



*The Internal Revenue Service Is Making
Progress Toward Implementing Daily
Processing of Individual Tax Returns*

July 24, 2012

Reference Number: 2012-40-085

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.

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HIGHLIGHTS

THE INTERNAL REVENUE SERVICE IS MAKING PROGRESS TOWARD IMPLEMENTING DAILY PROCESSING OF INDIVIDUAL TAX RETURNS

Highlights

Final Report issued on July 24, 2012

Highlights of Reference Number: 2012-40-085 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

The Customer Account Data Engine 2 (CADE 2) will expand daily processing of individual tax returns and will result in a single relational database that houses all individual taxpayer accounts. This database will replace the Individual Master File and serve as a central source of individual tax return data, making reporting and retrieval of taxpayer account data faster and more efficient. The benefits of daily processing include faster refunds for taxpayers and timelier responses to taxpayers' inquiries about their accounts.

WHY TIGTA DID THE AUDIT

This audit was initiated as part of our efforts to evaluate the IRS's modernization of its tax processing systems. The overall objective of this review was to evaluate the accuracy of the IRS's implementation of daily tax return processing during the 2012 Filing Season.

WHAT TIGTA FOUND

At the end of Calendar Year 2011, the IRS had identified more than 122 million taxpayer accounts for daily processing and more than 148 million taxpayer accounts for weekly processing. Through April 30, 2012, the IRS had successfully processed 71 million individual tax returns through daily tax return processing.

The IRS's planning efforts reduced the risk associated with the daily processing of individual tax returns. In addition, the IRS accurately identified tax accounts for daily processing.

The IRS analyzed tax account transactions and other conditions that affect tax return processing and identified those that would require additional time to ensure tax returns were processed correctly. These transactions are referred to as disqualifiers. Tax accounts that contain one or more disqualifiers will continue to be processed weekly. Our review of 89 of 108 disqualifiers on more than 79 million taxpayer accounts processed between January 17 and February 29, 2012, found that the IRS computer system was correctly programmed.

The IRS conducted reviews of tax accounts and tax return transactions during the 2012 Filing Season to monitor the accuracy of CADE 2 processing. However, it verified only a fraction of the approximately 119 million individual tax returns processed through April 30, 2012. In addition, the IRS did not track which disqualifiers it verified as part of its review. Unless the IRS verifies at least a limited number of tax accounts that contain each of the identified disqualifiers, it cannot be assured that individual tax account transactions are properly posting to the Master File.

WHAT TIGTA RECOMMENDED

TIGTA made no recommendations as a result of the work performed during the review. However, key IRS officials reviewed the report prior to its issuance and agreed with the facts and conclusions presented.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 24, 2012

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael E. McKenney
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Is Making Progress
Toward Implementing Daily Processing of Individual Tax Returns
(Audit # 201140048)

This report presents the results of our review to evaluate the accuracy of the Internal Revenue Service's implementation of daily tax return processing during the 2012 Filing Season.¹ This review is included in our Fiscal Year 2012 Annual Audit Plan and addresses the major management challenge of Modernization.

Management did not provide a formal response to this report. However, key IRS officials reviewed the report prior to its issuance and agreed with the facts and conclusions presented.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report. Please contact me at (202) 622-6510 if you have questions or Augusta R. Cook, Acting Assistant Inspector General for Audit (Returns Processing and Account Services), at (770) 617-6434.

¹ See Appendix IV for a glossary of terms.



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Abbreviations

CADE	Customer Account Data Engine
GAO	Government Accountability Office
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration



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Background

The Internal Revenue Service's (IRS) main processing system for individual tax returns was developed more than 50 years ago and processes tax returns on a weekly basis. The IRS continued to process individual tax returns on a weekly basis until Processing Year¹ 2005, when the IRS implemented an initiative to process individual tax returns daily. This initiative, referred to as the Customer Account Data Engine (CADE), was designed to post information to taxpayers' accounts daily rather than weekly. The IRS anticipated that the CADE would facilitate faster refunds to taxpayers and allow IRS employees to provide improved service to taxpayers because employees would have up-to-date, accurate account information available. As of Processing Year 2009, the IRS had posted more than 40 million individual tax returns to the Individual Master File (Master File) through the CADE.

