



*Income and Withholding Verification
Processes Are Resulting in the Issuance of
Potentially Fraudulent Tax Refunds*

August 7, 2013

Reference Number: 2013-40-083

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:

2 = Risk Circumvention of Agency Regulation or Statute

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HIGHLIGHTS

INCOME AND WITHHOLDING VERIFICATION PROCESSES ARE RESULTING IN THE ISSUANCE OF POTENTIALLY FRAUDULENT TAX REFUNDS

Highlights

Final Report issued on August 7, 2013

Highlights of Reference Number: 2013-40-083 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

A common characteristic of fraudulent tax returns is that the income and withholding reported on the tax return is false. The Electronic Fraud Detection System (EFDS) is the IRS's primary tool used to identify potentially fraudulent tax returns at the time they are processed. Ineffective income and withholding verification processes are resulting in the issuance of potentially fraudulent tax refunds.

WHY TIGTA DID THE AUDIT

For Processing Year 2013, as of April 3, 2013, the IRS reported that, through its income and withholding verification processes, it prevented the issuance of almost \$1.2 billion in fraudulent tax refunds. The overall objective of this review was to assess the effectiveness of the EFDS in identifying tax returns which report false income and withholding.

WHAT TIGTA FOUND

IRS access to third-party income and withholding information is not available until well after the tax return filing season begins and tax returns are processed.

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In July 2012, TIGTA reported that analysis of Tax Year 2010 tax returns identified almost 1.5 million tax returns that were not detected by the IRS as potentially fraudulent despite having

the same characteristics as IRS confirmed identity theft fraudulent tax returns. Analysis of the 1.5 million undetected tax returns identified that only 120,197 (8 percent) received a fraud score high enough to be sent for verification.

Our review of a random sample of 272 of the 120,197 tax returns found that ****2*****
*****2*****
*****2***** In some of the cases, fraudulent refundable credits were issued because the IRS does not have the authority to prevent the issuance of the credits. In Fiscal Year 2012, the IRS requested expanded math error authority to deny the issuance of refundable credits when *****2*****
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In addition, some of the potentially fraudulent tax refunds were issued because *****2*****
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In certain instances, the documentation was not sufficient to determine actions taken by examiners performing the verifications.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS ensure that actions are taken to prevent the issuance of potentially fraudulent refunds when tax returns are not timely screened and verified and ensure that case actions are sufficiently documented. In addition, procedures should be revised to ensure that when tax returns identified as potentially fraudulent are also assigned to another IRS function, the tax refunds are held until the tax return is screened and verified.

In their response to the report, IRS officials stated that they agreed with our recommendations and have implemented actions to extend tax account freezes to prevent the release of potentially fraudulent tax refunds. They plan to reemphasize documentation requirements of case actions and revise instructions for Tax Examiners to require positive verification that an issue triggering an error code or referral has been addressed.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 7, 2013

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

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

SUBJECT: Final Audit Report – Income and Withholding Verification Processes
Are Resulting in the Issuance of Potentially Fraudulent Tax Refunds
(Audit # 201240021)

This report presents the results of our review to assess the effectiveness of the Electronic Fraud Detection System in identifying tax returns reporting false income and withholding. This audit was included in our Fiscal Year 2012 Annual Audit Plan and addresses the major management challenge of Fraudulent Claims and Improper Payments.

Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Russell P. Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services).



Income and Withholding Verification Processes Are Resulting in the Issuance of Potentially Fraudulent Tax Refunds

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Abbreviations

EFDS	Electronic Fraud Detection System
e-filed	Electronically filed
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration



Income and Withholding Verification Processes Are Resulting in the Issuance of Potentially Fraudulent Tax Refunds

Background

The Electronic Fraud Detection System (EFDS) is the nationwide system the Internal Revenue Service (IRS) uses to identify the potentially fraudulent paper and electronically filed (e-filed) tax returns. During tax return processing, paper and e-filed tax returns are analyzed through various EFDS data model formulas. The data models identify suspicious paper and e-filed tax returns based on specific characteristics of the tax return. An associated score is computed for each tax return. The higher the score, the greater the likelihood that the tax return is fraudulent.

