



*Processes to Resolve Business Taxpayers'
Undeliverable Refunds Need to Be
Strengthened*

August 24, 2007

Reference Number: 2007-30-111

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1 = Tax Return/Return Information

Phone Number | 202-927-7037

Email Address | Bonnie.Heald@tigta.treas.gov

Web Site | <http://www.tigta.gov>



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 24, 2007

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION
CHIEF INFORMATION OFFICER

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Processes to Resolve Business Taxpayers’
Undeliverable Refunds Need to Be Strengthened (Audit #200630030)

This report presents the results of our review to identify the conditions creating Business Master File credit balance accounts and determine whether there are areas where the Internal Revenue Service (IRS) could improve resolution of these accounts.¹ This audit focused on accounts with undeliverable refunds to determine how they were affected by IRS processing of business taxpayers’ address changes. Because undeliverable refunds include both checks returned by the United States Postal Service and checks not cashed by taxpayers within a year, we also attempted to determine whether the refunds had been issued in error.

Impact on the Taxpayer

Some business taxpayers’ refunds were undeliverable because the addresses on their accounts were different from the addresses on the taxpayers’ most current returns or other documents in the IRS’ possession. We determined that the process to resolve business taxpayers’ undeliverable refunds needs to be improved to ensure that account addresses are corrected and that refunds are reissued only when better addresses are identified. We found that many taxpayers’ refunds went undelivered several times. Improper resolution of credit balance accounts can result in significant burden to taxpayers who may not receive refunds timely and increased interest costs to the Federal Government.

¹ The Business Master File is the IRS database that consists of Federal tax-related transactions for business accounts. The accounts are made up of modules for each tax period for each type of tax (employment taxes, income taxes on businesses, excise taxes, estate tax, income taxes for estates and trusts, etc). An account module reflects a credit balance when payments applied to that type tax and period are greater than the tax, penalties, and interest assessed.



Processes to Resolve Business Taxpayers' Undeliverable Refunds Need to Be Strengthened

Synopsis

As of December 31, 2005, the Business Master File contained approximately 11,000 account modules for which a change of address had been entered and the module reflected an undeliverable refund and a credit balance greater than \$1,000. Credit balances on these accounts totaled about \$148 million. Undeliverable refunds can be (1) refund checks returned as undeliverable by the United States Postal Service or (2) refund checks not cashed within a year and credited back to the taxpayers' accounts after 14 months.

We selected a statistical sample of 338 of these account modules and determined the IRS had not taken sufficient actions to correct addresses on some of the modules. In 25 percent of our sampled cases, the IRS had in its possession tax returns or other documents with more current address information than that reflected on the Business Master File. This information could have been used to ensure the taxpayers received refunds to which they were entitled. Also, the IRS missed opportunities to assess the proper tax and resolve incorrect credits. As a result, we estimated credits totaling approximately \$10.4 million on 440 account modules are potentially incorrect.

In addition, because of the method it used to perfect certain address information, we estimate the IRS reissued about 8,300 undeliverable refunds totaling approximately \$85 million during a 5-week period in September and October 2006 without obtaining new addresses. Many of these reissued refunds were for older accounts, some over 20 years old. There is the potential for loss or theft of funds when refunds are reissued to old or incorrect addresses; however, the full effects will not be known for at least 1 year. At the time of our review, 117 (38 percent) of the 304 refunds reissued in our samples had been returned by the United States Postal Service or by taxpayers.

Finally, due to a system problem, the IRS may have paid unnecessary interest totaling approximately \$2.6 million on 260 refunds reissued from accounts with previously undelivered refunds without first determining whether additional interest was due. Generally, interest should not be recomputed on an undeliverable refund when it is reissued unless the refund was undeliverable due to some fault of the IRS. Almost 1,400 modules (with credit balances of almost \$12 million) could be affected by the system problem that caused refunds to be inappropriately reissued with additional interest. In 17 cases where the refund was already reissued, no interest was paid on the new refunds. Of these 17 taxpayers, 15 were entitled to at least the interest computed on the original refunds, which totaled about \$8,000.



