



*Improvements Are Needed to
Better Ensure That Refunds Claimed
on Potentially Fraudulent Tax Returns
Are Not Erroneously Released*

November 12, 2015

Reference Number: 2016-40-006

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

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HIGHLIGHTS

IMPROVEMENTS ARE NEEDED TO BETTER ENSURE THAT REFUNDS CLAIMED ON POTENTIALLY FRAUDULENT TAX RETURNS ARE NOT ERRONEOUSLY RELEASED

Highlights

Final Report issued on November 12, 2015

Highlights of Reference Number: 2016-40-006 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

The IRS's Return Integrity and Compliance Services organization is responsible for identifying, evaluating, and preventing the issuance of improper refunds. This mission includes the protection of revenue by identifying potentially fraudulent tax returns and verifying the accuracy of reported income and withholding information. The IRS reported that the Integrity and Verification Operations function prevented more than \$15 billion in refunds for over 2 million tax returns for confirmed identity theft or fraud during Calendar Year 2014.

WHY TIGTA DID THE AUDIT

This audit was initiated because an IRS employee reported to the TIGTA Office of Investigations that the IRS was not working some taxpayer cases in which refunds were held. The Office of Investigations identified that these tax accounts were not timely addressed to ensure that the refunds are not erroneously released. This review assessed IRS processes to ensure that tax refunds are not erroneously released.

WHAT TIGTA FOUND

TIGTA identified that because of a programming error, over \$27 million of refunds were erroneously issued for 13,043 Tax Year 2013 tax returns. The programming error is overriding the IRS's two-week processing delay on some refund tax returns that are identified by the IRS as potentially fraudulent. These are tax returns that the IRS Examination function also identified

as claiming a questionable tax credit. The portion of the refund that is not reviewed by the Examination function is erroneously issued before the IRS can complete its verification of income and withholding.

TIGTA also identified that ineffective monitoring of potentially fraudulent tax returns is resulting in the erroneous release of refunds before the required verification. TIGTA identified 3,910 Tax Year 2013 tax returns selected for verification with no indication that tax examiners verified the returns. The IRS issued refunds totaling over \$19 million for these tax returns. The IRS did not ensure that tax examiners timely completed their verification work. Name mismatches in IRS systems prevented refund holds from posting to tax accounts. Refund holds were either not set correctly or not functioning as intended.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS 1) correct the programming that is erroneously overriding the two-week return processing delay needed to ensure that refunds are not issued prior to screening and verification of the tax returns, 2) develop a periodic reconciliation process to ensure that refunds associated with identified potentially fraudulent tax returns are not erroneously released, 3) develop a process to ensure that tax examiners verify a potentially erroneous refund claimed by a taxpayer within the refund hold period or place an unexpiring refund hold on the taxpayer's account until verification can be completed as required, and 4) identify why refund holds placed on some accounts were not delaying processing of the tax returns and address the causes.

The IRS agreed with all recommendations. The IRS stated that it took action to address the programming conflict that was overriding the two-week return processing delay, plans to periodically reconcile account inventory information to identify refunds at jeopardy for erroneous release, initiated actions to change the refund hold from a temporary freeze to an unexpiring freeze, and agreed to periodically reconcile records between computer systems to address anomalies and prevent the issuance of erroneous refunds.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

November 12, 2015

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Improvements Are Needed to Better Ensure That Refunds Claimed on Potentially Fraudulent Tax Returns Are Not Erroneously Released (Audit # 201540026)

This report presents the results of our review to determine if processes in the Internal Revenue Service (IRS) Integrity and Verification Operations function ensure that tax refunds are not erroneously released. This audit was conducted because an IRS employee reported to the Treasury Inspector General for Tax Administration Office of Investigations that the IRS was not working some taxpayer cases in which refunds were held. The Office of Investigations identified that these tax accounts were not timely addressed to ensure that the refunds are not erroneously released. This audit addresses the major management challenge of Fraudulent Claims and Improper Payments.

