

**The Internal Revenue Service Improved Its
Process for Screening Prospective Preparers
and Transmitters of Electronic Returns for
1999 Electronic Filing**

November 1999

Reference Number: 2000-40-011

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.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

November 8, 1999

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in black ink that reads "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Improved Its Process for Screening Prospective Preparers and Transmitters of Electronic Returns for 1999 Electronic Filing

This report presents the results of our review of the Internal Revenue Service's (IRS) Electronic Return Originator (ERO) suitability screening process for processing year 1999. We conducted our review as part of our overall review of the Revenue Protection Strategy to evaluate the effectiveness of the consolidation of suitability screening to one site.

In summary, we found that the IRS improved its process for screening prospective preparers and transmitters of electronic returns for the 1999 electronic return (*e-file*) program. However, improvements should be made to the suitability screening computer program, and cases referred to IRS management should be reviewed.

We recommended that management correct the gap in the computer screening program and that the IRS review the cases we identified that by-passed the suitability screening process.

IRS management agreed with the recommendations in the report when they were submitted as part of an interim memorandum we issued during the review. However, as of the date of this final report, IRS management had not provided a written response to the draft report. IRS management's response to our interim memorandum has been incorporated into the report, where appropriate, and the full text of their response to that memorandum is included as an appendix.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have any questions, or your staff may call Walter E. Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs), at (770) 455-2475.

The Internal Revenue Service Improved Its Process for Screening Prospective Preparers and Transmitters of Electronic Returns for 1999 Electronic Filing

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Executive Summary

Reducing the filing of federal tax returns claiming abusive refunds has been identified as a national problem. In March 1994, United States House of Representatives Ways and Means Committee members expressed to the Secretary of the Treasury their concern about the Internal Revenue Service's (IRS) tax refund fraud prevention and detection systems. In October 1994, the Chairman of the Treasury Department Task Force on Tax Refund Fraud (the Treasury Under Secretary for Enforcement) reported back to the Ways and Means Committee that up to "\$5 billion in 'problematic' refunds¹ [was being] paid out annually."

One of the controls the IRS has in place to reduce the risk of bulk filing of electronic tax returns claiming abusive refunds is a process for analyzing (screening) the histories of businesses and individuals desiring to participate in electronic filing as electronic return originators (EROs).² This control checks, among other things, whether individuals or firms desiring to participate in federal electronic filing as EROs have filed their federal tax returns, have paid their taxes, or have a criminal history. If a prospective or previously accepted ERO fails the suitability review, the IRS formally informs the ERO which criteria they failed. They then have appeal rights.

The objective of this audit was to determine if the IRS' process for annually rechecking (screening) the histories of previously admitted preparers and transmitters of electronic returns effectively ensured that only EROs meeting publicized qualifications continued to be approved to participate in the IRS' electronic return (*e-file*) program. This IRS screening process is commonly referred to in IRS publications and Internet sites as determining EROs' "suitability" to participate in electronic filing.

Results

With the exception of one computer programming problem, the IRS' annual suitability screening of bulk preparers and transmitters of electronic returns effectively ensured that only EROs meeting publicized qualifications were approved to participate in the 1999 *e-file* program.

¹ The term "problematic refund," used in the 1994 Congressional testimony by a Treasury official, is believed to describe a federal income tax refund (often a refund associated with an Earned Income Tax Credit) which the IRS considered very likely to be partially or totally erroneous, and possibly abusive or fraudulent. However, resolution of the correct refund amount could take considerable research and/or investigation.

² In this audit report, the terms "Electronic Return Originator" and "ERO" are used to denote those authorized by the IRS to be bulk preparers and/or transmitters of electronic federal returns.

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Internal Revenue Service Tax Examiner Decisions to Allow Preparers and Transmitters of Electronic Returns to Continue to Participate in 1999 Electronic Filing Were Reasonably Accurate

The IRS' annual recheck of the suitability of preparers and transmitters of electronic returns was reasonably effective in ensuring that only EROs meeting publicized standards were approved to participate in the 1999 *e-file* program. A Federal Managers' Financial Integrity Act report in 1992 had cited, as a material control weakness, the problem of electronic return preparers and transmitters with problem histories successfully re-applying "from IRS district office to IRS district office" around the country, until finding an office willing to admit them as electronic return preparers or transmitters.

