



*Controls Over Refunds to Certain Taxpayers  
Could Be Improved*

**September 29, 2011**

**Reference Number: 2011-40-126**

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

2(f) = Risk Circumvention of Agency Regulation or Statute

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# HIGHLIGHTS

## CONTROLS OVER REFUNDS TO CERTAIN TAXPAYERS COULD BE IMPROVED

# Highlights

Final Report issued on September 29, 2011

Highlights of Reference Number: 2011-40-126 to the Internal Revenue Service Commissioners for the Large Business and International Division and the Wage and Investment Division.

### IMPACT ON TAXPAYERS

In Calendar Year 2009, the Internal Revenue Service (IRS) issued approximately 74,000 refunds totaling more than \$472 million to taxpayers filing Tax Year 2008 U.S. Individual Income Tax Returns (Form 1040, 1040A, and 1040EZ) with (b)(6) it is imperative that controls are in place to ensure these refunds are accurate to prevent duplicate refunds and fraudulent claims.

### WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether controls over (b)(6) were effective in minimizing the risk of issuing erroneous refunds. (b)(6)

Thorough examination of returns with (b)(6) claiming (b)(6) credits is essential to ensure accuracy and to identify or prevent duplicate and fraudulent refunds.

### WHAT TIGTA FOUND

TIGTA found no major overall trends indicating significant volumes of questionable refunds being issued to individual income taxpayers (b)(6) However, TIGTA found a disproportionate number of returns filed (b)(6)

\*\* The IRS had identified a refund scheme involving returns filed by taxpayers (b)(6) However, manual controls to freeze subsequent

refunds of taxpayers involved in this scheme were ineffective. TIGTA notified the IRS of this finding and it took immediate actions to address the issue. TIGTA provided the IRS with databases of potentially questionable refund returns filed by individuals (b)(6) (b)(6)

TIGTA also found control weaknesses regarding (b)(6) (b)(6)

In addition, fraud awareness training was not provided to campus employees as part of their annual (b)(6) return processing training.

### WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, Large Business and International Division, further refine the databases of returns with potentially questionable refunds issued to (b)(6) by applying filters (b)(6) (b)(6) (b)(6) to ensure returns with the highest risk are identified and considered for further examination. TIGTA also recommended that the Commissioner, Wage and Investment Division, ensure employees receive fraud awareness training in their annual (b)(6) tax return processing training.

In their response to the report, IRS officials agreed with the recommendations and plan to take appropriate corrective actions.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

September 29, 2011

**MEMORANDUM FOR** COMMISSIONER, LARGE BUSINESS AND INTERNATIONAL  
DIVISION  
COMMISSIONER, WAGE AND INVESTMENT DIVISION

*Michael R. Phillips*

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

**SUBJECT:** Final Audit Report – Controls Over Refunds to Certain Taxpayers  
Could Be Improved (Audit # 201040032)

This report presents the results of our review of refunds issued to individual taxpayers \*\*\*2(f)\*\*  
\*\*\*\*\*2(f)\*\*\*\*\* The overall objective of this review was to determine whether controls over  
\*\*\*\*\*2(f)\*\*\*\*\*were effective in minimizing the risk of issuing erroneous refunds. This audit  
was included in our Fiscal Year 2011 Annual Audit Plan and addresses the major management  
challenge of Erroneous and Improper Payments and Credits facing the Internal Revenue Service.

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

Copies of this report are also being sent to the Internal Revenue Service managers affected by the  
report recommendations. Please contact me at (202) 622-6510 if you have questions or  
Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account  
Services), at (202) 622-5916.



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*Abbreviations*

***2(f)***	*****2(f)*****
CI	Criminal Investigation
***2(f)***	*****2(f)*****
IRS	Internal Revenue Service
SSN	Social Security Number
TIGTA	Treasury Inspector General for Tax Administration
TIN	Taxpayer Identification Number
U.S.	United States



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Background

In Calendar Year 2009, the Internal Revenue Service (IRS) issued approximately 74,000 refunds totaling more than \$472 million<sup>1</sup> to taxpayers filing Tax Year<sup>2</sup> 2008 U.S. Individual Income Tax Returns (Form 1040, 1040A, and 1040EZ) \*\*\*\*\*2(f)\*\*\*\*\*

\*\*\*\*\*2(f)\*\*\*\*\* it is imperative that controls are in place to ensure these refunds are accurate to prevent duplicate refunds and fraudulent claims. The IRS has 45 days from the due date of the return to issue a refund without paying interest on the refund amount.