The Electronic Fraud Detection System is the primary tool used to identify potentially fraudulent tax returns at the time they are processed.

Prior to the start of each filing season,¹ the IRS works with a contractor to develop the various data model formulas used by the EFDS to score tax returns for fraud potential. *****2*****

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*****2*****. The IRS and the contractor evaluate the data models each year in an attempt to minimize the number of tax returns screened by tax examiners with no fraud while maximizing the detection rate² in order to most effectively employ resources.

Tax examiners in the Integrity and Verification Operations screen and verify tax returns for fraud potential

Once a questionable tax return is identified by the EFDS, processing is delayed for one or two weeks and the tax return is placed in inventory for tax examiner screening and/or verification. The IRS’s Integrity and Verification Operations, part of the Wage and Investment Division’s Return Integrity and Correspondence Services organization, is where potentially fraudulent tax returns are screened and/or verified.

- **Screening** – A tax examiner reviews the tax return for income and withholding information, including comparing the information reported on the current tax year return to previous tax year returns to identify inconsistencies. If the tax examiner concludes that the tax return is potentially fraudulent, the tax return is sent for verification and a refund hold is placed on the individual’s tax account for 11 weeks to prevent the issuance of any refund.

¹ The period from January 1 through mid-April when most individual income tax returns are filed.

² Detection rate measures the percentage of known fraudulent tax returns scanned that are actually flagged by the EFDS model.



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- Verification** – A tax examiner attempts to contact employers to confirm wages and withholding reported on any Form W-2, *Wage and Tax Statement*, or Form 1099-MISC, *Miscellaneous Income*, associated with the potentially fraudulent tax return. ****2****
 *****2*****the refund is frozen to prevent it from being issued. The tax examiner will then send a letter to the individual listed on the tax return*****2*****
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In Processing Year³ 2013, through April 3, 2013, the Integrity and Verification Operations prevented the issuance of almost \$1.2 billion in fraudulent tax refunds. Figure 1 provides the number of fraudulent tax returns identified and the associated tax refunds prevented from being issued during Processing Years 2010 through 2013.

Figure 1: Integrity and Verification Operations Comparative Results for Processing Years 2010–2013

Processing Year	Tax Returns Verified As False	Fraudulent Tax Refunds Prevented
2010	250,824	\$1,449,223,808
2011	396,742	\$2,571,545,948
2012	749,540	\$4,651,018,529
2013 ⁴	96,783	\$1,156,326,468

Source: IRS fraudulent tax return statistics for Processing Years 2010–2013.

The Return Review Program will replace the EFDS

The IRS is developing a new system, the Return Review Program, to replace the EFDS. This new system is expected to enhance the IRS’s ability to detect, resolve, and prevent criminal and civil tax noncompliance. The IRS determined that the EFDS, which was implemented in 1994, is outdated and would be inefficient to maintain, upgrade, or operate beyond calendar year 2015. The IRS expects that the new system will be phased in beginning in January 2015.

³ The calendar year in which the tax return or document is processed by the IRS.

⁴ Results are through April 3, 2013.



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This review was performed at the IRS Wage and Investment Division's Return Integrity and Correspondence Services organization in Atlanta, Georgia, the Submission Processing Site in Austin, Texas, and the Information Technology Division in Lanham, Maryland, during the period April 2012 through March 2013. 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.



