



*Further Actions Are Needed to Resolve  
Millions of Dollars of Frozen Credits  
in Taxpayer Accounts*

**September 26, 2014**

**Reference Number: 2014-30-089**

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

**Redaction Legend:**

1 = Tax Return/Return Information

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## HIGHLIGHTS

### **FURTHER ACTIONS ARE NEEDED TO RESOLVE MILLIONS OF DOLLARS OF FROZEN CREDITS IN TAXPAYER ACCOUNTS**

## Highlights

**Final Report issued on  
September 26, 2014**

Highlights of Reference Number: 2014-30-089 to the Internal Revenue Service Commissioners for the Small Business/Self-Employed and the Wage and Investment Divisions.

### **IMPACT ON TAXPAYERS**

The IRS's computer system uses coding to identify situations that either require special handling by the IRS or for which the IRS is awaiting the outcome of a future event. These situations are commonly referred to as freeze conditions. Taxpayer accounts in "credit" status (payments exceeding assessments) and also coded with at least one freeze condition are commonly referred to as frozen credit accounts. If freeze conditions are not adequately identified and resolved, IRS processing of taxpayer frozen credit accounts can be delayed and taxpayers can be adversely affected by delayed refunds or payments not applied to the proper tax modules.

### **WHY TIGTA DID THE AUDIT**

This audit was initiated to determine what actions the IRS has taken to resolve both individual and business taxpayer accounts with certain frozen credits. The review is part of TIGTA's planned Fiscal Year 2014 audit coverage and addresses the major management challenge of Tax Compliance Initiatives.

### **WHAT TIGTA FOUND**

The IRS has procedural requirements and standardized systemic checks in place to identify and resolve most frozen credit accounts. In addition, the IRS has conducted research projects to identify ways to improve the processing of frozen credit accounts.

However, TIGTA found that further actions are needed to resolve some accounts with frozen

credit conditions. TIGTA also found that some IRS computer systems need modifications to better reflect current procedures.

TIGTA reviewed samples of three frozen credit conditions: (1) no returns with satisfying transactions, (2) advance payments for audit adjustments, and (3) taxpayers in bankruptcy. TIGTA identified 156 individual tax modules with credits of \$46.4 million and 128 business tax modules with credits of almost \$1.6 billion for which the IRS did not take actions that could have resolved the credit tax modules sooner.

### **WHAT TIGTA RECOMMENDED**

TIGTA made 10 recommendations including that the IRS reemphasize existing procedures for processing freeze conditions, establish and enforce new procedures for processing some freeze conditions, and make improvements to computer systems to more accurately reflect current procedures.

In response to the report, IRS management agreed with nine of the 10 recommendations and plans to take appropriate corrective actions. However, IRS management stated that, due to resource constraints, they will not take corrective actions for two agreed recommendations related to improving computer systems. For the one disagreed recommendation, IRS management believes the current process will ensure that credits are properly resolved within the Offshore Voluntary Disclosure Program. TIGTA continues to believe that the IRS remains at risk for not resolving frozen credits in taxpayer accounts by not implementing all of the recommendations.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

September 26, 2014

**MEMORANDUM FOR** COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION  
COMMISSIONER, WAGE AND INVESTMENT DIVISION

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

**SUBJECT:** Final Audit Report – Further Actions Are Needed to Resolve  
Millions of Dollars of Frozen Credits in Taxpayer Accounts  
(Audit # 201230025)

This report presents the results of our review to determine what actions the Internal Revenue Service has taken to resolve both individual and business taxpayer accounts with certain frozen credits. This audit is included in our Fiscal Year 2014 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

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

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have questions, please contact me or Bryce Kisler, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations).



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## *Abbreviations*

AUR	Automated Underreporter
BMF	Business Master File
CFf	Collection Field Function
FY	Fiscal Year
IMF	Individual Master File
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
ITAC	Individual Taxpayer Account Cleanup
LTS	Litigation Transcript System
TIGTA	Treasury Inspector General for Tax Administration



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## *Background*

The Internal Revenue Service's (IRS) Master File computer system uses coding to identify special situations, commonly referred to as freeze conditions.<sup>1</sup> This term can be misleading because the term "freeze" does not necessarily indicate that a taxpayer's account or tax module is completely or permanently frozen from IRS activity, but rather it identifies a condition that either requires special handling by the IRS or for which the IRS is awaiting the outcome of a future event before returning to normal processing (*e.g.*, the IRS needs to post an additional assessment or the taxpayer is in bankruptcy proceedings). However, if freeze conditions are not adequately identified and resolved, IRS processing actions such as assessments, abatements, refunds, credit offsets, status updates for compliance activity, issuance of notices, and/or suspension of statutes can be adversely affected.

There are more than 60 freeze conditions that may apply to a taxpayer's tax module within the Business Master File (BMF) or the Individual Master File (IMF). Tax modules in credit status (payments exceeding assessments) and also coded with at least one freeze condition are commonly referred to as frozen credits. At the end of Fiscal Year (FY) 2012, there were more than 10.1 million tax modules with frozen credits totaling approximately \$883 billion on the BMF. For the IMF, there were more than 15.2 million tax modules with approximately \$305 billion in frozen credits for the same time period. At the end of FY 2013, the BMF had increased to more than 10.2 million tax modules with approximately \$977 billion in frozen credits, while the IMF had increased to more than 15.6 million tax modules with approximately \$392 billion in frozen credits.

Most credits are frozen for just a few months. For the BMF tax modules with frozen credits at the end of FY 2012, approximately 8.6 million tax modules with more than \$736 billion in credits had been frozen for six months or less. Similarly, for the IMF tax modules with frozen credits at the end of FY 2012, approximately 13 million tax modules with more than \$293 billion in credits had been frozen for six months or less. However, not all frozen credits can be resolved by the IRS within a given period of time. For example, the IRS must wait for a court determination before it can remove a bankruptcy freeze condition. In addition, some frozen credits may never be resolved, such as when an overdue return is not provided by the taxpayer and the IRS is waiting to apply a credit (*e.g.*, estimated tax payments) previously provided by the taxpayer. If the return is not received, the IRS will eventually close the frozen credit tax module by moving the credit to the Excess Collections File, which restricts potential refunds from being given to taxpayers due to the refund statute of limitations.

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<sup>1</sup> See Appendix VI for a glossary of terms.



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Due to the large number of possible frozen credit conditions, we limited our review to frozen credits involving the three freeze conditions described below, which apply to both BMF and IMF tax modules.

1. ***No Return With Satisfying Transaction:*** This freeze condition indicates that the IRS has suspended enforcement action for securing a return that was not filed by the taxpayer. The reason for suspending enforcement action, commonly called a satisfying transaction, is one of the following IRS determinations: (1) the taxpayer was not liable; (2) the taxpayer owes little or no tax; (3) the IRS was not able to locate or contact the taxpayer; (4) the return was previously filed using a different account; (5) the issue was referred to another compliance function for consideration; (6) IRS resources are not available at this time to pursue the case; or (7) a return has been secured that is being processed. If the tax module has a credit balance, this freeze will systemically prevent refunding or transferring the credit to another account until the occurrence of one of the following events: (1) a return is posted to the tax module; (2) the tax module is reactivated for enforcement action; (3) a payment correction is made to the tax module; or (4) sufficient time has elapsed after the expiration of the refund statute of limitations and the credit is systemically moved to the Excess Collections File.
2. ***Advance Payment for Audit Adjustment:*** This freeze condition indicates that the taxpayer made a payment before a proposed additional assessment was applied to the account. This can be a timing issue between receiving payments from the taxpayer and the posting of assessments by the IRS; however, some taxpayers may do this to stop or minimize the amount of interest to be paid on a proposed assessment and/or may be planning to challenge the proposed assessment in future litigation. This freeze will systemically prevent refunding or transferring the advance payment credit to another account until the proposed assessment is posted or, if necessary, a litigation determination is made to the account.
3. ***Taxpayer in Bankruptcy:*** This freeze condition indicates that the taxpayer has filed a petition for bankruptcy, causing the IRS to suspend enforcement actions, with some exceptions, until the bankruptcy court decides to dismiss the case or issue a discharge. If the court dismisses the case, the account is returned to prebankruptcy status subject to accrued interest and penalties; if the court issues a discharge, the account is updated based on the court order. The Bankruptcy Code, not the Internal Revenue Code, is the prevailing authority when a taxpayer files for bankruptcy. For tax modules with credit balances, this will systemically prevent refunding or transferring the credit to another account until the bankruptcy case is concluded or, if necessary, a correction is made to the tax module that is allowed by the Bankruptcy Code.

This review was performed with information obtained from Criminal Investigation, the Large Business and International Division, the Office of Appeals, the Office of the Chief Financial



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Officer, the Office of the Chief Technology Officer, the Small Business/Self-Employed Division, and the Wage and Investment Division Headquarters in Washington, D.C., during the period July 2012 through June 2014. 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 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*

The IRS is charged with collecting the Nation's taxes while also providing quality customer service. Accurate processing of frozen credit accounts is important to ensure that the IRS is providing quality customer service. Frozen credit accounts that are not adequately identified and resolved could lead to:

- Barred assessments, collections, and refunds due to the expiration of the applicable statute of limitations.
- Unnecessary payment of additional interest to taxpayers for not timely issuing applicable refunds.
- Taxpayer burden if delayed refunds or payments not applied to the proper tax module affect the taxpayer's ability to meet financial obligations.

The IRS has procedural requirements and standardized systemic checks in place to identify and resolve most frozen credit accounts. In addition, the IRS has conducted research projects to help identify ways to improve the processing of these accounts. However, our review found that further IRS actions are still needed to resolve some frozen credit accounts. In addition, some IRS computer systems need modifications to better reflect current procedures. By improving adherence to its processing procedures and making improvements to certain computer systems, the IRS can minimize resolution delays for many frozen credit accounts.

### ***Adequate Procedures and Systems Are in Place to Identify and Resolve Most Frozen Credit Accounts***

The procedures for IRS employees to consider when working frozen credits are contained in its Internal Revenue Manual (IRM). For example, IRM 21.5.6 provides general explanations of the different freeze conditions, what factors should be present for each condition, and what actions should be taken to resolve the conditions, including whether the condition should only be worked by a specific function. Some IRM references provide required actions for a specific function to resolve a frozen credit. For example, IRM 5.9.4.4 requires employees of the Insolvency function to make a determination within 20 calendar days of credit identification to either issue a refund, offset the credit to another tax module, or retain the credit until the bankruptcy case is completed.