\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*

Our review focused on Tax Year 2008 refunds of \$500 or more issued to taxpayers who filed individual income tax returns \*\*\*\*\*2(f)\*\*\*\*\* \*\*\*\*\*2(f)\*\*\*\*\*

\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*<sup>3</sup>

This review was performed from the TIGTA office at the Fresno Campus<sup>4</sup> in Fresno, California, during the period November 2009 through June 2011. It included a review of individual income tax returns filed nationwide with \*\*\*\*\*2(f)\*\*\*\*\* and discussions with IRS personnel assigned to the Wage and Investment Division Headquarters in Atlanta, Georgia; the Large Business and International Division in Washington, D.C.; and the Criminal Investigation Headquarters in Washington, D.C. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and

<sup>1</sup> Tax Year 2008 \*\*\*\*\*2(f)\*\*\*\*\* returns processed in Calendar Year 2009 excluding the following returns: those \*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\* and returns with refunds of less than \$500.

<sup>2</sup> 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.

<sup>3</sup> \*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*.

<sup>4</sup> The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



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



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*Results of Review*

Individual income tax returns \*\*\*\*\*2(f)\*\*\*\*\* are processed at the IRS's Submission Processing Center in \*\*\*\*\*2(f)\*\*\*\*\*. These returns are subject to the same scrutiny as other refund returns. For instance, IRS employees ensure that required documentation is present to substantiate certain payments and credits claimed by taxpayers. Returns are analyzed through the Electronic Fraud Detection System and screened for characteristics of fraud.

In addition, other controls have been established specific to these types of returns. Employees processing these returns must meet specific experience requirements and receive \*\*\*\*\*2(f)\*\*\*\*\* return processing training at the beginning of the filing season.<sup>5</sup> They are provided written guidance specific to processing \*\*\*\*\*2(f)\*\*\*\*\* returns.

Certain refund returns \*\*\*\*\*2(f)\*\*\*\*\* are subject to separate reviews in the IRS's Notice Review function. This function reviews the complete return and attachments submitted to determine the validity of the refund (including credits claimed) and substantiate the taxpayers' \*\*\*\*\*2(f)\*\*\*\*\*.

We analyzed the database of approximately 74,000 Tax Year 2008 Form 1040 refund returns \*\*\*\*\*2(f)\*\*\*\*\*. We also selected a statistical sample of 397 of these returns and reviewed them to determine if the refunds appeared valid. We focused on such things as:

- Did the Taxpayer Identification Number (TIN) belong to the taxpayer?
- Did the exemptions, deductions, and credits claimed appear valid for the taxpayer?
- \*\*\*\*\*2(f)\*\*\*\*\*
- Did the wage and withholding amounts match the information in IRS records?

We found some control weaknesses that need to be addressed, and we found that control breakdowns allowed subsequent refunds related to an identified refund scheme to be issued. With the exception of that one scheme, we found no major overall trends indicating significant volumes of questionable refunds being issued to taxpayers \*\*\*\*\*2(f)\*\*\*\*\*. However, we found a disproportionate number of returns filed from \*\*\*\*\*2(f)\*\*\*\*\* \*\*\*\*\*2(f)\*\*\*\*\*.

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<sup>5</sup> The period from January through mid-April when most individual income tax returns are filed.



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Manual Controls to Freeze Subsequent Refunds of Taxpayers in One Identified Scheme Were Ineffective

From the population of approximately 74,000 Tax Year 2008 Forms 1040 receiving refunds for \$500 or more, we found more than 10,600 returns that claimed more than \$24 million We found that 6,847 (64 percent) of these refunds were sent to taxpayers Figure 1 shows the top five

2(f)  
2(f)

2(f)	2(f)	2(f)	2(f)
2(f)	2(f)	2(f)	2(f)
2(f)	2(f)	2(f)	2(f)
2(f)	2(f)	2(f)	2(f)
2(f)	2(f)	2(f)	2(f)
2(f)	2(f)	2(f)	2(f)
2(f)	2(f)	2(f)	2(f)
2(f)	2(f)	2(f)	2(f)
2(f)	2(f)	2(f)	2(f)

2(f)

6 2(f)  
2(f)  
2(f)  
2(f)  
2(f)  
2(f)  
2(f)  
2(f)

We discussed the 2(f) returns with the IRS and learned that the IRS's Criminal Investigation (CI) function had identified a refund scheme involving 2(f) returns filed by taxpayers and had referred the associated returns to the IRS Examination function to

6 2(f)  
2(f)  
2(f)  
2(f)



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determine the validity of the refunds being claimed. The Examination function determined the refunds were fraudulent.