Processes to Resolve Business Taxpayers' Undeliverable Refunds Need to Be Strengthened

Recommendations

We recommended the Commissioner, Wage and Investment Division, review Business Master File undeliverable refunds to determine when it would be beneficial for employees to verify addresses reported on tax returns against IRS records; perform adequate research on accounts with uncashed refund checks to determine whether credits were claimed, additional taxes are due, or payments may have been misapplied; coordinate with the Chief Information Officer to address the design of the program that perfects Business Master File street addresses to ensure it does not reissue previously undelivered refunds; and ensure the automatic transfer of credit balances and subsequent reinstatement of the credits does not cause an automatic recomputation of interest on reissued refunds.

Response

IRS management agreed with three of the four recommendations and disagreed with one recommendation. Management agreed to review the sample cases to determine how often a better address is found for consideration of procedural changes, and to determine whether additional Internal Revenue Manual procedures need to be added or reinforced on accounts with uncashed refund checks. Programmers are currently working to correct the problem with the program that was intended to prevent the payment of additional interest on reissued undeliverable refunds.

IRS management disagreed with the specific recommendation to perfect Business Master File street addresses using a transaction code other than the code normally used to record address changes, but proposed an alternative solution. Rather than creating a new transaction code for any future Business Master File address-hygiene efforts, the address change transaction code will be used and combined with a unique date so the Business Master File will recognize the transactions as coming from the cleanup database and will not release the undeliverable refund freeze. In our opinion, this alternative corrective action should correct the condition cited. Management's complete response to the draft report is included as Appendix V.

Copies of this are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-5894.



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

Table of Contents

Background	Page 1
Results of Review	Page 2
Actions Were Insufficient to Correct Addresses on Taxpayers’ Accounts	Page 2
<u>Recommendation 1:</u>	Page 3
Opportunities to Assess the Proper Tax and Resolve Incorrect Credits Were Missed.....	Page 3
<u>Recommendation 2:</u>	Page 4
Thousands of Undeliverable Refunds Were Reissued Without Obtaining New Addresses.....	Page 5
<u>Recommendation 3:</u>	Page 6
Unnecessary Interest May Have Been Paid on Refunds Reissued Without Determining Whether Additional Interest Was Due.....	Page 6
<u>Recommendation 4:</u>	Page 7
Appendices	
Appendix I – Detailed Objective, Scope, and Methodology	Page 8
Appendix II – Major Contributors to This Report	Page 10
Appendix III – Report Distribution List	Page 11
Appendix IV – Outcome Measures.....	Page 12
Appendix V – Management’s Response to the Draft Report	Page 15



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

Abbreviations

BMF	Business Master File
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration
USPS	United States Postal Service



Processes to Resolve Business Taxpayers' Undeliverable Refunds Need to Be Strengthened

Background

As of December 2005, there were approximately 1.2 million taxpayer account modules on the Internal Revenue Service (IRS) Business Master File (BMF) that had remained in a credit balance status for more than a year.¹ The credit balances on these accounts totaled over \$20 billion. This indicates the taxpayers failed to file tax returns, additional taxes should have been assessed, payments were misapplied, or taxpayers are due refunds. Generally, an account should not remain in a credit balance status for a long period.

Included in these account modules were about 143,000 modules with “undeliverable” refunds and credit balances totaling in excess of \$326 million. More than half the dollars are attributable to approximately 14,000 account modules with credit balances greater than \$1,000. Undeliverable refunds can be (1) refund checks returned as undeliverable by the United States Postal Service (USPS) or (2) refund checks not cashed within a year and credited back to the taxpayers’ accounts after 14 months.

When an undeliverable refund is credited back to the taxpayer’s account for either reason, a notice is issued requesting the taxpayer to provide a current address or to call the IRS. When a taxpayer contacts the IRS and provides a current address, the check is reissued. If an IRS error(s) resulted in the taxpayer not receiving the refund, the taxpayer can request that interest be paid on the refund amount.

This audit focused on accounts with undeliverable refunds to determine how they were affected by IRS processing of business taxpayers’ address changes. We included only those accounts that reflected a change of address. Because undeliverable refunds include both checks returned by the USPS and checks not cashed by taxpayers within a year, we also attempted to determine whether the refunds had been issued in error.

