



*Inadequate Controls Over Dishonored Checks  
Put Millions of Dollars at Risk for Erroneous  
Refund Issuance*

**September 23, 2009**

**Reference Number: 2009-40-143**

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.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 23, 2009

**MEMORANDUM FOR** COMMISSIONER WAGE AND INVESTMENT DIVISION

**FROM:** *Michael R. Phillips*  
Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – Inadequate Controls Over Dishonored Checks Put Millions of Dollars at Risk for Erroneous Refund Issuance (Audit # 200940020)

This report presents the results of our review to determine the efficiency and effectiveness of the processing of dishonored checks. This review was conducted as part of the Treasury Inspector General for Tax Administration Fiscal Year 2009 Annual Audit Plan. This review addresses the Internal Revenue Service's (IRS) major management challenge of Reducing Erroneous and Improper Payments.

*Impact on the Taxpayer*

In some instances a taxpayer's payment cannot be processed by the bank. This includes payments for which there may not be sufficient funds to cover the taxpayer's payment. The IRS refers to an unprocessed payment as a "dishonored check." Our analysis determined the IRS generated<sup>1</sup> refunds resulting from dishonored check overpayments totaling approximately \$53 million to 15,192 taxpayers during the period January through July 17, 2008. We estimate the IRS was unable to stop more than \$20 million in refunds from being erroneously issued to 13,891 taxpayers (91 percent).

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<sup>1</sup> The IRS generates refund transactions in a taxpayer's account. These transactions must then post to its Master File and a request for issuance of the refund is sent to the Financial Management Service. The Financial Management Service issues the refund to the taxpayer. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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### Synopsis

Although the number of payments that are dishonored represents an extremely small percentage of the payments processed by the IRS (less than 1 percent), weaknesses in the IRS' dishonored check processing put millions of dollars at risk. Our analysis showed the IRS generated refunds totaling approximately \$53 million on 15,823 dishonored checks during the period January through July 17, 2008. Our review of a statistically valid sample of 268 taxpayer accounts

***The IRS received 245,007 dishonored payments totaling approximately \$1.55 billion in Processing Year 2008.***

(294 refunds) identified that 130 (55 percent) of the 236 dishonored checks that were subject to the 21-day standard<sup>2</sup> were not worked within 21 days. In general, it took the IRS approximately 40 days from the date of the original payment to reverse the payment as dishonored.

Further complicating the processing of dishonored checks was the issuance of the economic stimulus payments in Processing Year 2008. According to the IRS, some taxpayers who were entitled to receive an economic stimulus payment stopped payment on their checks in anticipation of the stimulus payment satisfying their tax debt. In some of these instances, the economic stimulus payment was refunded to the taxpayer before the IRS processed the dishonored check. As a result, taxpayers received economic stimulus payments that should have been offset to their tax debt per the Economic Stimulus Act of 2008.<sup>3</sup>

The same control deficiencies identified in our current review were cited in a previous review.<sup>4</sup>

Because the IRS did not implement previous recommendations, millions of dollars in erroneous refunds continue to be issued as a result of dishonored check overpayments. Further, Tax Examiners were not always preparing and forwarding necessary documentation to the IRS' Erroneous Refund Unit to initiate procedures to recover erroneously issued refunds as required. Tax Examiners did not refer to the Erroneous Refund Unit, as required, 193 (79 percent) of the 245 dishonored check refunds in our sample that were erroneously issued to the taxpayer.

***Implementation of prior audit recommendations would have improved the IRS' ability to identify and stop erroneous refunds based on dishonored check overpayments.***

Establishing an effective process to identify and stop dishonored check overpayments from refunding until the IRS is reasonably sure the related payment has cleared the bank would protect

<sup>2</sup> IRS employees generally are not required to resolve dishonored checks within 21 days when the notification from the bank involves a missing check, an out-of-sequence encoding error, or a payment received on a full paid tax return received during peak processing.

<sup>3</sup> Pub. L. 110-185, 122 Stat. 613.

<sup>4</sup> *Review of Dishonored Check Processing* (Reference Number 063001, dated March 29, 1996).



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more than \$20 million a year, almost \$102 million over the next 5 years, from erroneously being issued to taxpayers. In addition, the IRS could redirect resources costing \$119,308 per year (\$596,540 over 5 years) currently used in the Erroneous Refund Unit to recover these refunds.

Finally, the IRS has the opportunity to enhance its systemic controls to prevent the erroneous issuance of refunds resulting from a dishonored check as it modernizes its payment processing in the Submission Processing sites. The IRS plans to convert all payments into an electronic transaction to be posted to the taxpayers' accounts. However, the IRS' plans do not include modernizing the deposit of paper checks with the banks nor the identification or processing of dishonored checks.

### *Recommendations*

The Commissioner, Wage and Investment Division, should establish a systemic process that identifies and stops overpayments involving a dishonored check from erroneously refunding to taxpayers, and identify erroneous refunds of dishonored checks issued to taxpayers that were not referred to the Erroneous Refund Unit in Calendar Years 2008 and 2009 to ensure referrals are made to initiate recovery of the refunds. In addition, in the long term, the IRS should modify the payment processing modernization project to include converting paper checks to electronic fund withdrawals.