The Examination function focused on \*\*\*\*\*2(f)\*\*\*\*\*  
\*\*2(f)\*\* to determine if the refunds were valid. They described the following characteristics related to this scheme:

- \*\*\*\*\*2(f)\*\*\*\*\*
- \*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*
- \*\*\*\*\*2(f)\*\*\*\*\*
- \*\*\*\*\*2(f)\*\*\*\*\*
- \*\*\*\*\*2(f)\*\*\*\*\*

In an attempt to ensure that all returns with similar characteristics were frozen from refunding, the IRS issued two Servicewide Alerts in February 2010 listing the characteristics of the returns and providing instructions regarding how to freeze the returns from refunding and refer the returns to the Examination function. \*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*

We found that the steps taken to stop subsequent fraudulent claims from refunding were largely ineffective. From the 4,889 refunds to \*\*\*\*\*2(f)\*\*\*\*\*, we identified 627 that claimed \*\*\*\*\*2(f)\*\*\*\*\* We reviewed a statistical sample of 84 of these returns to determine if the controls established by the IRS were effective in preventing these taxpayers from receiving subsequent erroneous refunds. Almost half (38) of the taxpayers in our sample filed subsequent returns (Tax Year 2009) \*\*\*\*\*2(f)\*\*\*\*\* Appropriate steps were not taken to stop \*\*2(f)\*\* of these 38 returns from refunding. Approximately \$172,000 in questionable \*\*2(f)\*\*refunds were issued to these \*\*2(f)\*\*taxpayers. Based on the results of our sample, we estimate that more than \*\*\*\*\*2(f)\*\*\*\*\* in refunds for similar questionable \*\*2(f)\*\*claims were issued despite IRS attempts to stop these claims from refunding.

We notified the IRS of our findings. In response, another Servicewide Alert was issued in March 2011 to all IRS employees to provide an overview and reminder of this type of questionable claim. The Alert also provided instructions to prevent the reversal of freeze codes<sup>7</sup> on any questionable refunds associated with the scheme.

<sup>7</sup> A freeze code is an indicator the IRS uses for preventing the issuance of refunds, credit offsets, or the assessment of accrued interest and/or penalty.



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We provided the IRS with three databases of potentially questionable refund returns (b) (5) - A. The three databases were returns (b) (5) - A. (b) (5) - A.

**Control Weaknesses Existed for (b) (5) - A Returns**

To evaluate internal controls over refunds issued to (b) (5) - A, in addition to the analyses previously discussed, we sent questionnaires to three functions responsible for processing individual income tax returns (the Code and Edit, Error Resolution, and Notice Review functions) and to CI and reviewed a sample of 84 (b) (5) - A returns filed by taxpayers (b) (5) - A. We identified the following control weaknesses that may have contributed to the release of some potentially erroneous refunds.

**Fraud awareness training is not provided to campus employees as part of their annual (b) (5) - A training**

The Resident Agent in Charge of CI's Scheme Development Center is responsible for the training and orientation of IRS campus employees in the recognition and referral of potentially fraudulent returns. It is also CI's responsibility to secure a commitment from IRS campus management to allow fraud awareness presentations.

One of the questions posed to the functions responsible for processing tax returns and to CI addressed fraud awareness training given. CI replied that it provides a variety of fraud awareness training to other IRS functions throughout the year, including local field office, campus, and national levels. However, the Code and Edit, Error Resolution, and Notice Review functions responded that they did not receive any fraud awareness training from CI in their annual training. In addition, the Notice Review function stated that training and alerts were needed for the tax examiners to be able to identify fraud.

In a discussion with IRS management in October 2010 regarding the (b) (5) - A scheme involving taxpayers (b) (5) - A, they stated that some training is provided to Examination function employees, but not to campus employees. They added that Code and Edit function employees should receive training about the (b) (5) - A scheme because they are allowing the refunds up front.

From our sample of 84 (b) (5) - A returns filed by taxpayers (b) (5) - A, we found that campus employees had released all 84 refunds. Fraud awareness training may have provided campus employees with scheme characteristics to look for, which might have resulted in these returns being identified as questionable before the refunds were released.

