# Improvements Are Needed in the Monitoring of Criminal Investigation Controls Placed on Taxpayers' Accounts When Refund Fraud Is Suspected

**March 2003**

**Reference Number: 2003-10-094**

INSPECTOR GENERAL
for TAX
ADMINISTRATION

**DEPARTMENT OF THE TREASURY**
**WASHINGTON, D.C. 20220**

March 31, 2003

MEMORANDUM FOR CHIEF, CRIMINAL INVESTIGATION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Improvements Are Needed in the Monitoring of Criminal Investigation Controls Placed on Taxpayers' Accounts When Refund Fraud Is Suspected (Audit # 200210033)

This report presents the results of our review of the Criminal Investigation (CI) function's controls on taxpayer accounts when refund fraud is suspected. The objective of this review was to evaluate the effectiveness of the Fraud Detection Centers' (FDC) monitoring of computer controls placed on taxpayers' accounts that have been identified as having fraudulent or potentially fraudulent refund returns.

In summary, FDC personnel generally provided proper justification for controlling fraudulent or potentially fraudulent refund returns. However, they were not always reviewing and reconciling the quarterly control reports and taking timely actions to resolve tax return periods that lacked criminal prosecution potential. In addition, there were no reviews performed to ensure the FDCs were complying with established procedures.

We recommended that the Chief, CI function, consider providing future report listings to the FDCs in an electronic media format and changing the frequency of the report listings from quarterly to twice a year, during non-peak processing periods. In addition, the Chief, CI function, should ensure the Office of Review and Program Evaluation conducts regular reviews of the Questionable Refund Program to assess compliance with procedures, and require that the Director, Refund Crimes, perform analyses of the FDCs' control listings to ensure that reviews are completed and accounts are resolved.

Management's Response: CI management agreed to the recommendations and is requesting access to and working toward connectivity to the Internal Revenue Service (IRS) network to gain access to automated databases that will improve their business processes. Once connectivity is established, they will provide timely guidance and training to appropriate staff. In addition, they will conduct visitations and track the results of those reviews.

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

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 questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations), at (202) 622-8500.

# Table of Contents

## Background

The Criminal Investigation (CI) function operates a Questionable Refund Program (QRP) at Fraud Detection Centers (FDC) located within or in close proximity to each of the 10 Internal Revenue Service (IRS) Campuses.[1]

The purpose of the QRP is to detect fraudulent or potentially fraudulent refund returns, prevent the issuance of refunds related to those returns, and refer cases meeting certain criteria to the CI field offices for investigation of criminal prosecution potential. Those returns not meeting criminal prosecution potential criteria are retained at the FDCs, and the accounts should be adjusted to reflect the correct balance.[2] Returns that are determined to be valid should have the refunds released to the taxpayers. Returns with questionable civil issues should be referred to other IRS functions for appropriate actions.

According to CI function statistics, during 2001 FDC personnel collectively detected almost 39,000 fraudulent returns claiming approximately $338 million in false refunds, and successfully stopped the issuance of about $303 million in false refunds. The QRP has detected over $2 billion in false refunds since its inception in 1977.

An important part of the QRP process is the input and maintenance of computer controls on taxpayers' accounts having fraudulent or potentially fraudulent refund returns. These computer controls, called transaction codes (TC),[3] are input to the IRS' computers to prevent questionable refunds from being issued and to ensure that subsequent activity in

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[1] The campuses are 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.
[2] Beginning in August 1999, based on an opinion from the IRS' Chief Counsel, all fraudulent refund returns were sent to the Examination function for appropriate action, including the adjustment of false claims. In February 2002, based on a revised opinion, guidance was issued allowing FDC personnel to adjust returns claiming false income and withheld income tax but not those with refundable credits, such as the Earned Income Tax Credit.
[3] Three-digit codes identifying actions processed and causing the actions to post to the IRS' main databases of taxpayers' accounts.

the accounts (e.g., the filing of an amended tax return or the applying of a payment to an account) is systemically identified and reviewed by FDC personnel.