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

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 or Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services), at (978) 809-0296 if you have questions.



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

Table of Contents

BackgroundPage 1

Results of ReviewPage 5

 Because of a Programming Error, Some Erroneous
 Refunds Are Issued After Tax Returns Are Identified
 As Potentially FraudulentPage 5

Recommendations 1 and 2:Page 6

 Ineffective Monitoring of Potentially Fraudulent Tax
 Returns Resulted in the Erroneous Issuance of Refunds
 Prior to Required VerificationPage 7

Recommendations 3 and 4:Page 9

Appendices

 Appendix I – Detailed Objective, Scope, and MethodologyPage 10

 Appendix II – Major Contributors to This ReportPage 12

 Appendix III – Report Distribution ListPage 13

 Appendix IV – Outcome Measures.....Page 14

 Appendix V – Management’s Response to the Draft ReportPage 16



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

Abbreviations

BFS	Bureau of the Fiscal Service
EFDS	Electronic Fraud Detection System
IRS	Internal Revenue Service
IVO	Integrity and Verification Operations



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

Background

The Internal Revenue Service's (IRS) Return Integrity and Compliance Services organization is responsible for identifying, evaluating, and preventing the issuance of improper refunds. Within the Return Integrity and Compliance Services organization is the Integrity and Verification Operations (IVO) function, whose mission includes support of the IRS's prerefund fraud detection and prevention efforts (*i.e.*, detection during tax return processing prior to a refund being issued). The IVO function protects revenue by identifying potentially fraudulent tax returns and verifying the accuracy of reported income and withholding information. For example, once a potentially fraudulent tax return is identified, the IVO function screens the tax return to determine whether verification of reported income and withholding is warranted. If verification is warranted, the return is sent to a tax examiner in the IVO function, where this verification is performed.

The IVO function receives its inventory from the following sources:

- ***Dependent Database Filters*** – The Dependent Database addresses noncompliance relevant to the Earned Income Tax Credit and other tax benefits related to the dependency and residency of children, various other credits, identity theft, and frivolous filers. Tax returns meeting certain identity theft criteria are routed to the IVO function's Taxpayer Protection Program.
- ***Electronic Fraud Detection System (EFDS)*** – The EFDS is the system the IRS uses to identify potentially fraudulent paper and electronically filed tax returns. During tax return processing, paper and electronically filed tax returns are analyzed through various EFDS data model formulas. The data models identify suspicious paper and electronically filed tax returns based on specific characteristics of the tax return. An associated score is computed for each tax return. The higher the score, the greater the likelihood that the tax return is fraudulent. Tax returns with high scores are routed to the IVO function to be screened and verified.
- ***External Leads*** – The External Leads Program is an IRS program that receives external communications (leads) about questionable tax refunds received from sources outside the IRS such as financial institutions, Federal and State agencies, and various other third-party providers. Leads may involve Treasury Checks, direct deposits, Automated Clearing House deposits, refund anticipation loans, refund anticipation checks, or third-party checks and prepaid debit cards. The IVO functions reviews these leads.

The IVO function has a total of 41 teams in nine locations (Fresno, California; Atlanta, Georgia; Andover, Massachusetts; Kansas City, Missouri; Brookhaven, New York; Cincinnati, Ohio; Memphis, Tennessee; Austin, Texas; and Ogden, Utah). Tax Examiners on these teams verify



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

questionable information documents such as Form W-2, *Wage and Tax Statement*; Form 4852, *Substitute for Form W-2, Wage and Tax Statement*; Form 1099, *Information Return*; and Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, Individual Retirement Arrangements, and Insurance Contracts, etc.*

Figure 1 shows the number of refunds that the IVO function prevented for confirmed identity theft or fraud during Calendar Year 2014.