### *Response*

IRS management agreed with three of our recommendations and disagreed with one recommendation. They shared one of the recommendations with their Accounting Operations function reinforcing the need to ensure referrals are made to the Erroneous Refund Unit. In addition to the corrective actions in response to our recommendations, the IRS will update the Internal Revenue Manual to better clarify procedures for identifying and routing erroneous refunds of dishonored checks to the Erroneous Refund Teams and increase managerial review during peak processing times. Management did not agree with our recommendation to modify its payment processing modernization project to convert paper checks to electronic fund withdrawals. It stated that the current banking system prevented the conversion of paper checks without enrolling in the Electronic Federal Tax Payment System. Management's complete response to the draft report is included in Appendix V.

### *Office of Audit Comment*

We appreciate IRS management's recognition of the benefits of converting paper checks to electronic payments. We recognize the current limitations the IRS has regarding the conversion of paper checks to electronic fund withdrawals. The IRS currently uses the EFTPS to



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receive electronic payments from taxpayers. However, as we noted in our audit report, no process has been established to convert paper checks to an electronic payment for transmission to the bank. The EFTPS does not have the functionality to allow the IRS to convert paper checks to an electronic format for transmitting the payments via the EFTPS. As the IRS moves forward with its payment modernization, consideration should be given to develop such a process. We also encourage the IRS to continue to promote its electronic payment options for taxpayers in an effort to increase taxpayers' usage and further reduce the risk of issuing refunds of overpayments on dishonored checks.

Copies of this report 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 Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services) at (202) 622-5916.



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*Abbreviations*

EFTPS	Electronic Federal Tax Payment System
IRS	Internal Revenue Service



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## *Background*

The Internal Revenue Service (IRS) received payments totaling \$2.7 trillion in Processing Year 2008.<sup>1</sup> Payments were received by paper check, electronic remittance, or cash. When payments are received, the funds are deposited daily in Federal Reserve Banks or other depository banks. In addition, IRS employees enter information relating to the payment into the taxpayer's account on the Master File<sup>2</sup> including the amount of the payment, the tax return period the payment is associated with, and the date the payment was received.

***The IRS received 245,007 dishonored payments totaling approximately \$1.55 billion in Processing Year 2008.***

However, in some instances, the payment cannot be processed by the bank. This includes payments where there may not be sufficient funds to cover the taxpayer's payment. The IRS refers to an unprocessed payment as a "dishonored check." Figure 1 identifies the number and amount of dishonored checks processed by the IRS during Processing Years 2007 and 2008.

***Figure 1: Number and Amount of Dishonored Checks Processed by the IRS***

	<b>Number of Dishonored Checks</b>	<b>Dollars</b>
<b>Processing Year 2007</b>	261,192	\$1,588,256,202
<b>Processing Year 2008</b>	245,007	\$1,550,257,647

*Source: IRS Dishonored Check Analysis Reports for 2007 and 2008.*

At times, the amount of a taxpayer's payment exceeds what was owed by the taxpayer, resulting in an overpayment. Once notified by the bank that the payment was dishonored, IRS employees are required to review the taxpayer's account to determine if a refund has been generated<sup>3</sup> in the account. However, sometimes the overpayment is refunded to the taxpayer even though the payment was dishonored. For example:

<sup>1</sup> The Processing Year is the year in which tax returns and other tax data are processed; in this case January 1 to December 31, 2008.

<sup>2</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

<sup>3</sup> The IRS generates refund transactions in a taxpayer's account. These transactions must then post to its Master File and a request for issuance of the refund is sent to the Financial Management Service. The Financial Management Service issues the refund to the taxpayer.