To help effectively manage the QRP, the FDCs receive quarterly reports listing all tax accounts controlled by the input of QRP TCs. FDC personnel should use these reports to validate the controls placed on the accounts and to screen the accounts for credits and controls older than 2 years. They should also review the reports to identify tax return periods for which the 3-year statutory limitation on civil assessment of tax will soon expire.[4]

In December 1999, the Treasury Inspector General for Tax Administration's (TIGTA) Office of Audit reported that FDC personnel were not timely removing controls placed on taxpayers' accounts. The Office of Audit recommended that CI function management provide clear guidelines to the FDCs on how the quarterly reports should be reviewed.[5]

We conducted this audit between July and December 2002 at the Office of Refund Crimes in Washington, D.C., and the Atlanta, Brookhaven, Cincinnati, Fresno, Kansas City, Ogden, and Philadelphia FDCs. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

## The Fraud Detection Centers Were Not Following Procedures for Monitoring and Resolving Controls Over Questionable Refunds

In general, the FDCs provided proper justification for controlling fraudulent or potentially fraudulent refund returns identified in our samples. Also, the Director, Refund Crimes, who has functional responsibility for the FDCs, issued several guidance documents between 2000 and 2002 pertaining to the reviews of the quarterly reports and procedures for resolving certain types of fraudulent or potentially fraudulent refund returns.

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[4] 26 U.S.C. § 6501, Limitations on Assessment and Collection (2002).
[5] *The Internal Revenue Service Can Improve the Effectiveness of Questionable Refund Detection Team Activities* (Reference Number 2000-40-018, dated December 1999).

However, FDC personnel were still not always reviewing and reconciling the quarterly reports as required and were not taking timely actions to resolve all tax return periods that lacked criminal prosecution potential. As a result:

- There were unnecessary delays in resolving accounts and in issuing refunds to taxpayers who had legitimate refunds due.
- Revenue recovery efforts were jeopardized because statutory limitation periods for civil assessments of tax expired.

**Unnecessary delays in resolving tax accounts**

We identified delays of over a year in taking actions to resolve 37 of 100 individual tax return periods; these 37 tax periods had credits totaling approximately $91,000. Actions had been taken for 27 of the 37 tax return periods at the time of our review; however, the delays in taking actions averaged a little over 3 years, with some actions taking as long as 7 years. For the remaining 10 tax return periods, actions still had not been taken as of the time of our review. We estimated that year-long delays in resolving tax accounts controlled by QRP TCs applied to over 10,000 of the approximately 29,000 tax return periods with credit balances for 1998 and earlier. We also estimated that the total dollar amount of the credits in the tax return periods that needed to be resolved was over $26 million. Detailed information about our sampling methodology and measurement of these reported benefits are presented in Appendix IV.

Although most of the $26 million resulted from fraudulent refund claims, it is still important that the FDCs take timely action to resolve the accounts to enforce the IRS' commitment to promptly apply "the tax law with integrity and fairness to all," especially since some of the claims may be legitimate and, therefore, owed to the taxpayers.

**Unnecessary delays in issuing legitimate refunds**

We determined that an additional 3 of the 100 individual tax return periods sampled contained credits that were not fraudulent. At the time of our review, action had been taken to issue the refund for 1 of the 3 tax return periods; however, the action took almost 4 years. For the two remaining tax return periods, at the time of our review, actions to issue refunds had not been taken for over a year. The amount of these credits was approximately $1,758. We estimated that 865 of the approximately 29,000 individual tax return periods contained credits that were not fraudulent, so the monies belonged to the taxpayers.

We also determined that 9 of 71 judgmentally selected business tax return periods contained credits totaling approximately $35,000 that were not fraudulent.

**Revenue recovery efforts were jeopardized due to expired limitation periods for making civil assessments of tax**

Two of the 71 judgmentally selected business tax return periods had expired statutory periods for making civil assessments of tax, thereby preventing recovery of erroneously refunded monies through an examination of income or expense items on the tax returns.[6] FDC personnel had not input their computer controls to the taxpayers' accounts until after the refunds were sent to the taxpayers during normal IRS processing of the returns.

