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THE INTERNAL REVENUE SERVICE IS SHIFTING AMERICAN TAXPAYERS FROM A PAPER BASED FILING SYSTEM TO ELECTRONIC FILING - IS THE IRS OFFERING A CAPABLE SYSTEM THAT PROTECTS TAXPAYER CONFIDENTIALITY?

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INTRODUCTION

The 2001 income tax filing season will mark the fifteenth year that the Internal Revenue Service ("IRS," or "Service") has allowed taxpayers to file income tax returns electronically.[1] Today the IRS encourages American taxpayers, individuals and businesses alike, to file their tax returns electronically.[2] The Service has invested billions of taxpayer dollars to modernize its systems to accommodate electronic filing, and it

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1. *1986 Individual Income Tax Return Electronic Filing Pilot*, 50 Fed. Reg. 30041 (July 23, 1985). The 1986 Individual Income Tax Return Electronic Filing Pilot program ("Electronic Filing Pilot Program") first allowed qualified automated return preparers to electronically transmit tax year 1985 individual income tax returns to the IRS.

2. See e.g. Electronic Services: IRS e-file for Taxpayers ¶¶ 1-2 <http://www.irs.ustreas.gov/plain/elect_svs/elf_txpy.html> (last updated Nov. 22, 1999) (explaining and promoting electronic filing of tax returns). The site touts the advantages to taxpayers of using electronic filing, stating that:

> [Y]ou don't have to worry about your return being lost or delayed in the mail. . . . The IRS quickly and automatically checks for errors or other missing information . . . [and] [w]ithin 48 hours of electronic transmission, IRS acknowledges acceptance of the return. Only IRS e-file options provide this assurance. Best of all, IRS e-file means fast refunds – in half the time as when filing on paper.

Id.

plans to invest billions more.[3] American taxpayers may be alarmed to learn that many of the billions of dollars invested to date have "essentially been wasted."[4] Despite this waste, the IRS continues to move full speed ahead to utilize the electronic medium. More alarming to taxpayers though, is that the IRS offers no guarantees that vital taxpayer information transmitted electronically will remain confidential.

This article considers the state of the IRS electronic filing program today by examining the development of electronic filing and the statutory authority that directs the IRS to shift the American tax system from a paper-based system to electronic filing. We consider litigation issues that have involved IRS administration of its electronic filing and then examine the abuses of the taxation system that have developed alongside electronic filing and the corresponding corrections and preventive measures instituted by the IRS. Next, we examine the government's own criticisms of IRS' efforts to modernize along with efforts by Congress to control the development. Consideration will be given to the privacy concerns raised with the American taxation system and the issues raised when the IRS breaches taxpayer confidentiality. Finally, we will look to confidentiality issues raised by electronic filing and the measures that have been taken by the IRS to protect taxpayers.

I. ELECTRONIC FILING OF INDIVIDUAL INCOME TAX RETURNS TODAY

A. THE EVOLUTION OF THE USE OF ELECTRONIC FILING BY THE IRS

Since the Electronic Filing Pilot program was launched in 1986, the IRS use of Internet technology has, like the use of the Internet itself, grown steadily. The Pilot program limited electronic filing to certain taxpayers within three geographically diverse metropolitan areas.[5] With the 1988 income tax filing season, came implementation of a pilot program to test a scannable, condensed answer sheet return, IRS Form 1040-OCR. For the first time ever, Form 1040-OCR allowed compression of required taxpayer-furnished information, including forms and schedules, into a one page columnar format.[6] By the 1990 tax filing season,

3. 143 Cong. Rec. S11515-01 (daily ed. Oct. 31, 1997).

4. *Id.* Senator Kerrey cited a 1995 General Accounting Office disclosure that nearly $4 billion worth of modernization and purchase of computers and software had not produced the desired result. *Id.*

5. 50 Fed. Reg. 30041. The initial Pilot program was limited to taxpayers in the Phoenix, Arizona, Cincinnati, Ohio, and Raleigh-Durham-Fayetteville, North Carolina metropolitan areas. *Id.*

6. *Condensed Hardcopy to Automate Manual Processing System*, 52 Fed. Reg. 21403 (June 5, 1987). (providing that all taxpayer-furnished information required on current forms will be required on Form 1040-OCR.) Form 1040-OCR did require the attachment of a separate page containing a taxpayer signature. *Id.*

electronic filing was available to taxpayers nationwide,[7] and the IRS was touting its advantages to taxpayers.[8] While making electronic filing available to individual income taxpayers, the IRS also utilized it for the non-income tax purposes as well.[9]

The latest tax filing seasons saw a dramatic increase in the availability of electronic filing for taxpayers. Prior to the 1996 filing season, those taxpayers that chose to file electronically had to use an income tax-preparation service to transmit their electronically prepared returns. In 1996 tax-preparation software became available that allowed taxpayers to transmit their returns through the software vendor and avoid the use of a paid preparer. Beginning with the 1999 tax filing season, the IRS increased its efforts to provide free electronic preparation and transmission at IRS sites throughout the country. More importantly, 1999 saw the availability of income tax software that could be downloaded from the Internet or even run directly from the Internet through an online tax-preparer's server.[10]

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7. *1990 Electronic Filing Program*, 54 Fed. Reg. 28148 (July 5, 1989).

> In 1990, the Internal Revenue Service plans to continue the [electronic filing] program to allow the filing of Form 1040, U.S. Individual Income Tax returns[,] electronically. Electronic filing will now be available nationwide, including Hawaii and Alaska. Electronic filing is also available to U.S. citizens living abroad having an APO or FPO address.

Id.

8. *Id.* at 28149.

> The principle advantages to participants of electronic filing are that: (1) [m]ost taxpayers will receive their refunds within three weeks of the date the return is acknowledged as received by the IRS; (2) most errors are detected up front, the filer is advised and can correct and resubmit the return, eliminating delays; (3) the return preparers will be able to serve their clients more efficiently; and (4) taxpayers participating in Direct Deposit will receive their refunds quickly and more conveniently.

Id.

9. *See e.g. Electronic Filing of Notice of Federal Tax Lien*, 53 Fed. Reg. 47675, 47675-47676 (Nov. 25, 1988) (amending Internal Revenue Regulation § 301.6323(f)-1(c) to provide that notice of lien may be filed by use of electronic or magnetic medium). *Electronic Filing of Employee Pension Plan Returns*, 57 Fed. Reg. 23456 (June 3, 1992) (providing notice that the IRS will accept Employee Pension Plan Returns (Form 5500) filed electronically). *Comment Request for Revenue Procedure 97-47*, 62 Fed. Reg. 55668 (Oct. 27, 1997) (soliciting comments concerning Form 941 Employer's Quarterly Federal Tax Return, electronic filing program). *1998 Electronic Filing: Low-Income Housing Credit Forms*, 63 Fed. Reg. 2722 (Jan. 16, 1998) (announcing automated pilot program for filing Low-Income Housing Credit forms electronically). *See also, Notice of Meeting with Current and Prospective Tax Software Developers for Electronic Filing of Form 1065, U.S. Partnership Return of Income*, 63 Fed. Reg. 26681 (May 13, 1998) (announcing a meeting to "share the thinking about the strategic direction of mandating electronic filing of partnerships with more than 100 partners").

10. Catherine Greenman, *Filing Your Taxes Online: It's Faster, More Accurate and Welcomed by the I.R.S.*, N.Y. Times §G, ¶ 9 (Jan. 27, 2000) (available in archives at <http://www.Newyorktimes.com>). Software programs mentioned included Quicken TurboTax

The 2000 filing season saw even more options for electronic filing become available.[11] At least one tax preparation business offered free federal or state return preparation and transmission to taxpayers regardless of their level of income and the complexity of their return.[12]

The IRS has recognized the advantages electronic filing provides to the Service itself: "electronic filing eliminates most of the manual processes required by IRS to handle paper documents, which will increase the quality of the final product, speed up the processing and reduce unnecessary correspondence."[13] The advantages to the Service and to taxpayers resulted in a Congressionally mandated goal of the IRS to electronically transact 80 percent of all of individual tax returns by the year 2007.[14] The intermediate goal is that, to the extent practicable, all returns prepared electronically should be filed electronically by the year 2002.[15] Clearly, the Service intends to utilize Internet technology to aid the enormous task of processing over 115 million individual income tax returns annually.[16]

B. Statutory Authority for Use of Electronic Filing

As IRS and taxpayer use of electronic filing has evolved, Congress has enacted provisions to the Internal Revenue Code ("Code") to recognize the electronic medium. The most significant statutory changes came about through the Internal Revenue Service Restructuring and Reform Act of 1998 ("1998 Act").[17] In addition to the electronic utilization mandate, the 1998 Act added statutory language to the Code to promote

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Deluxe by Intuit on CD-ROM in stores and online, and Kiplinger TaxCut Deluxe sold by H & R Block in stores and online. *Id.* at ¶ 10-11.

11. *Id.* at ¶ 9.

12. *Id.* at ¶ 18. Among the new software available in the 2000 filing season was Microsoft's TaxSaver Federal Deluxe on CD-ROM. *Id.* at ¶ 15. In 2000, H. D. Vest Online offered free preparation and transmission services for the first year "with the hopes of attracting potential new customers to other financial services offered by the company." *Id.* at ¶ 18. Another newcomer in the 2000 filing season was Taxes4Less, an online tax preparation service. *Id.* at ¶ 19.

13. 63 Fed. Reg. at 2722.

14. *The Internal Revenue Service Restructuring and Reform Act of 1998*, Pub. L. No. 105-206, § 2001, 112 Stat. 685, 723 (1998).

15. *Id.* at 723 (1998). Subsection (a) of § 2001 provides: "It is the policy of Congress that . . . it should be the goal of the Internal Revenue Service to have at least 80 percent of all such returns filed electronically by the year 2007." *Id.* Subsection (b)(1) provides: "To the extent practicable, such plan shall provide that all returns prepared electronically for taxable years beginning after 2001 shall be filed electronically." *Id.*

16. *Substitute Return Format Standardization for Individual Returns Filed on Paper*, 59 Fed. Reg. 48362 (Sept. 20, 1994). "The IRS receives more than 115 million individual tax returns and the volume increases annually." *Id.*

17. 112 Stat. at 723-27. Title II to the enactment is entitled "Electronic Filing of Tax and Information Returns." *Id.* at 723.

electronic filing and provided incentives toward that end.[18] Further, the 1998 Act made specific changes to the Code to address certain paper filing requirements that were not compatible with the electronic medium.