**(b) (5) - A**

We also reviewed our sample of 84 (b) (5) - A returns filed by taxpayers (b) (5) - A to determine if they contained any characteristics that might be identified by (b) (5) - A rather than



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relying \*\*\*\*\*2(f)\*\*\*\*\* to identify and stop these questionable refunds. \*\*\*\*\*2(f)\*\*\*\*\*  
 \*\*\*\*\*2(f)\*\*\*\*\*  
 \*\*\*\*\*2(f)\*\*\*\*\*:

- \*\*\*\*\*2(f)\*\*\*\*\*  
 \*\*\*\*\*2(f)\*\*\*\*\*.
- \*\*\*\*\*2(f)\*\*\*\*\*.

We determined that more than 80 percent of the Tax Year 2008 Form 1040 refund returns in our  
 \*\*2(f)\*\* population overall, including those \*\*\*\*\*2(f)\*\*\*\*\* and those with  
 taxpayers \*\*\*\*\*2(f)\*\*\*\*\*.

\*\*\*\*\*2(f)\*\*\*\*\*  
 \*\*\*\*\*2(f)\*\*\*\*\*  
 \*\*\*\*\*2(f)\*\*\*\*\*  
 \*\*\*\*\*2(f)\*\*\*\*\*  
 \*\*\*\*\*2(f)\*\*\*\*\*  
 \*\*\*\*\*2(f)\*\*\*\*\*.

\*\*\*\*\*2(f)\*\*\*\*\*<sup>8</sup>

**2(f)**	*****2(f)***** *****		*****2(f)*****		*****2(f)*****	
	***2(f)**	**2(f)**	**2(f)**	**2(f)**	**2(f)**	**2(f)**
***2(f)**	***2(f)**	***2(f)**	***2(f)**	***2(f)**	***2(f)**	***2(f)**
***2(f)**	***2(f)**	***2(f)**	***2(f)**	***2(f)**	***2(f)**	***2(f)**
Total	***2(f)**	***2(f)**	***2(f)**	***2(f)**	***2(f)**	***2(f)**

\*\*\*\*\*2(f)\*\*\*\*\*.

As shown in Figure 3, only 3 percent of the \*\*2(f)\*\* returns in our overall population claimed  
 \*\*\*\*\*2(f)\*\*\*\*\*, while 31 percent of the \*\*2(f)\*\* returns in the \*\*2(f)\*\* scheme filed by  
 taxpayers \*\*\*\*\*2(f)\*\*\*\*\*.

<sup>8</sup> From our population count and percentage of \*\*\*\*\*2(f)\*\*\*\*\*, and returns  
 with \*\*\*\*\*2(f)\*\*\*\*\*.



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\*\*\*\*\*2(f)\*\*\*\*\*

	***2(f)***		***2(f)***		***2(f)***	
***2(f)***						
***2(f)***						
***2(f)***						
***2(f)***						

\*\*\*\*\*2(f)\*\*\*\*\*

\*\*\*\*\*2(f)\*\*\*\*\*. The duplicate use of dependent SSNs was reported in a prior TIGTA report.<sup>9</sup> Another TIGTA report estimated that \*\*\*\*\*2(f)\*\*\*\*\*claims paid in error were associated with the multiple use of SSNs on Tax Year 2007 income tax returns.<sup>10</sup> We recommended, and the IRS agreed, to assess the feasibility of systemic identification of questionable returns to facilitate reviewing them prior to issuance of the refunds.

\*\*\*\*\*2(f)\*\*\*\*\*

The time period which the IRS has to issue refunds to U.S. citizens is much shorter than those for non-U.S. citizens. The IRS has 180 days to issue refunds to non-U.S. citizens (filing Form 1040NR) but only 45 days for U.S. citizens (filing Form 1040). The extra processing time allows the IRS more time to validate income, withholding, and other information provided by third parties. \*\*\*\*\*2(f)\*\*\*\*\*. In our statistical sample of 397 returns which were reviewed to determine if the refunds appeared valid, 146 had wages reported that did not match third-party data, 25 had withholding reported that did not match third-party data, and 110 had other income reported that did not match third-party data.

**Taxpayer\*\*\*\*\*2(f)\*\*\*\*\*are often missing**

Taxpayer \*\*\*2(f)\*\*\* is vital to determine if filing status and exemptions claimed by some \*\*\*2(f)\*\*\*taxpayers are valid. \*\*\*2(f)\*\*\* data are maintained by the Social Security Administration. These data are provided to the IRS and are included as part of a taxpayer's account information on the IRS's Master File.<sup>11</sup> In our database of approximately 74,000 Tax

<sup>9</sup> *Duplicate Dependent and Qualifying Child Overclaims Result in Substantial Losses of Tax Revenue Each Year* (Reference Number 2001-40-059, dated March 21, 2001).