- The IRS' preliminary computerized review program checked the histories of over 150,000 EROs seeking to participate in 1999, and identified 11,804 EROs (8 percent of all reviewed) whose histories were designated for more detailed suitability research by tax examiners.
- The subsequent more detailed IRS tax examiner research into the suitability of the 11,804 EROs with possible problem histories resulted in reasonably accurate determinations of their suitability to continue as EROs. Our test of 111 randomly selected cases showed that 105 (95 percent) of the tax examiner analyses for 1999 were accurately completed. The six errors were due to tax examiner misjudgments or incomplete research.
- The tax examiner research on the 11,804 EROs confirmed that 3,834 EROs (3 percent of the over 150,000) did not meet suitability criteria. These EROs were suspended from the 1999 program.³
- The percentage of computer-identified cases *confirmed* by tax examiners as having problems was higher for 1999 than in previous years (12 percent for 1997, 9 percent for 1998, and 32 percent for 1999). We believe the increased confirmation rate for 1999 reflects, for the first time, the inability of EROs with questionable histories to "shop around" for IRS approval.

The Internal Revenue Service's Preliminary Computerized Review of Electronic Return Preparers and Transmitters Was Incomplete Due to a Programming Oversight

We noted that inappropriate EROs were scheduled to participate in the IRS' 1999 *e-file* program. Due to a programming flaw, the preliminary computer screening program did

³ Tax examiner review of the remaining 7,970 prospective EROs revealed primarily that these EROs had cleared up their tax problems, making them admissible.

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not check for suitability problems in the histories of 7,274 of the approximately 195,000 ERO cases subject to review. Our follow up of the 7,274 revealed that the histories of 699 prospective EROs contained such characteristics as unpaid federal tax and unfiled federal tax returns, which should have subjected them to detailed suitability review by tax examiners prior to acceptance in the 1999 program.

We notified the Assistant Commissioner (Electronic Tax Administration) of this condition in a memorandum dated November 6, 1998, in time to suspend any unsuitable EROs before the 1999 tax filing season.

Summary of Recommendations

To further improve the suitability process for *e-file* EROs, we recommend that the IRS correct the gap in the computer screening program to prevent its recurrence in future years, and review the 699 cases for 1999 that should have been highlighted by the screening program.

Management's Response: The Assistant Commissioner (Electronic Tax Administration) agreed with the recommendations listed in the report when they were submitted as part of an interim memorandum we issued during the review. However, as of the date of this report, IRS management had not provided a response to the report itself. The Assistant Commissioner's response to our interim memorandum has been incorporated into the report, where appropriate, and the full text of the response to that memorandum is included as an appendix (see Appendix V). We provided the IRS with a draft report on September 15, 1999, with a 30-calendar day comment period.

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Objective and Scope

We determined if the annual suitability process was effective in preventing inappropriate EROs from participating in e-file.

The objective of this audit was to determine if the Internal Revenue Service's (IRS) process for annually rechecking (screening) the histories of previously admitted preparers and transmitters of electronic returns effectively ensured that only electronic return originators (EROs), meeting publicized qualifications, continued to be approved to participate in the IRS' electronic return (*e-file*) program.¹ To accomplish our objective, we analyzed the overall annual suitability process, and tested it by assessing the appropriateness of suitability determinations made on:

- Ninety randomly selected ERO cases that the computer screening program had identified as having at least one potential suitability exception condition.
- Twenty-one specific cases from our prior review of the phased consolidation of the ERO suitability screening process.² We had identified these cases as having inappropriate suitability conditions, yet they had been allowed to participate in *e-file* in the preceding year.
- Ten cases that had been cleared for participation in the 1999 filing season.

We initiated this review as part of our overall strategy to provide coverage of the IRS' revenue protection activities.

¹ In this audit report, the terms "Electronic Return Originator" and "ERO" are used to denote those authorized by the IRS to be bulk preparers and/or transmitters of electronic federal returns.