**Figure 1: Refunds Prevented by the IVO Function for
Confirmed Identity Theft or Fraud During Calendar Year 2014**

Fraud Category	Source	Returns	Dollar Amount
Identity Theft	Dependent Database	1,071,691	\$6,577,972,000
	EFDS	661,430	\$3,960,778,704
	Subtotal	1,733,121	\$10,538,750,704
Other Fraud	EFDS	256,065	\$4,432,284,837
	External Leads	194,592	\$535,364,026
	Subtotal	450,657	\$4,967,648,863
Total		2,183,778	\$15,506,399,567

Source: IRS Refund Fraud and Identity Theft Global Report.

Identification and verification of potentially fraudulent tax returns

Tax returns that are identified during processing as potentially fraudulent and meet IVO workload and tolerance selection criteria are automatically resequenced (processing and issuance of any associated refund is delayed) for two weeks. Once a questionable tax return is identified, the tax return is placed in IVO inventory for tax examiner screening and verification.

- **Screening** – A tax examiner reviews the tax return for income and withholding information, including comparing the information reported on the current tax year¹ return to previous tax year returns to identify inconsistencies. For returns that tax examiners verify as legitimate, the tax examiner “refiles” the return (the return is considered verified as good and the refund is to be released). If the tax examiner concludes that the tax return is potentially fraudulent, the tax return is sent for verification and a refund hold is placed on the individual’s tax account. The refund hold will prevent the issuance of the

¹ A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

associated refund for 11 weeks. This hold gives the IRS additional time to verify the legitimacy of the tax return.

- **Verification** – A tax examiner attempts to contact employers to confirm wages and withholding reported on the potentially fraudulent tax return. If the tax examiner is unable to verify the income with the employer, the refund is permanently frozen to prevent it from being issued.

A prior Treasury Inspector General for Tax Administration review identified concerns with the issuance of potentially fraudulent tax refunds due to IVO processes

In August 2013, we reported² that 104 tax returns sampled with refunds totaling \$613,929 were not worked timely by the IVO function. Tax examiners confirmed that 96 tax returns had false income and withholding, but actions to prevent the issuance of the fraudulent refunds were not taken timely. The remaining eight tax returns were not screened within the required time period to prevent the issuance of a refund.

The IRS explained that a limit in the number of refund hold transactions that could be manually processed each day prevented permanent holds from being placed on accounts in time to prevent the automatic release of the refunds. The IRS indicated that changes were made in January 2013 to stop the automatic release of refunds for tax returns with confirmed false income and withholding. The IRS stated that system capacity for pending transactions was increased five-fold and daily manual monitoring would be performed to ensure that maximum daily limits are not exceeded.

We recommended that the IRS ensure that actions are taken to prevent the issuance of potentially fraudulent refunds when tax returns are not timely screened and verified and ensure that case actions are sufficiently documented. In addition, procedures should be revised to ensure that when tax returns identified as potentially fraudulent are also assigned to another IRS function, the tax refunds are held until the tax return is screened and verified. IRS officials agreed with our recommendations and planned to implement actions to extend tax account freezes to prevent the release of potentially fraudulent tax refunds. They also planned to reemphasize documentation requirements of case actions and revise instructions for tax examiners to require positive verification that an issue triggering an error code or referral has been addressed by the other function before returns are released for further processing.

This review was performed at the Wage and Investment Division's IVO function locations in Atlanta, Georgia, and Ogden, Utah, during the period October 2014 through July 2015. We conducted this performance audit in accordance with generally accepted government auditing

² Treasury Inspector General for Tax Administration, Ref. No. 2013-40-083, *Income and Withholding Verification Processes Are Resulting in the Issuance of Potentially Fraudulent Tax Refunds* (Aug. 2013).



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are in Appendix II.



