordinate national and international enforcement efforts. Without data driven prosecution and enforcement, the culprits face little risk in continuing to conduct this sort of activity.

States must also work collaboratively with one another to develop and share effective analytics, algorithms, and best practices. The Federation of Tax Administrators (FTA) has convened a Fraud Working Group comprised of multiple states, including Indiana, that have already made a significant commitment to developing taxpayer identification validation standards and consistent communication and monitoring mechanisms to ensure that uniform data elements can be captured and shared. Their intent is to establish uniform practical measures that the software vendor industry can support and that will be applied consistently, avoiding disparate rule sets and expectations from each state. This will enhance the likelihood of industry compliance. The FTA has also positioned itself as a facilitator and clearinghouse for the states as well as the IRS in sharing best practices and innovations. They can be very effective in helping communicate with members the importance of identity theft and refund fraud prevention programs and the positive economic impact it will have. States must recognize this value and be willing to commit the necessary resources.

Software vendors must be responsive to the IRS and states as they learn more about the methods used by fraudsters. We have already learned that account access must be protected with multi-factor authentication. However, software vendors also have multiple other data sources and analytics which they must be willing to use to stop fraud from inception. Further, as their intelligence increases, they must be willing to share that intelligence with states and the IRS as their partners.

Conclusion
In conclusion, I would like to emphasize the following points:

First, identity theft and refund fraud is an epidemic problem and growing rapidly. It currently represents one of the easiest means available for fraudsters to monetize stolen identity information. We are all aware of the increased vulnerability we face for protection of identity information.

Second, collaboration and information sharing among the IRS, state departments of revenue, and tax processing and software vendors is essential. Strengthening of the "three legged stool" by tax processing partners will allow us to more effectively combat identity theft and refund fraud through enhanced analytics, sharing of information, and implementation of best practices. This sharing and collaboration must be in real time, not days or weeks down the road. Delays in digesting new information or implementing good ideas leaves the window of vulnerability open longer for fraudsters to enter.

Third, investment in identity theft and refund fraud prevention tools will provide a strong return on investment. In 2014, Indiana realized greater than a 10 times return on investment based upon fraudulent refunds stopped compared to actual program costs. I encourage states as well as the federal government to make our battle against identity theft and refund fraud a strategic priority. This also means backing that priority with necessary funding to move the dial. I'm confident it will provide a significant return on investment and also protect our citizens.

On behalf of Governor Mike Pence and the citizens of Indiana, I thank you for your time today. I appreciate the committee's willingness to examine this issue and we in Indiana stand ready to assist and participate in a comprehensive solution.