In addition, we identified 22 other business tax return periods, for which the periods for civil assessments of tax had expired. These additional tax return periods were not part of our judgmental sample but were included in the same grouping of potentially fraudulent tax returns as the other

[6] Although the normal 3-year period for civil assessment had expired, 26 U.S.C. § 6501(c) allows the assessment of tax at any time if the IRS can prove the existence of fraud. Further, 26 U.S.C. § 6532, Periods of Limitation on Suits (2002), provides for a 5-year period from the date of the refund to bring suit to recover erroneous refunds if it appears any part of the refund was induced by fraud or misrepresentation of a material fact.

two. The total dollar amount of the erroneously issued refunds for the 24 tax return periods was over $1.5 million.

Although the Director, Refund Crimes, had issued guidance to the FDCs pertaining to the reviews of the quarterly reports and procedures for resolving certain types of fraudulent returns subsequent to the TIGTA Office of Audit report issued in 1999, there were no reviews performed to ensure the FDCs were complying with established procedures. Furthermore, the CI function's Office of Review and Program Evaluation had not conducted a review of the QRP at an FDC since 1999. In our opinion, these reviews are an important management tool for ensuring program effectiveness and compliance with procedures.

At the time of our visits, five of the seven FDCs indicated they were currently in the process of reviewing the quarterly reports. However, the results of our audit and interviews with personnel at the seven FDCs visited indicated none had been conducting reviews in accordance with the guidelines. Reasons provided for not complying with established procedures included:

- The reports are not manageable and the review process takes too long to complete (e.g., the control listing for 1 of the FDCs visited was about 10,000 pages in length).
- Two of the quarterly reports are generated during peak tax return processing periods when FDC resources are most needed for detecting fraudulent or potentially fraudulent refund returns.
- Instructions on how to work the quarterly reports were not sufficiently specific.

We believe the FDCs continued to not comply with guidance because of ineffective oversight. The review of the quarterly reports and the timely resolution of tax return accounts are especially critical in protecting the statutory periods for civil assessments and ensuring that tax return periods containing credits that are not fraudulent are identified and refunded to taxpayers.

## Recommendations

The Chief, CI function, should:

1. Consider providing future report listings to the FDCs in an electronic media format. We believe having the information in a computer database would make it easier for the FDCs to search for and resolve credits and controls older than 2 years, and identify accounts nearing the statutory limitation period for civil assessment. Also, the Chief, CI function, should consider changing the frequency of the report from quarterly to twice a year, during non-peak processing periods, to allow the FDCs to focus their resources on taking necessary action to resolve accounts.

Management's Response: The Office of Refund Crimes is requesting access to and working toward connectivity to the IRS network to gain access to automated databases that will improve their business processes. Once connectivity is established, they will provide timely guidance and training to the appropriate staff.

2. Ensure the Office of Review and Program Evaluation conducts regular reviews of the QRP to assess compliance with procedures and provide feedback regarding program effectiveness. In addition, the Chief, CI function, should require that the Director, Refund Crimes, perform analyses of the FDCs' control listing data to ensure reviews are done and accounts are resolved.

Management's Response: The Offices of Review and Program Evaluation and Refund Crimes will conduct visitations and track the results.

## Appendix I

### Detailed Objective, Scope, and Methodology

The overall objective was to evaluate the effectiveness of the Fraud Detection Centers' (FDC) monitoring of computer controls placed on taxpayers' accounts that have been identified as having fraudulent or potentially fraudulent refund returns. To accomplish our objective, we:

I. Obtained FDC procedures for monitoring taxpayers' accounts identified as having fraudulent or potentially fraudulent refund returns and the actions to be taken with regard to those accounts.

II. Evaluated operating procedures and guidelines used by FDC personnel for controlling taxpayers' accounts with fraudulent or potentially fraudulent refund returns.