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

Results of Review

Because of a Programming Error, Some Erroneous Refunds Are Issued After Tax Returns Are Identified As Potentially Fraudulent

Our review identified that a programming error is resulting in the erroneous issuance of some refunds before the income and withholding is screened and verified. Although the IRS reported that the IVO function prevented the issuance of more than \$15 billion in refunds for confirmed identity theft or fraud during Calendar Year 2014, we identified an additional 13,043 Tax Year 2013 tax returns with refunds totaling over \$27 million that were erroneously issued because of the programming error. We forecast that over five years the IRS could issue \$135 million in potentially erroneous refunds due to this programming error.³

The programming error is causing the two-week resequencing marker placed on potentially fraudulent tax returns to be overridden if the tax return is also selected by the IRS Examination function. This results in the issuance of the portion of the associated refund that is not being reviewed by the Examination function. Below is a hypothetical example of the error:

A tax return that includes a claim for the Earned Income Tax Credit is submitted to the IRS for processing. During processing, the tax return is identified as having a questionable Earned Income Tax Credit claim and is selected by the Examination function for a prerefund review. An Examination marker is placed on the taxpayer's account indicating that the tax return is being reviewed. The portion of the refund associated with the Earned Income Tax Credit is held from being issued. At the same time, the tax return is sent through the EFDS, identified as potentially fraudulent, selected for IVO screening, and a two-week return processing hold is placed on the tax account. An IVO function tax examiner screens the tax return, concludes that it is potentially fraudulent, and selects it for verification. The tax examiner places an 11-week refund hold on the tax account to stop the refund from issuing. However, because of the programming error, the placement of the Examination marker on the tax account overrides the two-week return processing hold, which results in the release of the portion of the refund not associated with the Earned Income Tax Credit.

The IRS could have detected the erroneous issuance of refunds that we identified if it established a process to periodically reconcile tax returns identified as potentially fraudulent between the

³ See Appendix IV. The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

EFDS and the Integrated Data Retrieval System.⁴ For example, a reconciliation process would identify tax returns identified for resequencing for which a portion of the refund was issued but an IVO tax examiner never notated in the EFDS the refiling of the tax return (return considered verified as good and refund to be released). The IRS stated that it completes periodic reviews for tax returns with fraudulent characteristics to ensure that appropriate actions are taken, but it would be difficult to perform this type of reconciliation because the IVO's EFDS inventory system does not interface with the Integrated Data Retrieval System, which provides detailed tax account information along with refund hold and release information.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Correct the programming that is erroneously overriding the IVO function resequencing tax account marker to ensure that refunds are not issued prior to tax examiners screening and verifying the tax return.

Management's Response: The IRS agreed with this recommendation. The IRS agreed there is a programming conflict causing an erroneous override of the IVO return resequencing function. In June 2015, the IRS took action to reflect current processing conditions and prevent a conflict of business rules. A programming update request was input for the 2016 Filing Season which will resolve the conflict; however, the implementation of such programming changes are subject to budgetary constraints, limited resources, and competing priorities. Consequently, and due solely to those constraints, the IRS cannot provide an implementation date.

Recommendation 2: Develop a process that periodically reconciles IVO function inventories between the EFDS and the Integrated Data Retrieval System to ensure that refunds associated with identified potentially fraudulent tax returns are not erroneously released.

Management's Response: The IRS agreed with this recommendation. The IRS will periodically reconcile information from the EFDS to Master File data to identify refunds at jeopardy for erroneous release.

⁴ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

Ineffective Monitoring of Potentially Fraudulent Tax Returns Resulted in the Erroneous Issuance of Refunds Prior to Required Verification

Our review identified 3,910 Tax Year 2013 tax returns the IRS selected for IVO verification as being potentially fraudulent with no indication that tax examiners verified the income, withholding, and other information as required. The IRS issued refunds totaling over \$19 million for these returns. We forecast that over five years the IRS could issue more than \$95 million in potentially erroneous refunds because tax returns are not being verified as required.⁵

When we brought this issue to IVO management's attention, they stated that the erroneous release of the refunds associated with these 3,910 tax returns resulted from:

