

# SPECIAL ALERT

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## FEDERAL TAX TREATMENT OF IDENTITY THEFT PROTECTION

A growing problem in the United States involves unscrupulous people wrongfully obtaining and using someone else's personal information typically for economic gain. This identity theft has been the number one consumer complaint to the Federal Trade Commission for fifteen consecutive years. Recently, a number of high profile data breaches have exposed millions of people to the risk of identity theft. The IRS has now outlined the tax consequences on some of the services organizations provide in response to data breaches.

Most organizations make significant efforts to protect their employees' and clients' personal information, but even with such efforts, data breaches can occur. For that reason, organizations now commonly provide credit monitoring services, identity theft insurance policies, identity restoration services or similar services in data breach situations. The IRS refers to these services as "identity protection services." These protection services prevent or mitigate losses when a data breach results in identity theft.

Organizations have asked the IRS about tax implications on identity theft protection services provided at no cost to employees, customers or anyone whose personal information may have been compromised by a data breach. In response, the IRS has said it will not require people to include in their gross income the value of identity protection services provided by an organization or an employer that experienced a data breach.

The tax-free status does not apply:

- If the organization offers the option to receive cash in lieu of identity protection services.
- If an organization provides identity theft services for reasons other than a data breach.
- If an employee receives proceeds under an identity theft insurance policy. Existing law will govern the tax treatment of insurance recoveries.



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The IRS has requested comments on whether organizations commonly provide identity protection services for reasons other than in response to a data breach. It has also asked whether additional guidance would be helpful in clarifying tax laws regarding services provided in these situations.

In summary, whether these services are considered taxable depends on the reason for providing the identity theft protection services. If the services are necessary because of a data breach, they are tax-favored. *MMA*

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