Processes Are Not Sufficient to Minimize Fraud and Ensure the Accuracy of Tax Refund Direct Deposits

September 25, 2008

Reference Number: 2008-40-182

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.

Phone Number | 202-622-6500
Email Address | inquiries@tigta.treas.gov
Web Site | http://www.tigta.gov

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 25, 2008

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Processes Are Not Sufficient to Minimize Fraud and Ensure the Accuracy of Tax Refund Direct Deposits (Audit # 200840007)

This report presents the results of our review to determine whether Internal Revenue Service (IRS) processes and controls over the direct deposit of refunds into taxpayer bank accounts[1] are adequate to ensure the deposits are accurate and to identify potentially misrouted or fraudulent direct deposits. This audit was included in our Fiscal Year 2008 Annual Audit Plan.

Impact on the Taxpayer

The IRS states that direct deposit provides taxpayers with a faster, more secure, more convenient means by which to receive their tax refunds. The IRS has offered taxpayers who electronically file this option since Tax Year 1987, and then expanded this option to include paper tax return filers beginning in Tax Year 1995. However, the IRS has not developed processes to ensure that the more than 61 million Filing Season 2008 tax refunds were deposited only to an account in the name of the filer, as required by Federal direct deposit regulations.[2] Consequently, there is an increased risk of refund fraud as well as the potential that inadvertent errors can result in depositing refunds into the wrong bank account.

[1] The term bank account is used throughout the report to indicate an allowed depository account. These accounts may also be at non-bank financial institutions such as savings and loans, credit unions, or investment institutions.
[2] Code of Federal Regulations Title 31 Part 210.

Synopsis

The IRS has not developed sufficient processes to ensure that the more than 61 million Filing Season 2008 tax refunds were deposited to an account in the name of the filer. Federal regulations specify that non-vendor direct deposit payments should be made only to a deposit account in the name of the recipient. The IRS acknowledged that tax refunds are subject to payment guidance in the regulations but stated that the regulations do not specify responsibility for enforcing the requirements. The IRS places responsibility for compliance with Federal direct deposit regulations on the taxpayer—indicating it is the taxpayer's responsibility to ensure that their tax refunds are only directly deposited into their accounts.

The IRS is not in compliance with direct deposit regulations that require tax refunds be deposited to an account only in the name of the filer.

In our opinion, the IRS is responsible for ensuring that direct deposits are made to an account in the name of the recipient. Representatives from the Financial Management Service[3] also indicated that the IRS is responsible for enforcing the Code of Federal Regulations requirement.

The IRS has taken limited actions to ensure the accuracy of direct deposit information. These actions include verifying bank routing numbers, verifying that bank account numbers are formatted correctly, informing taxpayers in the tax return instructions about entering wrong account information, and informing taxpayers that they may not request that the IRS deposit their tax refund into an account that is not in their name. Nonetheless, some tax refunds are being sent to accounts that are not in the name of the taxpayer. Analysis of IRS direct deposit data identified bank accounts receiving multiple (three or more) tax refunds. For Calendar Year 2007, over 700,000 bank accounts received 3 or more tax refunds, totaling approximately $8.14 billion. In addition, during Calendar Year 2006,[4] the IRS worked an estimated 1,800 cases in which a taxpayer's refund was deposited into an account not in their name resulting from a taxpayer or IRS transcription error, with most being taxpayer error.

The IRS has not established a consistent process to assist taxpayers in recovering tax refunds deposited to the wrong bank accounts.

The inability of the IRS to ensure the accuracy of direct deposit account information increases fraud potential and taxpayer burden. Direct deposit is frequently the payment method used by individuals who

[3] The agency of the Department of the Treasury that issues, researches, and keeps all records of United States Treasury checks.
[4] Calendar Year 2006 is the most current year with complete information.

attempt to commit filing fraud. Direct deposit provides the ability to quickly receive fraudulent tax refunds without the difficulty of having to negotiate a tax refund paper check. In addition, taxpayer refunds can be deposited into a wrong bank account as a result of an error. When direct deposits are made to the wrong account, the assistance provided to taxpayers is inconsistent. Specifically, the IRS has not established a consistent process to assist taxpayers in recovering their tax refunds when erroneously deposited. Assistance provided ranged from no contact with the bank to which the refund was erroneously deposited to contacting the bank to request return of the refund.