Income and Withholding Verification Processes Are Resulting in the Issuance of Potentially Fraudulent Tax Refunds

Results of Review

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In July 2012, the Treasury Inspector General for Tax Administration (TIGTA) reported that its analysis of Tax Year 2010 returns identified almost 1.5 million tax returns that were not detected by the IRS as potentially fraudulent.⁵ These tax returns were not detected despite having the same characteristics as IRS confirmed identity theft fraudulent tax returns. These undetected tax returns have potential fraudulent tax refunds totaling in excess of \$5.2 billion.⁶ The common characteristic of these tax returns was that the income and withholding reported on the tax returns were false. Generally, the perpetrators reported fabricated income to maximize credits and increase the amount of the fraudulent tax refunds.

TIGTA has reported and testified before Congress that access to the current year third-party income and withholding information at the time tax returns are processed is the single most important tool that the IRS needs to identify and prevent tax refund fraud. However, most current year third-party information is not available until well after the tax return filing season begins and tax returns are processed. Legislation would be needed for any changes to the filing deadlines for information returns. The deadline for filing most information returns with the IRS is March 31, yet taxpayers can begin filing their tax returns as early as mid-January each year.

Our current review showed that without the third-party income and withholding information, the EFDS scores tax returns for fraud potential based primarily on tax return characteristics ***2**
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*****2*****. This is evident in our analysis of the 1.5 million tax returns identified in our prior review:

- 92 percent⁸ – almost 1.4 million tax returns did not receive an EFDS score high enough to be selected for screening and/or verification. In fact, 336,242 of the almost 1.4 million

⁵ TIGTA, Ref. No. 2012-42-080, *There Are Billions of Dollars in Undetected Tax Refund Fraud Resulting From Identity Theft* (Jul. 2012).

⁶ Based on the data available, we were unable to distinguish between tax returns filed by an identity thief claiming false income and withholding and those filed by the taxpayers themselves claiming false income and withholding.

⁷ Gross income minus certain expenses and deductions.

⁸ Percentages are based on the actual number of 1,369,798 tax returns that did not receive an EFDS score high enough to be selected for screening.



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tax returns received an EFDS score of zero, indicating that the tax return is likely not fraudulent. The low EFDS fraud score is despite the fact that income reported could not be matched to third-party income and withholding documents received by the IRS, because no employers reported wages or withholdings for these individuals.

The IRS continues to expand on the characteristics it uses to score and identify fraudulent tax returns when they are processed. For example, to better identify tax returns involving identity theft, the IRS has developed filters that incorporate criteria based on characteristics of confirmed identity theft tax returns, *****2*****. In Processing Year 2012, 11 filters⁹ were developed to better identify potential identity theft tax returns. The number of filters increased to more than 80 for Processing Year 2013. We are conducting a separate review¹⁰ to assess whether the improved filters are resulting in a reduction in the number of undetected, potentially fraudulent tax returns from what we identified in our July 2012 report.

In addition, in response to our July 2012 audit report, IRS management agreed to work with the Department of the Treasury to elevate the need for authority to expand its use of the National Directory of New Hires database.¹¹ *****2*****

- 8 percent – 120,197 tax returns received an EFDS score high enough to be sent for verification. However, we found that ineffective verification processes resulted in the issuance of the potentially fraudulent tax refunds associated with these tax returns.

Ineffective Income and Withholding Verification Processes Are Resulting in the Issuance of Potentially Fraudulent Tax Refunds

Our review of a random sample of 272 of the 120,197 tax returns for which tax refunds were issued even though the returns received a high EFDS score (indicating a high likelihood that the tax returns are fraudulent) showed that the income and withholding verification process is not always effective in stopping the issuance of fraudulent refunds. Fraudulent refundable credits *****2*****

⁹ These were filters that were implemented prior to April 15, 2012.
¹⁰ TIGTA, Audit No. 201240044, *Effectiveness of the Internal Revenue Service’s Efforts to Identify and Prevent Fraudulent Tax Refunds Resulting From Identity Theft (Follow-Up)*.
¹¹ A database that contains information on all newly hired employees. The data include the six basic elements on Form W-4, *Employee’s Withholding Certificate*, for newly hired employees: employee’s name, address, and Social Security Number, as well as the employer’s name, address, and Federal Employer Identification Number. The National Directory of New Hires database also includes quarterly wage information for individual employees provided by State Workforce agencies and Federal agencies, and unemployment information for individuals who have received or applied for unemployment benefits.