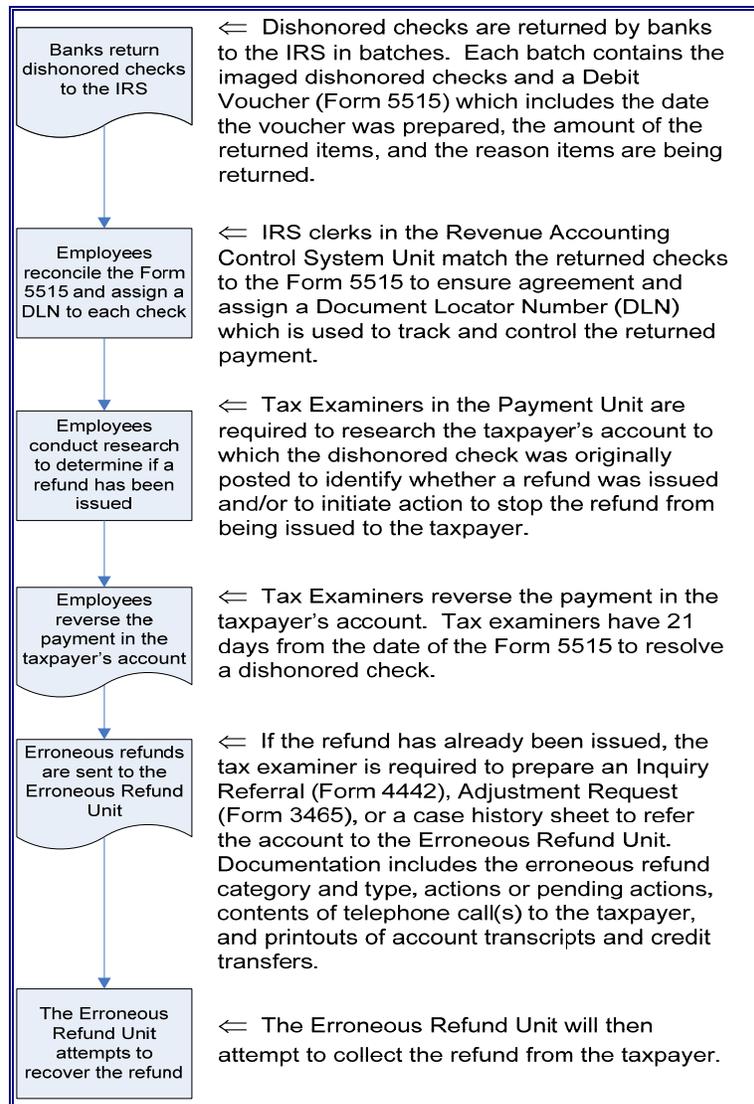


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*Taxpayer A sends the IRS a payment for \$300. The taxpayer owes only \$200, resulting in a \$100 credit balance on the taxpayer's account. The bank notifies the IRS that the payment was dishonored. However, the IRS does not timely review the taxpayer's account to prevent the overpayment from refunding. The \$100 credit is erroneously refunded to the taxpayer on a payment that was dishonored.*

Figure 2 provides an overview of the IRS' dishonored check process from bank notification through resolution of the dishonored check and related refund.

**Figure 2: Flowchart of the Dishonored Check Process**



Source: IRS Internal Revenue Manual.



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**A recent case shows the revenue loss that can result from the IRS not timely working dishonored checks**

An individual was prosecuted as the result of an investigation performed by the Treasury Inspector General for Tax Administration, Office of Investigations. The Office of Investigations determined the individual was inappropriately sending dishonored checks to fraudulently obtain erroneous tax refunds. The individual sent 150 dishonored checks totaling more than \$3.3 million to the IRS and was able to successfully receive more than \$107,000 in erroneous refunds as a result of the IRS not timely stopping the issuance of the refunds. The checks were written on closed or non-existent bank accounts. We initiated this review as a result of this case to assess the controls that enabled this individual to fraudulently receive these refunds.

This review was performed at the Wage and Investment Division Headquarters in Atlanta, Georgia, and the Submission Processing Sites in Fresno, California; Atlanta, Georgia; Andover, Massachusetts; Kansas City, Missouri; Cincinnati, Ohio; Austin, Texas; and Ogden, Utah, during the period October 2008 through May 2009. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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*Results of Review*

**Overpayments Resulting From Dishonored Check Payments Are Being Erroneously Refunded**

Although the number of payments that are dishonored represents an extremely small percentage of the payments processed by the IRS (less than 1 percent), weaknesses in the IRS' dishonored check processing put millions of dollars at risk. Our analysis determined the IRS generated refunds on dishonored checks totaling approximately \$53 million to 15,192 taxpayers during the period January through July 17, 2008.<sup>4</sup> We estimate the IRS was unable to stop more than \$20 million in refunds from being erroneously issued to 13,891 taxpayers (91 percent). Figure 3 shows the number of taxpayers and the amounts that resulted in an overpayment and refund issuance.

**Figure 3: Refunds of Overpayments on Dishonored Checks (January – July 17, 2008)**

	<b>Number of Taxpayers</b>	<b>Dollars</b>
<b>Dishonored Checks Resulting in Refund Generation</b>	15,192	\$52,778,617
<b>Refunds Stopped by the IRS<sup>5</sup></b>	1,301	\$32,408,364
<b>Refunds Erroneously Issued<sup>5</sup></b>	13,891	\$20,370,253

*Source: Analysis of the IRS Master File for the period January to July 17, 2008, and the projection of our statistically valid sample.*

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<sup>4</sup> Includes dishonored electronic payments.

<sup>5</sup> Projected from the results of our review of a statistical sample of 268 of the 15,192 taxpayers with dishonored checks resulting in refunds processed between January and July 17, 2008. We used a conservative approach in determining the number of taxpayers with refunds stopped by the IRS and the associated dollar amount. We subtracted our projection of refunds erroneously issued and dollars from the 15,192 taxpayers with dishonored check refunds and \$52,778,617.



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**Delays in working dishonored checks resulted in erroneous refunds**

Tax Examiners are not timely working dishonored check cases. To prevent erroneous refund issuance, IRS guidelines require dishonored checks to be worked within 21 days of bank notification. Our review of a statistically valid sample of 268 taxpayers' accounts with at least 1 dishonored check refund<sup>6</sup> identified that 130 (55 percent) of the 236 dishonored checks in those accounts that were subject to the 21-day standard<sup>7</sup> were not worked within 21 days. The IRS took 1 day to 38 days beyond the standard to work the 130 dishonored checks. It took the IRS an average of 26 days to work the 236 dishonored checks ranging from 2 days to 59 days.