In August 2008, a team of high-level IRS officials concluded that the IRS did not have the capability to complete and release the CADE as originally planned. Factors the IRS considered include:

- **Increased Cost for Each Filing Season.** Each filing season, the IRS expended the resources to design, develop, integrate, and test tax law changes in both the Master File and the CADE. As a result, the cost to deliver each filing season was increased.
- **Limited Processing Capability.** Although the CADE was implemented in Processing Year 2005, the system was still only able to process the simplest individual tax returns; *e.g.*, those with refunds claimed and no processing issues. The most complex functionality was planned for future CADE releases.
- **Lack of a Target-State Architecture.** The IRS did not have a vision for what the CADE would look like once fully implemented or an attainable goal for when it planned to complete the implementation of the CADE. Instead, the IRS made incremental changes to the current architecture to meet the business requirements of each release and filing season.
- **Integration Challenges.** As the IRS added more complex taxpayer returns to the CADE, integration with other systems became more complex and increased the likelihood of breakdowns during implementation.
- **Critical Resource Shortage.** The IRS has a limited number of staff who possess the in-depth business and technical knowledge of the CADE, Master File, and other core processes and applications associated with individual taxpayer account processing.

¹ See Appendix IV for a glossary of terms.



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In June 2009, the IRS Commissioner approved a revised plan to better manage individual tax return accounts called the CADE 2 Program. The CADE 2 Program will build on the CADE data model and database design to better manage all individual taxpayer accounts. In addition to expanding the daily processing of individual tax returns, the CADE 2 will result in a single relational database that houses all individual taxpayer accounts. This database will replace the Master File and serve as a central source of individual tax return data, making reporting and retrieval of taxpayer account data faster and more efficient. The IRS indicates that the CADE 2 will result in timelier taxpayer data, increased analytical data stores, improved or increased tools to more effectively use data for compliance and customer service, and enhanced data security. The CADE 2 Program is scheduled to replace the Master File in Calendar Year 2014 or 2015.

The IRS plans to deliver the CADE 2 Program through a series of stages known as Transition States. The IRS began to deliver Transition State 1 in January 2012. Transition State 1 consists of three primary objectives:

- Process individual tax returns daily rather than weekly. The IRS began processing individual tax returns daily through the CADE 2 in January 2012.
- Develop a CADE 2 database and populate the database with individual taxpayer accounts. The IRS is not scheduled to fully populate the CADE 2 database until August 2012.
- Make progress toward resolving material financial weaknesses reported by the Government Accountability Office (GAO).² For example, the GAO's Fiscal Year 2011 evaluation of the IRS's internal controls identified a continuing material weakness over unpaid tax assessments. The GAO indicated this weakness is due to the IRS's inability to rely on its financial management systems for tax-related transactions and its underlying subsidiary records to report taxes receivable, compliance assessments, or write-offs in accordance with Federal accounting standards. The implementation of the CADE 2 database during Transition State 1 will provide a basis for the IRS to begin to address reported financial material weaknesses.

Transition State 2 will focus on resolving financial material weaknesses and building or modifying existing applications to directly interact with the CADE 2 database. The IRS estimates it will complete Transition State 2 in Calendar Year 2014 or 2015. The IRS does not have an estimated date as to when all of the planned CADE 2 functionality (Target State) will be implemented.

This review was performed at the IRS National Headquarters in Washington, D.C., in the Wage and Investment Division, Business Modernization Office, and the Modernization and

² Government Accountability Office (formerly known as the General Accounting Office), GAO-12-165, *FINANCIAL AUDIT, IRS's Fiscal Years 2011 and 2010 Financial Statements* (Nov. 2011).