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*****¹²*****2*****
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*****2***** In addition, we found that documentation was not always sufficient to determine actions taken by examiners performing the verifications.

Our review of the 272 tax returns identified:

- 131 tax returns (48 percent) had claims totaling \$51,898 for the Making Work Pay Credit¹³ which were allowed and refunds issued even though tax examiners confirmed that the *****2*****
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- 104 tax returns (38 percent) with refunds totaling \$613,929 were not worked timely—examiners confirmed that 96 tax returns had false income and withholding, but actions to prevent the issuance of the fraudulent refunds were not taken timely. The remaining eight tax returns were not screened within the required time period to prevent the issuance of a refund.

Once a tax return is identified for screening, there is a two-week window to determine if the tax return should be sent to a tax examiner for verification. If verification is needed, an 11-week refund hold is placed on the account to allow time to complete the verification. If no action is taken to either extend the refund hold or place a permanent hold on the account, the refund is systemically released. The IRS explained that a limit in the number of refund hold transactions that could be manually processed each day prevented permanent holds from being placed on accounts in time to prevent the automatic release of the refunds. The IRS indicated that changes were made in January 2013 to stop the automatic release of refunds for tax returns with confirmed false income and withholding.

- 20 tax returns (7 percent) with refunds totaling \$92,202 had processing problems (computational errors, Earned Income Tax Credit qualification concerns, excess withholding claims, etc.) in addition to a high score indicating the tax return was likely

¹² Refundable credits can result in refunds even if no income tax is withheld or paid when the credits exceed the tax liability.

¹³ In Tax Year 2010, individuals with *earned income* were allowed to claim the Making Work Pay Credit equal to 6.2 percent of earned income, up to \$400.

¹⁴ Statutory Notice of Deficiency Procedures require the IRS, subsequent to the release of the refund, to formally notify the individual by certified or registered mail of the deficiency, giving the taxpayer the opportunity to appeal the determination before an assessment is made.



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fraudulent. Processing issues are addressed by other IRS functions outside of the Integrity and Verification Operations. *****2*****
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However, the guidelines do not specify whether the function addressing the processing issues should perform the verification. As a result, the refunds associated with these tax returns were released.

- 9 tax returns (3 percent) with refunds totaling \$39,022 were confirmed to have false income and withholding, and tax examiners stopped the refunds from being issued.¹⁵
- 5 tax returns (2 percent) with refunds totaling \$18,075 did not have sufficient information in the case files for us to determine whether required actions were taken by the tax examiner to verify the income and withholding claimed on the tax returns. Tax examiners are required to document in the case files the actions they have taken to verify the income and withholding claimed on the tax return. Notes should include how contact with the employer was made or if the income and withholding was verified using information returns provided to the IRS.
- 3 tax returns (1 percent) with refunds totaling \$3,365 were below the refund amount criteria to be screened despite receiving an EFDS score indicating a high likelihood that the tax returns were fraudulent.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Ensure that actions are taken to prevent the issuance of potentially fraudulent refunds when tax returns are not timely screened and verified and that case notes are sufficient to support the actions tax examiners took to verify income and release the tax refunds.

Management's Response: The IRS agreed with this recommendation. Corrective actions were implemented in January 2013 to prevent transactions intended to extend systemic account freezes from resequencing. System capacity for pending transactions was increased five-fold and daily manual monitoring is performed to ensure that maximum daily limits are not exceeded. The IRS will also reemphasize the documentation requirements of case actions and will ensure through operational reviews that procedures are being followed.

¹⁵ The tax refunds associated with these tax returns were not identified as having been stopped because of timing issues with the data used in our prior analysis.