This review was performed at the IRS office in Holtsville, New York, and included analyses of taxpayer accounts nationwide. We also discussed policy and procedures with IRS personnel from Customer Account Services, Wage and Investment Division, in the following offices: Ogden, Utah; Covington, Kentucky; Philadelphia, Pennsylvania; and Lanham, Maryland. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

¹ The BMF is the IRS database that consists of Federal tax-related transactions for business accounts. The accounts are made up of modules for each tax period for each type of tax (employment taxes, income taxes on businesses, excise taxes, estate tax, income taxes for estates and trusts, etc). An account module reflects a credit balance when payments applied to that type tax and period are greater than the tax, penalties, and interest assessed.



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

Results of Review

Actions Were Insufficient to Correct Addresses on Taxpayers' Accounts

On December 31, 2005, the BMF contained approximately 11,000 account modules for which a change of address had been entered and the module reflected an undeliverable refund and a credit balance greater than \$1,000. Credit balances on these accounts totaled about \$148 million. The IRS should ensure money collected in excess of a taxpayer's legal tax liability is timely refunded to the taxpayer. We selected a statistically valid sample of 338 of 7,558 of these account modules and determined that, for 85 cases (25 percent),² the IRS had in its possession tax returns or other documents with more current address information than the information reflected on the BMF. This information could have been used to ensure the taxpayers received refunds to which they were entitled.

The IRS had in its possession documents with more current address information that could have been used to correct addresses on taxpayers' accounts.

The addresses on 61 percent of these cases (52 of 85) contained a third party "in care of" line,³ but the "in care of" information on the BMF was different from that shown on the most current tax returns. Most (69 percent) of these 52 cases were trusts on which the addresses are almost always for a fiduciary or some other third party.

In September 2001, the Treasury Inspector General for Tax Administration (TIGTA) reported the IRS' computer records did not reflect the names contained in the third-party addresses as shown on 20 percent of the returns for 7.8 million BMF taxpayers with updated address information in 1998, 1999, and 2000.⁴ This was caused, in part, by systemic limitations of the electronic and paper return processing systems. IRS management agreed to implement programming changes in January 2004, but the changes were not implemented due to resource constraints. The IRS did use a workaround for paper returns and ultimately made the programming change for paper returns processed with address changes after January 2006. However, as illustrated by our sample, many addresses with erroneous or incomplete "in care of"

² See Appendix I and Appendix IV for details concerning our audit sampling.

³ The address on a tax return is sometimes that of a third party (i.e., a person or firm other than the taxpayer). Correspondence and refunds should be mailed "in care of" the third party at the address reported.

⁴ *Improvements in Recording Third Party Addresses From Tax Returns Will Reduce Undeliverable Business Mail* (Reference Number 2001-30-168, dated September 2001).



Processes to Resolve Business Taxpayers' Undeliverable Refunds Need to Be Strengthened

lines remain uncorrected. For the remaining 33 of 85 error cases in our sample, the BMF reflected addresses that were different from those on the taxpayers' most current tax returns or other documents in the IRS' possession, such as a letter or form signed by the taxpayer or his or her representative.

Because the IRS is liable for additional interest if it causes refunds to be undeliverable, interest is accruing on undeliverable refunds mailed to incorrect or incomplete addresses due to IRS systemic problems or incomplete research. For example, a 3-year old refund was originally issued with interest of about \$50,000 and recently reissued with interest of \$140,000.⁵

Recommendation

Recommendation 1: The Commissioner, Wage and Investment Division, should review BMF undeliverable refunds to determine when it would be beneficial for employees to verify addresses reported on tax returns against IRS records.

Management's Response: IRS management agreed with the recommendation and will review the sampled cases to determine how often a better address is found. If the results provide productive address information, management will consider procedural changes.

Opportunities to Assess the Proper Tax and Resolve Incorrect Credits Were Missed

During our research of undeliverable refunds, we found information indicating that (1) additional assessments should have been made or (2) funds were incorrectly credited to the taxpayers' accounts. ¹

The IRS is responsible for assessing the proper amount of tax on each taxpayer's account. During analyses of the 338 account modules included in our sample, we found 22 (6.5 percent) modules had incorrect credits totaling approximately \$3 million that should have been identified and corrected by the IRS. Included in these cases were the following:

⁵ This example is included to demonstrate the effect. Actual numbers were not used in order to protect the taxpayer's privacy.