- *The IRS not having an effective process to ensure that tax examiners verify a potentially erroneous refund claimed by a taxpayer within the 11-week hold period or place an unexpiring marker on the taxpayer's account to hold the refund longer until verification can be completed as required.* For example, management does not monitor tax returns as the 11-week refund hold expiration date approaches to ensure that the return is verified as required or that an additional refund hold (the IRS refers to this additional refund hold as an "unexpiring" refund hold) is placed on the tax account. When IVO tax examiners do not take timely actions to verify the tax return information during the 11-week hold or place an additional refund hold marker on the tax account prior to expiration of the 11-week hold, the refund will be systemically released and issued.
- *Name mismatches between the EFDS and the IRS's Master File.* IVO officials stated that their process to place unexpiring refund holds on some tax accounts requires analysts to record names and other information from the EFDS to a spreadsheet and upload the spreadsheet to the Master File. However, when the names on the spreadsheet are not an exact match to the Master File, the refund holds will not post to the tax accounts and the refunds will be erroneously issued. Officials stated that they implemented a process in March 2015 to ensure that the IRS identifies these name mismatches and inputs the refund holds. They also stated that the IRS now identifies these returns within 10 weeks of the 11-week refund hold. The related accounts are then researched and corrections are manually uploaded to the Master File on a weekly basis.

The name mismatches are similar to another name mismatch issue that we reported in September 2014.⁶ In this prior review, we reported that some tax returns in the EFDS had

⁵ See Appendix IV. The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.

⁶ Treasury Inspector General for Tax Administration, Ref. No. 2014-40-091, *Prisoner Tax Refund Fraud: Delays Continue in Completing Agreements to Share Information With Prisons, and Reports to Congress Are Not Timely or Complete* (Sept. 2014).



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

a two-character name control instead of the four-character name control in the Master File. A name control is the first four letters in an individual's last name, *e.g.*, the name control for Smith would be SMIT, but the two-character field would be something unrelated to the name control that loaded into the EFDS. The IRS's review of these tax returns identified that the two-character name control (included on "preprinted" address labels provided to the taxpayer by the IRS) was being loaded into the EFDS instead of the actual name control. This deficiency that we reported in our prior review resulted in the IRS not assigning a prisoner indicator to some tax accounts as warranted. We recommended that the IRS correct the computer programming errors that caused this deficiency. The IRS did not agree with this recommendation.

- *Tax returns being routed directly to the IVO scheme tracking system⁷ during the same time frame that they were received in the EFDS.* These tax returns involve known tax fraud schemes, and when tax returns associated with these schemes are processed, they are identified and routed directly to the IVO scheme tracking system. However, the direct routing requires a manual process to add an unexpiring refund hold marker to the tax account. IVO management indicated that the unexpiring refund hold should be added before the tax return is routed to its scheme tracking system. However, the unexpiring refund hold was not input on the tax accounts we identified, resulting in the erroneous issuance of the refunds. IRS officials stated that this weakness has been mitigated because tax returns routed directly to its scheme tracking system now first have an 11-week refund hold placed on the tax account.
- *Resequencing markers systemically set on some tax accounts did not delay processing the tax returns, which resulted in the release of the associated refunds.* IVO officials informed us they are investigating this problem.
- *Unexpiring refund hold markers were not placed on taxpayers' accounts by the IVO function.* These refunds were identified by the Dependent Database filters as suspicious because taxpayers claimed questionable credits on their tax returns. However, in Calendar Year 2014, the tax accounts needing an unexpiring account marker were manually recorded on a spreadsheet, which was then used to input the marker to the Master File. This process was not always effective. Thus, some tax accounts were not updated with the refund holds, and the refunds were issued before the IVO's Automated Questionable Credits program⁸ could verify taxpayers' eligibility for the credits. IVO officials stated that this problem is now resolved because the manual process was discontinued and the markers are now systemically input.