In addition, 245 (83 percent) of the 294 refunds generated in our sample were not stopped and were erroneously issued to the taxpayer. We estimate the IRS was unable to stop more than \$20 million of the almost \$53 million in refunds generated from being erroneously issued to 13,891 taxpayers (91 percent). We also identified that Tax Examiners:

- Did not begin working on 162 (60 percent) of the 269 dishonored checks until after the refund was erroneously generated.
- Did not reverse the dishonored payment for 137 (51 percent) of the 269 dishonored checks on the same day that the Tax Examiner began researching the account despite IRS guidelines requiring examiners to take this action. Our review identified that it took anywhere from 1 to 47 days to reverse the payment once the Tax Examiner began to research the taxpayer's account.

In general, it took the IRS approximately 40 days from the date of the original payment to reverse the payment as dishonored. However, refunds on the dishonored payments were erroneously issued to taxpayers an average of 36 days after the payment posted. Further complicating the processing of dishonored checks was issuance of the economic stimulus payments in Processing Year 2008. According to the IRS, some taxpayers who were entitled to receive an economic stimulus payment stopped payment on their checks in anticipation of the stimulus payment satisfying their tax debt. In some of these instances, the economic stimulus payment was refunded to the taxpayer before the IRS processed the dishonored check. As a result, taxpayers received economic stimulus payments that should have been offset to their tax debt per the Economic Stimulus Act of 2008.<sup>8</sup>

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<sup>6</sup> The 268 taxpayer accounts we reviewed involved 269 dishonored checks and 294 dishonored check refunds.

<sup>7</sup> IRS employees generally are not required to resolve dishonored checks within 21 days when the notification from the bank involves a missing check, an out-of-sequence encoding error, or a payment received on a full paid tax return received during peak processing.

<sup>8</sup> Pub. L. 110-185, 122 Stat. 613.



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**Implementation of prior audit recommendations could have improved the ability to identify and stop dishonored check refunds**

The same control deficiencies identified in our current review were cited in a previous review. Because the IRS did not implement previous recommendations, millions of dollars in erroneous refunds continue to be issued as a result of dishonored check overpayments. Specifically, a 1996 IRS Inspection Service audit<sup>9</sup> found control weaknesses allowed taxpayers who had an overpayment based on a dishonored check to erroneously receive refunds. The IRS generated 10,630 refunds of overpayments based on dishonored checks totaling more than \$18 million. However, the IRS was able to stop only 2,447 (23 percent) of the 10,630 refunds before they were issued to the taxpayers. The remaining 8,183 refunds totaling approximately \$10.5 million were erroneously issued to the taxpayers. Control weaknesses resulted from:

- Tax Examiners either not receiving dishonored checks from the Financial Management Service or depository banks in sufficient time to stop the refund from being issued and/or Tax Examiners not beginning to work the cases timely.
- Management not always ensuring erroneous refunds caused by dishonored checks were properly identified and/or stopped.

Recommendations not addressed included:

- Evaluating current procedures used to route dishonored checks between the Processing Centers and the banks. The IRS determined the current Memorandum of Understanding adequately addressed the timing of the receipt of dishonored checks from the banks and closed the recommendation with no action.
- Matching dishonored check transaction codes on the Integrated Data Retrieval System<sup>10</sup> to refund data. The IRS noted that this was not cost effective as the number of erroneous refunds issued on dishonored checks was only 0.0095 percent of all refunds issued in Processing Year 1994.
- Holding or “recirculating” the refund stop requests sent to the Financial Management Service. The IRS canceled this corrective action. We were unable to determine the reason for the cancellation.

The IRS needs to establish an effective process to identify and stop dishonored check overpayments from erroneously refunding. The manual process reviewed during the Inspection Service’s 1996 audit continues to allow millions of dollars in erroneous refunds to be issued. As a result, the approximately \$53 million in dishonored check refunds generated by the IRS between January and July 2008 were at risk of being issued to taxpayers in error. A systemic

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<sup>9</sup> *Review of Dishonored Check Processing* (Reference Number 063001, dated March 29, 1996).

<sup>10</sup> IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer’s account records.



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process needs to be developed to prevent a dishonored check overpayment from ever being erroneously issued to a taxpayer. In our opinion, the IRS should implement computer controls to prevent refunds of overpayments from posting to a taxpayer's account until it is reasonably assured the related payment has cleared the bank. For example:

*A taxpayer with a balance due of \$200 made a \$300 payment. The IRS could initiate a computer freeze to prevent the \$100 overpayment from posting to the taxpayer's account until enough time has passed for the bank to notify them if the payment was dishonored. Based on our analysis, freezing the refund for 21 days should provide reasonable time for the IRS to determine if the payment has been dishonored before the refund is issued.*

We estimate an effective process to systemically prevent refunds from generating until the IRS is reasonably sure the related payment has cleared the bank would protect more than \$20 million dollars a year, almost \$102 million over the next 5 years, from being issued to taxpayers in error. In addition, we estimate systemically stopping refunds on dishonored checks could allow the IRS to redirect resources totaling \$119,308 per year (\$596,540 over 5 years) currently used in the Erroneous Refund Unit to recover these erroneous refunds.

### ***Recommendation***

The Commissioner, Wage and Investment Division, should:

**Recommendation 1:** Establish a systemic process to identify overpayments of dishonored checks and stop the overpayments from erroneously refunding to taxpayers until the IRS is reasonably sure the related payment has cleared the bank.