First, Congress added subsection (b) to Code § 6061[19] to allow for the development of "procedures for the acceptance of signatures in digital or other electronic form."[20] That section provides that "until such time as such procedures are in place, the Secretary may either waive the requirement of a signature for; or provide for alternative methods of signing."[21] The Service had been working on an alternative means to the signature requirement long before the 1998 Act though. During the 1993 and 1994 income tax filing seasons, the Service tested the TeleFile Voice Signature Test.[22] The electronic filing system has not eliminated paper

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18. *Id.* at 723. § 2001 (c) added new subsection (f) to 26 U.S.C. § 6011:

> Promotion of Electronic Filing.— (1) In General.—The Secretary [of the Department of the Treasury] is authorized to promote the benefits of and encourage the use of electronic tax administration programs, as they become available, through the use of mass communications and other means. (2) Incentives.—The Secretary may implement procedures to provide for the payment of appropriate incentives for electronically filed returns.

Id. To date, the IRS has not offered any incentives to promote electronic filing. However, on January 14, 2000, President Clinton announced he would include as part of his budget request to Congress a proposal to create a special income tax credit for electronic filers. *Clinton Proposal Would Grant Tax Credit to Electronic Filers,* Boston Globe (Jan. 14, 2000) (available in 2000 WL 3308657). His proposed credit would be $10 for taxpayers filing through computers and $5 for those filing through use of a telephone voice system. *Id.*

19. 26 U.S.C. § 6061 (1998).

20. 112 Stat. at 724-25. Under the 1998 Act, 26 U.S.C § 6061(b) was added, which reads:

> Electronic Signatures.—(1) In General.—The Secretary [of the Department of the Treasury] shall develop procedures for the acceptance of signatures in digital or other electronic form. Until such time as such procedures are in place, the Secretary may—(A) waive the requirement of a signature for; or (B) provide for alternative methods of signing or subscribing, a particular type or class of return, declaration, statement, or other document required or permitted to be made or written under internal revenue laws and regulations. (2) Treatment of Alternative Methods.—Notwithstanding any other provision of law, any return, declaration, statement, or other document filed and verified, signed, or subscribed under any method adopted under paragraph (1)(B) shall be treated for all purposes (both civil and criminal, including penalties for perjury) in the same manner as though signed or subscribed. (3) Published Guidance—The Secretary shall publish guidance as appropriate to define and implement any waiver of the signature requirements or any method adopted under paragraph (1).

Id.

21. *Id.* at 724.

22. *TeleFile Voice Signature Test*, 58 Fed. Reg. 68295 (Dec. 27, 1993). The IRS enacted amendments to temporary regulations which allowed tax returns completed as part of TeleFile Voice Signature Test to be treated as a return that is signed, authenticated, verified, and filed by the taxpayer for a second consecutive year. *Id.* Under the system, taxpayers use a touch tone telephone and enter the required information in response to computer prompts. *Id.* at 68296. Once the return is complete, the computer system advises the taxpayer that their filing is completed. *Id.*

filing entirely.[23] Taxpayers filing electronically for the first time still must sign and mail Form 8453 verifying the accuracy of the electronically filed return.[24] In 1999, the IRS began sending out postcards with "E-file Customer Numbers."[25] "[T]axpayers can enter [these numbers] on their returns in lieu of sending in the 8453 form."[26] "The[se] postcards were sent to taxpayers that had filed electronically the previous year."[27]

Secondly, in the 1998 Act, Congress added subsection (c) to Code § 7502 to recognize the timeliness of electronic filing.[28] In response, the IRS issued Temporary Regulation § 301.7502-1T(d).[29] It provides in part, "the date of an electronic postmark given by an authorized return transmitter will be deemed the filing date if the date of the electronic postmark is on or before the filing due date."[30] That regulation defines an electronic postmark as "a record of the date and time that an authorized electronic return transmitter receives the transmission of the taxpayer's electronically filed document on its host system.[31]

C. THE KINDER, FRIENDLIER IRS

In addition to compliance with the mandates required by Congress, the IRS has instituted other efforts to promote electronic filing. The most notable one being the establishment of the Electronic Tax Administration Office, whose mission is

> to revolutionize how taxpayers transact and communicate with the IRS. Strategies to fulfill the mission include:

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23. Greenman, *supra* n. 10, at ¶ 21.

24. *Id.*

25. *Id.* at ¶ 22.

26. *Id.*

27. *Id.*

28. § 2003(b) provides in pertinent part that 26 U.S.C. § 7502(c) is amended to read as follows:

> Registered and Certified Mailing; Electronic Filing.—(1) Registered Mail.—For purposes of this section, if any return, claim, statement, or other document, or payment, is sent by United States registered mail—(A) such registration shall be prima facie evidence that the return, claim, statement, or other document was delivered to the agency, officer, or office to which addressed; and (B) the date of registration shall be deemed the postmark date. (2) Certified mail; electronic filing.—The Secretary [of the Department of the Treasury] is authorized to provide by regulations the extent to which the provisions of paragraph (1) with respect to prima facie evidence of delivery and the postmark date shall apply to certified mail and electronic filing.

112 Stat. at 724-25.

29. *Timely Mailing Treated as Timely Filing / Electronic Postmark*, 64 Fed. Reg. 2568 (Jan. 15, 1999).

30. *Id.*

31. *Id.*

-Making electronic filing, payments, transactions and communications so simple, inexpensive, and trusted that taxpayers will prefer these to calling and mailing;

-Providing additional taxpayer access methods to products and services centering on electronic filing, payment, transaction, and communication products and services;

-Aggressively protecting transaction and information integrity and quality; and

-Seeking the best people, ideas and partners to assure IRS success.[32]

These strategies illustrate the Service's commitment to utilize emerging technologies to make transacting and communicating easier for taxpayers. Coupled with the Congressional mandate to promote electronic technology,[33] it is apparent that the traditional paper filing system will soon be a thing of the past for the vast majority of American taxpayers.[34]

II. Litigation Involving the IRS Electronic Filing Program

The Congressional directive and the IRS stance both proclaim that the use of electronic filing presents a win-win change for taxpayers and the IRS.[35] One cannot deny the numerous advantages of the electronic medium as have been enumerated by the IRS.[36] However, the purpose of this article is to examine any negative implications of the use of electronic filing for income tax returns. Accordingly, we now turn to the issues that have been raised in the courts concerning electronic filing. The litigation issues raised to date fall into two basic categories: actions challenging IRS administration of its electronic filing program and actions relating to abuses of the program.

A. Litigation Involving Participation in the Electronic Filing Program

Federal courts have decided three cases regarding IRS suspensions

32. *Internal Revenue Service Pilot of an Electronic Transcript Delivery System*, 64 Fed. Reg. 49540 (Sept. 13, 1999).

33. 112 Stat. at 723-27.

34. *See Id.* at 723 (stating that paperless filing is the most preferred means of filing one's taxes and that it is the goal of the IRS to have 80 percent of all individual tax returns filed electronically by 2007).

35. Greenman, *supra* n. 10, at ¶¶ 2-4 (explaining that electronic returns eradicate the need for IRS employees to manually enter tax information into the computer system, reduces costs to the IRS, allows refunds to be processed in half the time required under paper filing, and provides the IRS with returns that have less errors).

36. *See* 63 Fed. Reg. at 2722 (explaining that electronic filing eliminates most of the manual handling of paper documents, increases the quality of the final product, speeds up the processing of the returns, and reduces unnecessary correspondence).

of participants in the electronic filing program.[37] In each case, the plaintiffs had initially been granted approval to participate in the electronic filing program but subsequent investigations prompted the IRS to rescind their electronic filing privileges. Each of the plaintiffs based their arguments on different legal theories, so we briefly examine each assertion and the courts' holdings.

In *Forehand v. Internal Revenue Service*, an electronic filing program participant asserted a property interest in the program and that her suspension from participation constituted a deprivation of liberty.[38] Mrs. Forehand had been suspended by the IRS from participating in the electronic filing program, because of her failure to file a timely return for one year and an outstanding balance she had from another tax year.[39] The court said that she had no guarantee of an entitlement to participate in the electronic filing program and noted the IRS authority to set guidelines for participation.[40] Her deprivation-of-liberty claim was based on IRS Revenue Procedure 94-63 which provides for internal publication of the names of any entity suspended from the electronic filing program.[41] The court ruled that the IRS could provide intra-agency notices of her ineligibility to participate without violating the Due Process Clause.[42]

In *Compro-Tax Inc. v. Internal Revenue Service,* the suspended participant claimed the suspension of his firm violated "the Privacy Act, 5 U.S.C. §522a, the Due Process Clause of the Fifth Amendment, the Association Clause of the First Amendment, and unlawful disclosures of taxpayer information."[43] Compro-Tax had been suspended because the company's owners had failed to file timely individual income tax returns.[44] Plaintiffs based the Privacy Act allegation on the claim "that the [IRS] failed to compile and maintain accurate, timely and complete records."[45] The plaintiffs' claims were based, in part, on their assertion that the IRS determination that they were unsuitable for participation in the electronic filing program was based on inaccurate information.[46]

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37. *See Forehand v. Internal Revenue Service*, 877 F. Supp. 592 (M.D. Ala. 1995); *Compro-Tax, Inc. v. Internal Revenue Service,* 1999 WL 501014 (S.D.Tex. 1999); and *Brenner Income Tax Centers, Inc. v. Director of Practice of the Internal Revenue Service*, 87 F. Supp. 2d 252 (S.D.N.Y. 2000).

38. 877 F. Supp. at 595.

39. *Id.* at 594.

40. *Id.* at 595-96.