III. Determined if Criminal Investigation (CI) function management previously identified any problems in monitoring computer controls placed on taxpayers' accounts and what actions were taken.

IV. Determined if taxpayers' accounts identified as having fraudulent or potentially fraudulent refund returns were properly controlled and appropriate actions taken in a timely manner.

   A. Identified 28,822 Internal Revenue Service (IRS) Individual Master File[1] (IMF) and 427 Business Master File[2] (BMF) tax return periods dated on or before December 31, 1998, with credit balances that also had FDC computer controls[3] as of processing cycle[4] 13 of 2002 for the IMF and processing cycle 52 of 2001 for the BMF. We confirmed through our transaction testing described below that selected accounts met the criteria established for this data extract.

   B. Selected a random sample of 100 of the 28,822 IMF tax return periods to enable a statistical evaluation of the results. We also selected a judgmental sample of 71 of the 427 BMF tax return periods based on a review of the taxpayers' account data. We used judgmental sampling for the BMF transactions, as 388 of the 427 tax return periods were involved in one related scheme of potentially fraudulent tax returns.

   C. Reviewed IMF and BMF tax account data for the selected tax return periods and determined:

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[1] The IRS database that maintains transactions or records of individual tax accounts.
[2] The IRS database that consists of federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.
[3] FDCs use Transaction Codes 916 and 918 to control fraudulent or potentially fraudulent refund returns.
[4] A cycle is 1 week's processing. The cycle number is the processing week in any particular year.

1. When the returns were processed and/or when the accounts were credited with the monies.
2. When the FDC computer controls were input to the accounts.
3. If transaction codes indicated an open criminal investigation.
4. If transaction codes or other conditions indicated activity by other functions.

D. Selected the Atlanta, Brookhaven, Cincinnati, Fresno, Kansas City, Ogden, and Philadelphia FDC sites to visit based on the results of our review of taxpayers' accounts and the number of tax return periods in our samples.

1. Interviewed FDC personnel regarding why computer controls were placed on accounts and how controls were monitored to determine what actions, if any, were necessary to resolve accounts.
2. Reviewed FDC documents to determine why computer controls were placed on accounts and the status of accounts.

E. Telephonically contacted personnel at the Andover, Austin, and Memphis FDC sites to determine the status of selected accounts.

F. Evaluated the results of our tests pertaining to the statistical sample of the 100 IMF tax return periods using the United States Army Audit Agency's Statistical Sampling System computer program. See Appendix IV for details of our sampling methodology.

## Appendix II

### Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)
John R. Wright, Director
Ronald F. Koperniak, Audit Manager
Diana M. Tengesdal, Audit Manager
Todd M. Anderson, Senior Auditor
James D. Dorrell, Senior Auditor
Donald L. McDonald, Senior Auditor
Janice A. Murphy, Senior Auditor

## Appendix III

### Report Distribution List

Acting Commissioner N:C
Director, Refund Crimes CI:RC
Director, Strategy CI:S:PS
Director, Legislative Affairs CL:LA
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls: N:CFO:F:M
Audit Liaison: Criminal Investigation CI:S:PS

## Appendix IV

## Outcome Measures

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

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Unnecessary Delays in Resolving Tax Accounts
  - Actual; 37 fraudulent or potentially fraudulent individual taxpayer return periods with credits totaling $91,187 had delays of over a year in taking actions to resolve the accounts;[1] (see page 2).
  - Potential; estimated there was over a year's delay in resolving 10,665 fraudulent or potentially fraudulent tax return periods controlled by Fraud Detection Center (FDC) computer controls. We estimated the dollar amount of these unresolved credits to be $26,281,917;[1] (see page 2).
- Taxpayer Rights and Entitlements – Unnecessary Delays in Issuing Legitimate Refunds
  - Actual; FDC computer controls were not timely released on 1 of 3[2] individual taxpayer's tax return period with a credit in the amount of $1 that was not fraudulent, and on 1 of 9 business taxpayer's tax return period with a credit in the amount of $2,011; (see page 2).
  - Potential; 1of 3[2] individual taxpayer's tax return period with a credit in the amount of $35 that was not fraudulent, and 8 of 9 business taxpayers' tax return periods with credits totaling $32,827 were unnecessarily held by FDC computer controls; (see page 2).
  - Potential; estimated there were 865 tax return periods of individuals with credits that were not fraudulent and were unnecessarily held by FDC computer controls; (see page 2).