**Management's Response:** IRS management agreed with this recommendation. The IRS will initiate a Unified Work Request to generate a weekly listing from the Integrated Data Retrieval System. The IRS will determine the best approach to systemically identify overpayments due to dishonored checks and stop the overpayments from erroneously refunding to taxpayers. This is contingent on funding.

### **Referrals to the Erroneous Refund Unit are not being consistently initiated in an attempt to recover erroneous refunds**

Tax Examiners were not always preparing and forwarding required documentation to the IRS' Erroneous Refund Unit to initiate procedures to recover erroneously issued refunds. Specifically, Tax Examiners did not refer as required 193 (almost 79 percent) of the 245 refunds from our sample that were erroneously issued to taxpayers. IRS guidelines require Tax Examiners to prepare an Inquiry Referral (Form 4442), Adjustment Request (Form 3465), or a case history sheet to refer accounts to the Erroneous Refund Unit when a refund was erroneously issued based on a dishonored payment.



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Once a refund resulting from a dishonored payment has been issued to a taxpayer, the IRS can only recover the refund by:

- Offsetting a future refund.
- Initiating an erroneous refund lawsuit.
- Asking the taxpayer to voluntarily repay the refund.

We determined the IRS recovered 47 (90 percent) of the 52 refunds in our sample that were referred to the Erroneous Refund Unit. Failure to forward documentation to initiate the recovery of erroneously issued refunds to the Erroneous Refund Unit increases the risk that an erroneous dishonored check refund will not be recovered from the taxpayer.

### ***Recommendations***

The Commissioner, Wage and Investment Division, should:

**Recommendation 2:** Identify overpayments involving dishonored checks that resulted in erroneous refunds issued during Calendar Years 2008 and 2009 that were not referred to the Erroneous Refund Unit and initiate recovery of the refunds.

**Management's Response:** IRS management agreed with this recommendation. The IRS will initiate two separate Unified Work Requests for Calendar Years 2008 and 2009 to generate a one-time list. The lists will be reviewed by the Dishonored Check function at each Campus<sup>11</sup> location before referral to the Erroneous Refund Unit which will initiate recovery of the refunds.

**Recommendation 3:** If a systemic process is not developed in response to Recommendation 1, develop a process to ensure dishonored checks are worked timely and required referrals are made to the Erroneous Refund Unit when a dishonored payment results in an erroneous refund issuance. This would include ensuring dishonored check payments are reversed on the same day the Tax Examiner begins researching the dishonored check.

**Management's Response:** IRS management is planning to implement a systemic process as noted in their response to Recommendation 1; however, in the interim it has shared this report with its Accounting Operations function and reinforced the need to ensure these referrals are made. Hot Topic W&I-IA-2009-1113 was issued as follows:

- It is imperative that additional Integrated Data Retrieval System research be performed in every dishonored check case to identify and intercept any

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<sup>11</sup> The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



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Transaction Code 840 or Transaction Code 846 that are pending or posted to the Master File that may be issued in error.

- Management must ensure that Tax Examiners are trained to identify and intercept posting refunds.
- Tax Examiners must prepare and forward required documentation to the Erroneous Refund Unit to initiate procedures to recover erroneously issued refunds.

### ***Conversion of Paper Checks Into Electronic Transactions Could Prevent Issuance of Dishonored Check Erroneous Refunds***

The IRS has the opportunity to enhance its systemic controls to prevent the erroneous issuance of refunds resulting from a dishonored check overpayment as it modernizes its payment processing in the Submission Processing sites. Specifically, the IRS plans to convert all payments into an electronic transaction to then be posted to the taxpayers' accounts. However, the IRS' modernization project will not change the processes it uses to deposit paper checks or identify and work dishonored checks returned by the Federal Reserve or depository banks. As a result, the risk that the IRS will issue erroneous refunds on dishonored checks will still exist.

The IRS should include in its payment modernization a process to convert the deposit of paper checks into electronic fund withdrawals to prevent the issuance of erroneous refunds based on the receipt of a dishonored check. The IRS currently uses the Department of the Treasury's Electronic Federal Tax Payment System (EFTPS) to process electronic fund withdrawals initiated by taxpayers. This system sends the payment authorization to the bank before it posts to the taxpayer's account. The bank verifies the payment can be made (funds are available). If the payment is dishonored, the bank notifies the IRS that a payment was made and dishonored at the same time. The EFTPS systemically posts the payment to the taxpayer's account to show a payment was attempted and posts the dishonored check transaction to show the payment was not honored. Of the 15,823 dishonored checks with refunds during the period January through July 17, 2008, 96 percent (15,139 checks) were processed as paper checks.

Systemically processing the payment and dishonored check as an electronic fund withdrawal will dramatically reduce the risk that an erroneous refund of an overpayment on a dishonored check will be issued to the taxpayer. For example:

*The IRS receives a check from taxpayer A for \$200. It converts the check to an electronic fund withdrawal and forwards the payment authorization to the bank. The bank processes the authorization and determines it cannot be honored. Using the EFTPS, the bank provides the IRS with two records for taxpayer A – a payment record showing the taxpayer authorized a payment to the IRS and a dishonored check record. The IRS processes both records and posts them to taxpayer A's account in the same processing*



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*cycle. The payment transaction indicates the taxpayer made a payment. The dishonored check transaction reverses the payment in the taxpayer's account. Because the payment and the dishonored check transaction post to the taxpayer's account at the same time, the risk that a refund of the payment will occur is minimal.*

Systemic processing of the payment and the dishonored check will also reduce the resources needed to work dishonored checks. Currently, a Tax Examiner must research the taxpayer's account, initiate the dishonored check transaction to reverse the payment, and identify and stop the refund. However, if the dishonored check transaction was processed systemically, Tax Examiners would no longer have to perform these tasks.