In addition to its procedures, the IRS has standardized systemic checks to help identify and resolve frozen credits. One such check is the Accounts Maintenance program for tax modules that do not process through the Master File system correctly or completely. This program



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identifies unresolved tax modules and generates case work, commonly referred to as transcripts, depending on certain conditions. The transcripts are given a numeric category indicator, but not all transcript categories involve tax modules in credit status. An example for a frozen credit is the AM11 transcript, which indicates a tax module with an aging credit balance caused by one or more advance payments. In general for this program, employees will research the transcripts and take corrective actions to resolve the tax modules, contact taxpayers for additional information, or wait for future events to resolve the tax modules (*e.g.*, pending additional assessments). If a tax module is currently under the control of another function, the employee may wait for the controlling function to complete its work or refer the tax module to the controlling function, depending on the circumstances. As shown in Figure 1, there were 6.5 million Accounts Maintenance transcripts generated and 5.7 million transcripts closed during FYs 2011 through 2013. Accounts Management function officials told us that receipt of Accounts Maintenance transcripts have rapidly increased due to the increase of frozen tax modules involved in a variety of IRS initiatives to identify and stop fraudulent refunds.

**Figure 1: Accounts Maintenance Transcript Inventory for FYs 2011–2013**

<b>FY</b>	<b>Beginning Inventory</b>	<b>Receipts</b>	<b>Closures</b>	<b>Ending Inventory</b>
2011	211,735	1,504,239	1,283,525	432,458
2012	432,458	2,299,379	2,190,804	541,033
2013	541,033	2,699,598	2,218,666	1,021,965
<b>TOTAL</b>		<b>6,503,216</b>	<b>5,692,995</b>	

*Source: IRS Accounts Management function.*

Another standardized systemic check that helps the IRS identify and resolve frozen credits is the Litigation Transcript System (LTS) used for bankruptcy cases. Insolvency employees will systematically receive LTS transcripts for certain events like credit balances, payments unrelated to a bankruptcy, closed cases with a current bankruptcy freeze, and potential violations of the Bankruptcy Code. Insolvency employees will research the case by considering the reason for the LTS transcript and record any actions taken in the case history. This automated program allows Insolvency employees to manage their bankruptcy inventories based on cases needing action rather than on periodic general reviews of all cases assigned.

The IRS has also initiated research projects to help identify ways to improve the processing of frozen credits that may have been overlooked. For example, the Individual Taxpayer Account Cleanup (ITAC) pilot was conducted by the Wage and Investment Division's Customer Account Data Engine Program Office, with oversight from the Office of the Chief Financial Officer. This research project reviewed samples of debit, credit, and zero balance tax modules on the IMF with freeze conditions that would be beneficial to resolve before moving the tax modules to the



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Customer Account Data Engine computer system. The July 2010 ITAC report made seven recommendations and estimated that 559,000 tax modules should be “cleaned up,” representing 27,000 debit tax modules with \$460 million in uncollected revenue, 426,000 credit tax modules with \$1.3 billion in frozen credits, and 106,000 zero balance tax modules.

One ITAC recommendation was to establish a “Tiger Team” to study the effectiveness of using internal IRS transcripts to address unresolved tax module conditions. The ITAC Tiger Team consisted of representatives from several IRS operating divisions with the goal of determining root causes that, when corrected, would place frozen accounts accurately back into the compliance process, provide refunds to taxpayers in a more timely and efficient manner, reduce the transcript backlog, and potentially eliminate obsolete transcripts to free up valuable resources. This research team sampled frozen transcript categories and provided procedural, training, and systemic computer recommendations in a December 2011 report.

Other ITAC recommendations have been implemented or are in process to create permanent ownership for overseeing the ITAC effort, correct inconsistencies and inaccuracies with reports, provide each functional area with lists to address unresolved tax module conditions, and explore ways to systemically remove unresolvable tax modules from work processes. In addition, further research is being conducted to find ways to improve processes for working unresolved tax modules, including accounts on the BMF.

### ***Further Actions Are Needed to Resolve Some Accounts With Frozen Credit Conditions***

Results of our samples of tax modules with frozen credit conditions identified that IRS actions could have resolved 156 IMF tax modules with frozen credits of about \$46.4 million and 128 BMF tax modules with frozen credits of almost \$1.6 billion. Although there are procedures and systems in place to identify and resolve frozen credits, the IRS did not always take actions that could have resolved tax modules sooner. The IRS needs to improve adherence to some procedural requirements and make systemic improvements to minimize resolution delays for some frozen credits. Using copies of the IRS’s frozen credit data files for the IMF and BMF as of September 20, 2012, we reviewed samples of three specific frozen credit conditions:

(1) *no return with satisfying transaction*, (2) *advance payment for audit adjustment*, and (3) *taxpayer in bankruptcy*. The frozen credit data file is a listing of all credit tax modules with a freeze condition and includes age coding for the amount of time in the frozen status. If a tax module has more than one freeze condition, it is assigned to the most relevant condition based on an established hierarchy.



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We selected stratified random samples of IMF and BMF tax modules for each of the three frozen credit types based on the age of the freeze and amount of the credit. Figure 2 shows the overall populations and sample sizes we selected by frozen credit condition.<sup>2</sup>

**Figure 2: Overall Populations and Sample Sizes by Frozen Credit Condition**

Frozen Credit Condition	IMF Population and Sample Size				BMF Population and Sample Size			
	Number of Tax Modules	Amount of Credits (millions)	Sampled Tax Modules	Sampled Credit Amount (millions)	Number of Tax Modules	Amount of Credits (millions)	Sampled Tax Modules	Sampled Credit Amount (millions)
No Return With Satisfying Transaction	277,226	\$1,784	169	\$133	441,246	\$26,224	228	\$15,121
Advance Payment for Audit Adjustment	255,428	\$3,554	226	\$1,325	19,604	\$12,084	203	\$9,333
Taxpayer in Bankruptcy	60,094	\$190	154	\$42	17,834	\$1,552	183	\$1,219
<b>TOTAL</b>	<b>592,748</b>	<b>\$5,528</b>	<b>549</b>	<b>\$1,500</b>	<b>478,684</b>	<b>\$39,860</b>	<b>614</b>	<b>\$25,673</b>

Source: IRS frozen credit data files for IMF and BMF accounts and Treasury Inspector General for Tax Administration (TIGTA) sample review.

The IMF and BMF sample tax modules were researched using Master File taxpayer account information as of January or February 2013. Tax modules that no longer had the frozen condition or were no longer in credit status were considered acceptable and removed from further testing. For the remaining tax modules, we requested information on case backgrounds and prior actions from the IRS to determine if the frozen credits could have been resolved sooner.<sup>3</sup> Potential exception tax modules were then discussed with the IRS.

Some frozen credits cannot be resolved by IRS action alone. For example, if the IRS contacts a taxpayer for an overdue return or for a payment explanation but the taxpayer does not respond or fully cooperate, the IRS will not have enough information to adequately determine how to proceed with the frozen credit. Our review considered only the actions under IRS control that could resolve the frozen credits and determined if established IRS procedures were followed and

<sup>2</sup> See Appendix V for summaries of the stratified populations and sample results.

<sup>3</sup> This included information obtained from Criminal Investigation, the Large Business and International Division, the Small Business/Self-Employed Division, the Wage and Investment Division, and the Office of Appeals.



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if necessary checks were in place to prevent the frozen credits from being overlooked. Figure 3 shows the sample exceptions by frozen credit condition.<sup>4</sup>

**Figure 3: Sample Exceptions by Frozen Credit Condition**

Frozen Credit Condition	IMF Exceptions		BMF Exceptions	
	Number of Tax Modules	Amount of Credits (millions)	Number of Tax Modules	Amount of Credits (millions)
No Return With Satisfying Transaction	86	\$ 31.1	84	\$ 1,279.1
Advance Payment for Audit Adjustment	34	\$ 6.6	26	\$ 305.5
Taxpayer in Bankruptcy	36	\$ 8.7	18	\$ 8.5
<b>TOTAL</b>	<b>156</b>	<b>\$ 46.4</b>	<b>128</b>	<b>\$ 1,593.1</b>

*Source: TIGTA sample review results of frozen credit IMF and BMF tax modules.*

Based on our sample reviews, we estimate that the exceptions for the total population of the three frozen credit conditions could involve 198,855 IMF tax modules with credits of approximately \$950.8 million and 306,784 BMF tax modules with credits of approximately \$3.3 billion.<sup>5</sup> Zero defects with frozen credits is an unrealistic expectation given high inventory volumes, case complexities, limited resources, and human involvement. However, we found eight common situations for which we believe the IRS needs to consider developing a new process, strengthening existing procedures, and/or implementing systemic checks in order to improve the resolution of these frozen credits. Figure 4 shows our sample tax module exceptions (by frozen credit condition) with common situations requiring IRS consideration for improvement.

<sup>4</sup> See Appendix V for summaries of the stratified populations and sample results.

<sup>5</sup> The point estimate projections are based on a two-sided 90 percent confidence interval. We are 90 percent confident that the IMF tax module point estimate is between 168,463 and 229,247; IMF credit amount point estimate is between \$727,854,696 and \$1,173,766,011; BMF tax module point estimate is between 264,869 and 348,698; and BMF credit amount point estimate is between \$2,683,029,785 and \$3,988,628,958. See Appendix V for further details on our sample projections.



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**Figure 4: Common Tax Module Exception Situations by Frozen Credit Condition**

Common Exception Situation	Frozen Credit Condition Tax Modules <sup>6</sup>							
	No Return With Satisfying Transaction		Advance Payment for Audit Adjustment		Taxpayer in Bankruptcy		Total	
	IMF	BMF	IMF	BMF	IMF	BMF	IMF	BMF
Credit Research Not Conducted and/or Recorded	**1**	75	**1**	15	0	0	65	90
Computer System Programming in Error or Inconsistent	14	37	0	5	0	0	14	42
No Action Taken When Referred for Audit Consideration	**1**	**1**	**1**	**1**	0	0	10	4
Research Transcript Not Operating As Intended	0	0	25	**1**	0	0	25	**1**
Bankruptcy Credit Determination Not Made Timely	0	0	0	0	14	9	14	9
Bankruptcy Case Closing Actions Incomplete	0	0	0	0	12	5	12	5
Decision on Possible Motion to Dismiss Bankruptcy Not Documented	0	0	0	0	6	**1**	6	**1**
Bankruptcy Payments Erroneously Refunded	0	0	0	0	3	0	3	0

Source: TIGTA sample review results of frozen credit IMF and BMF tax modules.

**Credit research was not conducted and/or recorded**

We found 155 sampled tax modules (65 IMF and 90 BMF) for which research on the credit condition was not conducted and/or recorded. IRS officials were unable to determine if credit research was conducted for each of these exceptions because some case histories were no longer available, but they confirmed that credit research was not recorded on the 155 sampled tax

<sup>6</sup> Some sampled tax modules have multiple exception reasons.