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[1] The taxpayer rights and entitlements only pertain to the prompt determination of their correct liabilities since most of these credits resulted from fraudulent claims.
[2] One refund in the amount of $1,722 had been released for another one of the three taxpayers prior to our visit to the FDC; accordingly, we are not including the $1,722 in our reported benefit.

Methodology Used to Measure the Reported Benefit:

We randomly selected a sample of 100 of 28,822 individual tax return periods having credit balances and FDC computer controls for 1998 or earlier. The universe of tax return periods was identified from Internal Revenue Service (IRS) data produced quarterly that identifies tax return periods with credit balances and various computer conditions preventing the credits from being refunded to the taxpayers or used to offset existing liabilities.

We identified delays of over a year in taking actions to resolve 37 of the individual tax return periods. The amount of the credits in these individual tax return periods was approximately $91,000. We evaluated the results of these 37 cases using a confidence level of 90 percent and an estimated error rate of 7.9 percent. The estimated number of tax return periods with year-long delays in resolving the accounts was over 10,000. We also estimated there was over $26 million of credits in tax return periods that needed to be resolved. This amount was calculated based upon a precision of 26.5 percent. The estimated dollar amount ranged between $19.3 million and $33.2 million.

We determined that three tax return periods, containing credits that were not fraudulent, were unnecessarily held by FDC computer controls. We evaluated the results of these 3 cases using a confidence level of 90 percent and an estimated error rate of 2.8 percent. The estimated number of tax return periods with credits unnecessarily held by FDC computer controls was 865, and ranged from as few as 57 to as many as 1,671.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; 24 business tax return periods had erroneous refunds issued totaling $1,520,914. The amounts remaining unpaid after partial repayments of $177,865 totaled $1,343,049. Although the normal statutory periods for making civil assessments of tax for these business tax return periods had expired, assessments can be made at any time if the IRS can prove the existence of fraud. Also, the law provides for a 5-year period from the date of the refund to bring suit to recover erroneous refunds;[3] (see page 2).

Methodology Used to Measure the Reported Benefit:

We judgmentally selected a sample of 71 of 427 business tax return periods having credit balances and FDC computer controls for 1998 or earlier. The universe of tax return periods was identified from IRS data produced quarterly that identifies tax return periods with credit balances and various computer conditions preventing the credits from being refunded to the taxpayers or used to offset existing liabilities.

We determined that 2 of the 71 tax return periods had erroneous refunds issued and had expired statutory periods for making civil assessments of tax. In addition, we identified 22 other

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[3] 26 U.S.C. §§ 6501(a) and 6501(c), Limitations on Assessment and Collection (2002), and 26 U.S.C. § 6532, Periods of Limitation on Suits (2002).

business tax return periods that were included in the same grouping of potentially fraudulent tax returns as the other 2, but were not part of our judgmental sample. The normal 3-year period for making civil assessments of tax for these 22 tax return periods had also expired.

## Appendix V

## Management's Response to the Draft Report

Criminal Investigation

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

RECEIVED
MAR 27 2003

MAR 26 2003

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: David B. Palmer *[signature]* for
Chief, Criminal Investigation CI

SUBJECT: Response To Draft Audit Report—Improvements Are Needed in the Monitoring of Criminal Investigation Controls Placed on Taxpayers' Accounts When Refund Fraud Is Suspected (Audit # 2002-10-033) ECMS IR No. 0302-5K5JSHYC

I reviewed your draft report on Criminal Investigation (CI) controls placed on taxpayers' accounts when refund fraud is suspected. The IRS' Fraud Detection Centers (FDC) monitor various report listings to ensure controls and credit issues are accurately and timely resolved. Resource constraints impaired a comprehensive and complete review of controls placed on fraudulent returns. I agree that internal reviews and oversight are important in maximizing the effectiveness and efficiency of business processes. External reviews such as yours assist us in improving our program.