Processes to Resolve Business Taxpayers' Undeliverable Refunds Need to Be Strengthened

- Fifteen modules on which assessments should have been posted but were not. The assessment statute of limitations was close to expiring for two of these modules; we referred them to the appropriate IRS function for a prompt assessment.
- Two modules on which erroneous credits should have been reversed. One module had a credit for Federal income tax withheld posted; the other had an Advance Earned Income Credit posted.¹
- Three modules on which employment taxes had been paid but not reported on the applicable tax returns. We were able to determine from other documents these taxes were due.
- Two accounts in which returns for different tax periods were erroneously posted to the account modules.

1

We estimate credits totaling approximately \$10.4 million in 440 account modules are potentially incorrect.

When a refund is returned as undeliverable, the IRS issues a notice to the taxpayer at the address recorded on the BMF but usually takes no other action unless the taxpayer contacts the IRS. Based on our sample results, we estimate credits totaling approximately \$10.4 million in 440 account modules may be incorrect.⁶ The IRS missed opportunities to assess the proper taxes and resolve these incorrect credits. Our samples included account modules that remained unresolved for more than 20 years, although many had refunds issued multiple times. Federal Government funds could be lost because there is a statute of limitations for assessment of taxes on these accounts.

Recommendation

Recommendation 2: The Commissioner, Wage and Investment Division, should ensure employees perform adequate research on accounts with uncashed refund checks to determine whether credits were claimed, additional taxes are due, or payments may have been misapplied. This research should be accomplished before the assessment statute of limitations expires on the accounts and before the tax returns and other documents are destroyed.

Management's Response: IRS management agreed with the recommendation. They stated that current Internal Revenue Manual procedures are in place to address this issue and that IRS functions are instructed to coordinate with each other to ensure that actions taken on accounts will result in correct refund amounts. However, management will

⁶ See Appendix IV for details concerning this estimate.



Processes to Resolve Business Taxpayers' Undeliverable Refunds Need to Be Strengthened

complete a review of the BMF returns that the TIGTA identified where credits were missed or payments not applied to determine if procedures need to be added or reinforced.

Thousands of Undeliverable Refunds Were Reissued Without Obtaining New Addresses

During a 5-week period in September and October 2006, the IRS reissued BMF undeliverable refunds without obtaining new addresses. We found that 304 (75 percent) of 408 modules in our samples were among those with reissued refunds.⁷ Normally, the IRS does not reissue an undeliverable or uncashed refund check (greater than a specific amount) unless the taxpayer contacts the IRS or changes his or her address with the IRS or USPS. These undelivered refunds are vulnerable to theft or misuse because they represent amounts that may not be missed by taxpayers if they are misappropriated.

In an effort to perfect the addresses of some accounts on the BMF, the IRS corrected certain minor errors on the file; for example, it added “St” or “Ave” to an address when recognized to be missing. Address changes are input to taxpayers’ accounts using specific computer transaction codes. Certain transaction codes update address information without causing a refund to be released, while others update address information and cause refunds to be released.

The IRS reissued an estimated 8,300 refunds totaling approximately \$85 million on accounts without obtaining new addresses.

If the updated address information does not represent a significant change, employees should use one of the transaction codes that will not cause a refund to be generated. However, for this address cleanup, the IRS used a transaction code that allowed taxpayers’ credit balances to refund. This transaction code posted to all BMF accounts reviewed (except the few with a foreign address). We estimate about 8,300 refunds totaling approximately \$85 million were reissued using this transaction code.

Many of these reissued refunds were for older accounts, some over 20 years old. There is the potential for loss or theft of funds when large numbers of refunds are reissued to old or incorrect addresses. In addition, this action results in increased IRS workload. At the time of our review, 117 (38 percent) of the 304 refunds reissued by the BMF cleanup in our samples had been returned by the USPS or by taxpayers. We cannot determine what happened to those that were not returned. The full effects will not be known for at least 1 year. In addition, if these refunds had not been reissued, some of the undeliverable refunds would have been sent to correct addresses when tax returns reporting address changes were processed in 2006 under the new program changes made for the “in care of” line.

⁷ The 408 modules included our 338 sample modules plus another statistically valid sample of 70 modules.