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modules. The credits were created because taxpayers made one or more payments to the tax modules (e.g., estimated payments, Federal tax deposits, or payments with extensions of time to file), but the IRS did not receive any tax returns for the related tax modules. When the IRS does not receive an expected return by the due date and there is no resolution from the notices sent by the IRS, a Taxpayer Delinquency Investigation, commonly called a nonfiler case, is created and assigned to an IRS compliance function, such as the Automated Collection System or Collection Field function (CFf). The compliance function will attempt to secure the overdue return from the taxpayer. If it is determined that (1) a return is not required, (2) a return cannot be secured, (3) the nonfiler case should be referred to another function, or (4) resources are not available to continue the nonfiler case, then the compliance function will close the nonfiler case with the appropriate reason code (commonly known as a satisfying transaction) to suspend its enforcement actions. If there is a credit balance, it will be frozen in the tax module, preventing it from being systemically refunded or transferred to another tax module. Depending on future events, the suspended nonfiler case may be reactivated for the compliance function to again attempt to secure the overdue return from the taxpayer.

However, before adding the no return with satisfying transaction condition to a tax module with a credit balance, the IRM requires the compliance function to research the credit to ensure that one or more payments were not misapplied to the tax module and to record on the tax module that this credit research took place. Not conducting and recording credit research can lead to missed opportunities to resolve frozen credits and clarify account balances earlier in the process as well as prevent future IRS resources from being used to identify misapplied payments or to address taxpayer inquiries about misapplied payments when those actions have already occurred. Furthermore, we believe there is a greater need to conduct credit research when closing credit nonfiler cases that have advance payments for audit adjustments because this payment type is generally made for potential audit results involving returns that have been filed.

In addition, we found that a systemic computer check is not operational that was intended to prevent the closing of certain nonfiler cases without credit research being recorded. The IRM states that a systemic computer check will not allow the nonfiler case to be closed unless the credit research is first recorded when closing with one of the following satisfying transactions: (1) the taxpayer was not liable, (2) the taxpayer owes little or no tax, or (3) the IRS was not able to locate or contact the taxpayer. We found 89 sampled tax modules (53 IMF and 36 BMF) with the no return with satisfying transaction frozen credit condition and nine sampled tax modules (\*\*1\*\* IMF and \*\*1\*\* IMF) with the advance payment for audit adjustment frozen credit condition for which this systemic computer check did not prevent the closing of nonfiler cases when using one of the stated satisfying transactions.

IRS Information Technology officials informed us that this systemic check is not part of the current Master File computer programming and had not been requested by the compliance functions to be implemented. Automated Collection System officials said an error message is



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displayed on the Automated Collection System as a warning during closing, but this will not prevent the closure if credit research is not conducted and recorded. We believe this systemic computer check not operating as intended gives false assurance to the IRS that credit research will be conducted and recorded before closing the nonfiler case.

**Computer system programming was in error or inconsistent**

We found 56 sampled tax modules (14 IMF and 42 BMF) for which the computer system programming affecting these modules was in error or inconsistent. These errors or inconsistencies involved Master File programming related to systemic nonfiler closures, the backup withholding indicator, and the entity combat zone indicator.

**Systemic Nonfiler Closures**

For 42 BMF sampled tax modules, we found that closures were entered for nonfiler cases after the nonfiler case had already been closed. These extra closures were consistently being entered around the beginning of each calendar year, and the coding indicated that the cases were being closed by the Automated Collection System. According to Automated Collection System and Information Technology officials, these closures were being systemically entered by Master File programming for mass systemic closings of nonfiler cases based on an operational request implemented around July 1994. However, it was not known that these closures, sometimes done year after year, were being entered on tax modules that were already closed. In addition to causing confusion about when and why a case was closed, these duplicate closures were needlessly using the Master File computer system's limited computer storage. Upon further review, Information Technology officials said they found a computer programming error that they are in the process of fixing to prevent the extra closures in the future.

**Backup Withholding Indicator**

We also found additional exceptions involving inconsistent IRS computer programming to remove older tax modules from the Master File to the Retention Register. The IRS will move older tax modules that are no longer active for operations to a retention file called the Retention Register. Tax modules must meet retention criteria before being moved but can be brought back to the Master File if later deemed necessary. We found 13 IMF sampled tax modules for which the backup withholding indicator is preventing these older tax modules from being moved to the Retention Register. The Master File computer system will not move tax modules to the Retention Register if the backup withholding indicator is turned on for the tax module. Within the Master File computer system, there is a process to turn off the indicator for nonfiler tax modules if the tax module is more than six years old. However, this was not done for the frozen credit nonfiler cases closed with a satisfying transaction we reviewed. Not turning off the indicator for nonfiler cases with a satisfying transaction, as is done with other nonfiler cases, results in tax modules remaining on the Master File unnecessarily. This could lead to frozen





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credits being mistakenly transferred to other accounts and/or mistakenly given back to the taxpayers. Information Technology officials confirmed this current programming and stated that a compliance operation's request would be required to change the programming since this is not a programming error.

**Entity Combat Zone Indicator**

In addition, we found another IRS computer programming error affecting older tax modules that should be removed from the Master File to the Retention Register. \*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*. Information Technology officials informed us that there was a discrepancy between the documentation criteria and the actual Master File computer system when considering tax modules with the entity combat zone indicator. This discrepancy has resulted in tax modules remaining on the Master File unnecessarily, which could lead to frozen credits being mistakenly transferred to other accounts and/or mistakenly given back to the taxpayers. Information Technology officials informed us that this computer programming error was resolved during our review.

**No actions were taken when cases were referred for audit consideration**

We found 14 sampled tax modules (10 IMF and four BMF) that were referred to the Examination function for audit consideration, but we could find no evidence of audits being opened or the cases being returned to the referring function. \*\*\*\*\*1\*\*\*\*\* tax module, the CFf referred the nonfiler cases to the Small Business/Self-Employed Division's Examination function for audit consideration, but no examination cases were opened and the nonfiler cases were not returned to the CFf. These tax modules are neither in the CFf nor the Examination function inventories and are not being addressed by IRS compliance actions for their nonfiling condition.

There is no procedural requirement for the CFf to monitor referrals to the Examination function. Similarly, there is also no requirement for the Examination function to report back to the CFf on referrals they received and whether an audit was opened or the referral will not be worked. We believe this lack of coordination to ensure that nonfiler referrals are appropriately addressed can result in missed opportunities to timely resolve compliance issues and could potentially lead to a loss of tax revenue.

**Systemic checks and research transcripts were not operating as intended**

The IRS has developed several systemic checks that generate transcript case work for employees to research accounts that have typical problem scenarios. However, systemic checks that do not operate as intended can result in missed opportunities to resolve frozen credits at the earliest point. If credit situations are not resolved timely and the taxpayers were due refunds, taxpayers



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would be unable to use these funds while the credits are held, and the IRS may be required to pay interest because the frozen credits were held longer than necessary. In addition, this may delay bringing taxpayers into compliance and could potentially result in the loss of revenue if the assessment is not applied and the frozen credit is mistakenly refunded to the taxpayer or transferred to another account. We found 26 sampled tax modules (\*\*1\*\* IMF and \*\*1\*\* BMF) for which the systemic check and resulting research transcript was not operating as intended.

**AM11 Transcript**

One such systemic check not operating as intended is the one that generates the AM11 transcripts, which are sent to Accounts Management employees to check on tax modules with aging credit balances caused by advance payments. For 12 sampled tax modules (\*\*1\*\* IMF and \*\*1\*\* BMF), the AM11 transcript did not generate even though the tax module appeared to meet the criteria. After discussing these cases with Accounts Management officials, they checked with the computer programmers but could not determine the reason that the transcripts did not generate because the history information for these sample cases is no longer available.

**Civil Penalties**

Another systemic check not operating as intended involves generated research transcripts for civil penalties. For nine IMF sampled tax modules, credits from advance payments for audit adjustments appeared to be waiting for civil penalty assessments and contained multiple notations that a civil penalty credit transcript was generated. According to the IRM, this transcript should be routed to the "Examination Processing Function." We were not able to locate any unit called the Examination Processing Function within the IRS, and we could not find any IRM reference for the transcript criteria or any information on how or by whom this transcript was to be worked. Information Technology officials stated that these transcripts are still being generated every 12 weeks for civil penalty accounts with a frozen credit caused by an advance payment, and the transcripts are sent to the Examination function at the campus locations. However, Examination officials explained that these transcripts are neither received nor worked by any unit within the Examination function. Not working civil penalty credit transcripts may result in the loss of revenue if the assessment is not applied and the frozen credit is mistakenly refunded to the taxpayer or transferred to another account.

**Automated Underreporter**

Some transcripts are not being used effectively to identify potential problems. \*\*\*\*1\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*



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\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*1\*\*\*\*.

**Offshore Voluntary Disclosure Program**

Some transcripts have incomplete action due to current procedures. \*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*.

**Bankruptcy credit determinations were not made timely**

The IRM requires the Insolvency function to make a determination within 20 calendar days of identification of a frozen credit to issue a refund, offset the credit by transferring it to another tax module with a balance due, or retain the credit for bankruptcy court decisions yet to be determined for the taxpayer (this requires concurrence of IRS Counsel). For 23 sampled tax modules (14 IMF and nine BMF), the Insolvency function did not make a credit determination within the required 20 calendar days. Not properly making a credit determination can result in taxpayer accounts not reflecting current balances, restrict the taxpayers' ability to use the funds, cause the IRS to pay interest because the refunds are held longer than needed, and increase taxpayer burden by requiring bankruptcy payments to be made to the IRS instead of transferring credits to other tax modules with tax due balances.

During discussions with the IRS concerning our sampled exceptions, Insolvency officials stated that they are not sure they are always being notified of IMF frozen credits. The Insolvency function relies on the LTS to produce weekly credit reports that are retained for approximately five weeks. Since May 2009, the LTS will also make systemic notations in the case history when credits appear on bankruptcy tax modules. The Insolvency caseworkers are required to document in the case history their actions in response to the LTS weekly reports and notations. Although frozen credits appeared on the 14 IMF sampled tax modules during bankruptcy processing, the associated LTS weekly reports are no longer retained by the Insolvency function and there were no systemic LTS notations in the case histories to confirm that the Insolvency caseworkers were notified that eight of these frozen credits required a credit determination.

In addition, Insolvency officials said they were not notified of BMF credits for three sampled tax modules because of LTS programming criteria. These frozen credits either involved bankruptcy tax modules that (1) the Insolvency function decided to internally close because there was no



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outstanding tax liability but later a bankruptcy payment was misapplied to the tax module or (2) involve a nonfiler tax module closed by a compliance function with a credit balance using a satisfying transaction without securing a return. We were told by Insolvency officials that the LTS does not make credit notifications for bankruptcy cases that are closed or for nonfiler satisfying transactions; however, the compliance function should still inform the Insolvency function before taking any closing action.

The Insolvency function may not have known about every frozen credit, but the IRS had the ability to identify the credits by means of the Master File taxpayer accounts. Based on our sample results, we believe that the Insolvency function should improve adherence to its existing procedural requirement to make timely credit determinations and also make systemic improvements to the LTS notification process so that frozen credits can be timely identified and addressed by Insolvency caseworkers.