² The prior audit report was titled *Further Improvements Are Needed to the Internal Revenue Service's Process for Admitting Preparers and Transmitters into Its Electronic Filing Program* (Reference Number 092104, Dated September 1999).

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We performed our tests at the Andover Service Center (ANSC). The audit was conducted between September 1998 and June 1999 in accordance with *Government Auditing Standards*.

See Appendix I for more information on our detailed objective, scope, and methodology. Major contributors to this report are listed in Appendix II.

Background

Suitability screening helps to ensure that e-file preparers and transmitters maintain a high degree of integrity.

In March 1994, United States House of Representatives Ways and Means Committee members expressed concern to the Secretary of the Treasury about the IRS' tax refund fraud prevention and detection systems. In October 1994, the Chairman of the Treasury Department Task Force on Tax Refund Fraud (the Treasury Under Secretary for Enforcement) testified before the Congress that up to "\$5 billion in 'problematic' refunds³ [was being] paid out annually."

One IRS revenue protection control is to screen the characteristics of all organizations and individuals that participate as EROs (preparers or transmitters) in the IRS' *e-file* program. This process verifies, among other things, that individuals or firms desiring to participate as EROs have filed their federal tax returns and paid their taxes. The criteria the IRS uses to disqualify EROs is published on the Internet, and is prominently described in detail in the *Handbook for Electronic Filers of Individual Income Tax Returns* (IRS Publication 1345), which is provided to all EROs.

The *e-file* preparer/transmitter suitability computer program analyzes information on each ERO for

³ The term "problematic refund," used in the 1994 Congressional testimony by a Treasury official, is believed to describe a federal income tax refund (often a refund associated with an Earned Income Tax Credit) which the IRS considered very likely to be partially or totally erroneous, and possibly abusive or fraudulent. However, resolution of the correct refund amount could take considerable research and/or investigation.

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IRS consolidated suitability processing in response to a FMFIA material weakness that found preparers had been “shopping around” to gain entry into e-file.

compliance with the above-cited criteria. Tax examiners research each ERO the computer program identifies as possibly not meeting the qualifying criteria before final determination of suitability. New applicants are checked prior to admission, and previously accepted EROs are rechecked once a year (in an “annual” suitability recheck) to ensure continued adherence to the suitability standards.

The IRS centralized the national screening of ERO suitability from 33 district offices to a consolidated site at the ANSC. The consolidation of suitability processing was made in response to a 1992 report of a Federal Managers’ Financial Integrity Act (FMFIA) material weakness. That report stated that EROs with questionable histories had successfully “shopped” among IRS district offices around the country until they found an IRS office which would authorize their participation as bulk preparers or transmitters of federal income tax returns for that year.

The consolidation of the suitability process was done in two phases. In the first phase, for electronic returns to be processed in 1998, the IRS consolidated the processing of applications for *new* preparers and transmitters of electronic returns at the ANSC. For that year, the IRS’ 33 district offices continued to recheck the “annual” suitability of *previously* approved EROs. In preparation for processing returns in 1999, ANSC took over from the districts the “annual” rechecks of previously accepted EROs.

The consolidated site’s computerized preliminary annual suitability process for 1999 screened over 150,000 EROs, and identified 11,804 (8 percent) for further suitability research by tax examiners.

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Results

The IRS effectively implemented the final phase of the consolidation of suitability processing into one site.

With the exception of one computer programming problem, the IRS' annual recheck of the suitability of preparers and transmitters of electronic returns was reasonably effective in ensuring that only electronic return originators meeting publicized standards were approved to participate in the 1999 *e-file* program. Our audit work showed that for the 1999 processing year:

- Tax examiners made reasonably accurate suitability determinations in cases referred to them by the preliminary computer screening program (105 of 111 cases tested).
- The preliminary computer screening program identified 11,804 cases as potential problem EROs. Subsequent tax examiner review confirmed that 32 percent (3,834) of these EROs were unsuitable, a significantly higher percentage than in previous years. We believe this indicates that, for 1999, unsuitable EROs had been unable to "shop around" for acceptance into the *e-file* program. This had previously been cited as a FMFIA material weakness.
- Due to a programming flaw, 7,274 of the over 195,000 ERO Taxpayer Identification Numbers (TINs) available for 1999 processing, had not been subjected to suitability screening. Our analysis showed that 699 of the 7,274 ERO TINs had potential problem histories which merited detailed review by tax examiners. We notified the Assistant Commissioner (Electronic Tax Administration) of this condition in a memorandum dated November 6, 1998.