### ***Recommendation***

Because the IRS has plans to modernize its payment processing, we are making the following recommendation as a long-term solution to improve the IRS' ability to prevent refunds on dishonored checks.

**Recommendation 4:** The Commissioner, Wage and Investment Division, should modify the IRS' payment processing modernization project to include converting paper checks to electronic fund withdrawals instead of continuing to process them as a paper deposit to the bank. This will allow the IRS to eliminate the manual processing of dishonored checks and dramatically reduce the risk that refunds of overpayments on dishonored checks will be erroneously issued to taxpayers.

**Management's Response:** IRS management disagreed with this recommendation. While electronic fund withdrawals would be the preferred way to deposit payments, the current banking system prevents converting paper checks to electronic fund withdrawals without enrolling in the EFTPS. The IRS' current modernization efforts, the Campus Bulk Remittance Processing project and the Remittance Processing – Paper Check Conversion program, are in the planning stages. With these projects, the deposit is transmitted electronically from the IRS to the bank. The deposit is electronic but the method for transferring funds will not change. Due to the electronic nature of deposit transmittal, it will reduce the risk that refunds of overpayments on dishonored checks will be erroneously issued to taxpayers.

**Office of Audit Comment:** We appreciate IRS management's recognition of the benefits of converting paper checks to electronic payments. We recognize the current limitations the IRS has regarding the conversion of paper checks to electronic fund withdrawals. The IRS currently uses the EFTPS to receive electronic payments from taxpayers. However, as we noted in our audit report, no process has been established to convert paper checks to an electronic payment for transmission to the bank. The EFTPS does not have the functionality to allow the IRS to convert paper checks to an electronic format for transmitting the payments via the EFTPS. As the IRS moves forward with its



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payment modernization, consideration should be given to develop such a process. We also encourage the IRS to continue to promote its electronic payment options for taxpayers in an effort to increase taxpayers' usage and further reduce the risk of issuing refunds of overpayments on dishonored checks.



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## Appendix I

### *Detailed Objective, Scope, and Methodology*

Our overall objective was to assess the efficiency and effectiveness of the processing of dishonored checks. To review the efficiency and effectiveness of the processing of dishonored checks, we obtained Master File<sup>1</sup> data from the Treasury Inspector General for Tax Administration Data Center Warehouse.<sup>2</sup> We extracted 340,727 dishonored payments processed during the period January 1, 2008, through July 17, 2008.<sup>3</sup> We further determined 15,823 of the 340,727 had a refund generated on the dishonored check. We used the Integrated Data Retrieval System<sup>4</sup> to validate the Master File data we extracted. We also obtained source documents for our sampled selection of dishonored check cases.

To accomplish our objective, we:

- I. Determined whether corrective actions were taken on recommendations made in the prior Inspection Service report.<sup>5</sup>
- II. Determined the cost of resolving a dishonored check and recovering the related erroneously issued refund in Fiscal Year 2007. Using this information, we estimated the total cost of working dishonored checks, including the cost to recover refunds erroneously issued to taxpayers.
- III. Assessed the effectiveness of controls to ensure dishonored checks are processed timely.
  - A. Reviewed the Internal Revenue Manual and conducted a walkthrough of the dishonored check process in the Kansas City, Missouri, Processing Center to identify internal controls designed to ensure dishonored checks are worked timely.
  - B. Analyzed a statistical sample of 268 of the 15,192 taxpayer accounts that had a dishonored check and a refund transaction posting during the period January 1 through July 17, 2008, to determine whether current processes and procedures effectively ensure dishonored checks are worked timely to prevent erroneous refunds. Our sample was a stratified sample consisting of 234 individual and 34 business

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<sup>1</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

<sup>2</sup> Data Center Warehouse provides data and data access services through the Treasury Inspector General for Tax Administration intranet.

<sup>3</sup> Includes checks received from individual and business taxpayers as well as EFTPS payments.

<sup>4</sup> IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

<sup>5</sup> *Review of Dishonored Check Processing* (Reference Number 063001, dated March 29, 1996).



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taxpayer accounts with dishonored checks with a refund. The sample size was based on an expected error rate of 77 percent, a 95 percent confidence level, and a  $\pm 5$  percent precision and was selected using a random number generator.

- C. Contacted the Wage and Investment Headquarters and the Federal Tax Deposit – EFTPS Unit in the Ogden Processing Center to determine how the IRS is notified of a dishonored EFTPS payment and how the payments are resolved.
- IV. Determined the impact of not timely working dishonored payments by projecting the results of our sample review in Step III.B. to the total population of dishonored checks with a refund transaction posting for Processing Year 2008.
- V. Determined whether the IRS can improve its ability to prevent refunds on dishonored checks from being issued to taxpayers through the use of improved technology.