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

Recommendation

Recommendation 3: The Commissioner, Wage and Investment Division, should coordinate with the Chief Information Officer to ensure the IRS uses the ZIP Code perfection transaction code or a new code to perfect BMF street addresses rather than the address change transaction code normally used to record address changes reported to the IRS or the USPS by taxpayers.

Management's Response: IRS management disagreed with the specific recommendation, but proposed an alternative solution. Rather than creating a new transaction code, the address change transaction code will be used and combined with a unique date so the BMF will recognize the transaction as coming from the cleanup database and not release the undeliverable refund freeze.

Office of Audit Comment: Management's proposed action should correct the condition cited.

Unnecessary Interest May Have Been Paid on Refunds Reissued Without Determining Whether Additional Interest Was Due

The IRS may have paid unnecessary interest on 260 refunds reissued over the last 6 years from accounts with previously undelivered refunds. Most (224 of 260) were refunds reissued by the BMF address cleanup. Generally, interest should not be recomputed on an undeliverable refund when it is reissued unless the refund was undeliverable due to some fault of the IRS.

Interest was inappropriately computed on reissued refunds because of a system error that automatically computed interest to the new refund date when dormant credit balances were removed from taxpayers' account modules and later reinstated to the modules. When accounts remain dormant, overpayments are automatically transferred to the Unapplied Statute Expired Credits file. Activity on the account module causes the credit to automatically transfer back into the module. The IRS reissued these refunds without first determining whether additional interest was due.⁸

For example, a refund was sent to a taxpayer's address of record (a post office box) more than 20 years ago for an overpayment of \$2,000 and interest of approximately \$300. The refund check was returned as undeliverable. The taxpayer took no steps to update his or her address; although the IRS had no new information, it recently reissued the refund to the same post office box and improperly included interest of \$15,000. The refund has not been returned.⁹

⁸ Reissuance of undeliverable refunds is not prohibited by a statute of limitations if the refunds were claimed timely.

⁹ This example is included to demonstrate the effect. Actual numbers were not used in order to protect the taxpayer's privacy.



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

The 260 modules identified in our sample included inappropriate interest totaling almost \$2.6 million. Interest on the original refunds, which were undeliverable before the balances were transferred out of the accounts, totaled \$238,000. Fortunately, about one-half of these refunds have already been returned as undeliverable by the USPS or by the taxpayer. Almost 1,400 of the modules in our review of undeliverable refunds had credit balances totaling almost \$12 million transferred to the Unapplied Statute Expired Credits file that could be reissued with additional interest.

Unnecessary interest of almost \$2.6 million may have been paid on reissued refunds.

In addition, some taxpayers did not receive any interest on their reissued refunds even though their original refund checks included interest. In 17 of 36 cases for which undeliverable refunds had been already reissued after the reversal of the credit transfers, and then issued again by the BMF address cleanup, no interest was paid on the new refunds. Of these 17 taxpayers, 15 were entitled to at least the interest computed on the original refunds, which totaled about \$8,000.

Recommendation

Recommendation 4: The Commissioner, Wage and Investment Division, should coordinate with the Chief Information Officer to ensure credit balances automatically transferred to the Unapplied Statute Expired Credits file and subsequent reinstatement of the credit does not cause an automatic recomputation of credit interest or other transactions that would not otherwise have occurred.

Management's Response: IRS management agreed with the recommendation. New programming was implemented in 2004 that was intended to prevent the payment of additional interest on reissued undelivered refunds. Programmers are currently working to correct the problem with the program.



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to identify the conditions creating BMF credit balance accounts¹ and determine whether there are areas where the IRS could improve resolution of these accounts. To accomplish our objective, we:

- I. Performed a risk assessment to identify any internal control weaknesses that needed to be included in our audit tests.
- II. Identified and analyzed some of the 1.2 million BMF account modules in a credit balance status for more than 1 year as of December 2005 by obtaining a database from the TIGTA Data Center Warehouse.²
 - A. Extracted those 455,822 modules with a credit balance greater than \$1,000. From the resulting database, we extracted files by the various conditions causing the credit balances and by type of return to determine whether that was significant to the condition.
 - B. Reviewed accounts from the files by condition or type of return on the IRS Integrated Data Retrieval System.³ We reviewed a judgmental sample of 102 accounts to determine whether there was an obvious issue or trend that warranted further investigation.
 - C. Assessed the reliability of data while researching the Integrated Data Retrieval System. We verified the data against account information and determined the information appeared to be complete based on account numbers, type of tax, and tax periods.⁴

¹ The BMF is the IRS database that consists of Federal tax-related transactions for business accounts. The accounts are made up of modules for each tax period for each type of tax (employment taxes, income taxes on businesses, excise taxes, estate tax, income taxes for estates and trusts, etc). An account module reflects a credit balance when payments applied to that type tax and period are greater than the tax, penalties, and interest assessed.