The use of direct deposit is encouraged by the IRS because of the benefits to both the taxpayer and the Federal Government. The lack of a process to ensure that tax refunds are directly deposited only into an account in the name of the taxpayer results in erroneous deposits. Although the IRS cautions taxpayers as to the need to provide accurate direct deposit information, IRS assistance should be provided in an attempt to recover the tax refund in cases in which the taxpayer provided a wrong bank routing or account number.

Recommendations

The Commissioner, Wage and Investment Division, should coordinate with responsible Federal agencies and banking institutions to develop a process to ensure that direct deposit payments are made only to a deposit account in the name of the recipient. Meanwhile, until a process is in place, the IRS should limit the number of direct deposits being sent to the same account to both help the IRS comply with Federal regulations and to reduce fraud potential. In addition, an education campaign should be developed to clearly alert taxpayers and tax return preparers of the requirement that direct deposits only be made to accounts in the name of a recipient. Finally, procedures should be improved for assisting taxpayers in recovering their erroneously deposited tax refunds.

Response

IRS management partially agreed with part of our first recommendation and disagreed with the second part of that recommendation, and agreed with our other two recommendations. IRS management agreed that coordination between the IRS, responsible Federal agencies, and banking institutions is necessary to develop a process to ensure that direct deposit payments are made only to a deposit account in the name of the recipient. However, IRS officials believe that coordinating a recommendation of this type is beyond their jurisdiction. The IRS disagreed with the recommendation to limit the number of direct deposits allowed to the same account because limiting the number of direct deposits would not verify that the refunds are deposited in an account in the taxpayer's name. A similar proposal was previously implemented by the IRS but had to be withdrawn due to the number of circumstances in which multiple deposits to a single account were legitimate and acceptable because the accounts were held in the names of multiple individuals.

Management agreed to include a statement in the instructions for the U.S. Individual Income Tax Return (Form 1040) cautioning taxpayers that refunds may be direct deposited only into accounts in their name. In addition, taxpayers obtaining assistance via an IRS Volunteer Income Tax Assistance site will be alerted of the requirement to deposit refunds only into an account in their name. The IRS plans to explore additional opportunities to highlight direct deposit requirements to taxpayers and tax professionals. To improve procedures for assisting taxpayers in recovering erroneously deposited refunds, the IRS will update its internal guidance to include specific steps IRS employees are to initiate when an inquiry is received. Management's complete response to the draft report is included as Appendix IV.

Office of Audit Comment

Although IRS management agreed that coordination between responsible Federal agencies and banking institutions is necessary to develop a process to ensure that direct deposit payments are made only to an account in the name of the recipient, IRS management does not believe they should initiate this coordination. In addition, the IRS disagreed with the recommendation to limit the number of direct deposits being sent to the same account. However, IRS management offered no alternative actions to reduce the potential fraud associated with multiple direct deposits to the same account. The IRS noted that a similar proposal was previously implemented in which it completed programming to identify direct deposits being sent to the same account. For those accounts with more than five deposits, the refund was converted to a paper check. However, the IRS used this process for only one cycle (1 week). Subsequent to receiving a number of complaints from small tax return preparers who were initiating Refund Anticipation Loans and Refund Anticipation Checks,[5] the IRS cancelled this process. If the preparers had established unique accounts for the Refund Anticipation Loans and Refund Anticipation Checks as required, they would not have encountered a problem.