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Internal Revenue Service Tax Examiner Decisions to Allow Preparers and Transmitters of Electronic Returns to Continue to Participate in 1999 Electronic Filing Were Reasonably Accurate

IRS tax examiners had made appropriate suitability decisions in 105 of 111 (95 percent) of the cases reviewed

Consolidated site tax examiners made reasonably accurate suitability determinations.

- Tax examiners correctly decided on the suitability of 86 of 90 (96 percent) of the randomly selected EROs being rechecked for 1999. Of the 86 appropriate decisions, 45 EROs had been properly rejected from the program, for such conditions as owing significant federal tax, or having not filed a federal tax return. Tax examiners had properly cleared 41 EROs for participation. For example, EROs shown as having problems by the preliminary computer screening could be cleared to participate when a tax examiner's follow-up revealed that between the time of the computer run and the time the tax examiner reviewed the case, the EROs had resolved their federal tax problems.
- Our follow-up review of 21 cases selected from the cases noted in our prior audit report, *Further Improvements Are Needed to the Internal Revenue Service's Process for Admitting Preparers and Transmitters Into Its Electronic Filing Program* (Reference Number 092104, Dated September 1999), showed that tax examiners correctly decided on the suitability of 19 of 21 (90 percent) of the cases. These EROs had been identified during the prior audit as having suitability conditions that warranted rejection from the program, but, for various reasons, had been allowed to participate in the previous year's *e-file* program. Of the 19 appropriate decisions, 18 EROs had been properly suspended from the program for 1999, and 1 ERO had been properly cleared for participation.

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Inappropriate decisions were made on 6 (5 percent) of the 111 cases selected for review. These inappropriate decisions were due to incomplete research and human error.

The percentage of ERO suspensions as a result of the annual suitability process increased for the 1999 processing year

As of October 15, 1998, the consolidated site's preliminary screening of the approximately 150,000 EROs had identified 11,804 for tax examiner research.

Analysis by consolidated site tax examiners confirmed that 32 percent (3,834) of the 11,804 computer-identified EROs did not meet the criteria to participate for 1999.⁴ In the prior two years, when the annual suitability reviews were still dispersed around the nation, the IRS had confirmed as unsuitable only 12 percent (1997) and 9 percent (1998), respectively, of the computer-identified cases.

We believe this indicates that the IRS was successful in preventing unsuitable EROs from applying at multiple offices ("shopping around") for acceptance into the *e-file* program, as had been cited in the past. Specifically, the 1992 FMFIA report found that IRS' ERO clearance systems had a material weakness because questionable ERO applicants were successfully "shopping around" the country for less-stringent IRS offices which would approve their suitability.

We reviewed the suitability characteristics of 10 EROs **not** identified by the preliminary screening computer program as having potential suitability problems (cleared before tax examiner review). Results showed that the suitability computer program for the 1999 processing year worked as intended in 9 of the 10 cases.

The IRS successfully reduced "shopping around" the country for admission by unsuitable preparers and transmitters.

⁴ Tax examiner review of the remaining 7,970 prospective EROs had revealed primarily that these EROs had cleared up their tax problems, making them admissible.

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Our research into the tenth case, however, showed that the computerized screening program contained a gap (see the “Preliminary Computerized Review” section which follows).

The Internal Revenue Service’s Preliminary Computerized Review of Electronic Return Preparers and Transmitters Was Incomplete Due to a Programming Oversight

The preliminary suitability computer program did not examine every participant as intended.

Through our review of current and prior year cases, we noted that inappropriate EROs were scheduled to participate in the IRS’ 1999 *e-file* program. We identified 7,274 ERO TINs (of the over 195,000) which had bypassed the preliminary computerized suitability check.