² The TIGTA Data Center Warehouse provides data and data access services; centralizes storage, security, and administration of files; and develops uniform and user-friendly interfaces for users to access data.

³ This is the IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

⁴ Upon completion of our tests of data reliability, we deemed the data sufficiently reliable to accomplish the overall objective of the audit.



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

- D. Identified a potential problem with undeliverable refunds on accounts for which we could determine through Integrated Data Retrieval System research that the current addresses on the accounts were incorrect.
- III. Determined the extent of the undeliverable refund problem identified.
- A. Determined the universe of 13,955 BMF account modules with a credit balance greater than \$1,000 with an undeliverable refund. We extracted a database of taxpayers' accounts that reflected an address change. We matched the files to obtain a database of 11,363 accounts most likely to include an incorrect or incomplete address on IRS records.
 - B. Prepared a stratified statistically valid sampling plan with the assistance of a statistician contracted by the TIGTA to determine the appropriate total sample size. Since 10,267 of the 11,363 were concentrated in corporate income tax returns, estate and trust income tax returns, payroll tax returns, and estate tax returns, we extracted 16 samples totaling 408 account modules from these types of cases. In four samples, we selected all account modules in the range. The other 12 were random samples selected using a 95 percent confidence level and a precision of +/- 10. We expected an error rate of 23 percent for incorrect addresses, most for an incorrect "in care of" line for estate and trust income tax returns, because this was where the problem was identified. Since the incorrect address issue existed for these returns, it would also be a problem for other return types, but we expected a lower error rate for the other segments. These samples were selected so that we could project the results of our findings to the 10,267 account modules. Appendix IV contains more detailed information.
 - C. Researched the account modules on the Integrated Data Retrieval System and reviewed tax returns for sample cases. We determined, where possible, whether IRS records reflected the correct addresses as reported by taxpayers and whether the overpayments should have been refunded.
 - D. Determined the potential impact of the problems identified.



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs)

Kyle R. Andersen, Director

Robert K. Irish, Audit Manager

Dolores Castoro, Lead Auditor

Paul R. Baker, Senior Auditor

Bernard F. Kelly, Senior Auditor



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

Appendix III

Report Distribution List

Acting Commissioner C
Office of the Commissioner – Acting Chief of Staff C
Deputy Commissioner for Operations Support OS
Deputy Commissioner for Services and Enforcement SE
Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Wage and Investment Division SE:W
Deputy Chief Information Officer OS:CIO
Associate Chief Information Officer, Applications Development OS:CIO:AD
Deputy Associate Chief Information Officer, Applications Development OS:CIO:AD
Director, Corporate Data, Applications Development OS:CIO:AD:CD
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:
 Chief Information Officer OS:CIO
 Commissioner, Small Business/Self-Employed Division SE:S
 Commissioner, Wage and Investment Division SE:W



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

Increased Revenue – Potential; \$10.4 million (see page 3).

Funds Put to Better Use – Actual; \$2.6 million (see page 6).

Taxpayer Rights and Entitlements – Actual; \$8,000 (see page 6).

Taxpayer Rights and Entitlements – Actual; 15 taxpayer account modules (see page 6).

Methodology Used to Measure the Reported Benefit:

Using the TIGTA Data Center Warehouse,¹ we extracted the 455,822 BMF cases with credit balances greater than \$1,000 as of December 31, 2005, that were over 52 weeks old.² From that, we extracted those with an account freeze type signifying an undeliverable refund. We also extracted the BMF address changes and matched the resulting files to obtain account modules with credit balances greater than \$1,000, an undeliverable refund, and an address change (volume 11,363).