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Information Technology Services organization, Applications Development Office, during August 2011 through April 2012. Our review was limited to an assessment of the IRS's implementation of daily processing for individual tax returns as part of the CADE 2 Transition State 1. 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

Our assessment of the IRS's planning efforts for the implementation of daily tax return processing during the 2012 Filing Season showed that the IRS's efforts were sufficient to ensure tax account transactions are processed to the Master File on a daily basis. The IRS processed approximately 119 million individual tax returns as of April 30, 2012. Of these, approximately 71 million (60 percent) individual tax returns were posted to the Master File using daily tax return processing.

Planning Efforts Were Sufficient to Reduce the Risk Associated With Daily Processing for Individual Tax Returns

The IRS began work on the CADE 2 in the middle of Calendar Year 2009. Each IRS business unit with a role in individual tax return processing participated in the planning activities by completing an assessment to determine how its unit would be affected by the CADE 2. These impact assessments addressed several categories: training, policy, resources, the Internal Revenue Manual, changes in tours-of-duty, new position descriptions, and standard operating procedures. The assessments also included an evaluation of the number of employees affected.

Once the impact assessments were completed, the business units worked with the Business Modernization Office's CADE 2 Transition Management team (Transition team) to develop readiness plans to address the impacted areas. The readiness plans included descriptions of the impacts identified, actions that would be taken to address the impacts, and the dates the actions would be completed or implemented. Each business unit had a national point of contact that was responsible for updating their business unit's readiness plan and coordinating with the Transition team. In addition, the Transition team had biweekly meetings with the national points of contact to discuss the status of the readiness plans and any related issues. IRS executives certified in late December 2011 and early January 2012 that their business units were prepared for the deployment of the CADE 2 Transition State 1 in January 2012.

We reviewed 18 impact assessments and 31 readiness plans. In addition, we attended weekly meetings between the Transition team and the national points of contact between October 2011 and February 2012. Our assessment raised no concerns with the IRS's planning efforts for the CADE 2 Transition State 1. Figure 1 presents a timeline of the IRS's planning for the first phase of the CADE 2 implementation.



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Figure 1: Timeline of IRS Planning Efforts for CADE 2 Daily Processing

Time Frame	Activity
June 2009	The IRS Commissioner chartered the CADE 2 Program to implement a revised plan that would build on some features of the previous CADE processing platform.
August 2009	The Business Modernization Office's CADE Project Office staff (referred to as the Project Office) at the National Office and representatives from all of the business operating divisions put together the plan for the CADE 2. The Project Office started with the existing CADE requirements and enhanced them for the CADE 2. In addition, it analyzed more than 900 of the various processing codes ³ and determined whether each item should be processed daily or weekly.
August and September 2009	The Project Office had multiple meetings with the Master File programmers to analyze how the various processing codes interrelated with the computer programs. Additional information and details were obtained from meetings between the Modernization and Information Technology Services organization and technical persons within the business operating divisions, meetings among the business partners, and meetings with the Chief Financial Officer. The combined information obtained from these meetings was used to prepare the first draft of the information technology products and services request in September 2009.
May 2010 to November 2011	The Project Office had numerous follow-up meetings with the business operating divisions to analyze and compare the requirements against the draft computer programming.
December 2011	A computer program was executed that would establish an indicator on all individual tax accounts to show whether an account could be processed daily.
January 2012	The final computer programming was put into place for the beginning of the 2012 Filing Season.

Source: CADE Project Office.

The IRS developed a list of items that can be processed daily versus weekly

Although the IRS is moving from weekly processing of individual tax returns to daily processing, not all individual tax returns can be processed daily. Individual tax returns that require additional actions to ensure the tax return is accurate before it can be processed must continue to be processed on a weekly basis to allow the IRS time to verify and correct the tax return before it posts to the Master File. The IRS included efforts in its CADE 2 planning to identify specific tax return transactions and taxpayer accounts that require additional review prior to processing the tax return. Based on its analysis, the IRS identified approximately 148 million taxpayer accounts that contained characteristics that would cause a tax return to be processed weekly (called disqualifiers). The IRS grouped the disqualifiers into four categories.