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**Appendix II**

*Major Contributors to This Report*

Michael E. McKenney, Assistant Inspector General for Audit, (Returns Processing and Account Services)  
Russell P. Martin, Director  
Deann L. Baiza, Audit Manager  
Linda L. Bryant, Lead Auditor  
Sharon A. Buford, Senior Auditor  
Karen C. Fulte, Senior Auditor  
Kathleen A. Hughes, Senior Auditor  
Sharla J. Robinson, Senior Auditor  
Van A. Warmke, Senior Auditor  
Chanda L. Stratton, Auditor



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**Appendix III**

*Report Distribution List*

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Services and Enforcement SE  
Deputy Commissioner, Wage and Investment Division SE:W  
Director, Communications and Liaison, Wage and Investment Division SE:W:C  
Director, Customer Account Services, Wage and Investment Division SE:W:CAS  
Director, Strategy and Finance, Wage and Investment Division SE:W:S  
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP  
Senior Operations Advisor, Wage and Investment Division SE:W:S  
Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PRA:PEI  
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 Liaison: Chief, Program Evaluation and Improvement SE:W:S:PRA:PEI



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## 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:**

- Inefficient Use of Resources – Potential; \$596,540 in resources the IRS can redirect to other programs over the next 5 years as a result of not having to refer erroneous refunds on overpayments of dishonored checks to the Erroneous Refund Unit (see page 4).

#### **Methodology Used to Measure the Reported Benefit:**

Implementing a systemic process to identify and stop overpayments on dishonored checks from refunding to taxpayers would eliminate the need for the IRS to work erroneous dishonored check refunds in its Erroneous Refund Unit.

According to the IRS, it processed 2,601 erroneous refunds resulting from a dishonored check in Processing Year 2008 at a cost of \$45.87 per refund. Using this data, we estimated it cost the IRS \$119,308 to process erroneous dishonored check refunds in 2008. The projected value of resources that can be redirected to other IRS programs over 5 years as a result of preventing overpayments from refunding to taxpayers is \$596,540 ( $\$119,308 \times 5$ ).

#### **Type and Value of Outcome Measure:**

- Revenue Protection - Potential; \$101,851,265 in potentially erroneous refunds on dishonored checks over the next 5 years (see page 4).

#### **Methodology Used to Measure the Reported Benefit:**

Control weaknesses in the IRS' dishonored check process and the timing of Master File<sup>1</sup> processing increase the risk that a refund will be issued on a dishonored check. We analyzed the IRS' Master File for the period January 1, 2008, through July 17, 2008, and identified 15,192 taxpayer accounts with dishonored check refunds totaling \$52,778,617.

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<sup>1</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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Our review of a statistical sample of 268 of the 15,192 taxpayer accounts determined the IRS did not stop the dishonored check refunds in 91 percent of the taxpayer accounts. We then projected the results of our sample to the 15,192 taxpayer accounts using a 95 percent confidence level and a  $\pm 5$  percent precision. We estimate the IRS will issue \$20,370,253 in erroneous refunds of dishonored checks to 13,891 taxpayers annually. We are 95 percent confident the actual amount of refunds issued in error is between \$10,955,922 and \$29,784,584. We estimate the IRS could issue \$101,851,265 in erroneous dishonored check refunds over the next 5 years (\$20,370,253 x 5).



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**Appendix V**

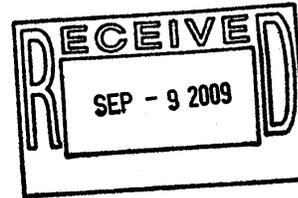
*Management's Response to the Draft Report*



COMMISSIONER  
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
ATLANTA, GA 30308

SEP 09 2009



MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *Richard Byrd, Jr.*  
Richard Byrd, Jr., *Larry Bogadi*  
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Inadequate Controls Over Dishonored Checks Put Millions of Dollars at Risk for Erroneous Refund Issuance (Audit #200940020)

I reviewed the subject draft report and agree that measures could be taken to strengthen the dishonored check processing program. Although the number of dishonored payments represents less than one percent of the entire amount of payments the IRS processes, we agree there are improvements that could be made to this process.

In your report, you stated Tax Examiners are either not receiving dishonored checks from the Financial Management Service (FMS) or depository banks in sufficient time to stop the refund from being issued, and/or Tax Examiners are not working the cases timely. An analysis of the 294 refunds issued, shows 99 (34 percent) were received 15 days or less from the date of the debit. In fact, several of the cases were refunded before the IRS received notification of the dishonored check from the bank. Based on this information, intercepting these refunds were not possible.

As with any manual processing system, tracking and monitoring require special steps. Our dependency on the banks to receive the information that a check has not been honored, further hampers our ability to reduce the possibility of an erroneous refund.

To help facilitate the processing of dishonored checks once notification is received, we plan to submit a Unified Work Request (UWR) to generate a weekly report to list refunds where a dishonored check transaction code is shown on the account. We are also working with FMS to explore ways to change current procedures used to route dishonored checks between processing centers and banks.



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In addition, we have submitted two more UWRs to generate reports for 2008 and 2009, listing all refunds issued due to the posting of a dishonored check transaction. These listings will be reviewed by the Dishonored Check Teams for referral to the Erroneous Refund Teams for recovery of the refunds issued in error.