Because most (10,267) of these account modules involved corporate income tax, income tax for estates and trusts, payroll taxes, and estate tax, we took our samples from these segments. We provided the numbers to the statistician contracted by the TIGTA, who stratified the results and determined the required sample volumes for 16 statistically valid samples. In four samples, we selected all the account modules in the segment. The other 12 samples were random samples selected using a computer program. We used a 95 percent confidence level and a precision of +/-10. Samples totaled 408 account modules out of the universe of 10,267.

¹ The TIGTA Data Center Warehouse provides data and data access services; centralizes storage, security, and administration of files; and develops uniform and user-friendly interfaces for users to access data.

² The BMF is the IRS database that consists of Federal tax-related transactions for business accounts. The accounts are made up of modules for each tax period for each type of tax (employment taxes, income taxes on businesses, excise taxes, estate tax, income taxes for estates and trusts, etc). An account module reflects a credit balance when payments applied to that type tax and period are greater than the tax, penalties, and interest assessed.



Processes to Resolve Business Taxpayers' Undeliverable Refunds Need to Be Strengthened

One of the 16 samples, corporate credit balances greater than \$1,000 and less than \$20,000.01 (sample of 70 representing 2,709 account modules), was not completed due to time constraints. The remaining 338 (408 - 70) sample cases represented 7,558 (10,267 - 2,709) account modules.

We found 22 of the 338 account modules sampled had incorrect credit balances totaling approximately \$3 million due to the following situations:

- Assessments of \$1,506,222 had not been posted on 15 modules but should have been. The assessment statute of limitations was close to expiring for two of these modules; we referred them to the appropriate IRS function for a prompt assessment.
- Credits of \$173,905 had been posted on 2 modules but should have been reversed. One module had a credit for Federal income tax withheld; the other module had an Advance Earned Income Credit. ¹
- Employment taxes of \$1,460,406 had been paid on 3 modules but not reported on the applicable tax returns. We were able to determine from other documents these taxes were due.
- A net amount of \$1,100 was due on 2 accounts in which returns for another tax period had been posted to the account modules.

We provided a breakdown of erroneous credit balances by type and stratum to the statistician, who projected them to the universe from which they were selected and provided us with a total account module volume and dollar projection by type. The total for the 4 types of tax was 444 account modules (range = minimum 92, maximum 797) with incorrect credit balances totaling \$10,397,854 (range = minimum -\$1,969,416, maximum \$22,765,123).³

The IRS may have inappropriately recomputed interest on some refunds issued from account modules for which the credit balances had been transferred to the Unapplied Statute Expired Credits file and subsequently reversed. We used the actual volume of accounts in which this occurred and the difference between the interest on the original refunds and the interest on the refunds reissued after the reversal of the credits back into the taxpayers' accounts.

- Approximately \$2.6 million in interest on 260 modules may have been paid unnecessarily on refunds reissued from accounts with previously undelivered refunds because the IRS did not determine whether additional interest was actually due.

³ The variance, standard error, precision, and standard deviation for types and segments were provided by the statistician.



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

In cases for which undeliverable refunds had been already reissued after the reversal of the credit transfers to the Unapplied Statute Expired Credits file, and then issued again by the BMF address cleanup, no interest was paid on the new refunds.

- Of the 17 taxpayers receiving no interest, 15 were entitled to at least the interest computed on the original refund, which totaled about \$8,000.



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

Appendix V

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

RECEIVED
JUL 20 2007

July 20, 2007

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard J. Morgante *Richard J. Morgante*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Processes to Resolve Business Taxpayers'
Undeliverable Refunds Need to Be Strengthened
(Audit # 200630030)

I reviewed your draft report and appreciate your observations regarding Business Master File (BMF) undeliverable refunds. Your report indicated our actions to correct addresses were insufficient on taxpayer accounts because the IRS had tax returns or other documents with more current address information that could have been used to ensure taxpayers received the refunds. In response to the Treasury Inspector General for Tax Administration (TIGTA) audit, 2006-40-133, Processes to Resolve Undelivered and Expired Refunds Are Generally Effective, Accounts Management conducted a review of the TIGTA sample of Individual Master File (IMF) returns in November 2006 and very few contained helpful new address information. We believe BMF accounts will yield the same results; however, we will review the sampled BMF returns to determine how often a better address is found. If the results of the review produce additional address information, we will consider changes to our procedures.