### **Bankruptcy case closing actions were incomplete**

We found 17 sampled tax modules (12 IMF and five BMF) for which the Insolvency function did not complete all required actions when closing the bankruptcy case. The Insolvency function performs various closing actions on an account when a bankruptcy is completed.

#### **Bankruptcy Freeze**

One closing action is to remove the bankruptcy freeze from the account as required by the IRM. During our review, we found 11 sampled tax modules (eight IMF and three BMF) for which the Insolvency function did not remove the bankruptcy freeze during closing. Not properly removing the bankruptcy freeze prevents normal IRS processing for tax modules that could cause a loss of tax revenue due to delayed compliance action by other IRS functions, restrict the taxpayers' ability to use the funds, or cause the IRS to pay interest because refunds are held longer than necessary.

#### **Bankruptcy Payments for Nonfiler Tax Modules**

In addition, the Insolvency function did not properly complete closing actions for cases involving bankruptcy payments for nonfiler tax modules. When a taxpayer in bankruptcy has not filed an overdue return and the IRS can estimate the tax liability (called an estimated proof of claim), the IRS can receive payments from the bankruptcy process for the estimated nonfiler liability. When the bankruptcy is complete and the taxpayer has still not provided the overdue return, the IRM requires the Insolvency function to move the bankruptcy payments to excess collections during closing. If a return is subsequently filed after the bankruptcy closing, the payments can be retrieved from excess collections and applied to the taxpayer's account. For six sampled tax modules (\*\*1\*\* IMF and \*\*1\*\* BMF), we found that the Insolvency function did not move nonfiler bankruptcy payments to excess collections as required. Not moving payments to excess collections can result in the unnecessary use of resources if other IRS functions subsequently



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attempt to research the frozen credit as well as the loss of tax revenue if the payments are mistakenly refunded or applied to another account.

**Decisions on possible motions to dismiss bankruptcy were not documented**

When one or more overdue returns have not been filed and the taxpayer is in bankruptcy, the IRS can receive bankruptcy payments for the estimated tax liability of the nonfiled returns by providing an estimated proof of claim. The IRS can also make a motion to the bankruptcy court to dismiss the bankruptcy on the grounds of noncompliance. If granted, the taxpayer will no longer receive protection from the bankruptcy process and will return to a prebankruptcy status, which exposes them to possible collection actions by all creditors. Due to limited staff resources, probable bankruptcy results, and historic bankruptcy court actions, the IRS will not make a motion to dismiss each time a nonfiler is in bankruptcy. However, the Insolvency function is required by the IRM to make a decision about whether a possible motion to dismiss should be referred to IRS Counsel. If used properly, this option can be a significant tool for the IRS to encourage some taxpayers back into tax compliance.

For eight sampled tax modules (\*\*1\*\* IMF and \*\*1\*\* BMF), we found that the Insolvency function employees did not always document their decision related to a possible motion to dismiss the bankruptcies on the grounds of noncompliance. Insolvency officials were not in agreement with our \*\*1\*\* IMF exceptions because they said that documentation of the motion to dismiss decision in the case history is not required if the action will not be taken. Insolvency officials stated that this practice is based on staffing resources and inventory demands for IMF bankruptcy cases, but it is not formalized in the IRM. They believe it does not make business sense to document “no actions” that ultimately have no effect on the IRS’s interest in the bankruptcy case. However, limiting when to document the motion to dismiss decision is not the Insolvency function’s practice for BMF cases because Insolvency officials said that they want to prevent possible pyramiding of BMF tax liabilities by ensuring that the possible motion to dismiss decision was addressed every time by Insolvency employees.

We do not agree with Insolvency management’s decision to limit when to document motion to dismiss decisions in the case histories by the Insolvency function. Decisions should be made and documented regardless of the actions taken. Decisions not to take action should be thoroughly, factually, and timely documented in the case history to allow others to better understand the case. If not documented, neither we nor the IRS can know whether an accurate decision was made. This greatly increases the risk that a necessary action was overlooked. In addition, not knowing if this decision was made may result in missed opportunities to bring taxpayers into tax compliance at an earlier point in the process, which could prevent the need for future IRS compliance resources to attempt securing delinquent returns.



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**Bankruptcy payments were erroneously refunded**

For three IMF sampled tax modules, payments received from the bankruptcy trustees were being systemically refunded by the IRS to the taxpayers. We determined that the bankruptcy payments were refunded because either the pending AUR assessment had been changed without the Insolvency function adjusting the proof of claim or the coding was improper to freeze the payments. Insolvency management informed us that they were not systemically notified by the LTS that these bankruptcy payments were being refunded while the bankruptcy was in progress. We found 17 erroneous refunds in our sample totaling \$2,625, which may result in a loss of tax revenue if the IRS cannot get the refunds back.

The 17 erroneous refunds followed a specific pattern in which a bankruptcy payment and a corresponding systemic refund posted to the tax module during the same processing week. In addition, interest paid to the taxpayers was also posted to the tax module at the same time. This pattern would repeat for any later bankruptcy payments received for the tax module until a correction was made.

Using this specific pattern, we analyzed IMF data as of the end of December 2013 and identified 16,030 tax modules with 58,129 bankruptcy payments totaling \$14.3 million that were refunded to taxpayers during the same processing week as well as \$104,347 in interest paid to the taxpayers. From this population, we provided the Insolvency function with a random sample of 30 tax modules with 398 refunded bankruptcy payments for review. The Insolvency function agreed that 27 of the 30 sampled tax modules with 379 bankruptcy payments were erroneous refunds. For the remaining three sampled tax modules with 19 refunded bankruptcy payments, information was no longer available for them to make a determination due to the bankruptcy being concluded over eight years ago.

Insolvency officials said that they previously identified a problem with bankruptcy payments being erroneously refunded when payments were received for an estimated proof of claim. According to Insolvency officials, they implemented a programming change on July 26, 2010, to systemically prevent these types of refunds. However, they acknowledged that the programming change is not preventing refunds of bankruptcy payments if the estimated proof of claim was submitted before July 26, 2010.

Based on this criterion, we performed additional analysis of the IMF data and identified 9,851 tax modules with 33,266 bankruptcy payments totaling approximately \$7.5 million that were refunded with interest of more than \$54,000 paid to taxpayers between August 2010 and December 2013. The \$7.6 million in refunds with interest were not prevented by the Insolvency function's July 2010 programming change. These could be erroneous refunds if the bankruptcy payments should have been refunded to the bankruptcy trustees or were intended for pending tax assessments, which may result in a loss of tax revenue if the IRS cannot get the refunds back. In addition, not all of the \$7.6 million in refunds were caused by an estimated proof of claim





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submitted before the July 2010 programming change because they include 1,830 tax modules with 5,075 refunded bankruptcy payments totaling \$1.1 million for bankruptcies that started after July 2010 for which the proof of claim would also have been submitted after July 2010. See Appendix IV for additional details of our IMF analysis for refunded bankruptcy payments.

Insolvency officials said that an “All Other” LTS transcript is generated to notify employees when a systemic refund transaction posts to a bankruptcy tax module; however, they also said the transcript does not specifically state why it was generated for that tax module other than a recent transaction has posted. We noticed that the IRM procedures to address “All Other” LTS transcripts does not instruct employees on how to use the transcript to identify, correct, and prevent future erroneous refunded bankruptcy payments. We believe an effective approach to this situation may be to enhance the Insolvency function’s notification process to specifically alert and provide instructions for Insolvency employees to address bankruptcy payments being immediately refunded. This would provide an opportunity for the Insolvency function to identify bankruptcy payment problems, start the process to attempt retrieving erroneous refunds when applicable, and prevent future erroneous refunds of bankruptcy payments to the same tax module.

## ***Recommendations***

The Director, Enterprise Collection Strategy, Small Business/Self-Employed Division, should:

**Recommendation 1:** Ensure that future nonfiler training emphasizes the requirement to conduct credit research when closing nonfiler cases as well as consider establishing a systemic check to ensure that credit research is recorded before closing nonfiler cases.

**Management’s Response:** IRS management agreed with this recommendation and plans to reemphasize the requirement to conduct credit research when closing nonfiler cases during future continuing professional education training and review current processes to determine whether a systemic check should be implemented.

**Recommendation 2:** Confirm that turning off the backup withholding indicator for older tax modules involving nonfilers with satisfying transactions will not be detrimental to compliance programs and then submit a computer work request to the Chief Technology Officer to change the retention programming so that all nonfilers are treated the same for this indicator.

**Management’s Response:** IRS management agreed with this recommendation but stated that corrective action will not be taken to improve the computer system because of limited information technology resources and because they believe the benefit associated with this change is not a priority.

**Office of Audit Comment:** TIGTA continues to believe that the IRS remains at risk for not resolving frozen credits on these taxpayer accounts. Information Technology



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officials informed TIGTA that a computer system change to turn off the backup withholding indicator for older tax modules involving nonfilers with satisfying transactions would not be difficult and would require minimal programming resources. TIGTA found 13 IMF sampled tax modules for which the backup withholding indicator is preventing these modules from being moved to the Retention Register, resulting in the tax modules remaining on the Master File unnecessarily. This could lead to frozen credits being mistakenly transferred to other accounts and/or mistakenly given back to the taxpayers. The IRS should reconsider the potential benefit of systemically resolving the frozen credits instead of relying on manual identification for tax modules that are not in active compliance inventories.

**Recommendation 3:** Establish responsibility and procedures to monitor nonfiler referrals from a collection function to an examination function in order to ensure that the cases remain in an active inventory for compliance consideration.

**Management's Response:** IRS management agreed with this recommendation and plans to issue guidance requiring collection employees to monitor nonfiler referrals to the examination function to ensure that cases not accepted are returned to the collection function.

**Recommendation 4:** Ensure that future bankruptcy training emphasizes the requirements for Insolvency employees to make a timely credit determination, to timely remove the bankruptcy freeze, and to move nonfiler bankruptcy payments to excess collections during the closing of bankruptcy cases. In addition, determine if systemic improvements can be made to the LTS notification process to ensure that these requirements are being addressed by Insolvency employees.

**Management's Response:** IRS management agreed with this recommendation and plans to include these requirements during future continuing professional education training and review current processes to determine whether systemic improvements should be implemented for the LTS notification process.

**Recommendation 5:** Establish procedures for Insolvency employees to document that a decision was made for a possible motion to dismiss on the grounds of noncompliance when an individual or business nonfiler is in bankruptcy. This should be documented regardless of the decision on whether to refer the taxpayer for a possible motion to dismiss the bankruptcy.

**Management's Response:** IRS management agreed with this recommendation and plans to issue guidance reminding Insolvency employees to consider whether a motion to dismiss on the grounds of noncompliance should be filed when an individual or business nonfiler is in bankruptcy. The guidance will also remind employees to document this decision in the case history.