<sup>10</sup> *Multiple Use of Taxpayer Identification Numbers Continues to Result in Significant Erroneous Exemptions and Credits* (Reference Number 2010-40-117, dated September 14, 2010).

<sup>11</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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Year 2008 Forms 1040 generating refunds to \*\*\*\*\*2(f)\*\*\*\*\*, we found 33 percent with blank \*\*\*\*\*2(f)\*\*\*\*\* on the IRS’s Master File and 35 percent with blank \*\*\*\*\*2(f)\*\*\*\*\* (taxpayer’s spouse). See Figure 4 for percentages of \*\*\*\*\*2(f)\*\*\*\*\* types in our population.

\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*

We reviewed the filing status on 308 of the 397 returns in our sample to determine if the appropriate filing status for the \*\*\*\*\*2(f)\*\*\*\*\*. In general, taxpayers \*\*\*\*\*2(f)\*\*\*\*\* \*\*2(f)\*\*\* may use only filing status Single or filing status Married Filing Separately.<sup>12</sup> An exception to the rule allows \*\*\*\*\*2(f)\*\*\*\*\* and is allowed to use the filing status Married Filing Jointly. We used the \*\*\*\*\*2(f)\*\*\*\*\* to determine if the taxpayers met the exception criteria. In our review of the 308 returns, 67 taxpayers (22 percent) met the exception to the rule and used filing status Married Filing Jointly.

We determined that 166 (54 percent) of the remaining 241 returns had \*\*\*\*\*2(f)\*\*\*\*\* and 75 (24 percent) did not. \*\*\*\*\*1\*\*\*\*\*. Based \*\*\*\*\*2(f)\*\*\*\*\* on the returns, we were able to determine that 38 of the 75 returns with no \*\*\*\*\*2(f)\*\*\*\*\* had the correct filing status. Without the \*\*\*\*\*2(f)\*\*\*\*\* we were unable to determine if remaining 37 of the 75 had the correct filing status.

In a separate test, we determined that 159 of the 397 taxpayers claimed their children as exemptions but we could not determine if 23 (14 percent) of those were entitled to do so because the taxpayers’ \*\*\*\*\*2(f)\*\*\*\*\* were blank.

We could not determine why the \*\*\*\*\*2(f)\*\*\*\*\* was blank for these taxpayers. The IRS did not take actions during processing to ascertain the correct \*\*\*\*\*2(f)\*\*\*\*\*. When \*\*2(f)\*\*\*\*\* information on the IRS’s Master File is blank, there is no other IRS resource available for campus employees to validate the accuracy of the \*\*\*\*\*2(f)\*\*\* claimed by the taxpayer. In these cases, the IRS cannot always determine whether these taxpayers were entitled to exemptions and credits claimed on their tax returns without an Examination.

**Recommendations**

**Recommendation 1:** The Commissioner, Large Business and International Division, should further refine TIGTA’s database of returns with potentially questionable refunds issued to

<sup>12</sup> For this test, we excluded 89 of the 397 returns with \*\*\*\*\*2(f)\*\*\*\*\* because taxpayers from these \*\*2(f)\*\*\* may qualify to use additional filing statuses.



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\*\*\*2(f)\*\*\* by applying filters \*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\* to ensure returns  
with the highest risk are identified and considered for further examination with particular  
attention to those taxpayers \*\*\*\*\*2(f)\*\*\*\*\*. These filters should be applied and  
refined on an ongoing basis to identify potentially questionable refunds issued to \*\*\*2(f)\*\*\*  
\*\*\*2(f)\*\*\*

**Management’s Response:** IRS management agreed with this recommendation.  
Using IRS data, they will take the following actions:

- Perform an initial screening of returns filed with \*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\* before the  
refunds are released to assess whether the refund should be released. Refunds will be  
frozen on returns where it appears likely \*\*\*\*\*2(f)\*\*\*\*\* credits are  
not allowable.
- Coordinate with the Wage and Investment Division to refine filters used to identify  
abusive \*\*2(f)\*\* filings on an ongoing basis to ensure the returns with the highest risk  
are identified and considered. Items that will be considered in the refined filters  
include \*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*.