In addition, we already have procedures in place to review accounts with uncashed refund checks to determine whether there are misapplied payments, additional taxes or credits. To ensure these procedures are working correctly, we will complete an additional review of the BMF sampled accounts where credits were missed or payments not applied to determine if we need to add additional procedures or reinforce existing ones.

We are also aware of the address "cleanup" issues, where BMF refunds were reissued without obtaining new addresses. This was a one time action, and before any future address cleanups are performed, programming will be in place to stop undeliverable refunds from being reissued without an action by the taxpayer.



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

2

We agree with the Outcome Measures as stated in Appendix IV. Our detailed comments to your recommendations are attached. If you have any questions, please contact me at (404) 338-7060, or members of your staff may contact Pete Stipek, Director, Customer Account Services, at (404) 338-8910.

Attachment



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

Attachment

RECOMMENDATION 1

The Commissioner, Wage and Investment Division, should review BMF undeliverable refunds to determine when it would be beneficial for employees to verify addresses reported on tax returns against IRS records.

CORRECTIVE ACTION

We agree with this recommendation and will review the sampled TIGTA cases to determine how often a better address is found. If the results provide productive address information, we will consider procedural changes.

IMPLEMENTATION DATE

September 15, 2007

RESPONSIBLE OFFICIAL

Director, Wage and Investment (W&I), Customer Account Services (CAS) Accounts Management

CORRECTIVE ACTION MONITORING PLAN

We will monitor these corrective actions as part of our internal management control system.

RECOMMENDATION 2

The Commissioner, Wage and Investment Division, should ensure employees perform adequate research on accounts with uncashed refund checks to determine whether credits were claimed, additional taxes are due, or payments may have been misapplied. This research should be accomplished before the assessment statute of limitations expires on the accounts and before the tax returns and other documents are destroyed.

CORRECTIVE ACTION

We agree with this recommendation. Current Internal Revenue Manual procedures are in place to address this issue. Areas are instructed to coordinate with each other to ensure that the action taken on the account will result in the correct refund amount. However, we will complete a review of the BMF returns that TIGTA identified where credits were missed or payments not applied to determine if procedures need to be added or reinforced.

IMPLEMENTATION DATE

September 15, 2007

RESPONSIBLE OFFICIAL

Director, W&I, CAS Accounts Management



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

2

CORRECTIVE ACTION MONITORING PLAN

We will monitor these corrective actions as part of our internal management control system.

RECOMMENDATION 3

The Commissioner, Wage and Investment Division, should coordinate with the Chief Information Officer to ensure the IRS uses the ZIP Code perfection transaction code or a new code to perfect BMF street addresses rather than the address change transaction code normally used to record address changes reported to the IRS or the USPS by taxpayers.

CORRECTIVE ACTION

We disagree with this recommendation. Rather than creating a new transaction code (TC) we are going to use the current TC 014 (address change transaction code) and in addition, reference a special Julian date to determine what to do if the refund is undeliverable. For any future BMF address-hygiene efforts, Finalist will use a Julian date of 955 in their BMF TC 014 transactions. BMF will make programming changes so that when BMF receives a TC 014 transaction with a Julian date of 955, it will recognize this transaction as coming from the cleanup database that contains all valid addresses for any given zip code and will not release the undeliverable refund freeze for this address change transaction.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 4

The Commissioner, Wage and Investment Division, should coordinate with the Chief Information Officer to ensure credit balances automatically transferred to the Unapplied Statute Expired Credits file and subsequent reinstatement of the credit does not cause an automatic recomputation of credit interest or other transactions that would not otherwise have occurred.

CORRECTIVE ACTION

We agree with this recommendation. A Request for Information Services (RIS EXM-2-0147) was implemented January 16, 2004, for Prevention of Credit Interest on Limited Payability Refunds. The purpose of this new programming was to prevent the payment of additional interest on reissued undelivered refunds, both for individual and business refunds. The programming was successfully implemented for individual refunds but



*Processes to Resolve Business Taxpayers' Undeliverable Refunds
Need to Be Strengthened*

3

research indicates there was a problem with programming for the business refunds. The Business Masterfile programmers are working to correct the problem.

IMPLEMENTATION DATE

October 15, 2007

RESPONSIBLE OFFICIAL

Director, Accounts Management, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

IRS will monitor this corrective action as part of our internal management control system.