While we currently have instructions in the Internal Revenue Manual (IRM), we will update IRM 3.17.10, Dishonored Check File, to better clarify procedures for identifying and routing erroneous refunds to the Erroneous Refund Teams, and increase managerial review during peak processing times.

We agree with the outcome measures reported in Appendix IV. Attached are our comments on your recommendations. If you have any questions, please call me at (404) 338-7060, or have a member of your staff contact Peter J. Stipek, Director, Customer Account Services, Wage and Investment Division, at (404) 338-8910.

Attachment



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*Inadequate Controls Over Dishonored Checks Put Millions of Dollars at Risk for Erroneous Refund Issuance*

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Attachment

The Commissioner, Wage and Investment Division, should:

**RECOMMENDATION 1**

Establish a systemic process to identify overpayments of dishonored checks and stop the overpayments from erroneously refunding to taxpayers until the IRS is reasonably sure the related payment has cleared the bank.

**CORRECTIVE ACTION**

We agree with this recommendation. The IRS will initiate a Unified Work Request (UWR) to generate a weekly listing from the Integrated Data Retrieval System (IDRS). We will determine the best approach to systemically identify overpayments due to dishonored checks and stop the overpayments from erroneously refunding to taxpayers. This is contingent on funding.

**IMPLEMENTATION DATE**

January 15, 2011

**RESPONSIBLE OFFICIAL**

Director, Submission Processing, Customer Account Services, Wage and Investment Division

**CORRECTIVE ACTION MONITORING PLAN**

This corrective action will be monitored as part of our internal managerial control system.

The Commissioner, Wage and Investment Division, should:

**RECOMMENDATION 2**

Identify overpayments involving dishonored checks that resulted in erroneous refunds issued during Calendar Years 2008 and 2009 that were not referred to the Erroneous Refund Unit and initiate recovery of the refunds.

**CORRECTIVE ACTION**

We agree with this recommendation. We will initiate two separate UWRs for Calendar Years 2008 and 2009 to generate a one time listing. The listings will be reviewed by the Dishonored Check Function at each Campus location before referral to the Erroneous Refund Unit who will initiate recovery of the refunds.

**IMPLEMENTATION DATE**

February 15, 2010 for Calendar year 2008  
May 15, 2010 for Calendar year 2009



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**RESPONSIBLE OFFICIAL**

Director, Submission Processing, Customer Account Services, Wage and Investment Division

**CORRECTIVE ACTION MONITORING PLAN**

This corrective action will be monitored as part of our internal managerial control system.

**RECOMMENDATION 3**

If a systemic process is not developed in response to Recommendation 1, develop a process to ensure dishonored checks are worked timely and required referrals are made to the Erroneous Refund Unit when a dishonored payment results in an erroneous refund issuance. This would include ensuring dishonored check payments are reversed on the same day the Tax Examiner begins researching the dishonored check.

**CORRECTIVE ACTION**

We are planning to implement a systemic process as noted in our response to Recommendation 1; however, in the interim, we have shared this report with our Accounting Operations and reinforced the need to ensure these referrals are made. Hot Topic W&I-IA-2009-1113 was issued as follows:

- It is imperative that additional IDRS research be performed in every dishonored check case to identify and intercept any TC 840 or TC 846 that are pending or posted to the Master File that may be issued in error.
- Management must ensure that tax examiners are trained to identify and intercept posting refunds.
- Tax Examiners must prepare and forward required documentation to the Erroneous Refund Unit to initiate procedures to recover erroneously issued refunds.

**IMPLEMENTATION DATE**

N/A

**RESPONSIBLE OFFICIAL**

N/A

**CORRECTIVE ACTION MONITORING PLAN**

N/A



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*Inadequate Controls Over Dishonored Checks Put Millions of Dollars at Risk for Erroneous Refund Issuance*

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3

Because the IRS has plans to modernize its payment processing, we are making the following recommendation as a long-term solution to improve the IRS' ability to prevent refunds on dishonored checks.

**RECOMMENDATION 4**

The Commissioner, Wage and Investment Division, should modify the IRS payment processing modernization project to include converting paper checks to electronic fund withdrawals instead of continuing to process them as a paper deposit to the bank. This will allow the IRS to eliminate the manual processing of dishonored checks and dramatically reduce the risk that refunds of overpayments on dishonored checks will be erroneously issued to taxpayers.

**CORRECTIVE ACTION**

We disagree with this recommendation. While an electronic funds withdrawal would be the preferred way to deposit payments, the current banking system prevents converting paper checks to electronic fund withdrawals without enrolling in the Electronic Federal Tax Payment System. Our current modernization efforts, the Campus Bulk Remittance Processing (CBRP) project and the Remittance Processing-Paper Check Conversion (RPPCC) program, are in the planning stages. With these projects, the deposit is transmitted electronically from the IRS to the bank. The deposit is electronic but the method for transferring funds will not change. Due to the electronic nature of deposit transmittal, (even without electronic funds the withdrawals CBRP and RPPCC) it will reduce the risk that refunds of overpayments on dishonored checks will be erroneously issued to taxpayers.

**IMPLEMENTATION DATE**

N/A

**RESPONSIBLE OFFICIAL**

N/A

**CORRECTIVE ACTION MONITORING PLAN**

N/A