**Recommendation 2:** The Commissioner, Wage and Investment Division, should ensure  
campus employees in the Code and Edit, Error Resolution, and Notice Review functions receive  
fraud awareness training in their annual \*\*\*\*\*2(f)\*\*\*\*\* individual income tax return processing  
training.

**Management’s Response:** IRS management agreed with this recommendation to  
provide fraud awareness training to their employees working \*\*\*\*\*2(f)\*\*\*\*\* returns. The  
2012 Submission Processing work plan will include questionable refund return training  
for all IRS Submission Processing employees in the Code and Edit, Error Resolution, and  
Notice Review functions, including IRS employees working \*\*\*\*\*2(f)\*\*\*\*\* returns.



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**Appendix I**

*Detailed Objective, Scope, and Methodology*

Our overall objective was to determine whether controls over \*\*\*\*\*2(f)\*\*\*\*\* were effective in minimizing the risk of issuing erroneous refunds. Our audit scope included individual income tax refunds of \$500 or more issued to \*\*\*\*\*2(f)\*\*\*\*\* in Calendar Year 2009 for Tax Year<sup>1</sup> 2008. To accomplish this objective, we:

- I. Determined if returns \*\*\*\*\*2(f)\*\*\*\*\* were adequately reviewed before the refunds were released.
  - A. Researched TIGTA and Government Accountability Office audit reports for any previously reported control breakdowns.
  - B. Researched the Internal Revenue Manual to determine if procedures used by the IRS to process \*\*\*\*\*2(f)\*\*\*\*\* returns were adequate.
  - C. Contacted responsible IRS personnel to determine if \*\*\*\*\*2(f)\*\*\*\*\* returns were adequately reviewed.
- II. Determined if erroneous or fraudulent refunds were released to \*\*\*\*\*2(f)\*\*\*\*\*
  - A. Obtained refund transaction files (Individual Master File<sup>2</sup> computer extract of Tax Year 2008 U.S. Individual Income Tax Returns (Form 1040) refund returns \*\*\*\*\*2(f)\*\*\*\*\* from the TIGTA Data Center Warehouse. We validated the data by examining a random sample of 25 records using the Integrated Data Retrieval System.<sup>3</sup> All criteria used to extract the data were confirmed in the data validation sample. This validation test demonstrated that the data were sufficiently reliable and could be used to meet the objective of this audit.
  - B. Selected a statistically valid random sample<sup>4</sup> of 397 taxpayers from the computer extract of 74,174 taxpayers obtained in Step II.A.

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<sup>1</sup> 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.

<sup>2</sup> The IRS database that maintains transactions or records of individual tax accounts.

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

<sup>4</sup> After we determined control weaknesses existed that could allow erroneous refunds to be released, we selected a statistically valid random sample to help quantify the extent of the problem over the entire population. The statistically valid random sample size was selected using a 95 percent confidence level, an expected error rate of 50 percent, and a precision factor of  $\pm 5$  percent.



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- C. Reviewed the statistical sample to determine if any of the returns appeared to be fraudulent. Specific tests included:
1. Verified that the TIN on the Form 1040 belonged to the taxpayer.
  2. Verified if the filing status claimed was valid for the taxpayer **\*\*\*\*2(f)\*\*\*\***.
  3. Verified if the exemption(s) claimed was valid for the taxpayer **\*\*\*\*2(f)\*\*\***.
  4. Verified if the deduction(s) claimed was valid for the taxpayer **\*\*\*\*2(f)\*\*\*\***.
  5. Matched the total wages, withholding, and other income amounts claimed on the returns to the amounts from Wage and Tax Statement (Form W-2), Miscellaneous Income (Form 1099-MISC), and other third-party data found on the Information Returns Processing Transcript.<sup>5</sup> We determined the ratio of withholding to wages and if the ratio was reasonable.
  6. Determined if certain credits (i.e., the Earned Income Tax Credit, CTC, **\*\*2(f)\*\***, and Foreign Tax Credit) claimed were substantiated and valid for **\*\*\*\*2(f)\*\*\*\***.
  7. Verified the validity of other credits (i.e., the Economic Stimulus Payment and Education Tax Credit) and withholding tax from foreign partners that appeared questionable.
- III. Determined if refunds issued to taxpayers **\*\*\*\*\*2(f)\*\*\*\*\*** were valid.
- A. Obtained a database that contained returns of taxpayers **\*\*\*\*\*2(f)\*\*\*\*\*** currently under audit by the Examination function. We determined the criteria used by the Examination function to identify potential fraudulent refund returns.
  - B. Based on the computer extract obtained in Step II.A., identified Tax Year 2008 Forms 1040 filed by taxpayers **\*\*\*\*\*2(f)\*\*\*\*\*** **\*\*\*\*2(f)\*\*\***.
  - C. Selected and reviewed a random sample of 84 taxpayers from 627 taxpayers **\*\*2(f)\*\*\*\*\***.<sup>6</sup> We performed the following tests:
    1. Matched the total wages and withholdings amounts claimed on the returns to the amounts found on the Information Returns Processing Transcript. We verified the reported income qualified for the credits.