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Recommendation 2: Revise procedures to ensure that when tax returns identified as potentially fraudulent are also assigned to another IRS function to address processing issues, the tax refunds are held until the tax return is screened and verified by a tax examiner in the Integrity and Verification Operations.

Management's Response: The IRS agreed with this recommendation. The IRS will revise instructions in the Internal Revenue Manual for Tax Examiners in the Error Resolution System and Integrity and Verification Operations functions to require positive verification that the issue triggering an error code or referral has been addressed by the other function before returns are released for further processing. For prerefund referrals to other functions, accounts will be updated to prevent the account from refunding prior to resolution.

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As previously noted, 131 of the tax returns we reviewed had a total of \$51,898 in fraudulent
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*****2***** Once issued, the IRS is required to formally notify the individual by certified or registered mail of the deficiency, giving the taxpayer the opportunity to appeal the determination before an assessment is made.

We expanded our analysis of this issue to include both Tax Years 2010 and 2011 tax returns. This analysis identified 97,162 tax returns in which a tax examiner confirmed the reported income as false*****2*****

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Income and Withholding Verification Processes Are Resulting in the Issuance of Potentially Fraudulent Tax Refunds

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Tax Year	***2*** ***2***	***2*** ***2*** ***2***	*****2***** ***2*** ***2***	*****2***** ***2*** ***2***
2010	\$32,215,358	\$156,906	\$22,115	\$32,670,031
2011	N/A ¹⁶	\$3,570,803	\$61,283	\$3,673,360
Total	\$32,215,358	\$3,727,709	\$83,398	\$36,343,391

Source: TIGTA analysis of the Individual Return Transactions File and the Individual Master File.¹⁷

We brought this concern to the attention of IRS management on December 12, 2012. The IRS stated that in a Fiscal Year 2012 proposal¹⁸ to the Department of the Treasury Office of Tax Policy, they requested expanded math error authority to*****2*****
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****2***when the tax return involves identity theft because the actual taxpayer did not sign the tax return; therefore, the tax return is considered an invalid tax return. The IRS is not required to process invalid tax returns.

The IRS is continuing to seek the authority*****2*****
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*****2*****. Tax examiners assigned to this program review tax returns identified through the data analytics scoring models. The tax examiners correspond with the taxpayer to request documentation supporting the claim for the refundable credit before the refundable credit is released. If the appropriate documentation is not received,*****2*****
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The reduction of improper payments is a priority of both the President and Congress. TIGTA and the Government Accountability Office have recommended the increased use of preventive controls, stressing the importance of identifying questionable refundable credits prior to the

¹⁶ *****2*****.

¹⁷ The IRS database that maintains transactions or records of individual tax accounts.

¹⁸ Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals* (Feb. 2012).

¹⁹ This proposal is still open but has not been acted upon.



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issuance of the refund. Once fraudulently claimed refundable credits are issued, it is highly unlikely the IRS will be able to recover the funds.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to assess the effectiveness of the EFDS at identifying tax returns reporting false income and withholding. To accomplish our objective, we:

- I. Assessed the effectiveness of the EFDS data models in identifying potentially fraudulent tax returns by obtaining background information and programming details on these models. We determined the process for creating the data models and setting the tolerance levels for the models.
- II. Electronically analyzed the population of approximately 1.5 million potentially fraudulent tax returns identified in a prior TIGTA audit¹ to determine if the tax returns were scored by the EFDS and selected for screening and/or verification.
 - A. We did not perform additional data validation steps of the data from the previous TIGTA audit. We relied on that audit team's validation. We were able to validate limited information we received from the EFDS to the Integrated Data Retrieval System² during the review of the sample of 272 tax returns selected in Step II.C. Based on this validation, we determined that the data were reliable.
 - B. Electronically identified the Processing Year³ 2011 EFDS score for each of the approximately 1.5 million tax returns to determine if each of the 1.5 million tax returns received an EFDS score.
 - C. Determined if tax examiners correctly screened the income claimed on the tax returns by identifying tax returns selected for Integrity and Verification Operations screening and selecting a random sample of 272⁴ of the population of 120,197 tax returns meeting the criteria to be screened by a tax examiner. We researched the Integrated Data Retrieval System to *****2*****.