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**Recommendation 6:** Enhance the LTS notification process to specifically alert Insolvency employees to bankruptcy payments being immediately refunded and establish procedures for Insolvency employees, when notified, to address bankruptcy payments being immediately refunded.

**Management's Response:** IRS management agreed with this recommendation but stated that corrective action will not be taken to improve the computer system because of limited information technology resources and because they believe the benefit associated with this change is not a priority.

**Office of Audit Comment:** TIGTA continues to believe that the IRS remains at risk for not properly resolving frozen credits on these taxpayer accounts that may lead to erroneous refunds of bankruptcy payments. The IRS agreed that 33,266 bankruptcy payments totaling approximately \$7.6 million were erroneously refunded since the last programming attempt to correct this situation in August 2010. The IRS should reconsider this opportunity to prevent future erroneous refunds of bankruptcy payments as well as provide opportunities to identify and correct bankruptcy payment problems.

The Commissioner, Small Business/Self-Employed Division, should:

**Recommendation 7:** Establish responsibility and procedures to ensure that civil penalty credit transcripts are being worked to resolve advance payment for audit adjustment frozen credit accounts.

**Management's Response:** IRS management agreed with this recommendation and plans to review procedures to ensure that civil penalty credit transcripts are worked as intended.

The Commissioner, Wage and Investment Division, should:

**Recommendation 8:** Work with the Chief Technology Officer to evaluate the AM11 transcript programming and ensure that all tax modules meeting the criteria will have this transcript generated for review.

**Management's Response:** IRS management agreed with this recommendation and plans to review the criteria for generating the AM11 transcript and determine if the programming is working as intended.

**Recommendation 9:** Evaluate the AM11 transcript criteria for changes that will alert employees to aging frozen credits resulting from the AUR program.

**Management's Response:** IRS management agreed with this recommendation and plans to evaluate the criteria for generating the AM11 transcript to ensure that unresolved credits are identified.



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**Recommendation 10:** Work with the Large Business and International Division to evaluate the procedures for forwarding to the examination function the Accounts Maintenance transcripts that are generated for Offshore Voluntary Disclosure Program payments\*\*\*\*\*1\*\* \*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*.

**Management's Response:** IRS management disagreed with this recommendation. They stated this recommendation was not necessary because the examination function is aware of the credits and believes the current process will ensure that credits are properly resolved within the Offshore Voluntary Disclosure Program.

**Office of Audit Comment:** TIGTA continues to believe that the IRS remains at risk for not resolving frozen credits on these taxpayer accounts. Sending generated Accounts Maintenance transcripts to the examination function as a backup process would help to ensure that credits are not mistakenly refunded or transferred to another account before examination activity is started as well as prevent credits from potentially being overlooked when the Offshore Voluntary Disclosure Program examination is concluded.



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## Appendix I

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

Our overall objective was to determine what actions the IRS has taken to resolve both individual and business taxpayer accounts with certain frozen credits.<sup>1</sup> Our review of sampled accounts was limited to three frozen credit conditions that included taxpayer accounts with advance payments for audit adjustments, accounts with no returns with satisfying transactions, and accounts for which the taxpayer is in bankruptcy. To accomplish this objective, we:

- I. Determined the overall process and population of taxpayer accounts with frozen credits by interviewing IRS officials, researching IRS policies and procedures, reviewing available data such as frozen credit reports, and reviewing the results of the ITAC pilot as well as determining the status of any additional ongoing IRS efforts and initiatives related to freeze conditions.
- II. Determined the effectiveness of procedures for processing and identifying taxpayer accounts with the advance payment for audit adjustment frozen credit condition.
  - A. Researched and discussed with IRS officials the procedures for processing and identifying taxpayer accounts with the advance payment for audit adjustment frozen credit condition.
  - B. Selected and reviewed a statistical stratified random sample of individual and business taxpayer accounts with the advance payment for audit adjustment frozen credit condition to determine if the accounts should have been resolved at an earlier time. We selected a statistical sample to allow us to project our sample results to the population.<sup>2</sup> This included:
    1. Obtaining BMF and IMF frozen credit data files as of September 20, 2012, from TIGTA's Data Center Warehouse.
    2. Conducting validation testing that included comparing data totals to applicable IRS frozen credit reports and conducting reasonableness scans of the data fields and elements to ensure that the data are sufficiently reliable for our testing needs. We determined that the data were sufficiently reliable for the purposes of this report.

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<sup>1</sup> See Appendix VI for a glossary of terms.

<sup>2</sup> See Appendix V for summaries of the stratified populations, sample selection criteria, and sample results.



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3. Discussing the sampling methodology with TIGTA's contracted statistician.
  4. Selecting a statistical stratified random sample of business and individual taxpayer accounts from the frozen credit data files based on credit amount and age of frozen credits.
  5. Researching sample tax accounts to determine IRS activity and circumstances involved with the frozen credit condition.
  6. Obtaining additional information and discussing with IRS officials the current status of the sample accounts.
  7. Confirming sample exceptions with IRS officials.
- C. Calculated and discussed with IRS officials the effect for taxpayers and for the IRS associated with the sample review results for the advance payment for audit adjustment frozen credit condition.
- D. Discussed the sample projections with TIGTA's contracted statistician.
- E. Discussed with IRS officials the weaknesses and potential improvements to procedures for taxpayer accounts with the advance payment for audit adjustment frozen credit condition.
- III. Determined the effectiveness of procedures for processing and identifying taxpayer accounts with the no return with satisfying transaction frozen credit condition.
- A. Researched and discussed with IRS officials the procedures for processing and identifying taxpayer accounts with the no return with satisfying transaction frozen credit condition.
- B. Selected and reviewed a statistical stratified random sample of individual and business taxpayer accounts with the no return with a satisfying transaction frozen credit condition to determine if the accounts should have been resolved at an earlier time. We selected a statistical sample to allow us to project our sample results to the population.<sup>3</sup> This included:
1. Obtaining BMF and IMF frozen credit data files as of September 20, 2012, from TIGTA's Data Center Warehouse.
  2. Conducting validation testing that included comparing data totals to applicable IRS frozen credit reports and conducting reasonableness scans of the data fields and elements to ensure that the data are sufficiently reliable for our testing needs.

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<sup>3</sup> See Appendix V for summaries of the stratified populations, sample selection criteria, and sample results.



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We determined that the data were sufficiently reliable for the purposes of this report.

3. Discussing the sampling methodology with TIGTA's contracted statistician.
  4. Selecting a statistical stratified random sample of business and individual taxpayer accounts from the frozen credit data files based on credit amount and age of frozen credits.
  5. Researching sample tax accounts to determine IRS activity and circumstances involved with the frozen credit condition.
  6. Obtaining additional information and discussing with IRS officials the current status of the sample accounts.
  7. Confirming sample exceptions with IRS officials.
- C. Calculated and discussed with IRS officials the effect for taxpayers and for the IRS associated with the sample review results for the no return with a satisfying transaction frozen credit condition.
- D. Discussed the sample projections with TIGTA's contracted statistician.
- E. Discussed with IRS officials the weaknesses and potential improvements to procedures for taxpayer accounts with the no return with a satisfying transaction frozen credit condition.
- IV. Determined the effectiveness of procedures for processing and identifying taxpayer accounts with the bankruptcy frozen credit condition.
- A. Researched and discussed with IRS officials the procedures for processing and identifying taxpayer accounts with the bankruptcy frozen credit condition.
  - B. Selected and reviewed a statistical stratified random sample of individual and business taxpayer accounts with the bankruptcy frozen credit condition to determine if the accounts should have been resolved at an earlier time. We selected a statistical sample to allow us to project our sample results to the population.<sup>4</sup> This included:
    1. Obtaining BMF and IMF frozen credit data files as of September 20, 2012, from TIGTA's Data Center Warehouse.
    2. Conducting validation testing that included comparing data totals to applicable frozen credit reports and conducting reasonableness scans of the data fields and

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<sup>4</sup> See Appendix V for summaries of the stratified populations, sample selection criteria, and sample results.



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elements to ensure that the data are sufficiently reliable for our testing needs. We determined that the data were sufficiently reliable for the purposes of this report.

3. Discussing the sampling methodology with TIGTA's contracted statistician.
  4. Selecting a statistical stratified random sample of business and individual taxpayer accounts from the frozen credit data files based on credit amount and age of frozen credits.
  5. Researching sample tax accounts to determine IRS activity and circumstances involved with the frozen credit condition.
  6. Obtaining additional information and discussing with IRS officials the current status of the sample accounts.
  7. Confirming sample exceptions with IRS officials.
- C. Identified potential population of individual taxpayer accounts with bankruptcy payments being refunded in the same processing week as when received that could be erroneously refunded.
1. Obtained an IMF data extract from TIGTA's Data Center Warehouse for bankruptcy payments being refunded in the same processing week as when received.
  2. Conducted a validation to ensure that the data are sufficiently reliable for our testing needs that included conducting reasonableness scans of the data fields and elements and randomly sampling 30 tax modules to ensure that the extracted data matches taxpayer accounts using Master File account information. We determined that the data were sufficiently reliable for the purposes of this report.
  3. Discussed the 30 randomly sampled tax modules with IRS officials to determine if the bankruptcy payments were erroneously refunded.
- D. Calculated and discussed with IRS officials the effect for taxpayers and for the IRS associated with the sample review results for taxpayers with the bankruptcy frozen credit condition.
- E. Discussed the sample projections with TIGTA's contracted statistician.
- F. Discussed with IRS officials the weaknesses and potential improvements to procedures for taxpayer accounts with the bankruptcy frozen credit condition.



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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 that the following internal controls were relevant to our audit objective: the IRS's processes and procedures for resolving three frozen credits conditions that included tax accounts with advance payments for audit adjustments, accounts with no returns with satisfying transactions, and accounts for which the taxpayer is in bankruptcy. We evaluated these controls by discussing with IRS officials the actions taken to resolve the sampled frozen credit cases.