³ Processing codes could include any of the various transaction codes, resequencing codes, notice codes, or other characteristics in a taxpayer's account.



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- **Entity:** Entity disqualifiers relate to transactions or characteristics that are on the entity portion of a tax account. Examples include accounts marked as identity theft, accounts in bankruptcy litigation, and accounts with an IRS processing center zip code.
- **Tax Module – Freeze:** Tax Module Freeze disqualifiers relate to conditions present on the individual tax periods within a tax account. Examples include tax periods with a claim pending, with an offer-in-compromise, or marked uncollectible.
- **Tax Module – Transactions:** Tax Module Transaction disqualifiers relate to codes or transactions present on the individual tax periods within a tax account. Examples include tax periods with certain penalty transactions or underreporter issues.
- **Incoming Transactions:** Incoming transaction disqualifiers relate to conditions posting to tax periods during the 2012 Filing Season. Examples include changes to the tax account or adjustments made to the tax return as a result of actions taken at the time the tax return is processed.

We reviewed the IRS's categories of disqualifiers and performed limited testing to ensure the lists were complete. We identified four key areas of tax return processing that we believe could result in erroneous refunds being issued if tax returns identified by these programs are not resequenced to allow the IRS adequate time to verify the tax return.

- Taxpayer accounts that went through the Electronic Fraud Detection System.
- Taxpayer accounts reviewed by the Accounts Management Taxpayer Assurance Program.
- Taxpayer accounts that could receive a notice.
- Taxpayer accounts that went through a pre-refund examination program.

We met with representatives from each of these areas and identified transactions that they believed would be on the tax account if a tax return went through one of these areas. We then compared the transactions identified with the IRS's list of disqualifiers. Our analysis found that the IRS adequately considered all of the transactions associated with our four high-risk areas when compiling the items that should be disqualified from daily processing.

In addition, the IRS is continuing to refine its list of transactions and tax accounts that can be processed daily. Representatives from the CADE 2 Business Modernization Office and the Modernization and Information Technology Services organization met in early March 2012 to discuss the need to identify additional transactions that could be processed daily. As a result of these meetings, the IRS requested revisions to the programming for Processing Year 2013 to allow additional items to be processed daily. It requested these revisions because IRS employees need to know events that occur on tax accounts as quickly as possible to ensure they have the most accurate information when processing the tax return and responding to taxpayer inquiries.



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The Internal Revenue Service Accurately Identified Tax Accounts for Daily and Weekly Processing

At the end of Calendar Year 2011, the IRS identified all individual tax accounts with one or more Entity, Tax Module Freeze, or Tax Module Transaction disqualifiers. The IRS placed an indicator on each of these accounts to show that the individual tax returns filed on these tax accounts must be processed weekly. The IRS marked all other tax accounts for daily processing. At the end of Calendar Year 2011, the IRS had identified more than 122 million tax accounts for daily processing and more than 148 million tax accounts for weekly processing.

The IRS began applying the Incoming Transactions disqualifiers to taxpayer accounts during Processing Year 2012. As individual tax returns are processed, the IRS evaluates the actions taken on the tax returns. If a disqualifying incoming transaction occurs on a tax account that was previously identified for daily processing, the IRS updates the daily processing indicator on the tax account to show the account must now be processed weekly.

Our analysis of the IRS's processing of tax return transactions posting to the Master File indicates that the IRS correctly programmed transactions that should have been disqualified from daily processing. We selected a judgmental sample⁴ of 89 (82 percent) of the 108 IRS-identified disqualifiers posting between January 17 and February 29, 2012. Our analysis of more than 79 million taxpayer accounts that contained one or more of these 89 disqualifiers found that the majority of items designated for weekly processing are being processed correctly. Figure 2 below provides the results of our analysis.