41. *See* Rev. Proc. 94-63, 1994-2 C.B. 785, 1994-401 I.R.B. 7 (providing a complete set of guidelines for participation in the electronic filing program, now superseded by Rev. Proc. 98-50, 1998-2 C.B. 368, 1998-38 I.R.B. 8).

42. 877 F. Supp. at 597.

43. 1999 WL 501014 at *1.

44. *Id.*

45. *Id.* at *3.

46. *Id.* at *4.

The plaintiffs said that use of this inaccurate information in turn violated the Privacy Act.[47] The court held that "[t]he Privacy Act may not be used to collaterally attack a final agency decision as 'inaccurate,' or 'incomplete' merely because the individual contests the decision."[48]

A thorough review of the administrative procedures involved in contesting suspension from participation in the electronic filing program was made by the court in *Brenner Income Tax Centers, Inc. v. Director of Practice of the Internal Revenue Service.*[49] After exhausting the administrative appeals process, the *Brenner* plaintiffs sought injunctive relief requiring the IRS to reinstate the firm in the electronic filing program.[50] Brenner had been suspended for failure to file timely and accurate tax returns.[51] The court specifically noted language from the IRS decision being appealed: "implicit trust must be placed on electronic filers to possess a high degree of integrity as well as to be in compliance with revenue laws."[52] The court held that "[t]he IRS has the authority to set guidelines for the exercise of the privilege of participating in the [electronic filing program], and [that] the plaintiffs were notified of [the] requirements."[53] The court held that based on the late filings of income tax returns, the administrative decision to suspend "was [not] arbitrary, capricious or an abuse of discretion."[54]

These three decisions illustrate that courts recognize the authority of the IRS to promulgate standards for participation in the electronic filing program. In sum, Congress has granted broad administrative powers to the IRS and the courts generally uphold that authority. This broad authority to administer electronic filing follows logically from the long recognized authority of the IRS to administer the traditional paper filing

47. *Id.*

48. *Compro-Tax, Inc. v. Internal Revenue Service,* 1999 WL 501014 at *4 (S.D.Tex. 1999). The court, in *Compro-Tax,* was dealing with motion by the IRS to dismiss the entire claim based on subject matter jurisdiction and sovereign immunity. *Id.* at *2. The court held that that subject matter jurisdiction existed to hear claims concerning the constitutionality of federal rules and regulations pursuant to 28 U.S.C. §§ 1331 and 2201. *Id.* at *3. Further the court held that Compro-Tax, Inc. failed to state a claim under the Administrative Procedures Act, 5 U.S.C. § 706, and recommended dismissal of any claim under it. *Id.* The court reasoned that the allegations in the complaint relating to unlawful disclosures of tax return information filed under 26 U.S.C. 7217 was improperly invoked under a repealed statute, as the statute was repealed by the Tax Equity and Fiscal Responsibility Act of 1982. *Id.* at *5. The court noted that a claim for unauthorized disclosure of tax return information would be proper under 26 U.S.C. §§ 6103 and 7431. *Id.*

49. 87 F. Supp. 2d at 252.

50. *Id.*

51. *Id.*

52. *Id.* at 254.

53. *Id.* at 257.

54. *Brenner Income Tax Centers, Inc. v. Director of Practice of the Internal Revenue Service,* 87 F. Supp. 2d 252, 257 (S.D.N.Y. 2000).

systems. Our American system of taxation is one of self-assessment; taxpayers report their income and compute their taxes via their income tax returns and the IRS sets the standards for doing so. Now that we have considered the legal challenges relating to administration of electronic filing, we turn to legal issues raised by taxpayers that have utilized the electronic filing program.

B. Litigation Issues Raised as a Result of Taxpayer Utilization of the IRS Electronic Filing Program

1. *Refund-Anticipation Loans*

With the widespread availability of electronic filing beginning in 1990, professional tax preparers soon began marketing "rapid refund" services.[55] These so-called rapid refunds are not really refunds, they are loans against a taxpayer's expected income tax refund.[56] Financial institutions and the IRS call them refund-anticipation loans.[57]

A refund-anticipation loan generally works as follows: the taxpayer uses a professional tax preparation service to prepare and electronically transmit its individual income tax return.[58] In exchange, the preparers charge fees for preparation of the return and/or fees to electronically transmit the return to the IRS.[59] The refund-anticipation loan is offered as an optional service. A taxpayers electing a refund-anticipation loan sign a loan agreement that is then processed by a financial institution. That institution then issues a check to the taxpayer in exchange for a collateral interest in the taxpayer's refund due from the IRS. The financial institution will also deduct any charges owed by the taxpayer to the preparation service and the institutions own fee for making the loan.[60] Generally, the taxpayer receives the loan within two to fourteen days compared to the five to six weeks it takes to receive the refund directly from the IRS. When the IRS later pays the refund, it is generally via a pre-authorized direct deposit to the taxpayer's account at the financial institution, which in turn pays off the loan. Usually, the financial institution pays a part of its fees to the tax preparation service as an incen-

55. *See generally Taxpayers Benefit from Electronic Filing*, Information Today (Jan. 1, 1989) (available in 1989 WL 2587667) (explaining the increase in use of electronic filing of tax returns and the rapid refund option offered by H&R Block).

56. *Id.* at ¶ 4.

57. *See* Rev. Proc. 98-50, 1998-38 IRB 8, 1998 WL 638827, § 10 (Sept. 21, 1998) (explaining refund-anticipation loans).

58. *See generally U.S. v. Williams*, 164 F.3d 627 (4th Cir. 1998) (explaining rapid refunds and refund-anticipation loans).

59. *See e.g. Id.* (explaining that, in 1991, customers of H&R Block paid $25-$35 for electronic filing).

60. *See e.g. Id.* (explaining that, in 1991, H&R Block customers paid a $29 finance charge to Beneficial National Bank for a refund-anticipation loans).

tive for generating the loan.[61]

With the increasing popularity of electronic filing, refund-anticipation loans have become a big business.[62] For example, H & R Block reported that for 1997, its stake in the refund-anticipation loan business generated $54.4 million in revenues and an estimated $8.1 million in operating earnings.[63] The interest rates charged on refund-anticipation loans have drawn wide criticism from consumer advocates.[64] As of 1998, H & R Block had been named in at least six lawsuits in federal and state courts claiming unfair practices relative to its rapid refund program.[65] We now consider the courts' analysis of the issues that have been raised over these loans.

2. *Consumer Litigation Involving Refund-anticipation loans*

In *Cades v. H & R Block, Inc.*, the taxpayer plaintiff had utilized the tax preparer's rapid refund program for his 1990 income tax return.[66] Cades asserted that the fees charged by Block, the defendant, and Beneficial, the bank administering their refund-anticipation loan, violated numerous provisions of the South Carolina Consumer Protection Code and the South Carolina Unfair and Deceptive Trade Practices Act.[67] The plaintiff "asked the court to certify a class action, and sought treble actual damages. . ., punitive damages and attorneys' fees."[68] Block removed the case to federal court on the basis of federal question jurisdiction, and Cades amended his complaint to allege Truth in Lending Act and National Bank Act violations.[69] The district court granted summary judgment to both Block and Cades, on Cades' amended complaint.[70]

Cades contended that Beneficial was effectively operating branch banks through Block's South Carolina offices.[71] The court noted that "Beneficial ha[d] no ownership or leasehold interest in Block's South Carolina offices," that "no Beneficial employees work in Block offices," and that "Beneficial exercise[d] no authority or control over Block's em-

61. *See Id.* (explaining refund-anticipation loans).

62. Beth Kobliner, *SPENDING IT: Tax Giant's Loan Deals Stir Dispute*, N.Y. Times ¶ 2 (Apr. 12, 1998) (available in archives at <http://www.newyorktimes.com>).

63. *Id.* at ¶ 12.

64. *Id.* at ¶ 11.

65. *Id.* at ¶ 4.

66. 43 F.3d 869, 872 (4th Cir. 1994), *cert. denied*, 515 U.S. 1103 (1995).

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.* at 874.

ployees or methods of operations."[72] The court held that "Block's South Carolina offices [were] not branch offices established and operated by Beneficial."[73]

Cades' other arguments centered upon the $29 fee charged by Beneficial to process his refund-anticipation loan.[74] The court held that state law permitted Beneficial to charge a flat financing fee.[75] Cades also claimed "that Beneficial [had] understated the annual percentage rate of interest charged on his loan" in violation of the Truth Lending Act.[76] The court held that Regulation Z (12 C.F.R. pt. 226.17) allowed "disclosures [on] demand obligations [to be] based on an assumed one-year term unless an alternate maturity date is stated in the [loan document]."[77] Since Cades's loan documents described the loan as payable 'on demand,' the court stated that "Beneficial properly based the annual percentage [ ] rate on a maturity date of one year."[78]

Finally, Cades claimed that Beneficial failed to provide him with required lending disclosures in a timely manner.[79] He claimed that Block should have disclosed the information at the time he signed the application for the refund-anticipation loan.[80] Block provided the required disclosures two days later, immediately before Cades endorsed the loan check from Beneficial.[81] The court held that the loan transaction was not consummated until the latter date and that Beneficial provided the required disclosure in accordance with Regulation Z.[82] "The district court correctly granted summary judgment on this claim."[83]

Peterson v. H&R Block Tax Services, Inc., another case involving H & R Block, provides insight into the abuse of the IRS' electronic filing in conjunction with refund-anticipation loans.[84] In *Peterson,* the court examined the IRS reaction to tax fraud it encountered as a result of its

72. *Cades v. H & R Block, Inc.*, 43 F.3d 869, 874 (4th Cir. 1994), *cert. denied*, 515 U.S. 1103 (1995).

73. *Id.*

74. *Id.*

75. *Id.* The court said Beneficial was a Delaware corporation and examined Delaware Code Ann. tit. 5 § 965 (1993), which allows for a flat financing fee. *Id.*

76. *Id.* Beneficial's loan documents stated an annual percentage rate of 2.406 percent. *Id.* at 872. Beneficial's disclosure was based on an annual term for a demand obligation. *Id.* at 875. Had it been based on a three week maturity date, the annual percentage rate would have been over 40 percent. *Id.*

77. *Id.* at 875.