⁷ The Scheme Tracking and Referral System is the subsystem of the EFDS that captures statistical information and tracks the status of refund schemes.

⁸ Tax examiners in the Automated Questionable Credits program review tax accounts and determine if appropriate documentation exists for the credit(s) claimed.



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 3: Develop a process to ensure that tax examiners verify a potentially erroneous refund claimed by a taxpayer within the 11-week hold period or place an unexpiring refund hold marker on the taxpayer's account to hold the refund longer until verification can be completed as required.

Management's Response: The IRS agreed with this recommendation. The IRS agreed that returns should be verified or an unexpiring refund hold input on a taxpayer's account prior to the 11-week refund hold. The IRS currently has a manual monitoring process in place to use queries of the EFDS to identify accounts that need additional refund hold actions. A programming update was requested for the 2016 Filing Season to change the initial systemic refund freeze action from a temporary freeze to an unexpiring freeze; however, the implementation of such programming changes are subject to budgetary constraints, limited resources, and competing priorities. Consequently, and due solely to those constraints, the IRS cannot provide an implementation date.

Recommendation 4: Ensure that actions are taken to identify and address the causes for the instances in which resequencing markers placed on accounts were not delaying the IRS's processing of the tax returns and thus preventing the erroneous issuance of refunds.

Management's Response: The IRS agreed with this recommendation. The IRS will complete periodic reconciliations of the EFDS data to Master File information to ensure that resequence markers are working appropriately and actions are taken to address anomalies to prevent erroneous issuance of refunds.



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to assess the IVO function processes to ensure that tax refunds are not erroneously released.

- I. Evaluated IVO processes to ensure that refunds are not erroneously released for potentially fraudulent tax returns without being screened and verified by the IVO function.
 - A. Identified the universe of Tax Year¹ 2013 returns routed to the IVO function for screening and verification in Processing Year² 2014.
 - B. Identified the population of returns in the Step I.A universe for which a refund was issued and confirmed by the Bureau of the Fiscal Service. We created a list of these returns.
 - C. Identified Tax Year 2013 accounts for the scenario discovered in which the Examination function indicator overrode an IVO indicator. The Examination function indicator caused a portion (usually the Earned Income Tax Credit) of the taxpayer's refund claim to freeze. Any remaining refund claimed (prior to the IVO function having a chance to review this portion of the refund) was immediately released.
 - D. Validated the list of returns routed to the IVO function with a confirmed refund from Step I.B by comparing data fields from 20 records on this list to the Integrated Data Retrieval System.³
 - E. Validated the EFDS data extract by comparing a judgmental sample⁴ of 20 returns in the extract to the EFDS data online. For each return sampled, we ensured that all requested data fields were in the extract.
 - F. Removed from our list all returns with indications that a tax examiner worked the case prior to the release of the refund.

¹ A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

² The calendar year in which a tax return or document is processed by the IRS.

³ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

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



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

- G. Provided the list from Step I.F of potentially erroneous refunds to IVO officials for review and explanation.
1. Interviewed IVO officials to determine the reasons the refunds were issued without being worked.
 2. Assessed the validity of the reasons provided by IVO officials and performed additional queries, as needed, to refine our query and create a final list of accounts with erroneous refunds that were issued without being worked.
 3. For the final list of erroneous refunds, we interviewed IVO officials to obtain agreement and determined the reasons for potentially erroneous refunds.
- H. Interviewed management to determine the reasons why returns failed to resequence and the effect on refunds. A contract statistician assisted with reviewing outcome measure projections.

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: 1) the processing controls to ensure that the IRS can identify and track tax returns identified for verification by the IVO function using the EFDS and 2) the controls that prevent refunds for these tax returns from being issued prior to IVO verification. We evaluated these controls by assessing the EFDS data interface used by IVO tax examiners, evaluating the EFDS data supplied by the IVO function to perform our data queries, and by comparing the EFDS data results to the Integrated Data Retrieval System.