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**Appendix II**

*Major Contributors to This Report*

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Louis Zullo, Senior Auditor





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## **Appendix III**

### *Report Distribution List*

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Operations Support OS  
Deputy Commissioner for Services and Enforcement SE  
Commissioner, Large Business and International Division SE:LB  
Deputy Commissioner, Small Business/Self-Employed Division SE:S  
Deputy Commissioner, Wage and Investment Division SE:W  
Chief, Appeals AP  
Chief, Criminal Investigation SE:CI  
Chief Financial Officer OS:CFO  
Chief Technology Officer OS:CTO  
Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS  
Director, Compliance, Wage and Investment Division SE:W:CP  
Director, Customer Account Services, Wage and Investment Division SE:W:CAS  
Director, Enterprise Collection Strategy, Small Business/Self-Employed Division SE:S:CS  
Director, Examination, Small Business/Self-Employed Division SE:S:E  
Director, Field Collection, Small Business/Self-Employed Division SE:S:FC  
Director, Specialty Programs, Small Business/Self-Employed Division SE:S:SP  
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM  
Director, Advisory and Insolvency, Small Business/Self-Employed Division SE:S:FC:AI  
Director, Campus Filing and Payment Compliance, Small Business/Self-Employed Division  
SE:S:CCS:FPC  
Director, Campus Reporting Compliance, Small Business/Self-Employed Division  
SE:S:CCS:CRC  
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Director, Exam Policy, Small Business/Self-Employed Division SE:S:E:EP  
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Director, Reporting Compliance, Wage and Investment Division SE:W:CP:RC  
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP  
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Director, Office of Program Evaluation and Risk Analysis RAS:O  
Office of Internal Control OS:CFO:CPIC:IC  
Audit Liaisons:



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Commissioner, Small Business/Self-Employed Division SE:S  
Commissioner, Wage and Investment Division SE:W



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*Further Actions Are Needed to Resolve  
Millions of Dollars of Frozen Credits in Taxpayer Accounts*

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## Appendix IV

### *Outcome Measure*

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

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

- Revenue Protection – Potential; \$7.6 million for 33,266 erroneous refunds of bankruptcy payments including interest paid to taxpayers (see page 16).

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

We identified three IMF<sup>1</sup> tax modules during our sample review of modules that were in the bankruptcy frozen credit condition for which 17 payments received from the bankruptcy trustees were erroneously refunded by the IRS to the taxpayers. The 17 erroneous refunds followed a specific pattern in which a bankruptcy payment and its corresponding systemic refund posted to the tax module during the same processing week. In addition, interest paid to the taxpayers was also posted to the tax module at the same time. This pattern would repeat for any later bankruptcy payments received for the tax module until a correction was made to the tax module.

We computer analyzed all tax modules on the IMF as of December 2013 and identified more than 6 million bankruptcy payments. We then identified 147,012 systemic refunds and 25,540 cancelled or identified erroneous refunds within the tax modules with bankruptcy payments. Using the specific posting pattern discovered during our sample review, we identified 58,129 bankruptcy payments that had a systemic refund posting in the same processing week as the payment and did not have a later refund cancellation or other identification as an erroneous refund. The interest paid to taxpayers for the refunding of bankruptcy payments was also identified.

We validated that each of the 58,129 bankruptcy payments plus interest paid to the taxpayers equaled the corresponding systemic refund amounts. In addition, we confirmed that the 17 erroneous refunds from our sample review were included in the 58,129 refunds our analysis identified. Furthermore, we randomly selected 30 tax modules containing 398 of the 58,129 refunds for bankruptcy payments and manually researched the tax modules using Master File account information to confirm that bankruptcy payments, systemic refunds, and interest

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<sup>1</sup> See Appendix VI for a glossary of terms.



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paid to taxpayers matched our computer analysis. The random sample of 30 tax modules with 398 refunded bankruptcy payments were also provided to the Insolvency function. Insolvency employees agreed that 27 of the 30 sampled tax modules with 379 bankruptcy payments were erroneous refunds. However, the Insolvency function could not make a determination for the remaining three sampled tax modules with 19 refunded bankruptcy payments because the information was no longer available due to the bankruptcy being concluded over eight years ago.

Since Insolvency officials informed us that they previously identified a problem and implemented a July 26, 2010, programming change to systemically prevent these types of refunds, we used our previous IMF data to identify refunded bankruptcy payments between August 2010 and December 2013. We found 9,851 tax modules with 33,266 bankruptcy payments totaling approximately \$7.5 million that were refunded with more than \$54,000 of interest paid to taxpayers between August 2010 and December 2013. The \$7.6 million of refunds with interest were not prevented by the Insolvency function's July 2010 programming change. These could be erroneous refunds if the bankruptcy payments should have been refunded to the bankruptcy trustees or were intended for pending tax assessments, which may result in a loss of tax revenue if the IRS cannot get the refunds back. Figure 1 is a summary of our IMF analysis for refunded bankruptcy payments.

**Figure 1: Summary of Refunded Bankruptcy Payments as of December 2013**

Analysis Topic	All Refunded Bankruptcy Payments	Refunded Bankruptcy Payments After July 2010
Number of Refunded Bankruptcy Payments	58,129	33,266
Number of Tax Modules	16,030	9,851
Number of Taxpayers	14,860	9,262
Amount of Bankruptcy Payments	\$14,275,684.96	\$7,518,618.14
Amount of Interest Paid to Taxpayers	\$104,346.50	\$54,285.42
Amount of Refunds	\$14,380,031.46	\$7,572,903.56

*Source: TIGTA analysis of IMF tax modules.*



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## Appendix V

### *Stratified Populations and Sample Results*

We reviewed samples of three frozen credit conditions:<sup>1</sup> (1) no returns with satisfying transactions, (2) advance payments for audit adjustments, and (3) taxpayers in bankruptcy. The populations for each were identified using copies of the IRS's frozen credit data files for the IMF and BMF as of September 20, 2012. The frozen credit data file is a listing of all credit tax modules with a freeze condition and includes age coding for the amount of time in freeze status. If a tax module has more than one freeze condition, it is assigned to the most relevant condition based on a hierarchy established by the IRS (*i.e.*, no tax module is included in more than one frozen credit condition within the frozen credit data file). Sample exceptions were discussed with IRS officials. Sampling methodology and calculations for estimates were discussed with TIGTA's contracted statistician.

#### **No return with satisfying transaction frozen credit condition**

We identified 277,226 IMF and 441,246 BMF credit tax modules with a no return with satisfying transaction freeze. These tax modules had total credits of \$1.78 billion for the IMF and \$26.22 billion for the BMF. Stratified random samples of 169 IMF and 228 BMF tax modules were selected based on the age of the freeze and amount of the credit. We identified 86 IMF tax modules with credits of \$31.1 million and **\*\*1\*\*** BMF tax modules with credits of \$1.28 billion for which IRS actions were not taken that may have affected earlier resolution of the credits. Figures 1 and 2 shown below display the populations and sample results.

We estimate that the IMF no return with satisfying transaction frozen credits have a 59.4 percent exception rate involving 164,595 tax modules with credits of \$829 million. The precision of lower and upper limits were calculated using a two-sided 90 percent confidence interval to determine that the exception rate is from 49.3 to 69.4 percent involving 136,716 to 192,475 tax modules with credits of \$621.1 million to \$1.04 billion.

We estimate that the BMF no return with satisfying transaction frozen credits have a 68.4 percent exception rate involving 301,860 tax modules with credits of \$2.98 billion. The precision of lower and upper limits were calculated using a two-sided 90 percent confidence interval to determine that the exception rate is from 58.9 to 77.9 percent involving 260,006 to 343,715 tax modules with credits of \$2.33 billion to \$3.63 billion.

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<sup>1</sup> See Appendix VI for a glossary of terms.



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**Figure 1: IMF No Return With Satisfying Transaction Frozen Credits**

STRATIFICATION		POPULATION		SAMPLE REVIEW		
		Tax Modules	Frozen Credits	Sample Tax Modules	Exceptions	
Aging	Frozen Credit Range				Tax Modules	Frozen Credits
<3 Years	<\$25,000	149,871	\$357,201,448	30	20	\$36,077
	>=\$25,000 and <\$1 million	6,670	\$528,231,429	30	18	\$1,007,623
	>=\$1 million and <\$5 million	59	\$109,081,693	30	7	\$16,818,962
	>=\$5 million	6	\$53,726,049	6	0	\$0
>=3 Years	<\$25,000	115,309	\$361,461,056	30	15	\$37,713
	>=\$25,000 and <\$1 million	5,298	\$357,512,920	30	17	\$1,329,367
	>=\$1 million	13	\$16,804,439	13	9	\$11,913,395
<b>TOTAL</b>		<b>277,226</b>	<b>\$1,784,019,034</b>	<b>169</b>	<b>86</b>	<b>\$31,143,137</b>

Source: IRS frozen credit data files for IMF accounts and TIGTA's sample review results.

**Figure 2: BMF No Return With Satisfying Transaction Frozen Credits**

STRATIFICATION		POPULATION		SAMPLE REVIEW		
		Tax Modules	Frozen Credits	Sample Tax Modules	Exceptions	
Aging	Frozen Credit Range				Tax Modules	Frozen Credits
<3 Years	<\$25,000	214,913	\$545,809,870	30	22	\$77,829
	>=\$25,000 and <\$1 million	11,592	\$1,489,932,534	30	8	\$1,309,269
	>=\$1 million and <\$10 million	829	\$2,487,165,022	30	**1**	**1**
	>=\$10 million and <\$200 million	192	\$7,210,706,143	30	**1**	**1**
	>=\$200 million	15	\$13,558,699,271	15	**1**	**1**
>=3 Years	<\$25,000	209,103	\$407,655,880	30	20	\$49,814
	>=\$25,000 and <\$1 million	4,555	\$343,490,893	30	11	\$757,997
	>=\$1 million and <\$10 million	44	\$87,208,218	30	15	\$30,192,695
	>=\$10 million	3	\$92,968,413	3	**1**	**1**
<b>TOTAL</b>		<b>441,246</b>	<b>\$26,223,636,244</b>	<b>228</b>	<b>**1**</b>	<b>\$1,279,116,779</b>

Source: IRS frozen credit data files for BMF accounts and TIGTA's sample review results.



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**Advance payment for audit adjustment frozen credit condition**

We identified 255,428 IMF and 19,604 BMF credit tax modules with an advance payment for audit adjustment freeze. These tax modules had total credits of \$3.55 billion for the IMF and \$12.08 billion for the BMF. Stratified random samples of 226 IMF and 203 BMF tax modules were selected based on the age of the freeze and the amount of the credit. We identified **\*\*1\*\*** IMF tax modules with credits of \$6.6 million and **\*\*1\*\*** BMF tax modules with credits of \$305.5 million for which IRS actions were not taken that may have affected earlier resolution of the credits. Figures 3 and 4 shown below display the populations and sample results.

We estimate that the IMF advance payment for audit adjustment frozen credits have a 5.6 percent exception rate involving 14,379 tax modules with credits of \$88.8 million. The precision of lower and upper limits were calculated using a two-sided 90 percent confidence interval to determine that the exception rate is from 1.8 to 9.5 percent involving 4,513 to 24,244 tax modules with credits of \$9.1 million to \$168.5 million.

We estimate that the BMF advance payment for audit adjustment frozen credits have a 9.9 percent exception rate involving 1,945 tax modules with credits of \$313.5 million. The precision of lower and upper limits were calculated using a two-sided 90 percent confidence interval to determine that the exception rate is from 1.8 to 18.1 percent involving 348 to 3,541 tax modules with credits of \$303.5 million to \$323.5 million.