78. *Cades v. H & R Block, Inc.*, 43 F.3d 869, 875 (4th Cir. 1994), *cert. denied*, 515 U.S. 1103 (1995).

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.* at 876.

83. *Id.*

84. 22 F. Supp. 2d 795, 797 (N.D. Ill. 1998).

electronic filing program.[85] Prior to 1995, the IRS had issued Direct Deposit Indicators when it received electronically filed returns.[86] "A Direct Deposit Indicator was a signal from the IRS that it had received the return and had no information that would preclude direct deposit of the taxpayer's refund into a designated account."[87] However, the IRS discontinued Direct Deposit Indicators in late 1994 as part of its increased efforts "to detect fraud in tax returns filed electronically and those claiming an Earned Income Tax Credit ("EITC")."[88]

The increased detection efforts by the IRS affected tax filers for the first time during the 1995 income tax filing season.[89] As a result of the IRS changes, Block changed its disclosures to clients applying for refund-anticipation loans to state that filers claiming the EITC could experience delays from the IRS that could also affect the amount of the refund-anticipation loan approved by the lending institution.[90] Peterson filed electronically through Block and applied for a refund-anticipation loan.[91] Beneficial approved a partial refund-anticipation loan for the amount of her refund less the amount of her EITC.[92] Peterson asserted that Block's disclaimer language was not sufficient in light of the preparer's knowledge that substantial refund delays would occur for taxpayers claiming the EITC.[93] Peterson brought a state action presenting four state law claims and two claims under Racketeer Influenced and Corrupt Organizations Act ("RICO")[94] "Block removed the case to federal court under 28 U.S.C. § 1441(b)."[95] The court held that Peterson failed to present evidence to satisfy her burden of establishing an inference of intentional fraud.[96]

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85. *See generally Id.*

86. *Id.* at 798.

87. *Id.*

88. *Id.*

89. *Id.*

90. *Peterson v. H & R Block Tax Services, Inc.*, 22 F. Supp. 2d 795, 799-800 (N.D. Ill. 1998). H&R Block created a "RAL Fact Sheet" to give to its customer's seeking refund-anticipation loans. *Id.* at 799. The December fact sheet contained the new IRS policy that they had to file the customer's tax return with the IRS before the bank would tell you how fast you would receive their refunds. *Id.* H&R Block decided not to include a warning about the EITC delaying a return in their December fact sheet. *Id.* at 800. H&R Block did not include a statement about the delay of EITC returns until the February Fact Sheet. *Id.*

91. *Id.* at 801.

92. *Id.*

93. *Id.* at 803.

94. 18 U.S.C. § 1962 (1998).

95. *Id.* at 802.

96. *Peterson v. H & R Block Tax Services, Inc.*, 22 F. Supp. 2d 795, 804 (N.D. Ill. 1998). Subsequent to granting the IRS' motion for summary judgment on Peterson's RICO claims, the court declined to exercise its supplemental and discretionary jurisdiction over the remaining state law claims and remanded them back to state court. *Id.* at 806.

Taken together, *Cades* and *Peterson* illustrate that the courts will likely uphold the validity of refund-anticipation loans despite the annual percentage rate charged, provided that all applicable disclosure laws are met.[97] Having examined the procedures involved with refund-anticipation loans and the courts' endorsement of their validity, we now turn to a more disturbing abuse of electronic filing, fraudulent returns filed to obtain fraudulent refund-anticipation loans.

C. Criminal Litigation Involving the Electronic Filing Program

1. *Use of Electronic Filing to Obtain Fraudulent Refund-Anticipation Loans*

Almost as quickly as refund-anticipation loans became available, schemes to defraud the government and/or the refund-anticipation loan lenders appeared. Under a typical refund-anticipation loan scheme, "the conspirator[s] create [ ] false tax forms using aliases, submit[ ] them to independent tax return preparers for electronic filing, and obtain[ ] refund-anticipation loans from banks.[98] The IRS prosecutes those conspirators it can identify, but it is not known what percentage of the fraudulent returns the IRS fails to detect. On this issue, we will examine the holdings of intermediate federal courts that have considered appeals of criminal convictions based upon participation in these refund-anticipation loan schemes. In these cases, the appellants challenged the length of the sentences imposed by the district courts.

Federal Sentencing Guidelines allow for adjusting the offense level upward for a defendant found to have had a position of organization or leadership or as a manager or supervisor of a criminal offense.[99] Appeals courts have upheld increased plaintiffs' sentences based on leadership roles in tax fraud cases.[100] The Tenth Circuit, in *U.S. v. Alvarez*,[101]

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97. *Id.*

98. *U.S. v. Stewart*, 21 F.3d 1118, 1994 WL 108021, at *1 (9th Cir. 1994).

99. *Id.* at *2. Looking to the sentencing guidelines, the court said:

> When adjusting the offense level for the defendant's role in a criminal activity that involved five or more participants or was otherwise extensive, the Guidelines provide for a four-level upward adjustment if the defendant was an 'organizer or leader' and a three-level adjustment if the defendant was a 'manager or supervisor.' U.S.S.G. § 3B1.1(a), (b). To distinguish between a leadership or organizational role from one of mere management or supervision, the court considers the exercise of decision making authority, the nature of participation in the commission of the offense, the recruitment of accomplices, the claimed right to a larger share of the fruits of the crime, the degree of participation in planning or organizing the offense, the nature and scope of the illegal activity, and the degree of control and authority exercised over others. U.S.S.G. §3B1.1, comment. (n. 3).

Id. at **1-2.

100. *Id.* at *2. In *Stewart*, the defendant and two others created a "two-part scheme to obtain fraudulent income tax refunds." *Id.* at *2. In the first part, they "created false tax forms using aliases, submitted them to independent tax return preparers for electronic

considered a claim that the lower court "erred [by] refusing to grant downward departure [in sentencing] for acceptance of responsibility" by a defendant that pled guilty and truthfully admitted her conduct.[102] The court acknowledged the defendant's post-arrest cooperation but also noted that she "intentionally lied to investigating IRS agents, successfully evaded arrest for approximately four years, and continued her criminal conduct during most of that time [ ]."[103] The court said that when these facts were considered together, the defendant failed to fully accept responsibility for her conduct.[104] *Alvarez* was unique in that its facts revealed that it was the vendor of the computer software used in the scheme who alerted the IRS to the possibility of fraudulent returns.[105]

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filing, and obtained refund-anticipation loans from banks." *Id.* In the second part, "the conspirators obtained computer software to prepare and [electronically] transmit claims for refunds directly to the Internal Revenue Service." *Id.* The district court found that Stewart was the organizer or leader of the offense because "he had applied for the software and had it installed on his computer, applied for credit cards using aliases and used one to purchase the software, directed Mackey to apply for a post office box, recruited coconspirators to file [tax] returns and cash [refund] checks, and created the false tax forms and social security cards," which adjusted his sentence upward. *Id.* at *1.

On appeal, Stewart contended that the lower court's finding that he was the organizer or leader was in error and that the court had improperly rejected his plea for a downward departure of his sentence. *Id.* Stewart's argument about downward departure was "based on disparity between the intended loss for the entire conspiracy ($455,120.) and the amount he actually derived from the offense ($77,000.)," and that the district court should have adjusted his sentence downward because the conspiracies were only partially completed. *Id.* at *2. After review of the stipulated facts of the case, the Ninth Circuit held that the district court did not err in making the upward adjustment of his sentence since he had been an organizer of the scheme. *Id.* at **2-3. On the second claim, the Ninth Circuit said that the lower court had "based [the] sentence on facts and [Stewart's] culpability, not because it lacked authority to depart due to disparity between the intended and actual loss." *Id.* at *3.

See also U.S. v. Jones, 52 F.3d 697, 702 (7th Cir. 1995), *reh'g denied* (1995). In *Jones*, the appellant and another person had developed a refund-anticipation loan scheme and filed fraudulent returns in their own names. *Id.* at 698-99. The two also used other individuals to follow their scheme and shared a part of the proceeds from the resulting loans. *Id.* at 699. Jones appealed her sentence, claiming it should have been reduced as a result of her acceptance of responsibility for the scheme. *Id.* at 698. The Seventh Circuit rejected her arguments holding that the district court did consider whether or not she had truthfully accepted responsibility. *Id.* at 700-01. The court said that the record did not support her contention that the district court findings were based on her failure to cooperate or to accept responsibility. *Id.* at 702. Instead, the Seventh Circuit noted that the lower court simply did not believe that she was entirely truthful, which was a finding of fact. *Id.*

101. 166 F.3d 1222, 1998 WL 792067 at *1 (10th Cir. 1998).

102. *Id.*

103. *Id.* at *2.

104. *Id.*

105. *Id.* at *1. "A computer software company . . ., contacted the Internal Revenue Service . . . after it received numerous diskettes for electronic filings containing similar wage and earnings information for different people with common addresses. The IRS agents be-

The Fourth Circuit also upheld the conviction of a tax preparer's employee who had participated in a refund-anticipation loan scheme.[106] That appellant claimed that his submission to the IRS of fraudulent Forms 8453 did not constitute a claim against the government.[107] The defendant claimed that the lower court had issued summary judgment for the government on that point.[108] The appeals court though held that the district court's jury instruction merely defined a legal term and that the jury was left to decide the factual components of the case.[109]

The refund-anticipation loan scheme cases all support the IRS's efforts to prevent abuse of the tax system through electronic filing. These cases also demonstrate that the courts give the same recognition to Form 8453 as they give to a signed paper return the filer is certifying under penalties of perjury that the return is complete and accurate.[110] Further, the cases illustrate that the courts will impose tougher sanctions on organizers, leaders, managers and supervisors of refund-anticipation loan schemes.[111] At least one of the cases demonstrates that the electronic filing transmitter might be better able to detect fraudulent activity than the IRS. As a whole, all of the refund-anticipation loan cases show that the promotion of electronic filing by the IRS has resulted in the opportunity for fraud against the government itself and against participating tax preparers and financial institutions. We next consider the steps that the IRS has taken to address these abuses and to prevent fraud perpetrated through the use of its electronic filing program.