This condition occurred because the suitability programming had not considered certain possible ERO inter-relationships. Unless corrected, in future years inappropriate EROs could be admitted to the *e-file* program, increasing the program’s vulnerability to fraud.

Using readily available information to make computerized screening more complete is a sound management practice.

For the current tax processing year, we analyzed the 7,274 cases, and identified 699 ERO TINs meeting the criteria for tax examiner review. In a memorandum dated November 6, 1998, we notified the Assistant Commissioner (Electronic Tax Administration) of this condition (see Appendix IV). We also provided the 699 cases to consolidated site personnel at the ANSC. We were informed by local management that tax examiners worked these cases promptly, with a number of EROs being suspended from 1999 electronic filing.

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Recommendations

We recommend that the IRS enhance the computer program, and thoroughly research the 699 cases we referred to them.

To further improve the screening and suitability process for EROs, we recommend that the Assistant Commissioner (Electronic Tax Administration):

- Enhance the preliminary suitability computer programming so that all *e-file* EROs are subject to the suitability screening process.
- Ensure complete research on the 699 cases we identified as having a suitability exception condition, and determine if the EROs should continue to participate in the IRS' *e-file* program.

Management's Response: The Assistant Commissioner (Electronic Tax Administration) responded to the Office of Audit's memorandum issued November 6, 1998, that the 699 cases would be reviewed for suitability, and that procedures were initiated to implement the recommended programming change (see Appendix V). As of the date of this report, IRS management had not provided a response to this report. We provided the IRS with a draft report on September 15, 1999, with a 30-calendar day comment period.

Conclusion

In October 1994, the Chairman of the Treasury Department Task Force on Tax Refund Fraud (the Treasury Under Secretary for Enforcement) reported back to the Ways and Means Committee that up to "\$5 billion in 'problematic' refunds [was being] paid out annually." One of the controls the IRS has in place to reduce the risk of bulk filing of electronic tax returns claiming abusive refunds is a process for analyzing (screening) the histories of businesses and individuals desiring to participate in electronic filing as electronic return originators.

This audit showed that the IRS improved its process for screening prospective preparers and transmitters of electronic returns for the 1999 *e-file* program. However,

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improvements should be made to the suitability screening computer program, and cases referred to IRS management should be reviewed.

Detailed Objective, Scope, and Methodology

The objective of this audit was to determine if the Internal Revenue Service's (IRS) process for annually rechecking (screening) the histories of previously admitted preparers and transmitters of electronic returns effectively ensured that only electronic return originators (EROs), meeting publicized qualifications, continued to be approved to participate in the IRS' electronic return (*e-file*) program.

To accomplish our objective, we analyzed the overall annual suitability process, and tested it by assessing the appropriateness of annual suitability determinations made for 1999 processing. To conduct our tests, we:

- I. Obtained the computer file containing the analysis of EROs currently participating in the IRS' *e-file* program.
- II. Selected a random sample of 90 EROs from a universe of 14,171 EROs subject to the annual suitability process that were identified as not meeting suitability criteria. Determined if the correct suitability determinations were made on these cases. Attribute sampling formulas were used to estimate the number of occurrences in a specific population and to identify the sample size needed based on various confidence levels, error rates, and precision.
- III. Analyzed 21 cases identified in a prior audit report, *Further Improvements Are Needed to the Internal Revenue Service's Process for Admitting Preparers and Transmitters Into Its Electronic Filing Program* (Reference Number 092104, Dated September 1999), as having inappropriate characteristics, yet had been allowed to participate in *e-file* for the 1998 (preceding) processing year. Determined if the new consolidated site made the appropriate suitability determination on these EROs for the 1999 processing year.
- IV. Selected a random sample of 10 cases that had not been highlighted for annual recheck for the 1999 processing year to ensure they were not missed by the process.
- V. For cases selected, determined if a failed suitability determination was appealed and determined the final outcome of the appeal. (This was covered as part of the execution of Audit Objective II; no reportable condition was identified.)
- VI. Ensured that information from sampled cases was correctly updated on the Applicants Data Base. (This was covered in the execution of other audit steps.)