The FDCs monitor the use of computer controls placed on taxpayers' accounts as an integral step in properly identifying fraudulent or potentially fraudulent refund returns. Paper-based listings are currently used in the monitoring process. I agree that an electronic monitoring process is effective and efficient and CI is heading in that direction.

Refund Crimes conducts two management-level conferences each year to ensure that operational processes are followed and improved when the dynamic world of fraudulent return filings identifies a changing environment. Our Office of Review and Program Evaluation conducts external reviews that will enhance our efforts.

I appreciate your support in ensuring these efforts improve fraud detection and revenue protection. Our comments on the specific recommendations in this report are as follows:

**Recommendation #1**
Consider providing future report listings to the FDCs in an electronic media format. We believe having the information in a computer database would make it easier for the FDCs to search for and resolve credits and controls older than 2 years, and identify accounts nearing the statutory limitation period for civil assessment. Also, the Chief, CI function, should consider changing the frequency of the report from quarterly to twice a year, during non-peak processing periods, to allow the FDCs to focus their resources on taking necessary actions to resolve accounts.

**Assessment of Cause(s):**

Systems and network incompatibilities among the organizations of IRS presented difficulties in cross-functional automation processes. Limited resources in these organizations to work the issues of connectivity exacerbated the situation. However, CI is working alternatives, so access can be achieved. Not all reports available in print format are available in system access format. For example, the Electronic On-line/Output Network System (EONS) cannot be accessed through the CI network, and the CI Quarterly Control Listings are not available on EONS.

There is no established timeframe for FDC personnel to resolve tax accounts/tax modules reflecting false returns with fraudulent refunds. Criminal investigations and subsequent prosecutions often take several years to complete and in most cases the case-agent directs that no actions take place, during this time.

**Corrective Action(s):**

Refund Crimes is pursuing multiple alternatives of connectivity to gain access to automated databases that will improve our business processes. One alternative is access to EONS in order to develop major resource savers for the Fraud Detection Centers, e.g., unpostables created by TC91X controls, CI Quarterly Control Listings, etc. Connectivity through the CI Domain cannot be achieved. Consequently, we are requesting access to and working toward connectivity to the IRS Network. Once connectivity is established, Refund Crimes will provide timely guidance and training to the appropriate FDC staff members.

Revenue recovery efforts were instituted for civil tax assessments based on the data you provided. This enabled us to refer the unexpired statute returns to Examination for the initiation of erroneous refund suits. This involved 24 returns and approximately $1.5 million dollars.

**Implementation Date:**

October 1, 2003

**Responsible Official(s):**

Director, Refund Crimes CI:RC

**Corrective Action(s) Monitoring Plan:**

Refund Crimes will conduct visitations to ensure that CI can connect to necessary IRS Domain systems and gain access to necessary databases.

**Recommendation #2**
Ensure the Office of Review and Program Evaluation conducts regular reviews of the QRP to assess compliance with procedures and provide feedback regarding program effectiveness. In addition, the Chief, CI function, should require that the Director,

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Refund Crimes, perform analyses of the FDCs control listing data to ensure reviews are done and accounts are resolved.

**Assessment of Cause(s):**

Not Applicable

**Corrective Action(s):**

The Office of Review and Program Evaluation and Refund Crimes will coordinate visitations and track the results of the visitations as they occur to ensure effectiveness in these business processes.

**Implementation Date:**

October 1, 2003

**Responsible Official(s):**

Director, Refund Crimes CI:RC

**Corrective Action(s) Monitoring Plan:**

The Office of Review and Program Evaluation and Refund Crimes will coordinate visitations and track the results of the visitations as they occur to ensure effectiveness in these business processes.