D. THE IRS RESPONDS: EFFORTS TO CORRECT AND PREVENT ABUSES

1. *Perpetrated Through the Electronic Filing Program*

In addition to its suspension of the Direct Deposit Indicators in 1994,[112] the IRS issued new guidelines for participants in its electronic filing program.[113] Among the 1994 changes were increased "criminal and credit checks [to] help verify applicants' identities and insure that those with criminal histories do not gain entrance into the program."[114]

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gan surveillance . . . and . . . observed [the defendant] . . . pick up mail, which included IRS refund checks" at ten separate post office boxes and mail drop locations. *Id.*

106. *U.S. v. Williams*, 164 F.3d 627 (4th Cir. 1998).

107. *Id.* at *2.

108. *Id.* at *1.

109. *Id.* at *2.

110. *Id.*

111. *See generally Stewart*, 1998 WL 108021; *see generally Jones*, 52 F.3d 697; *see generally Alvarez*, 1998 WL 792067; *see generally Williams*, 1998 WL 726761.

112. *See Peterson*, 22 F. Supp. 2d at 798.

113. I.R.S. News Release IR-94-100 (Sept. 20, 1994) (available at <http://www.unclefed.com/Tax-News/1994/Nr94-100.html>).

114. *Id.* at ¶ 4.

Requirements for new program applicants were: I) submission of fingerprints, enabling the IRS to check criminal records; II) authorization of a credit check; III) a minimum age of 21; and IV) U.S. citizenship or permanent resident alien status.[115] Additionally, changes included requiring a company's branch offices to separately apply for acceptance into the program.[116] Also, the Service no longer allowed the address of an electronic return originator on either the client's signature document (Form 8453) or the electronic tax return.[117] Finally, the IRS no longer allowed returns with substitute W-2 forms to be filed electronically prior to February 15.[118]

By 1998, the IRS had revamped the participation requirements of its electronic filing program and changed the name of the program to "The Form 1040 e-file program."[119] Accordingly, it issued Revenue Procedure 98-50,[120] to detail the latest changes. It also reclassified into four categories those individuals and firms eligible to participate in e-filing.[121] The new categories include: I) Electronic Return Originators ("EROs") including electronic return preparers who prepare tax returns, including Forms 8453, for taxpayers who intend to have their returns electronically filed and electronic return collectors who accept completed tax returns, including Forms 8453, from taxpayers who intend to have their returns electronically filed; II) Service Bureaus that receive tax return information on any media from an ERO, formats the return information, and either forwards the return information to a transmitter or sends the return information to the ERO; III) Software developers that develop software for the purposes of formatting the electronic portion of the returns or transmitting the electronic portion of the returns directly to the Service; and IV) Transmitters who transmit the electronic portion of a return directly to the service.[122]

In 1999, the IRS announced a pilot program to replace the Direct Deposit Indicator service it had dropped in 1994.[123] The new indicator is called a Debt Indicator and unlike the Direct Deposit Indicator, it requires e-file participants to sign an agreement with IRS to actively screen returns and return information for potential fraud and abuse and

115. *Id.* at ¶ 3.

116. *Id.* at ¶ 5.

117. *Id.*

118. *Id.*

119. Rev. Proc. 98-50, 1998-38 I.R.B. 8, 1998 WL 638827, § 1 (Sept. 21, 1998).

120. *Id.* § 3.

121. *Id.*

122. *Id.*

123. *Announcement of Opportunity to Obtain a Debt Indicator in a Pilot Program for Tax Year 1999 Form 1040 IRS E-file and On-Line Returns*, 64 Fed. Reg. 67621 (Dec. 2, 1999).

report findings to the IRS.[124] "Parties to the agreement are eligible to obtain the Debt Indicator for their taxpayers who apply for bank products [refund-anticipation loans] and sign consents for disclosure of the Debt Indicator to Authorized IRS E-file Providers, Form 1040 online Filers, and financial institutions."[125] The new program illustrates the Service's realization that tax preparers may be best suited to detect fraudulent returns. "Partnered proposals offer greater opportunities for more comprehensive screening of returns and return information."[126]

The IRS has recognized the potential for abuse of its electronic filing program and has instituted measures to detect and prevent erroneous tax refunds.[127] More importantly, it recognized that by partnering with tax preparers and banks, it will be better able to detect fraudulent returns in the future.[128] However, due to the infancy of the IRS Debt Indicator program, it is too soon to evaluate the success of the IRS's new approach.

The refined Debt Indicator program is only one example of the evolution of the procedures employed by the IRS to process America's income tax returns. The majority of the multi-billion dollar cost to the IRS and ultimately to taxpayers, in attempting to switch from paper filing has gone to the systems the IRS has employed. It is appropriate then to have an overview of the current systems and others that failed.

The TeleFile program is still available but is limited to taxpayers in certain states who qualify to file a simplified return, Form 1040EZ.[129] One failed system, called cyberfile, was abandoned after some $17 million had been spent on its development.[130] Cyberfile was a systems modernization project that would have allowed taxpayers to prepare and electronically submit their returns using personal computers.[131] Electronic returns would have been submitted via telephone or the Internet, accepted at an outside agency's data centers and then forwarded to IRS Service Centers.[132] Taxpayers would not have been charged fees to electronically file their returns with cyberfile.[133] Among the shortcomings

124. *Id.*

125. *Id.*

126. *Id.* at 67622.

127. *Id.* at 67621-22.

128. *Id.* at 67622.

129. *See* Internal Revenue Service, *TeleFile: IRS E-file for Taxpayers Using a Touch-Tone Telephone TeleFile* ¶ 1 <http://www.irs.ustreas.gov/plain/elec_svs/telefile.html> (Nov. 3, 2000) (explaining the electronic filing of tax form 1040EZ using TeleFile and answering frequently asked questions about the program works).

130. Gen. Acctg. Off. Rpt. No. AIMD-96-140, *Tax Systems Modernization: Cyberfile Project Was Poorly Planned and Managed* (Aug. 26, 1996).

131. *Id.* at Ltr. 1.

132. *Id.* at Ltr. 2.

133. *Id.*

identified with cyberfile were transactions not being recorded promptly or accurately, the outside agency not maintaining proper documentation, and both the outside agency and the IRS having inadequate procedures to acquire the system and to account to one another.[134]

In December 1998, the IRS implemented its Prime System Integration Services ("PRIME") contract for systems modernization.[135] The objectives of PRIME are similar to those of cyberfile allowing American taxpayers to file their tax returns from their personal computers at no cost to the taxpayer. While the objectives are the same, the systems differ in that PRIME is meant to be implemented in incremental steps.[136]

The Integrated Data Retrieval System ("IDRS") is the Service's current database system to make taxpayer information readily available to all IRS employees.[137] For the entire time the IRS has tooled and retooled its systems, its programs have been examined by other parts of the government. We look now to government criticism of the IRS modernization efforts and the utilization of electronic filing.

III. GOVERNMENTAL CRITICISM OF THE IRS MODERNIZATION EFFORTS

A. Reports from the General Accounting Office

General oversight of the accountability of federal agencies is given to the General Accounting Office ("GAO"). The GAO audits various government agencies and reports the results to Congress. The GAO has analyzed the billions that the IRS has spent to modernize operations enabling it to shift from paper based to electronic filing. As late as 1993, the GAO said that the IRS got a late start in developing a viable system and faced many challenges to boost the number of returns being processed electronically.[138] In 1995, GAO's criticism of the IRS modernization efforts and the electronic filing program intensified.[139] "[A]fter spending almost $2 billion over eight years to modernize the nation's tax system, IRS has realized only marginal improvements in its operations and future efforts are at risk for failure."[140] Another 1995 report cited

134. *Id.* at Ltr. 7.

135. Gen. Acctg. Off. Rpt. No. GAO-01-42, *Internal Revenue Service: Recommendations to Improve Financial and Operational Management* Ch. 5 (Nov. 17, 2000).

136. *Id.* § Abbreviations (Nov. 17, 2000).

137. *See generally* Internal Revenue Service, Electronic Freedom of Information Act Reading Room: ADP and IRS Information §15 Integrated Data Retrieval Systems, IDRS <http://www.irs.ustreas.gov/prod/news/efoia/6209ch13.pdf> (last updated Aug. 20, 1999).

138. Gen. Acctg. Off. Rpt. No. T-GGD-94-58, *Tax Administration: IRS' New Business Vision* Cong. Test. (Nov. 17, 1993).

139. Gen. Acctg. Off. Rpt. No. T-AIMD-95-86, *Tax Systems Modernization: Unmanaged Risks Threaten Success* (Feb. 16, 1995).

140. *Id.* The General Accounting Office said,

management and technical weaknesses so serious as to place the modernization program on its 1995 list of high-risk federal programs.[141]

Another 1995 GAO Report examined the electronic filing program exclusively.[142] That GAO Report found, among other things that:

> [t]he IRS will fall short of its 2001 goal of 80 million electronic returns; II) the IRS [was] having little success in increasing the electronic filing of individual 1040 and business tax returns which constitute the bulk of the returns and take the most time to process manually; III) the transmittal fees for electronic filing tend to deter filers unless they need their income tax refunds quickly; IV) the IRS [had incomplete] data to determine whether electronic filing would reduce its administrative costs; and V) unless the IRS could increase electronic filing, its customer service and paper processing workload may overwhelm its planned staffing and alter various aspects of its modernization efforts.[143]

The report noted that "[s]ince the inception of electronic filing, the IRS' marketing strategy had been targeted primarily at professional tax return preparers."[144] The GAO stated "that strategy ha[d] not resulted in the level of electronic filing that will bring the IRS to its long-term goal nor ha[d] it attracted those taxpayers who file the kinds of returns that contribute most to the IRS' paper processing workload and costs."[145] The GAO cited its earlier recommendations to target additional market segments to electronic filing and noted that the IRS had implemented only a few of them.[146] The GAO concluded that the IRS default strategy had been to continue marketing electronic filing to professional tax preparers.[147] "[T]hat strategy has resulted in a program that primarily attracts individuals who file simple tax returns, are due refunds and are willing to pay the fees associated with electronic filing to get those re-

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> [I]nitial systems were not built to be integrated into IRS' comprehensive Tax Systems Modernization program and they have yet to deliver the expected increases in capability and customer service. Future efforts are at risk because of (1) the lack of technical and management expertise to implement Tax Systems Modernization; (2) the failure of the ongoing systems development to take into account changes arising from process improvements; and (3) the lack of set system development priorities, established performance measures, or fully established technical guidelines.