We believe that rather than cancelling this new process after 1 week, the IRS should have taken steps to refine the process and advise tax preparers and taxpayers to follow the regulations. As it stands, individuals use direct deposit to commit refund fraud, and there are instances in which thousands of refunds were sent to the same account in violation of the Code of Federal

[5] Refund Anticipation Loans are short-term loans secured by the taxpayer's expected tax refund. Refund Anticipation Checks are the non-loan bank products that many commercial tax preparers and their bank partners offer in addition to Refund Anticipation Loans.

Regulations. As the use of direct deposit grows, the risk of potential large-scale fraud will increase.

Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 622-5916.

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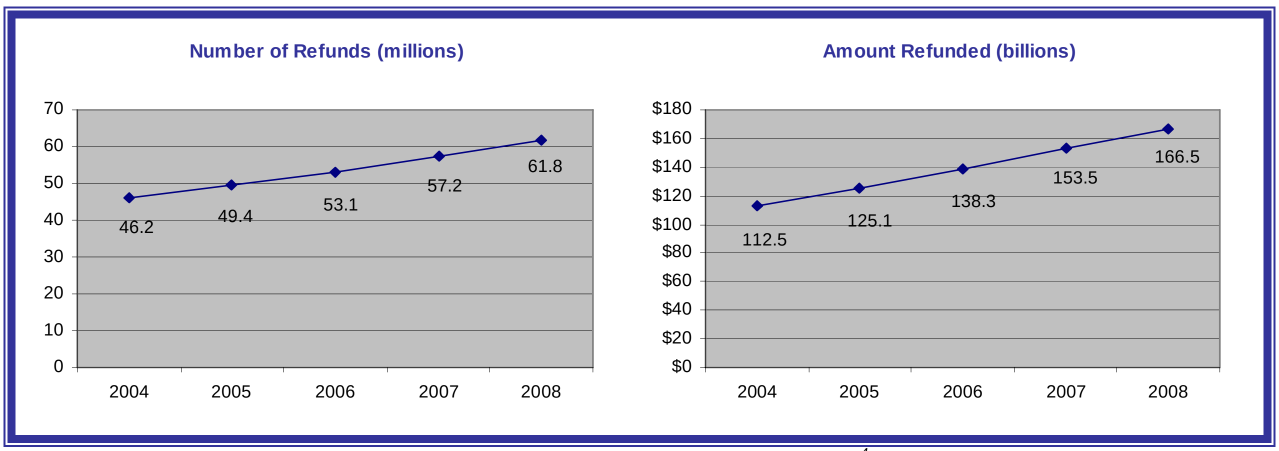
Abbreviations

FMS	Financial Management Service
IRS	Internal Revenue Service

Background

The Internal Revenue Service (IRS) states that direct deposit provides taxpayers with a faster, more secure, more convenient means by which to receive their tax refunds. Direct deposit of a tax refund costs the IRS less than the issuance of a paper refund check—$0.06 compared to $0.55.[1] Both electronic (*e-file*) and paper tax return filers may request direct deposit. The IRS has offered *e-file* taxpayers the option since Tax Year 1987, and then expanded the option to include paper tax return filers beginning in Tax Year 1995. In Tax Year 2006, the IRS began providing taxpayers with the ability to have their tax refund split and electronically deposited in up to three accounts.[2] Figure 1 shows the increase in the use of direct deposit over the last 5 filing seasons.[3]

Figure 1: Filing Season Direct Deposit Refund Statistics



Source: Statistics of Income Tax Statistics - Filing Season Statistics 2004-2008.[4]

Regulations require direct deposits be made to accounts in the recipient's name

Federal regulations[5] specify that non-vendor direct deposit payments should be made only to a deposit account in the name of the recipient. For consumer protection, the regulations are designed to ensure that payments reach the intended recipient by requiring payments to be

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[1] The Financial Management Service provided these cost estimates.
[2] As of May 26, 2008, a total of 225,364 individuals used this option.
[3] The filing season is the period from January through mid-April when most individual income tax returns are filed.
[4] IRS Filing Season statistics are for the weeks ending April 23, 2004, April 22, 2005, April 21, 2006, April 20, 2007, and April 19, 2008.
[5] 31 Code of Federal Regulations Part 210.

deposited into an account in which the recipient has an ownership interest.[6] The Federal Register[7] specified that regulations apply to payments made by the IRS (tax refunds), and the deposit account should not be a loan account or a general ledger account.[8] In accordance with Federal regulations, the IRS policy is that direct deposits of tax refunds be made only into an account in the name of the taxpayer.