**Figure 2: Analysis of Disqualifiers Posting to the Master File
Between January 17 and February 29, 2012**

Category	Disqualifiers IRS Identified	Disqualifiers TIGTA Sampled	Disqualifiers Programmed Incorrectly
Entity	20	14	2
Tax Module Freeze	14	13	0
Tax Module Transaction	9	7	0
Incoming Transactions	65	55	1
Total	108	89	3

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of Master File data posted from January 17 through February 29, 2012.

⁴ A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population.



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We discussed our concerns with three disqualifiers with IRS management in January and February 2012. These three disqualifiers related to the taxpayers' zip code, filing location, and a processing code that the IRS uses in its examination program. The volume of transactions associated with these three disqualifiers was extremely low (these three disqualifiers appeared in only 0.06 percent of the 79 million tax accounts we reviewed). Despite the low volumes, IRS management agreed that these three disqualifiers were not functioning as intended and indicated they would make programming changes to correct them.

The IRS could improve its verification of daily and weekly processing

The IRS established a process to verify that transactions are posting correctly to the Master File. However, our analysis of the IRS's verification plan indicates that the IRS's efforts may not be sufficient to identify errors in daily and weekly processing.

The Project Office randomly selected 20 tax accounts and verified that the processing indicator was correctly set as either daily or weekly during the first CADE 2 initialization run. This same review was performed on an additional 25 tax accounts after the March 2012 CADE 2 initialization. In addition, the Project Office randomly selected individual tax returns for verification of the accuracy of both daily and weekly processing. The Project Office verified the accuracy of the processing of 249 individual tax returns between January 31 and April 4, 2012. The IRS found that the CADE 2 is accurately processing individual tax returns on a daily and weekly basis.

Although our analysis of tax account transactions posting to the Master File between January 17 and February 29, 2012, indicate transactions are correctly posting to the Master File, we are concerned that the IRS verified the accuracy of tax return processing for only a fraction of the approximately 119 million individual tax returns processed through April 30, 2012. In addition, the IRS did not track which disqualifiers it verified as part of its review. Unless the IRS verifies at least a limited number of tax accounts that contain each of the identified disqualifiers, it cannot be assured that individual tax account transactions are properly posting to the Master File. As such, the IRS should consider creating a verification plan to determine if all tax account disqualifiers are accurately identified during processing. The systemic nature of daily and weekly processing should reduce the number of tax accounts the IRS needs to review.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate the accuracy of the IRS's implementation of daily tax return processing during the 2012 Filing Season.¹ This review is included in TIGTA's Fiscal Year 2012 Annual Audit Plan and addresses the major management challenge of Modernization.

To accomplish the objective, we:

- I. Assessed the IRS's planning efforts to implement daily processing for individual tax returns.
 - A. Interviewed IRS management about their process to identify transactions for daily or weekly processing and reviewed CADE 2 documentation and information for transactions used to process individual tax returns.
 - B. Evaluated the completeness of the IRS's identification of individual tax return transactions that should be processed weekly.² To do this, we obtained the IRS's list of transactions used to process individual tax returns. We also reviewed CADE 2 documentation and interviewed IRS program managers to identify transactions associated with the Electronic Fraud Detection System, Accounts Management Taxpayer Assurance Program, Notice Review Program, and Pre-Refund Program. We then evaluated if the IRS considered all of the transactions for these four program areas and whether the transactions were identified for daily or weekly processing.³
 - C. Assessed the IRS's efforts to continue to identify tax return transactions that should be processed weekly.
 1. Obtained additional information related to the IRS planned method to add the daily eligible indicator to the tax accounts in December 2011 and March 2012.
 2. Obtained counts of the number of tax accounts that were not able to be processed daily as identified by the computer runs in December 2011 and March 2012.