¹ TIGTA, Ref. No. 2012-42-080, *There Are Billions of Dollars in Undetected Tax Refund Fraud Resulting From Identity Theft* (Jul. 2012).

² IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

³ The calendar year in which the tax return or document is processed by the IRS.

⁴ We selected a random sample because we were not projecting the results to the population.



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III. Identified 644,082 Tax Year⁵ 2010 individual tax returns from the Individual Master File⁶ that were identified for the Integrity and Verification Operations screening process and
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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: the internal controls prescribed by the IRS’s Internal Revenue Manual that are used by the Integrity and Verification Operations to confirm fraudulent tax returns. We evaluated those internal controls by interviewing management and reviewing policies and procedures. We also conducted tests of IRS procedures to ensure that fraudulent tax returns were being identified.

⁵ The 12-month period for which tax is calculated. For most individual taxpayers, the tax year is synonymous with the calendar year.
⁶ The IRS database that maintains transactions or records of individual tax accounts.



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Appendix II

Major Contributors to This Report

Augusta R. Cook, Acting Assistant Inspector General for Audit (Returns Processing and Account Services)

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Deann L. Baiza, Acting Director

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Karen C. Fulte, Lead Auditor

Kyle D. Bambrough, Senior Auditor

Ngan B. Tang, Auditor

Linda M. Valentine, Auditor



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Appendix III

Report Distribution List

Acting Commissioner
Office of the Commissioner – Attn: Chief of Staff C
Office of the Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Services and Operations, Wage and Investment Division SE:W
Associate Chief Information Officer, Applications Development OS:CTO:AD
Director, Return Integrity and Correspondence Services, Wage and Investment Division
SE:W:RICS
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM
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, Wage and Investment Division
SE:W:S:PEI



Income and Withholding Verification Processes Are Resulting in the Issuance of Potentially Fraudulent Tax Refunds

Appendix IV

Outcome Measure

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

Type and Value of Outcome Measure:

Cost Savings (Funds Put to Better Use) – Potential; approximately \$2.9 million from 11,247 tax returns *****2*****
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Methodology Used to Measure the Reported Benefit:

We conducted computer analysis of the Tax Years 2010 and 2011 Individual Master File¹ to identify tax returns that *****2*****
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*****2*****. We identified 742 Tax Year 2010 tax returns that received \$350,241 in refunds, and we identified 10,505 Tax Year 2011 tax returns that received \$2,576,606 in refunds.

We did not include \$31,797,183 for 80,141 tax returns claiming the Making Work Pay Credit because it expired after Tax Year 2010. We also eliminated \$522,606 in refundable credits for 1,113 tax returns that were claimed as outcomes in a prior TIGTA report (TIGTA, Ref. No. 2012-42-080, *There Are Billions of Dollars in Undetected Tax Refund Fraud Resulting From Identity Theft* (Jul. 2012)). We also eliminated \$1,096,755 in refundable credits for 4,661 tax returns identified from a current TIGTA audit (TIGTA, Audit No. 201240044, *Effectiveness of the Internal Revenue Service’s Efforts to Identify and Prevent Fraudulent Tax Refunds Resulting From Identity Theft (Follow-Up)*).

¹ The IRS database that maintains transactions or records of individual tax accounts.