Id.

141. Gen. Acctg. Off. Rpt. No. AIMD-95-156, *Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is to Succeed* Ltr. June 15, 1999 (June 16, 1999).

142. Gen. Acctg. Off. Rpt. No. GGD-96-12, *Tax Administration: Electronic Filing Falling Short of Expectations* (Oct. 31, 1995).

143. *Id.*

144. *Id.* at Ltr. 4.

145. *Id.* at Ltr. 4.3.

146. *Id.* at Ltr. 4.1.

147. *Id.*

funds sooner."[148]

By June 1996, the GAO reported that the IRS had made some progress in implementing GAO's recommendations.[149] The GAO suggested that Congress limit the service's information-technology spending to certain cost-effective categories in order to minimize the risk of investing in systems before the auditors' recommendations were fully implemented.[150] In 1998, the GAO reported that the Service's recently adopted Modernization Blueprint was a good first step that provided a solid foundation from which to define the level of detail and precision needed to effectively and efficiently build a modernized system .[151] However, the GAO also noted that the Blueprint was incomplete and lacked enough detail for building and acquiring new systems.[152] Ironically the GAO was saying essentially the same thing in 1998 as it had said for years – the IRS had taken a good first step but faced considerable challenges ahead in its efforts to switch to electronic filing.

B. Congress Reacts

Congress' passage of the IRS Restructuring and Reform Act of 1998 brought mandates and deadlines for full-scale change of overall IRS operations.[153] "Its passage signaled Congress' strong concern that the IRS had been overemphasizing revenue production and compliance at the expense of fairness and service to taxpayers."[154]

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148. Gen. Acctg. Off. Rpt. No. GGD-96-12, *Tax Administration: Electronic Filing Falling Short of Expectations* Ltr. 4.1 (Oct. 31, 1995). The report goes on to list recommendations for successful implementation of electronic filing. *Id.* at Ltr. 8. The GAO recommended that to help insure the success of the IRS modernization program, the IRS should: 1) identify those taxpayers who offer the greatest potential to reduce the paper-processing workload and operating costs and to develop strategies aimed at eliminating impediments that inhibit those taxpayers from participating in the program; 2) adopt goals for electronic filing that focus on reducing the paper-processing workload and operating costs; and 3) prepare contingency plans for the possibility that the electronic filing program will fall short of expectations. *Id.*

149. Gen. Acctg. Off. Rpt. No. AIMD-96-106, *Tax Systems Modernization: Actions Underway But IRS Has Not Yet Corrected Management and Technical Weaknesses* (June 7, 1996). Although this report cited progress at the IRS, another 1995 GAO report (No. AIMD-96-140, *supra* n. 130) criticized the Service's previous management of the cyberfile project. That report said that the Service's utilization of an outside agency was not based on sound analysis. The GAO said that the development and acquisition of the program were undisciplined and that the program was poorly managed and overseen. *Id.*

150. *Id.*

151. Gen. Acctg. Off. Rpt. No. AIMD/GGD-98-54, *Tax Systems Modernization: Blueprint Is a Good Start But Not Yet Sufficiently Complete to Build or Acquire Systems* (1998).

152. *Id.*

153. *Id.*

154. Gen. Acctg. Off. Rpt. No. T-GGD/AIMD-99-255, *IRS Management: Formidable Challenges Confront IRS as It Attempts to Modernize* (1999). This testimony was presented to the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Repre-

The 1998 Act was widely welcomed by taxpayer advocates because of its broad objective to make the IRS more user-friendly for taxpayers. Other records reveal that Congress tightened the purse strings on the IRS spending for systems modernization. For example, for fiscal year 1999, Congress appropriated $211 million for acquisition of information technology systems. But, Congress refused to obligate the funds until the IRS submitted to Congress a plan for expenditure meeting certain conditions.[155] All told, for fiscal years 1998 and 1999, the IRS requested from Congress over $1 billion for its information-technology programs.[156] Congress, however, provided $506 million, and limited the IRS ability to obligate the appropriations by setting conditions upon them.[157] On the one-year anniversary of the 1998 Act, the GAO issued a report to Congress reviewing IRS modernization efforts. The anniversary report stated that the IRS had a poor track record for project implementation, and many of its past efforts would be considered modest in comparison to the current modernization. "Successfully implementing such a comprehensive modernization strategy, while continuing the business of day-to-day tax administration will push IRS . . . to [its] limits."[158]

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sentatives on the one-year anniversary of the IRS Restructuring and Reform Act of 1998. *Id.*

155. H.R. Conf. Rep. 105-760 (1998). In the Conference Report on H. R. 4104, Treasury and General Government Appropriations Act For Fiscal Year 1999, the Committee recommended provisions be made to the appropriations bill that required the IRS to submit a plan to Congress before any of the appropriated funds were obligated. The plan was required to: I) implement the IRS' Modernization Blueprint; II) meet the information systems management guidelines established by the Office of Management and Budget (OMB); III) be reviewed and approved by the OMB, the Department of the Treasury's IRS Management Board and the GAO; IV) meet the requirements of the Service's life cycle program; and V) comply with acquisition rules, requirements, guidelines, and systems acquisition management practices of the federal government.

156. Gen. Acctg. Off. Rpt. No. AIMD/GGD-99-206 *Tax Systems Modernization: Results of Review of IRS' Initial Expenditure Plan*, 4 (1999).

157. *Id.* at 4. In order to access the appropriated funds, the IRS and the Treasury Department were required to submit to Congress for approval an expenditure plan that, as stated in the law, (I) implements the IRS Modernization Blueprint, (II) meets OMB investment guidelines, (III) is reviewed and approved by the IRS's Investment Review Board, OMB, and Treasury's IRS Management Board and the GAO, (IV) meets requirements of the IRS's life cycle program, and (V) is in compliance with acquisition rules, requirements, guidelines, and systems acquisition management practices of the federal government. *Id.*

158. The GAO said the IRS had taken the appropriate first steps in a long-term, multi-increment modernization. However, GAO also noted that the IRS continued to face formidable modernization challenges including: I) completing the 1997 Modernization Blueprint; II) establishing the management and engineering capability to build and acquire modernized systems; and III) investing in small, low-risk, cost-effective modernization increments. The GAO said the key to effectively address these challenges was to ensure that long-standing modernization management and technical weaknesses are corrected before the IRS invests large sums of modernization funds.

After nearly $4 billion and a major restructuring law, the GAO again says what it has been saying all along the IRS has taken appropriate first steps, but still faces significant challenges to implement its modernization plan to shift from paper based to electronic filing. The GAO's anniversary report of the 1998 Act merely recognized some of the Service's past shortcomings. It failed to recognize those shortcomings as red flags signaling that the IRS will not be able to successfully implement the mandates imposed by Congress. At least Congress has slowed and safeguarded IRS spending on information technology through its accountability requirements, but ultimately, the success of the IRS in its attempt at modernization will turn on its ability to convince American taxpayers that electronic income tax filing is quicker, more efficient, more accurate and secure than paper filing. As the law has changed and as technology continues to change, the IRS should recognize that its entire modernization process is a work-in-progress.

While we may have doubts as to the potential for a successful shift to electronic income tax filing, that is not to say that the Service has not made some progress. Indeed, the increased availability of electronic filing options over the past two seasons is likely to continue. With increased availability, it is reasonable to predict that the number of taxpayers utilizing electronic filing will increase, just as American's use of the Internet increased with continued technological advances. The big question that remains is whether the IRS will be able to attract the numbers of filers it needs to reach its mandated goals. Regardless of whether or not the IRS is successful, our consideration includes examining how increased usage might negatively affect the American taxpayer. So far our analysis of the IRS modernization programs has concentrated on the processes and systems and their weaknesses; now we turn to a concern of all potential electronic filers—confidentiality of taxpayer records.

IV. Taxpayer Privacy and Electronic Income Tax Filing

One need only look to the IRS Web Security and Privacy Policy posted on its Internet Web page to recognize that the present system of electronic filing does not guarantee that taxpayers' privacy rights are protected.[159] The Web page proclaims, "[T]he IRS is committed to protecting the privacy rights of American taxpayers."[160] But close to the bottom of the page is a disclaimer: "Please be aware that the confidentiality of Internet transactions is not guaranteed. It is up to you if you want to assume the risk of an unauthorized person learning your e-mail

159. *See generally* IRS Web Security and Privacy Policy <http://www.irs.ustreas.gov/prod/news/efoia/priv-pol.html> (last updated on Apr. 26, 2000).

160. *Id.* at ¶ 1.

address or any other personal information you provide."[161] Compare this to the Basic Principles of Security contained in the Service's operating manual.[162] Those Principles include recognition that all information processed by the Service is sensitive and that "security is the responsibility of all Internal Revenue Service personnel, including contractors."[163]

A. Statutory Provisions for Taxpayer Confidentiality

The principles of confidentiality enumerated in the Internal Revenue Manual reiterate Code provisions enacted by Congress to protect taxpayers. Section 6103 of the Code states the general rule that prohibits the disclosure of tax returns and tax information except as otherwise authorized by the Code.[164] Section 6103 has exceptions that permit disclosure of tax return information under certain conditions.[165] These include:

> Disclosures to the taxpayer or her designee pursuant to taxpayer consent;
>
> Disclosures for the purposes of tax administration (including state tax administration);
>
> Disclosures to federal, state or local governmental agencies for non-tax administration purposes such as child support enforcement and verifying taxpayer eligibility for certain designated needs based programs, including food stamps, and certain Social Security benefits; and
>
> Disclosures for nontax law enforcement purposes.[166]

Section 7431 provides for damages for unauthorized disclosures of taxpayer information. Additionally, the Privacy Act[167] provides a general protection against unauthorized dissemination of information by all arms of the government.