¹ See Appendix IV for a glossary of terms.

² We were only concerned with weekly transactions because an erroneous refund could occur if a transaction that should be processed weekly was incorrectly processed daily.

³ There is a greater possibility of erroneous refunds in these four programs.



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- II. Evaluated the accuracy of daily and weekly processing of taxpayer accounts during the 2012 Filing Season to determine if tax return transactions are accurately posting to the Individual Master File.
 - A. Obtained an extract of tax account transactions that posted each day during January and February 2012 from the Individual Master File. The extract was created by TIGTA's Data Center Warehouse programmers. We validated the information received in the data extract by confirming record counts and tracing information to the Integrated Data Retrieval System.
 - B. Ensured that transactions were correctly posting daily and weekly by reviewing the posting dates and the daily eligible indicator.
- III. Assessed the effectiveness of the IRS process to monitor the accuracy of daily and weekly individual tax return processing during the 2012 Filing Season. To do this, we interviewed IRS management and reviewed the IRS's plan to validate the accuracy of daily and weekly processing.

Data Validation

To assess the reliability of computer-processed data, programmers in the TIGTA Strategic Data Services Division validated the data that were extracted, and we verified the data with appropriate documentation. Judgmental samples were selected and reviewed to ensure that the information presented was supported by external sources.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: CADE 2 Program criteria for daily or weekly processing of individual tax account data and the Internal Revenue Manuals used by the Wage and Investment Division's Submission Processing, Accounts Management, and Return Integrity and Correspondence Services functions to process individual tax returns. We evaluated the internal controls by interviewing IRS management and conducting tests of the IRS's procedures to ensure daily and weekly processing of individual tax accounts were functioning properly.



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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner C
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Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Services and Operations, Wage and Investment Division SE:W
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Return Integrity and Correspondence Services, Wage and Investment Division
SE:W:RICS
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Appendix IV

Glossary of Terms

Term	Definition
Accounts Management Taxpayer Assurance Program	The primary focus of this program is revenue protection. Under it, employees screen, verify, and stop refunds reported on questionable or potentially fraudulent returns; for example, returns filed by prisoners or identity thieves.
Calendar Year	The 12-consecutive-month period ending on December 31.
Electronic Fraud Detection System	A stand-alone automated system that detects reliable indicators of potential taxpayer fraud at the time individual tax returns are filed. It also provides employees with tools needed to perform pre-refund detection activities, <i>e.g.</i> , screening returns and verifying income and withholding information, and to stop the issuance of refunds for potentially fraudulent tax returns.
Entity	The portion of the Master File record that identifies the taxpayer. It contains the name, address, and Social Security Number or Employer Identification Number.
Filing Season	The period from January through mid-April when most individual income tax returns are filed.
Individual Master File (Master File)	The IRS database that maintains transactions or records of individual tax accounts.
Integrated Data Retrieval System	IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.
Internal Revenue Manual	A document containing the policies and procedural guidance for IRS operations.
Notice Review Program	A program that helps ensure taxpayers receive complete and correct information from the IRS and do not receive an erroneous refund. Under this program, notices are selected and reviewed with the goal of improving both the accuracy and quality of information sent to taxpayers.



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Term	Definition
Pre-Refund Program	A program that provides coordination of pre-refund compliance activities to ensure timely issuance of refunds and credits that are legally due to filers, while preventing issuance of refunds and credits that are not legally due to filers. A return is said to be pre-refund if the refund can be stopped, has been stopped, or has been offset to another obligation.
Processing Year	The calendar year in which the tax return or document is processed by the IRS.
Tax Module	A specific year and type of return within a taxpayer's account; all tax modules combined comprise a taxpayer's account.
Underreporter	The Automated Underreporter Program matches items reported on an individual's income tax return to information supplied to the IRS from outside sources (such as from employers, banks, and credit unions) to determine if the taxpayer's tax return reflected the correct amounts.