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

Appendix II

Major Contributors to This Report

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*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

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
Deputy Commissioner, Wage and Investment Division SE:W
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Senior Operations Advisor, Wage and Investment Division SE:W:S
Director, Customer Account Services, Accounts Management, Wage and Investment Division
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Audit Liaison: Chief, Program Evaluation and Improvement, Wage and Investment Division
SE:W:S:PEI



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

Appendix IV

Outcome Measures

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

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$135,456,560 in erroneous refunds over five years for 65,215 tax returns for which the IRS's two-week tax return resequencing marker is overridden by a marker that the Examination function uses to select tax returns for review of questionable refundable credits (see page 5).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 13,043 Tax Year 2013 tax returns with refunds totaling \$27,091,312 that should not have been issued. These tax returns were identified as potentially fraudulent with a resequencing marker added to the account to delay processing the tax returns and keep the refunds from being issued. However, a programming change in January 2008 resulted in the markers being overridden and portions of the refunds being erroneously released.

We forecast that the IRS could potentially pay \$135,456,560 in erroneous refunds for 65,215 tax returns over the next five years. We computed this forecast by multiplying the Tax Year 2013 total erroneous refund amount (\$27,091,312) by five years and the related Tax Year 2013 tax returns (13,043) by five years.¹

The actual amount of erroneous refunds paid is contingent upon the verification of income and withholding information shown on each tax return.

¹ The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$95,897,105 in erroneous refunds over five years issued for 19,325 tax returns selected for IVO review but not screened and verified by IVO screeners (see page 7).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 3,910 Tax Year 2013 tax returns selected for IVO review and verification but with no indication that tax examiners screened and verified the returns. First, we identified the universe of Tax Year 2013 tax returns routed to the IVO function for screening and verification in Processing Year² 2014. We then used data in the IRS's Integrated Data Retrieval System and EFDS to identify the erroneous refunds.

Of these erroneous refunds, 45 were due to a specific problem that IVO officials stated has been resolved and are thus not included in this forecast. We forecast that the IRS could potentially pay \$95,897,105 in erroneous refunds for 19,325 tax returns over the next five years. We computed this forecast by multiplying the total erroneous refund amount for Tax Year 2013 (\$19,179,421) and the 3,865 related tax returns by five years.³

The actual amount of erroneous refunds paid is contingent upon the verification of income and withholding information shown on each tax return.

² The calendar year in which a tax return or document is processed by the IRS.

³ The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.



*Improvements Are Needed to Better Ensure
That Refunds Claimed on Potentially Fraudulent
Tax Returns Are Not Erroneously Released*

Appendix V

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

OCT 28 2015

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Debra Holland *Debra Holland*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Improvements Are Needed to Better Ensure
Refunds Claimed on Potentially Fraudulent Tax Returns Are Not
Erroneously Released (Audit # 201540026)

Thank you for the opportunity to review and provide comments on the subject draft audit report. We appreciate the Treasury Inspector General for Tax Administration's (TIGTA) observations and acknowledgement of our efforts in preventing the issuance of improper refunds. As noted in the draft report, the Integrity and Verification Operations (IVO) function either prevented or recovered over 2.1 million refunds totaling over \$15.5 billion from returns confirmed as identity theft or fraud during Calendar Year 2014. In comparison, the 3,910 Tax Year 2013 returns identified by the TIGTA that appear to have refunds issued prior to an IVO fraud determination is a very small percentage from the overall amount of returns that IVO has been able to prevent.