<sup>5</sup> Command Code IRPTR allows Integrated Data Retrieval System users to request Information Returns Processing Transcripts from the Information Returns Master File.

<sup>6</sup> The statistically valid random sample size was selected using a 95 percent confidence level, an expected error rate of 50 percent, and a precision factor of  $\pm 10$  percent.



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2. \*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*.
3. Determined the number of refunds stopped where the taxpayer \*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*.
4. Determined the number of returns that went to the Examination function and were  
in the Appeals function.
5. Reviewed related Tax Year 2009 returns and identified if any refunds were  
restricted.

**Internal controls methodology**

Internal controls relate to management’s plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the IRS processes for ensuring that erroneous refunds issued to \*\*\*\*\*2(f)\*\*\*\*\* are detected and prevented. The steps taken to address these controls are described above.



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**Appendix II**

*Major Contributors to This Report*

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Kyle R. Andersen, Director

Richard J. Calderon, Audit Manager

Roy E. Thompson, Audit Manager

Jennie G. Choo, Lead Auditor

Glory Jampetero, Senior Auditor

John B. Mansfield, Senior Auditor

Jane G. Lee, Auditor

Lance J. Welling, Auditor

Kevin O’Gallagher, Information Technology Specialist



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*Controls Over Refunds to Certain Taxpayers  
Could Be Improved*

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**Appendix III**

*Report Distribution List*

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Services and Enforcement SE  
Chief, Criminal Investigation SE:CI  
Commissioner, Large Business and International Division SE:LB  
Deputy Commissioner, Wage and Investment Division SE:WI  
Director, Customer Account Services, Wage and Investment Division SE:W:CAS  
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Office of Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis RAS:O  
Office of Internal Control OS:CFO:CPIC:IC  
Audit Liaisons:  
    Commissioner, Large Business and International Division SE:LB  
    Chief, Program Evaluation and Improvement, Wage and Investment Division  
    SE:W:S:PEI



Controls Over Refunds to Certain Taxpayers  
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Appendix IV

Outcome Measure

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

**Type and Value of Outcome Measure:**

- Funds Put to Better Use – Potential;\*\*\*\*2(f)\*\*\*\*\* (page 4). This estimate is based on 238 individual taxpayers with an average of \*\*\*\*2(f)\*\*\*\*\*claimed.

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

From the 74,174 Tax Year 2008 individual income tax returns processed in Calendar Year 2009, we identified 4,889 returns of taxpayers \*\*2(f)\*\*\*\*\* who claimed a total of more than \$14 million of \*\*2(f)\*\* From this population, we identified 627 returns with \*\*\*\*\*2(f)\*\*\*\*\* \*\*2(f)\*\*. We reviewed a statistically valid random sample of 84 returns from the 627.<sup>1</sup>

For our projection, we reviewed the related Tax Year 2009 returns of the taxpayers in our Tax Year 2008 sample to see if refund freeze codes<sup>2</sup> were placed on the accounts after the February 4, 2010, Servicewide Alert was issued to IRS employees. There were 38 of 84 taxpayers who had filed their Tax Year 2009 return. Of the 38 who filed, \*\*2(f)\*\* did not have a freeze code, while \*\*2(f)\*\*had freeze codes. All \*\*2(f)\*\* without freeze codes were allowed to receive refunds. This resulted in \$172,276 of \*\*2(f)\*\*claims allowed.

We calculated the outcome measure as follows:

- \*\*\*\*\*2(f)\*\*\*\*\* of 84 had no freeze code and \$172,276 in \*\*2(f)\*\*claims.
- \$172,276 divided by \*\*\*\*\*2(f)\*\*\*\*\*.
- \*\*2(f)\*\* of 627 population (627 x \*\*2(f)\*\*) = \*\*2(f)\*\* potential erroneous refund returns.
- \*\*\*\*\*2(f)\*\*\*\*\*.