A decision by the Fifth Circuit *Hobbs v. U.S.* examined the interaction of Code § 6103 with the Privacy Act.[168] Hobbs had been terminated from employment as an engineer with the IRS after the Service learned

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161. *Id.* at ¶ 6.

162. Internal Revenue Service, Internal Revenue Manual, Handbook 4.7, ch. 2 § 2.2 (July 31, 2000) (available at <http://www.irs.ustreas.gov/prod/bus_info/tax_pro/irm-part04/30416.html>). In addition to the principles of security detailed in the text, others include: "[a]ccess to sensitive information is granted only on a 'need-to-know' basis . . . [p]rivacy protection is a personal and fundamental right of all taxpayers and employees. . ."

163. *Id.*

164. *Solicitation for Comment in Connection with a Study Being Conducted by the Department of the Treasury Relating to the Scope and Use of Provisions Regarding Taxpayer Confidentiality*, 64 Fed. Reg. 54960 (Oct. 8, 1999).

165. *Id.*

166. *Id.*

167. 5 U.S.C. § 522a.

168. 209 F.3d 408 (5th Cir. 2000).

that he had improperly filed past returns and claimed unsubstantiated deductions.[169] Hobbs had unsuccessfully exhausted his administrative appeals and filed two separate complaints against the IRS.[170] The first complaint alleged that he had been terminated for discriminatory reasons in violation of the Civil Rights Act of 1964.[171] After an unsuccessful appeal of the jury's rejection of that argument, Hobbs filed the second complaint.[172] He sought damages under Code § 7431 for unauthorized disclosure of tax return information and for violation of the Privacy Act.[173] The district court dismissed all of his claims and he subsequently appealed.[174]

Hobbs argued that the dismissal of his § 7431 claim was improper because his administrative appeals of his termination,during which his tax information was disclosed, did not pertain to tax administration as permitted by one exception to § 6103.[175] He also "challenged the lower courts holding that § 7431 [not the Privacy Act] is the exclusive remedy" "for unlawful disclosures of tax return information."[176] The Fifth Circuit noted that "the majority of courts that have considered the interaction of § 6103 with the Privacy Act . . . have concluded that § 6103 and § 7431 provide the exclusive remedy for disclosure of tax return information."[177]

The court reviewed the minority position relied on by Hobbs that "[s]ection 6103 should only implicitly repeal the Privacy Act to the extent it presents an irreconcilable conflict."[178] The court said there was a present conflict:

> [A]lthough the Privacy Act and § 7431 create damages actions for unauthorized disclosures, only § 6103 provides for a variety of tax-return-specific exceptions to the general confidentiality rule. Thus, if Hobbs were able to maintain a suit under the Privacy Act even where his § 7431 damages action was unsuccessful, this would punish the IRS for disclosing tax return information it was authorized to disclose under the express terms of § 6103.[179]

The court also said that "Congress could not have intended . . . that the IRS properly could make a disclosure . . . in accordance with § 6103(h)(4),

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169. *Id.* at 409.

170. *Id.*

171. *Id.* The first case was filed in the U.S. District Court for the Eastern District of Pennsylvania. *Id.* The merits of that case were not at issue in the second case. *Id.*

172. *Id.*

173. *Hobbs v. U.S.*, 209 F.3d 408, 409 (5th Cir. 2000).

174. *Id.*

175. *Id.* at 410.

176. *Id.* at 411.

177. *Id.*

178. *Id.* at 411-12. The court cites *Sinicki v. U.S. Dept. of Treasury*, No. 97 Civ. 0901 (JSM), 1998 WL 80188 (S.D.N.Y. 1998).

179. *Hobbs v. U.S.*, 209 F.3d 408, 411-12 (5th Cir. 2000).

but would be exposed to liability under the more general provisions of the Privacy Act,"[180]

Hobbs demonstrates that the majority of courts deem Code §§ 6103 and 7431 to provide the exclusive remedy for unauthorized disclosure of confidential taxpayer information. We now examine some instances where the IRS has breached its confidentiality obligation to the taxpayers.

B. Taxpayer Confidentiality Breaches by the IRS

Last fall, the IRS violated § 6103 by improperly disclosing tax information on 1,391 individual taxpayers.[181] A certified public accountant and former IRS employee fearful of the so-called Y2K bug, requested tax return information for 50 clients.[182] The IRS sent him information for 1,391 taxpayers including their names, Social Security numbers, tax liabilities and taxable income.[183] "As a result of the error, the agency could be liable for at least $1.3 million in penalties."[184] The IRS sent out 1,300 letters of apology, offering administrative awards of $1,000 per violation.[185] "[A] judge could award . . . actual damages above $1,000.00."[186] Other cases illustrate how the courts consider the degree of negligence involved when awarding damages based on unauthorized disclosures.

In a Fourth Circuit case, *Scrimgeour v. Internal Revenue*, the appellate court reviewed the district court's award of damages to the taxpayer whose income tax returns had been released to a third party without the taxpayer's authorization.[187] The taxpayer was involved in civil litigation with his sister, and her attorney submitted defective Form 4506 authorizations to two IRS Service Centers.[188] One Center immediately recognized that the forms were defective and did not release his returns.[189] At the other Service Center, the deficiencies were not detected, and the Service provided copies of plaintiff's income tax returns to the sister's attorney.[190]

Once Scrimgeour learned of the unauthorized disclosure he notified

180. *Id.*

181. Arthur H. Rotstein, *IRS Admits Violations in Disclosing Tax Data*, Grand Rapids Press A11 ¶ 1 (Apr. 23, 2000) (available in 2000 WL 19583850).

182. *Id.* at ¶ 3.

183. *Id.*

184. *Id.* at ¶ 2.

185. *Id.* at ¶ 7.

186. *Id.*

187. 149 F.3d 318, 320 (4th Cir. 1998).

188. *Id.* at 321-22.

189. *Id.* at 321-22.

190. *Id.* at 322.

the IRS to stop releasing his data.[191] In a sort of comedy of errors, the IRS passed his letter among various departments over a period of ten weeks before finally stopping the release of the taxpayer's information.[192]

Scrimgeour sued, alleging wrongful disclosure of tax returns in violation of § 7431 and for violations of the Privacy Act[193] and for attorney fees under § 7431.[194] The district court found that the IRS had negligently released his information but that the negligence was not willful.[195] That court awarded damages of $1,000 actual damages for each of sixty-one unauthorized disclosures but rejected his claim for punitive damages.[196] Later, the court also rejected the claim for attorney fees.[197]

Scrimgeour appealed asserting that the lower court erred when it determined that the IRS did not act in a willful or grossly negligent manner when it released his tax returns.[198] He also asserted that the district court's legal analysis of the attorneys' fees statute was incorrect.[199]

Scrimgeour's first contention on appeal was based on the fact that the IRS decided to investigate the unauthorized disclosure for potential criminal wrongdoing before ensuring that the improper releases of his tax returns ceased.[200] The appeals court examined IRC § 7431,[201] which provides for damages when IRS has violated IRC § 6103.[202] The court held that under IRC § 7431 punitive damages are allowed in wrongful disclosure cases only when the disclosure is willful or grossly negligent.[203] The court went on to say that grossly negligent conduct is "marked by wanton or reckless disregard of the rights of another."[204] The court said that there was no evidence in the record before it to reflect

191. *Id.*

192. *Id.*

193. 5 U.S.C. § 552a(b) and (c).

194. *Scrimgeour v. Internal Revenue*, 149 F.3d 318, 320-21 (4th Cir. 1998).

195. *Id.* at 321.

196. *Id.* at 322.

197. *Id.* at 323.

198. *Id.*

199. *Id.*

200. *Scrimgeour v. Internal Revenue*, 149 F.3d 318, 323 (4th Cir. 1998).

201. 26 U.S.C. § 7431 (West 1998). § 7431 provides for civil damages actions by taxpayers against the IRS when the IRS has violated provisions of IRC § 6103. § 7431(a) states: "If any officer or employee of the United States knowingly, or by reason of negligence, . . . discloses any return information with respect to a taxpayer in violation of section 6103, such taxpayer may bring a civil action for damages against the United States."

202. 26 U.S.C. § 6103 (West 1998). § 6103 (a) provides generally that "no officer or employee of the United States, . . . shall disclose any return or return information obtained by him in any manner in connection with his services as such an officer or an employee."

203. *Scrimgeour*, 149 F.3d at 323.

204. *Id.* at 324.

any greater degree of culpability than simple negligence.[205] Scrimgeour also argued that the negligence was willful since the disclosures continued after he notified the IRS that he had not authorized the release of his information.[206] The court said that although the ten-week delay was unnecessary, it did not constitute gross negligence since the IRS was inefficiently trying to remedy the complaint.[207] Finally, addressing Scrimgeour's Privacy Act claims, the court stated that the Privacy Act's intentional or willful standards required something greater than gross negligence.[208] Since that standard had not been met for the IRC claim, it also was not met for the Privacy Act Claim.[209] Finally, the court examined IRC § 7430 that provides for the award of attorneys' fees and rejected the plaintiff's contention that the release of his tax returns was a by-product of the tax collection process.[210]

In *Rice v. U.S.*[211], the court examined a case where the taxpayer had been convicted of filing false income tax refund claims and of making false income tax returns.[212] In accordance with its policy to publicize successful prosecutions, the IRS issued press releases in 1994, one to report the conviction and the other to report the sentencing.[213] The appeals court upheld the lower court's finding that the information contained in the press releases came from public documents and proceedings.[214] Rice contended that the information in the press releases was confidential tax return information.[215] The court adopted the reasoning of the Seventh Circuit that the definition of return information in IRC § 6103 applies only when the immediate source of the released information is a return or some internal document based on a return.[216] The court said that the definition does not include return information that is available based solely on public documents and proceedings.[217]

A novel argument for damages under § 7431 was presented in *Hrubec v. National Railroad Passenger Corp.*[218] In that case, the plaintiffs brought action against their employer, Amtrak, and other Amtrak