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Appendix V

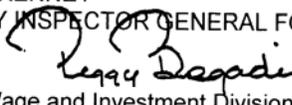
Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

July 18, 2013

MEMORANDUM FOR MICHAEL E. MCKENNEY
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Peggy Bogadi 
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Income and Withholding Verification Processes Are Resulting in the Issuance of Potentially Fraudulent Tax Refunds (Audit # 201240021)

Thank you for the opportunity to review the subject draft report. The report accurately describes the challenges the IRS faces in processing returns prior to the availability of third-party data. The report is based on Tax Year 2010 returns that were received and processed during Calendar Year 2011. In the two years since those returns were received and processed, the IRS has identified and changed processes where controls needed to be improved and new approaches taken to more effectively address the threats posed by unscrupulous individuals filing fraudulent claims for refund. It is important to note that the volume of fraudulent tax returns described by Figure 1 reflects the results of only one of the data models used by the Electronic Fraud Detection System (EFDS). When all EFDS data models are considered through May 25, 2013, the Integrity and Verification Operations function screened and stopped over 660,000 fraudulent returns with associated refunds of \$4.2 billion. Moreover, looking across all IRS activities in this area, in the first five months of calendar year 2013, we stopped over one million fraudulent refunds valued at more than six billion dollars.

The Treasury Inspector General for Tax Administration reports that almost 1.4 million returns did not receive an EFDS score high enough to be selected for screening or verification. However, potentially fraudulent returns identified by EFDS are subject to additional screening and verification activities that require manual review by Tax Examiners. The EFDS scores are used to determine which returns present the greatest risk of loss to the government and to ensure limited resources are used most effectively in providing additional levels of review and scrutiny. Another factor TIGTA noted was that some returns received an EFDS score of zero. We found that an upstream processing system was sending returns to EFDS for analysis and scoring in batch files that were incompatible with the format EFDS required; consequently, some returns



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were not scored. We have since implemented additional controls and balancing reports that ensure all returns sent to EFDS for scoring are processed.

As the report notes*****2*****

adjustment. Instead, these credits must be denied under deficiency procedures. Deficiency procedures permit taxpayers to challenge the proposed denial and provide additional information in support of their claim. In 2012*****2***** was launched. *****2*****
*****2*****
*****2***** may be addressed before refunds are issued. The AQC provides taxpayers notice of the questioned deductions or credits and preserves all taxpayer rights and protections afforded by the deficiency process.

Attached are our comments on your recommendations. If you have any questions, please contact me, or a member of your staff may contact Jodi L. Patterson, Director, Return Integrity and Correspondence Services, Wage and Investment Division, at (404) 338-9042.

Attachment



*Income and Withholding Verification Processes Are Resulting in
the Issuance of Potentially Fraudulent Tax Refunds*

Attachment

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1

Ensure actions are taken to prevent the issuance of potentially fraudulent refunds when tax returns are not timely screened and verified and that case notes are sufficient to support the actions tax examiners took to verify income and release the tax refunds.

CORRECTIVE ACTION

Corrective actions were implemented in January 2013 to prevent transactions intended to extend systemic account freezes from resequencing. System capacity for pending transactions was increased five-fold and daily manual monitoring is performed to ensure maximum daily limits are not exceeded. We will also re-emphasize the documentation requirements of case actions and will ensure through operational reviews that procedures are being followed.

IMPLEMENTATION DATE

Documentation of Operational Review requirements - January 15, 2014

RESPONSIBLE OFFICIAL

Director, Return Integrity and Correspondence Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

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

Recommendation 2

Revise procedures to ensure that when tax returns identified as potentially fraudulent are also assigned to another IRS function to address processing issues, the tax refunds are held until the tax return is screened and verified by a tax examiner in the Integrity and Verification Operations.

CORRECTIVE ACTION

We will revise instructions in the Internal Revenue Manual for Tax Examiners in the Error Resolution System and Integrity and Verification Operations functions, to require positive verification that the issue triggering an error code or referral has been addressed by the other function before returns are released for further processing. For pre-refund referrals to other functions, accounts will be updated to prevent the account from refunding prior to resolution.

IMPLEMENTATION DATE

January 15, 2014



*Income and Withholding Verification Processes Are Resulting in
the Issuance of Potentially Fraudulent Tax Refunds*

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RESPONSIBLE OFFICIAL

Director, Return Integrity and Correspondence Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

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