**The Internal Revenue Service Improved Its Process for Screening Prospective
Preparers and Transmitters of Electronic Returns for 1999 Electronic Filing**

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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Director, Andover Service Center
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National Director for Legislative Affairs CL:LA
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Appendix IV

Memorandum #1: Ensuring That All Electronic Return Originators (EROs) Are Subject to the Annual Suitability Screening Process for Processing Year 1999



REGIONAL INSPECTOR

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
NORTHEAST REGION
P.O. BOX 213, Church St. Station
NEW YORK, NEW YORK 10008

November 6, 1998

Response Date:
December 22, 1998

MEMORANDUM FOR ASSISTANT COMMISSIONER (ELECTRONIC TAX ADMINISTRATION)

FROM: William F. Gill III *Henry K. Ginter*
Regional Inspector, Northeast Region
FOR

SUBJECT: **Ensuring that all Electronic Return Originators (EROs) are subject to the annual suitability screening process for processing year 1999 (MIS #980097)**

The following conveys to you information noted during our ongoing audit of the "annual" ERO suitability screening process being conducted in Andover. This information will eventually be included in our audit report.

Inappropriate EROs are scheduled to participate in the Service's 1999 electronic filing program because a programming flaw has allowed some SSNs to by-pass the annual suitability screening process. We identified 7,274 ERO SSNs that by-passed the annual suitability process, yet most were in an approved status for participation in the electronic filing program for processing year 1999. Our test found that 699 (10%) of these SSNs met criteria requiring further review before acceptance. The criteria included balance due, fraud, and miscellaneous penalties, no return posted, and intelligence freeze conditions.

This condition occurred because the Automated Suitability Analysis Program (ASAP) did not analyze the SSN of EROs structured as a corporation or partnership, when both an SSN and an Employer Identification Number (EIN) are on the master record of the Applicants Database. Currently, when this circumstance occurs, the EIN is subject to the suitability screening process, but the SSN is not.

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Until these SSNs are further researched to determine their suitability status and the ASAP is corrected, some SSNs will continue to evade the suitability screening process - the key step in preventing inappropriate EROs from participating in ELF.

We have electronically provided a listing of the 699 SSNs and the associated exception criteria to the One Site Application and Suitability (OSAS) location at the Andover Service Center.

Recommendations:

- Research the 699 cases that have a suitability exception condition and determine if the ERO should continue to participate in the Service's electronic filing program.
- Enhance ASAP so that all SSNs are subject to the suitability screening process.

In accordance with IRM 1289, please respond within five workdays advising us of either your agreement with the facts or conclusions, or any disagreement. In accordance with the Deputy Commissioners memorandum on "Responding to Internal Audit Products", please respond within 30 workdays advising us of management actions taken to address the reported condition. If you have any questions, please contact the Acting Deputy Assistant Regional Inspector William Burke at (978)-474-5687, or Audit Manager Donald Butler at (978) 474-5746.

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Appendix V

Management's Response to Memorandum #1



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

RECEIVED

NOV 10 11 16

INSPECTOR

MEMORANDUM FOR REGIONAL INSPECTOR, NORTHEAST REGION

FROM:

Robert E. Barr
Assistant Commissioner (Electronic Tax Administration)

SUBJECT:

Ensuring that all Electronic Return Originators (EROs) are subject to the annual suitability screening process for processing year 1999 (MIS #980097)

In response to your memorandum, dated November 6, 1998, we have shared your concerns and information with Andover Service Center. The suitability area is in the process of reviewing the 699 cases which were identified as possibly having by passed some of the required criteria, for participation in the electronic filing program.

Your concerns regarding the Automated Suitability Analysis Program (ASAP) were shared with the Requirement Management Section of Information Services. The change you recommended, to enhance the program to subject all SSNs to the screening process, has been incorporated on a Request for Information Services (RIS) #ETA-8-0049 (Amendment 1).

If your office has any further questions or concerns, please contact Pat Howarth of my staff on 202-283-0369.