**Figure 3: IMF Advance Payment for Audit Adjustment Frozen Credits**

STRATIFICATION		POPULATION		SAMPLE REVIEW		
		Tax Modules	Frozen Credits	Sample Tax Modules	Exceptions	
Aging	Frozen Credit Range				Tax Modules	Frozen Credits
<3 Years	<\$25,000	244,200	\$461,918,140	80	4	\$4,306
	>=\$25,000 and <\$1 million	7,977	\$935,665,459	30	<b>**1**</b>	<b>**1**</b>
	>=\$1 million and <\$20 million	307	\$883,684,110	30	<b>**1**</b>	<b>**1**</b>
	>=\$20 million	13	\$1,152,149,786	13	0	\$0
>=3 Years	<\$25,000	2,773	\$3,496,192	30	20	\$15,370
	>=\$25,000 and <\$1 million	145	\$23,286,665	30	7	\$775,871
	>=\$1 million	13	\$93,914,287	13	0	\$0
<b>TOTAL</b>		<b>255,428</b>	<b>\$3,554,114,639</b>	<b>226</b>	<b>**1**</b>	<b>\$6,597,004</b>

Source: IRS frozen credit data files for IMF accounts and TIGTA's sample review results.





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**Figure 4: BMF Advance Payment for Audit Adjustment Frozen Credits**

STRATIFICATION		POPULATION		SAMPLE REVIEW		
		Tax Modules	Frozen Credits	Sample Tax Modules	Exceptions	
Aging	Frozen Credit Range				Tax Modules	Frozen Credits
<3 Years	<\$25,000	17,398	\$36,648,905	30	3	\$1,868
	>=\$25,000 and <\$1 million	1,321	\$203,702,321	30	**1**	**1**
	>=\$1 million and <\$100 million	186	\$2,834,242,804	30	0	\$0
	>=\$100 million	16	\$5,443,677,469	16	0	\$0
>=3 Years	<\$25,000	600	\$1,437,918	30	7	\$31,941
	>=\$25,000 and <\$1 million	46	\$7,093,898	30	11	\$655,685
	>=\$1 million	37	\$3,557,688,240	37	4	\$304,709,675
<b>TOTAL</b>		<b>19,604</b>	<b>\$12,084,491,555</b>	<b>203</b>	<b>**1**</b>	<b>**1**</b>

Source: IRS frozen credit data files for BMF accounts and TIGTA's sample review results.

**Taxpayer in bankruptcy frozen credit condition**

We identified 60,094 IMF and 17,834 BMF credit tax modules with a taxpayer in bankruptcy freeze. These tax modules had total credits of \$189.65 million for the IMF and \$1.55 billion for the BMF. Stratified random samples of 154 IMF and 183 BMF tax modules were selected based on the age of the freeze and amount of the credit. We identified \*\*1\*\* IMF tax modules with credits of \$8.7 million and \*\*1\*\* BMF tax modules with credits of \$8.5 million for which IRS actions were not taken that may have affected earlier resolution of the credits. Figures 5 and 6 shown below display the populations and sample results.

We estimate that the IMF taxpayer in bankruptcy frozen credits have a 33.1 percent exception rate involving 19,880 tax modules with credits of \$33 million. The precision of lower and upper limits were calculated using a two-sided 90 percent confidence interval to determine that the exception rate is from 21.4 to 44.7 percent involving 12,873 to 26,887 tax modules with credits of \$21 million to \$45 million.

We estimate that the BMF taxpayer in bankruptcy frozen credits have a 16.7 percent exception rate involving 2,979 tax modules with credits of \$39.8 million. The precision of lower and upper limits were calculated using a two-sided 90 percent confidence interval to determine that the exception rate is from 7.9 to 25.5 percent involving 1,412 to 4,546 tax modules with credits of \$5.4 million to \$74.3 million.





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**Figure 5: IMF Bankruptcy Frozen Credits**

STRATIFICATION		POPULATION		SAMPLE REVIEW		
		Tax Modules	Frozen Credits	Sample Tax Modules	Exceptions	
Aging	Frozen Credit Range				Tax Modules	Frozen Credits
<3 Years	<\$25,000	47,121	\$94,868,585	30	10	\$8,953
	>=\$25,000 and <\$250,000	600	\$30,827,320	30	3	\$148,380
	>=\$250,000	25	\$20,491,355	25	**1**	**1**
>=3 Years	<\$25,000	12,227	\$18,846,210	30	10	\$14,927
	>=\$25,000 and <\$250,000	112	\$6,277,901	30	9	\$484,825
	>=\$250,000	9	\$18,337,637	9	**1**	**1**
<b>TOTAL</b>		<b>60,094</b>	<b>\$189,649,008</b>	<b>154</b>	<b>**1**</b>	<b>\$8,738,200</b>

Source: IRS frozen credit data files for IMF accounts and TIGTA's sample review results.

**Figure 6: BMF Bankruptcy Frozen Credits**

STRATIFICATION		POPULATION		SAMPLE REVIEW		
		Tax Modules	Frozen Credits	Sample Tax Modules	Exceptions	
Aging	Frozen Credit Range				Tax Modules	Frozen Credits
<3 Years	<\$25,000	13,328	\$32,287,347	30	5	\$6,730
	>=\$25,000 and <\$1 million	1,102	\$145,968,062	30	3	\$699,533
	>=\$1 million and <\$10 million	88	\$234,343,604	30	0	\$0
	>=\$10 million	20	\$1,035,654,767	20	0	\$0
>=3 Years	<\$25,000	3,178	\$5,002,482	30	6	\$18,316
	>=\$25,000 and <\$1 million	105	\$15,659,486	30	3	\$546,627
	>=\$1 million	13	\$83,001,651	13	**1**	**1**
<b>TOTAL</b>		<b>17,834</b>	<b>\$1,551,917,399</b>	<b>183</b>	<b>**1**</b>	<b>**1**</b>

Source: IRS frozen credit data files for BMF accounts and TIGTA's sample review results.



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**Appendix VI**

*Glossary of Terms*

<b>Term</b>	<b>Definition</b>
<b>Account</b>	A record of tax data for one taxpayer identified by a Social Security Number or Employer Identification Number.
<b>Accounts Maintenance Transcript</b>	Case work generated by systemic computer checks for the Accounts Management function to review an unresolved credit account.
<b>Accounts Management</b>	Customer service program designed to answer taxpayer inquiries, adjust accounts, and resolve issues to settle accounts.
<b>Automated Collection System</b>	Compliance program designed to use telephone contact to collect unpaid taxes and secure unfiled tax returns from taxpayers who have not complied with previous notices.
<b>Automated Underreporter (AUR)</b>	Compliance program designed to match items reported on a tax return to information submitted to the IRS from outside sources ( <i>e.g.</i> , employers, banks, brokerage firms) to determine if correct amounts were reported.
<b>Backup Withholding Indicator</b>	Coding on the taxpayer's account that the taxpayer is or may become subject to mandatory withholding of tax by payers for certain types of income that includes interest and dividends.
<b>Bankruptcy Code</b>	Title 11 of the United States Code contains Federal law intended to provide an orderly method for a debtor's financial rehabilitation or the liquidation and distribution of a debtor's assets.
<b>Bankruptcy Court</b>	Court with legal jurisdiction over all matters concerning debtor's financial obligations under the Bankruptcy Code and administration of the bankruptcy estate.
<b>Bankruptcy Trustee</b>	Bankruptcy court representative with duties that include disbursing payments to creditors on behalf of the debtor.
<b>Barred Assessment, Collection, or Refund</b>	When an assessment, collection, or refund action cannot be conducted because the applicable statute of limitation has expired.
<b>Business Master File (BMF)</b>	Computer system that consists of Federal tax-related transactions and accounts for businesses including employment taxes, income taxes, and excise taxes.



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<b>Term</b>	<b>Definition</b>
<b>Campus</b>	IRS location that can include operations for processing returns and conducting activity for compliance, customer account services, and customer assistance.
<b>Collection Field Function (Cff)</b>	Compliance program designed to use personal contact to collect unpaid taxes and secure unfiled tax returns from taxpayers who have not complied with previous notices.
<b>Combat Zone Indicator</b>	Coding on a taxpayer's account to alert IRS employees and programs that the taxpayer is or has been in a combat zone.
<b>Credit Offset</b>	Transferring a credit to another tax module or account.
<b>Customer Account Data Engine</b>	Computer system for managing taxpayer accounts consisting of databases and related applications that will replace the existing Master File per the IRS modernization plan.
<b>Examination Function</b>	Primarily responsible for determining the correct tax liabilities of taxpayers. Examinations of taxpayers can range from reviewing their tax returns and resolving questionable items by corresponding with them through the mail to a detailed face-to-face examination of a taxpayer's financial records at their place of business.
<b>Excess Collections File</b>	Accounting control file used for payments that cannot be associated with correct accounts and for credits that cannot be refunded to taxpayers due to tax statute of limitations time requirements.
<b>Fiscal Year (FY)</b>	Yearly accounting period regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
<b>Freeze Condition</b>	Taxpayer account that either requires special handling by the IRS or for which the IRS is awaiting the outcome of a future event before returning to normal processing.
<b>Frozen Credit</b>	A tax module in credit status that has at least one freeze condition.
<b>Individual Master File (IMF)</b>	Computer system that consists of Federal tax-related transactions and accounts for individuals.
<b>Individual Taxpayer Account Cleanup (ITAC) Pilot</b>	Research project to review samples of debit, credit, and zero balance accounts with freeze conditions that would be beneficial to resolve before moving the accounts to the Customer Account Data Engine computer system.



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<b>Term</b>	<b>Definition</b>
<b>Information Technology</b>	The IRS organization with the mission of delivering information technology services and solutions that drives effective tax administration to ensure public confidence.
<b>Insolvency Function</b>	Responsible for coordinating the IRS actions when taxpayers are in bankruptcy.
<b>Internal Revenue Code</b>	Title 26 of the United States Code that contains Federal law related to taxes in the United States.
<b>Internal Revenue Manual (IRM)</b>	The IRS's primary official source of instructions to staff relating to the administration and operations of the IRS.
<b>Litigation Transcript System (LTS)</b>	Computer system used for bankruptcy cases by which systemic checks provide transcripts to the Insolvency function.
<b>Master File</b>	Computer system for managing taxpayer accounts consisting of databases and related applications.
<b>Nonfiler</b>	A common term used for a taxpayer with a Taxpayer Delinquency Investigation.
<b>Offshore Voluntary Disclosure Program</b>	An IRS initiative to bring taxpayers that have used undisclosed foreign accounts and entities to avoid or evade tax into compliance with U.S. tax laws. This initiative is a counterpart to Criminal Investigation's Voluntary Disclosure Practice that enables noncompliant taxpayers to resolve their tax liabilities and minimize their chance of criminal prosecution.
<b>Proof of Claim</b>	Creditor claim against a debtor submitted to the bankruptcy court and used by the trustee to disburse payments.
<b>Retention Register</b>	A computer retention storage file for older tax modules no longer active for day-to-day operations on the Master File.
<b>Return</b>	A legal form or written evidence used by a taxpayer to record tax information.
<b>Tax Module</b>	Part of a taxpayer's account that reflects tax data for one type of tax and one tax period that can be a period of either one year or quarter of a year.
<b>Taxpayer Delinquency Investigation</b>	Tax module with a filing requirement for which a return has not been received and is in collection status.