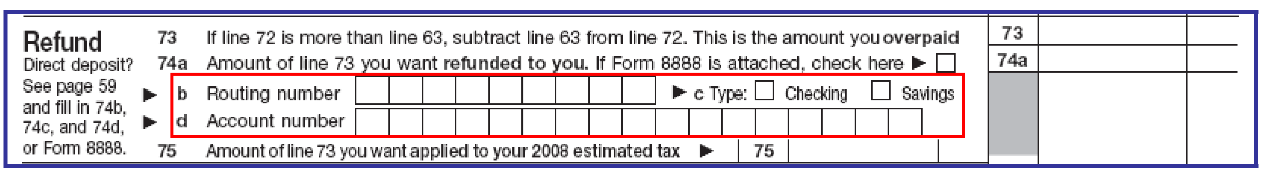
Electing to receive tax refunds via direct deposit

To obtain a tax refund via direct deposit, the taxpayer is required to provide the following information on his or her tax return:

- Bank routing number
- Bank account number
- Type of bank account (checking or savings)

Figure 2 provides an example of where the required information is to be provided on the tax return.

Figure 2: Direct Deposit Lines from 2007 Form 1040



Refund
Direct deposit? See page 59 and fill in 74b, 74c, and 74d, or Form 8888.

73 If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you **overpaid** 73
74a Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐ 74a
▶ b Routing number ▶ c Type: ☐ Checking ☐ Savings
▶ d Account number
75 Amount of line 73 you want applied to your 2008 estimated tax ▶ 75

Source: 2007 U.S. Individual Income Tax Return (Form 1040).

Processing of direct deposit tax refunds

When the IRS is ready to complete the direct deposit transaction, it transmits the tax refund information to the Financial Management Service (FMS). The FMS is the agency of the Department of the Treasury that issues, researches, and keeps all records of United States Treasury checks.[9] After it receives the direct deposit data from the IRS, the FMS transmits direct deposit information to the Automated Clearing House. The Automated Clearing House is the primary electronic funds transfer system used by Federal agencies to make payments. The Federal Reserve Bank operates the Federal Government's Automated Clearing House.

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[6] Federal Register, Vol. 64. No. 68, April 9, 1999, pp. 17479-17480.
[7] The Federal Register is the official daily publication for rules, proposed rules, and notices of Federal agencies and organizations, as well as executive orders and other presidential documents.
[8] Federal Register, Vol. 64. No. 68, April 9, 1999, pp. 17474 and 17477.
[9] These transactions are handled by FMS Regional Financial Centers.

If the bank account[10] number does not match an account number at the specific financial institution that receives the tax refund, then the financial institution normally rejects the direct deposit back to the FMS, generally within 3 days. The FMS notifies the IRS of any returned direct deposit refunds. The IRS will then issue the tax refund as a paper check and send the check to the taxpayer. A notice will automatically be sent to the taxpayer when this occurs explaining that the direct deposit was not honored and a paper check is being issued. Of the approximately 889,000 direct deposits that could not be processed in Calendar Year 2007, approximately 412,000 (46 percent) were due to rejection by the bank.

Refund traces are performed in an attempt to locate direct deposits sent to an incorrect bank account

If the IRS receives a taxpayer inquiry regarding a direct deposit that has not been received–and the IRS cannot find an obvious reason for non-receipt–a refund trace will be initiated. A refund trace results in the IRS forwarding information to the FMS for research to determine what occurred with the refund payment. The FMS will advise the IRS of the results of its research as to whether the refund was paid or is outstanding, or if the trace was not valid for some reason and additional action is required by the IRS.