205. *Id.*
206. *Id.* at 325.
207. *Id.*
208. *Scrimgeour v. Internal Revenue*, 149 F.3d 318, 326 (4th Cir. 1998).
209. *Id.*
210. *Id.* at 328-29.
211. *Rice v. U.S.* 166 F.3d 1088 (10th Cir. 1999).
212. *Id.*
213. *Id.* at 1089.
214. *Id.* at 1092.
215. *Id.* at 1090.
216. *Id.* at 1091.
217. *Id.* at 1092.
218. 829 F. Supp. 1502 (N.D. Ill. 1993).

employees.[219] The plaintiffs had learned that someone had forged their signatures on IRS request forms, Form 4506, asking for copies of the plaintiffs' tax returns.[220] The plaintiffs maintained that the defendants had conspired to obtain the returns without consent and sought actual and punitive damages.[221]

The district court said that the question of whether the actual damages language of § 7431 included damages for emotional distress was one of first impression.[222] After examining the legislative history, the court held that Code § 7431 includes mental damages as a part of actual damages.[223] "As with the right to privacy generally, when violated, the outstanding damage is mental and/or emotional distress. In order to further Congress' purpose, then, mental and emotional distress logically should be included in the 'actual damages' provided for in § 7431(c)."[224]

Another case illustrates where the IRS's conduct can reach the higher degrees of willful or gross negligence. A Colorado taxpayer was awarded $325,000 in punitive damages because the IRS discussed her case in the public realm.[225] The taxpayer and her son were involved in a dispute with the IRS.[226] The IRS claimed that the son owed over $300,000 in back taxes and penalties.[227] The Service eventually ordered that only $3,000 of what it had claimed was due be paid.[228] The taxpayer based her subsequent claim on rebuttals by the IRS of her story in the media.[229] The district court ruled that the IRS rebuttals included disseminating confidential information.[230]

These cases demonstrate Congress' concern that taxpayers are able to communicate accurately and completely with the IRS through their income tax returns. They also show that the courts will hold the IRS or the party causing unauthorized disclosures liable for damages provided that the plaintiff can establish something more than ordinary negligence. At least one court held that actual damages can include emotional distress. Having examined liability for violating taxpayer confidentiality under the tax return system, we now look to confidentiality issues under the electronic filing system.

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219. *Id.* at 1503.
220. *Id.* at 1504.
221. *Id.*
222. *Id.*
223. *Id.*
224. *Hrubec v. Nat'l Railroad Passenger Corp.*, 829 F. Supp. 1502, 1506 (N.D. Ill. 1993).
225. *IRS Loses Privacy Case*, 11 Accounting Today 12 ¶ 1 (July 7, 1997) (available in 1997 WL 0510374).
226. *Id.* at ¶ 2.
227. *Id.*
228. *Id.*
229. *Id.*
230. *Id.*

C. Taxpayer Confidentiality and the Electronic Filing System

1. *Browsing of Taxpayer Information by IRS Employees*

On August 5, 1997, the Taxpayer Browsing Protection Act ("Browsing Act") was enacted which made willful unauthorized inspection of taxpayer data illegal.[231] The Browsing Act was passed partly in response to concerns that the IRS modernization would make computer access to taxpayer accounts available to all IRS employees and provide a means for unauthorized persons to obtain confidential taxpayer data.[232] Also in August 1997, the IRS said that in the long run, modernization would be the best solution since it will allow the IRS to restrict employee access to only those accounts that they have a specific work-related reason to look at. However, since the IRS did not plan to implement its modernization efforts until several years later, it initiated some steps in 1997 to discourage employees from browsing taxpayer records.[233] Its largest step to comply with the Browsing Act was its 1999 implemention a tax of its Audit Trails Lead Analysis System ("ATLAS"). The IRS says ATLAS will provide greater unauthorized-access detection capabilities than the Service had previously. The IRS also says that ATLAS is a nationwide system and will not be subject to local modifications and practices by the ten Service Centers.

The GAO criticized the Service's plans to conform to the Browsing Act last year.[234] The GAO noted that the IRS had taken significant steps to identify unauthorized access involving IDRS. But, the GAO said that the IRS had done little to detect access involving the estimated 130 other information systems that contain taxpayer information. The GAO report also reviewed the potential cases of unauthorized access that have been identified since the passage of the Browsing Act. Of the 5,486 potential instances of unauthorized access by January 1999, the IRS had determined that fifteen instances did in fact involve unauthorized access. The IRS said those proven cases had all been referred to U.S. Attorneys for prosecution, and with the exception of one case, the U.S. Attorneys had declined to prosecute.

While both Congress and the IRS have recognized the potential for abuse of taxpayer confidentiality, no one is actively enforcing Congress' directive. The IRS has instituted efforts to satisfy the Browsing Act. However, the detection efforts will ultimately serve no real purpose if the

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231. *The Taxpayer Browsing Protection Act*, Pub. L. No. 105-35 (Apr. 14, 1997) (available in 1997 WL 183944).

232. *Id.*

233. *See* 1997 U.S.C.C.A.N. 1626-1 (explaining that H.R. 1226 "specifically prohibit[s] unauthorized inspection or browsing of tax returns and return information.").

234. Gen. Acctg. Off. Rpt. No. GGD-99-43 *Confidentiality of Tax Data: IRS' Implementation of the Taxpayer Browsing Protection Act* (1999).

abuse by employees is not prosecuted. Perhaps, like the refund-anticipation problem, better results can be achieved by having an outside agency detect and pursue internal abuses. For instance, the IRS could employ a unit of the Department of Justice to investigate and prosecute identified abuses by employees. The risk of outside involvement could serve as an effective deterrent. In sum, the potential for abuse is recognized but, actual abuses are not being investigated or prosecuted on a wide-scale basis.

2. *The Unanticipated Potential for Abuse of Taxpayer Confidentiality*

With all of the analysis of the IRS systems by Congress, the GAO and the IRS itself, no one has addressed the issue of unauthorized computer access to confidential taxpayer records by an outside party. Suppose, for example, that a computer hacker were to gain access to one of the IRS databases and obtained a taxpayer's confidential information. Once the hacker has obtained access to a taxpayer's annual return, he or she has then obtained the taxpayer's name, address, Social Security number, sources of income, types of income and other information the IRS promises to keep confidential. Suppose further that the hacker uses this information to obtain credit cards fraudulently or to convert the taxpayer's income or even the taxpayer's income tax refund for the hacker's own benefit. Under such a scenario, to whom can the innocent taxpayer turn for relief?

Such a scenario might not be as unlikely as one might expect. For instance, consider how one single hacker caused billions of dollars worth of damage by turning loose the "love bug" virus earlier this year.[235] Or, consider the case of the computer hacker who in December 1996, entered an Air Force Web site and replaced a page of aviation statistics with a pornographic picture.[236] Another hacker gained access to the Justice Department's home page and turned that home page into the "Department of Injustice."[237] That hacker posted swastikas, nude photographs and a likeness of George Washington saying "Move my grave to a free country!", among other insulting postings.[238]

We know from our analysis above that Code §§ 6103 and 7431 provide for civil penalties when the IRS releases taxpayer information without the taxpayer's authorization. But under this scenario, the IRS would

235. *Philippine Investigators Submit "Love Bug" Report*, Miami Herald (Jun. 13, 2000). The newspaper article says that estimates of the damage caused by the "love bug" virus range up to $10 billion. *Id.* at ¶ 4.

236. *Computer Hacker Plants Porno on Air Force Web Page* ¶ 1 <http://www.cnn.com/tech/9612/30/airforce.pom/index.html> (last updated July 7, 2000).

237. *Jury Still Out on Hacking* ¶¶ 1-2 <http://www.news.cnet.com/news/0-1005-200-312170.html> (accessed July 6, 2000).

238. *Id.* at ¶ 3.

not be releasing the taxpayer's data, a hacker would simply be taking it. One might make an argument that the IRS was negligent to institute a system that can be compromised so easily. You might successfully show simple negligence but would be hard-pressed to show willful culpability. Certainly, the IRS could point to a plethora of government studies and reports that would show that they had taken all available precautions. Ultimately to stand any chance at success against the IRS under this scenario, the taxpayer that filed electronically would need to show that the IRS was aware of its systems weaknesses and nevertheless encouraged the taxpayer to file electronically anyway.

Under the hypothetical, the taxpayer would have a claim against the hacker for conversion. However, few taxpayers would have the resources to track down the hacker. Even if one did locate the hacker, what assurance would the taxpayer have that the hacker was not already judgment proof? Of course, the hacker would be subject to criminal charges if the government were to track him down. If caught, the hacker could face prosecution under the Computer Fraud and Abuse Act of 1986,[239] and if caught after October 28, 2000, he or she could also face punishment under the Copyright Protection and Management Systems statute.[240]

This scenario illustrates that electronic filing programs employed by the IRS continues to have weaknesses. While the IRS has taken measures such as encryption of returns transmitted through the authorized electronic transmission services, no system is completely foolproof. Congress and IRS should reassess their positions on electronic filing and decide whether the safety measures available today provide the protection taxpayers demand and deserve.

V. CONCLUSION

Congress and the IRS have developed a "full steam ahead" strategy to radically change the way Americans file their income taxes. Undoubtedly, Congress granted the IRS the authority to pursue electronic filing as our nation increases its reliance on technology. The courts have demonstrated that they will uphold the authority Congress has given to the Service. When one considers the past abuses that have already plagued the electronic tax system and the Service's slow implementation of recommendations for improvements, one should question whether the IRS will ever be successful at implementing such a fundamental change. Further, the potential for additional abuses suggests that the Service, Congress, and the courts are unprepared to deal with unforeseen issues that are bound to develop as the use of the electronic medium increases.

239. 18 U.S.C.A. § 1030, *Computer Fraud and Abuse Act* (West 2000).

240. 17 U.S.C.A. § 1201, Copyright Protection and Management Systems (effective Oct. 28, 2000) (West 2000).

Indeed, Congress, as the ultimate law making authority, should ask itself whether the American system of taxation is prepared to meet the challenges that lie ahead.