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<b>Term</b>	<b>Definition</b>
<b>Transcript</b>	Systemically generated case work for a specific type of unresolved account.



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**Appendix VII**

*Management's Response to the Draft Report*

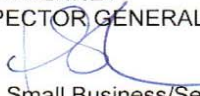


COMMISSIONER  
SMALL BUSINESS/Self-EMPLOYED DIVISION

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

SEP 05 2014

MEMORANDUM FOR MICHAEL E. MCKENNEY  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Karen Schiller   
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Further Actions Are Needed to Resolve  
Millions of Dollars of Frozen Credits in Taxpayer Accounts  
(Audit # 201230025)

Thank you for the opportunity to review your draft report titled "*Further Actions Are Needed to Resolve Millions of Dollars of Frozen Credits in Taxpayer Accounts*". We generally agree with your recommendations and we appreciate your acknowledgement that we have procedures and systems in place to identify and resolve most frozen credit accounts timely.

Taxpayer accounts that require special handling are placed in a freeze condition. These accounts are identified on our Master File computer system by the use of special codes that help our employees identify the reason for the freeze. When a tax module is in credit status (payments exceeding current assessments) and the account has at least one freeze condition present, the credit is frozen until the special condition is resolved. During the period in which the credit is frozen, the payment is not refunded and our processing of the payment is suspended. This ensures that amounts properly due to the government are not erroneously refunded before the freeze condition is resolved. In most instances taxpayers are not adversely affected by a delay in the resolution of a frozen credit condition because the resolution often results in an assessment equal to or greater than the payment. While the taxpayer will be paid interest on any amount refunded, we take our obligation for timely and efficient case resolution very seriously.

As you acknowledge in your report, we have procedures and standardized systemic checks to identify and resolve the conditions leading to a frozen credit in a taxpayer's account. Most special conditions are resolved within a few months. And, as you also note in your report, we have initiated research projects to help identify ways to improve frozen credit processing. These projects have resulted in several recommendations, many of which we have implemented with the goal of returning frozen accounts to the normal compliance process and providing taxpayer refunds, when appropriate, in a more timely and efficient manner. However, you found that further action is needed to resolve some accounts with frozen credit condition and recommended we take several actions to improve our performance in resolving these accounts. We agree that there



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are additional actions we can take. We also agree with the outcome measure in your report.

Attached is a detailed response with our corrective actions to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Darren John Guillot, Director, Enterprise Collection Strategy at (202) 317-3583.

Attachment





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*Further Actions Are Needed to Resolve  
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Attachment

**RECOMMENDATION 1:**

The Director, Enterprise Collection Strategy, Small Business/Self-Employed Division, should ensure that future nonfiler training emphasizes the requirement to conduct credit research when closing nonfiler cases, as well as consider establishing a systemic check to ensure that credit research is recorded before closing nonfiler cases.

**CORRECTIVE ACTION:**

In future continuing professional education training on nonfiler cases, we will reemphasize the requirement to conduct credit research when closing these cases. We also will review our current processes for closing a nonfiler case to determine whether we need a systemic check requiring the recordation of credit research before a nonfiler case is closed.

**IMPLEMENTATION DATE:**

November 15, 2015

**RESPONSIBLE OFFICIAL:**

Director, Collection Analytics, Automation, Inventory Selection and Delivery, SB/SE Division

**CORRECTIVE ACTION MONITORING PLAN:**

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

**RECOMMENDATION 2:**

The Director, Enterprise Collection Strategy, Small Business/Self-Employed Division, should confirm that turning off the backup withholding indicator for older tax modules involving nonfilers with satisfying transactions will not be detrimental to compliance programs and then submit a computer work request to the Chief Technology Officer to change the retention programming so that all nonfilers are treated the same for this indicator.

**CORRECTIVE ACTION:**

We agree that the backup withholding indicator should be turned off for older tax modules involving nonfilers with satisfying transactions if turning off the indicator will not be detrimental to compliance programs. However, we have limited information technology resources and the benefits associated with this change do not make this an information technology priority. We therefore cannot commit to the submission or completion of a work request at this time.

**IMPLEMENTATION DATE:**

N/A



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**RESPONSIBLE OFFICIAL:**

N/A

**CORRECTIVE ACTION MONITORING PLAN:**

N/A

**RECOMMENDATION 3:**

The Director, Enterprise Collection Strategy, Small Business/Self-Employed Division, should establish responsibility and procedures to monitor nonfiler referrals from a collection function to an examination function in order to ensure that the cases remain in an active inventory for compliance consideration.

**CORRECTIVE ACTION:**

We will issue guidance requiring Collection employees to monitor nonfiler referrals to Examination to ensure that cases not accepted for examination are returned to Collection for compliance consideration.

**IMPLEMENTATION DATE:**

September 15, 2015

**RESPONSIBLE OFFICIAL:**

Director, Collection Analytics, Automation, Inventory Selection and Delivery, SB/SE Division

**CORRECTIVE ACTION MONITORING PLAN:**

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

**RECOMMENDATION 4:**

The Director, Enterprise Collection Strategy, Small Business/Self-Employed Division, should ensure that future bankruptcy training emphasizes the requirements for Insolvency employees to make a timely credit determination, to timely remove the bankruptcy freeze, and to move nonfiler bankruptcy payments to excess collections during the closing of bankruptcy cases. In addition, determine if systemic improvements can be made to the Litigation Transcript System (LTS) notification process to ensure that these requirements are being addressed by Insolvency employees.

**CORRECTIVE ACTION:**

We will include instructions to 1) make timely credit determinations, 2) timely remove the bankruptcy freeze, and 3) move nonfiler bankruptcy payments to excess collections during the closing of bankruptcy cases in our continuing professional education (CPE)



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bankruptcy training for fiscal year 2015. We also will review our processes and determine if systemic improvements can be made to the LTS notification process.

**IMPLEMENTATION DATE:**

September 15, 2015

**RESPONSIBLE OFFICIAL:**

Director, Collection Policy, SB/SE Division

**CORRECTIVE ACTION MONITORING PLAN:**

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

**RECOMMENDATION 5:**

The Director, Enterprise Collection Strategy, Small Business/Self-Employed Division, should establish procedures for Insolvency employees to document that a decision was made for a possible motion to dismiss on the grounds of noncompliance when an individual or business nonfiler is in bankruptcy. This should be documented regardless of the decision on whether to refer the taxpayer for a possible motion to dismiss the bankruptcy.

**CORRECTIVE ACTION:**

We will issue guidance reminding our Insolvency employees to consider whether a motion to dismiss on the grounds of noncompliance should be filed when an individual or business nonfiler is in bankruptcy. The guidance also will remind our employees to document this decision on whether to file the motion to dismiss in the case history.

**IMPLEMENTATION DATE:**

September 15, 2015

**RESPONSIBLE OFFICIAL:**

Director, Collection Policy, SB/SE Division

**CORRECTIVE ACTION MONITORING PLAN:**

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

**RECOMMENDATION 6:**

The Director, Enterprise Collection Strategy, Small Business/Self-Employed Division, should enhance the LTS notification process to specifically alert Insolvency employees to bankruptcy payments being immediately refunded and establish procedures for



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Insolvency employees, when notified, to address bankruptcy payments being immediately refunded.

**CORRECTIVE ACTION:**

We agree that our Insolvency employees would benefit from an alert to bankruptcy payments being immediately refunded. However, we have limited information technology resources and the benefits associated with this change do not make it an information technology priority. We therefore cannot commit to the submission or completion of a work request at this time.

**IMPLEMENTATION DATE:**

N/A

**RESPONSIBLE OFFICIAL:**

N/A

**CORRECTIVE ACTION MONITORING PLAN:**

N/A

**RECOMMENDATION 7:**

The Commissioner, Small Business/Self-Employed Division should establish responsibility and procedures to ensure that civil penalty credit transcripts are being worked to resolve advance payment for audit adjustment frozen credit accounts.

**CORRECTIVE ACTION:**

We will review our procedures to ensure that civil penalty credit transcripts are worked as intended.

**IMPLEMENTATION DATE:**

September 15, 2015

**RESPONSIBLE OFFICIAL:**

Director, Campus Reporting Compliance, SB/SE Division

**CORRECTIVE ACTION MONITORING PLAN:**

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



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**RECOMMENDATION 8:**

The Commissioner, Wage and Investment Division, should work with the Chief Technology Officer to evaluate the AM11 transcript programming and ensure that all tax modules meeting the criteria will have this transcript generated for review.

**CORRECTIVE ACTION:**

We will review the criteria for generating the AM11 transcripts and determine if the programming is working as intended.

**IMPLEMENTATION DATE:**

April 15, 2016

**RESPONSIBLE OFFICIAL:**

Director, Accounts Management, Customer Account Services, Wage and Investment Division

**CORRECTIVE ACTION MONITORING PLAN:**

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

**RECOMMENDATION 9:**

The Commissioner, Wage and Investment Division, should evaluate the AM11 transcript criteria for changes that will alert employees to aging frozen credits resulting from the Automated Underreporter (AUR) program.

**CORRECTIVE ACTION:**

We will evaluate the criteria for generating the AM11 transcript to ensure unresolved credits are identified.

**IMPLEMENTATION DATE:**

April 15, 2016

**RESPONSIBLE OFFICIAL:**

Director, Accounts Management, Customer Account Services, Wage and Investment Division

**CORRECTIVE ACTION MONITORING PLAN:**

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



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**RECOMMENDATION 10:**

The Commissioner, Wage and Investment Division, should work with the Large Business and International Division to evaluate the procedures for forwarding to the Examination function the Accounts Maintenance transcripts that are generated for Offshore Voluntary Disclosure Program payments

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**CORRECTIVE ACTION:**

We discussed this recommendation with the Large Business and International Division and determined it is not necessary to forward the Accounts Maintenance transcripts to the Examination function. The Offshore Voluntary Disclosure Program (OVDP) requires taxpayers to apply for acceptance into the program. Advance payments on potential deficiencies are remitted with the taxpayer's application to the program. When the payment posts to the account, it creates an examination freeze condition to prevent the payment from refunding or being applied to other balances due. Because examination controls are not established on the account until the application is approved, the payments have the appearance of being unresolved credits. The Examination function is aware of the presence of the credit through the OVDP application process and use of the Examination Returns Control System in monitoring in-process inventory. No further corrective action will be taken.

**IMPLEMENTATION DATE:**

N/A

**RESPONSIBLE OFFICIAL:**

N/A

**CORRECTIVE ACTION MONITORING PLAN:**

N/A