The IRS is continually improving our ability to detect potentially fraudulent refund claims and stop them from being paid until we have had the ability to review them and make a determination as to their legitimacy. Most significant is the development and testing of the Return Review Program (RRP), an automated system that is more nimble than existing legacy systems with regard to its ability to recognize and evaluate the ever-evolving fraud landscape. The RRP will eventually replace the Electronic Fraud Detection System and the fraud detection capabilities of the Dependent Database. With specific regard to our ability to mitigate the risk of refunds being issued prior to the IVO finishing its fraud determination of suspicious claims, we have expanded the application of systemic account freezes to hold refunds arising from questionable claims for the American Opportunity Tax Credit. We have also reviewed processes and taken steps to ensure systemic transactions are applied in the correct sequence to ensure refunds are not released prematurely.



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2

Regarding the programming error referenced in the draft report, a programming change was implemented in 2008 to resolve problems we were experiencing when potentially fraudulent returns were selected for treatment by both the Examination and the Criminal Investigation functions. Although separate and distinct processes were to be performed by the two functions, the selection of the return by one was hindering the ability of the other to take its required actions. The programming change resolved the immediate problem; however, subsequent developments in the area of refund fraud and the changes the IRS had to take to effectively address them resulted in the implementation of additional business rules that caused an unintended conflict with the 2008 programming. In June 2015, the IRS took action to align programming with current processing conditions and prevent the conflict between business rules and a programming update is planned for the 2016 Filing Season that will resolve the conflict.

Attached are our comments to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Ken Corbin, Director, Return Integrity and Compliance Services, Wage and Investment Division, at (404) 338-8687.

Attachment



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Attachment

Recommendations

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 1

Correct the programming that is erroneously overriding the IVO function resequencing tax account marker to ensure that refunds are not issued prior to tax examiners screening and verifying the tax return.

CORRECTION ACTION

We agree there is a programming conflict causing an erroneous override of the Integrity and Verification Operations' return resequencing function. In June 2015, the IRS took action to reflect current processing conditions and prevent a conflict of business rules. A programming update request was input for the 2016 Filing Season which will resolve the conflict; however, the implementation of such programming changes are subject to budgetary constraints, limited resources, and competing priorities. Consequently, and due solely to those constraints, we cannot provide an implementation date at this time.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 2

Develop a process that periodically reconciles IVO function inventories between the EFDS and the Integrated Data Retrieval System to ensure that refunds associated with identified potentially fraudulent tax returns are not erroneously released.

CORRECTION ACTION

We agree with this recommendation and will periodically reconcile information from the Electronic Fraud Detection System (EFDS) to Master File data to identify refunds at jeopardy for erroneous release.

IMPLEMENTATION DATE

August 15, 2016

RESPONSIBLE OFFICIAL

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



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2

CORRECTIVE ACTION MONITORING PLAN

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

RECOMMENDATION 3

Develop a process to ensure that tax examiners verify a potentially erroneous refund claimed by a taxpayer within the 11-week hold period or place an unexpiring refund hold marker on the taxpayer's account to hold the refund longer until verification can be completed as required.

CORRECTION ACTION

We agree that returns should be verified or an unexpiring refund hold input on a taxpayer's account prior to the 11-week refund hold. We currently have a manual monitoring process in place to use queries of the EFDS to identify accounts that need additional refund hold actions. A programming update was requested for the 2016 Filing Season to change the initial systemic refund freeze action from a temporary freeze to an unexpiring freeze; however, the implementation of such programming changes are subject to budgetary constraints, limited resources, and competing priorities. Consequently, and due solely to those constraints, we cannot provide an implementation date at this time.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 4

Ensure that actions are taken to identify and address the causes for the instances in which resequencing markers placed on accounts were not delaying the IRS's processing of the tax returns, and thus, preventing the erroneous issuance of refunds.

CORRECTION ACTION

We agree with this recommendation and will complete periodic reconciliation of the EFDS data to Master File information to ensure that resequence markers are working appropriately and actions are taken to address anomalies to prevent erroneous issuance of refunds.

IMPLEMENTATION DATE

October 15, 2016



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3

RESPONSIBLE OFFICIAL

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

CORRECTIVE ACTION MONITORING PLAN

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