<sup>1</sup> The statistically valid random sample size was selected using a 95 percent confidence level, an expected error rate of 50 percent, and a precision factor of ±10 percent.

<sup>2</sup> A freeze code is an indicator the IRS uses for preventing the issuance of refunds, credit offsets, or the assessment of accrued interest and/or penalty.



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**Appendix V**

*Management's Response to the Draft Report*

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

COMMISSIONER  
LARGE BUSINESS AND  
INTERNATIONAL DIVISION

SEPTEMBER 15, 2011

MEMORANDUM FOR MICHAEL R PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *for* Heather C. Maloy /s/ Michael Danilack  
Commissioner, Large Business and International Division

SUBJECT: Draft Audit Report - Controls Over Refunds to \*\*\*2(f)\*\*\* Taxpayers  
\*\*\*\*\*2(f)\*\*\*\*\* Could Be Improved (Audit 201040032)

We have reviewed the subject draft report, and appreciate the acknowledgement that you found no significant volumes of questionable refunds issued to taxpayers \*\*\*2(f)\*\*\* \*\*2(f)\*\*\*. Our Wage and Investment (W&I) and Large Business and International (LB&I) Divisions have worked closely to prevent erroneous refunds to individual taxpayers \*\*\*\*\*2(f)\*\*\*\*\*.

We will continue to make improvements in this area and conduct additional research in order to refine our filters that prevent erroneous refunds and/or identify additional schemes. The Criminal Investigation Division will continue to provide fraud awareness training to all Campus employees at each campus in fiscal year 2012, through multiple events to accommodate the campuses' workload schedules.

\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*2(f)\*\*\*\*\*. All information on a tax return is used to verify TINs when returns are processed.

We reviewed the outcome measures identified in Appendix IV, and we agree with your assessment. Our comments to your recommendations are attached. If you have any questions, please contact me at (202) 283-8710, or \*\*\*\*\*2(f)\*\*\*\*\* \*\*\*\*\*2(f)\*\*\*\*\*.

Attachment



*Controls Over Refunds to Certain Taxpayers  
Could Be Improved*

Attachment

**RECOMMENDATION 1**

The Commissioner, Large Business and International (LB&I) Division, should further refine TIGTA's database of returns with potentially questionable refunds issued to (b) (6) by applying filters

(b) (6) to ensure returns with the highest risk are identified and considered for further examination, with particular attention to those taxpayers (b) (6). These filters should be applied and refined on an ongoing basis to identify potentially questionable refunds issued to (b) (6)

**CORRECTIVE ACTION**

We assume that the recommendation is referring to refunds issued to individual taxpayers with (b) (6). Using IRS data, we will take the following actions:

- Perform an initial screening of returns filed (b) (6) before the refunds are released to assess whether the refund should be released. Refunds will be frozen on returns where it appears likely the (b) (6) credits are not allowable.
- Coordinate with the Wage and Investment Division to refine filters used to identify abusive (b) (6) filings on an ongoing basis to ensure the returns with the highest risk are identified and considered. Items that will be considered in the refined filters include (b) (6), (b) (6).

**IMPLEMENTATION DATE**

June 15, 2012

**RESPONSIBLE OFFICIAL**

Director, (b) (6)

**CORRECTIVE ACTION MONITORING PLAN**

The LB&I Internal Control Coordinator will track the implementation date for the corrective actions through the Joint Audit Management Enterprise System that tracks implementation of corrective actions addressing audit recommendations.

**RECOMMENDATION 2**

The Commissioner, Wage and Investment (W&I) Division, should ensure Campus employees in the Code and Edit, Error Resolution, and Notice Review functions receive fraud awareness training in their annual (b) (6) Individual Income Tax Return Processing Training.

**CORRECTIVE ACTION**

We agree with your recommendation to provide fraud awareness training to our employees working (b) (6) returns. The 2012 Submission Processing (SP) work plan will include questionable refund return training for all our SP employees in Code and Edit, Error Resolution, and Notice Review functions, including our employees working (b) (6) returns.

**IMPLEMENTATION DATE**

June 15, 2012



*Controls Over Refunds to Certain Taxpayers  
Could Be Improved*

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**RESPONSIBLE OFFICIAL**

Director, Submission Processing, W&I Division

**CORRECTIVE ACTION MONITORING PLAN**

The W&I Internal Control Coordinator will track the implementation date for the actions through the Joint Audit Management Enterprise System that tracks implementation of corrective actions addressing audit recommendations.