> ***The National Taxpayer Advocate reported that the IRS has not developed procedures to assist taxpayers who provide incorrect direct deposit account information.***

The National Taxpayer Advocate[11] reported[12] that about 15,550 direct deposit refund traces were initiated in Calendar Year 2004 to resolve a potential problem with a direct deposit refund. Of those, almost 10 percent were the result of some type of error on the part of the taxpayer. The National Taxpayer Advocate was concerned that there is no process to handle cases resulting from taxpayer error and no IRS remedy is available to the taxpayer to attempt to recover his or her lost refund. The IRS responded that the actions it can take are limited by requirements enforced by financial institutions.

This review was performed at the IRS National Headquarters in Washington, D.C., during the period December 2007 through June 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit

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[10] The term bank account is used throughout the report to indicate an allowed depository account. These accounts might also be at certain non-bank financial institutions such as savings and loans or credit unions.
[11] An independent organization within the IRS to help taxpayers resolve problems with the IRS and recommend changes that will prevent these problems.
[12] *National Taxpayer Advocate 2005 Annual Report to Congress*, dated December 31, 2005.

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.

Results of Review

Processes Are Not Sufficient to Ensure the Accuracy of Direct Deposits

The IRS has not developed processes to ensure that the more than 61 million Filing Season 2008 tax refunds were deposited to an account in the name of the filer, as required by Federal direct deposit regulations. The IRS acknowledged that tax refunds are subject to payment guidance in 31 Code of Federal Regulations Part 210 but stated that the regulations do not specify responsibility for enforcing the requirements. In our opinion, the IRS is responsible for ensuring that direct deposits are made to an account in the name of the recipient. Representatives from the FMS also indicated that the IRS is responsible for enforcing the Code of Federal Regulations requirement.

The IRS is not in compliance with direct deposit regulations that require tax refunds be deposited to an account only in the name of the filer.

The IRS places responsibility for compliance with Federal direct deposit regulations on the taxpayer—indicating that it is the taxpayer's responsibility to ensure that their tax refunds are only directly deposited into their accounts. Taxpayers are informed that they may not request the IRS to deposit their tax refunds in an account that is not in their name. However, we found that this information is only included in the instructions associated with the use of the split-refund direct deposit option. As of May 26, 2008, a total of 225,364 of the more than 61 million taxpayers electing to directly deposit their tax refund used this option.[13] The IRS does not include a similar caution in the U.S. Individual Income Tax Return (Form 1040) or in the associated instructions. Developing a process to ensure the accuracy of direct deposits will minimize the potential for fraud and reduce taxpayer burden resulting from errors in depositing tax refunds into the wrong accounts.

Limited actions have been taken to ensure the accuracy of direct deposits

The IRS has taken certain actions to ensure the accuracy of direct deposit information by:

- Ensuring that 1) bank routing numbers are compared to a list of valid routing numbers from the Federal Reserve Bank, 2) bank routing numbers consist of numeric characters in a certain range of values, 3) bank account numbers consist of alphanumeric characters,

[13] The number of split-refund direct deposits is as of May 26, 2008. The number of taxpayer requests for direct deposits is as of April 19, 2008, the most recent date for which we could obtain reliable information.

with only a dash as a permitted special character, and 4) bank account numbers are entered twice to help prevent keying errors.

- Including in the Form 1040 instructions information that warns taxpayers that the IRS is not responsible for a lost refund if the taxpayer enters the wrong account information. It is the taxpayer's responsibility to ensure that the direct deposit information is accurate prior to filing the tax return.
- Including in the Direct Deposit of Refund to More Than One Account (Form 8888) instructions informing taxpayers that they may not request the IRS to deposit their tax refunds into an account that is not in their name.

Despite these actions, tax refunds are being sent to accounts that are not in the name of the taxpayer. Analysis of IRS direct deposit data identified bank accounts receiving multiple (three or more) tax refunds. For Calendar Year 2007, more than 700,000 bank accounts received 3 or more tax refunds, totaling approximately $8.14 billion. In addition, during Calendar Year 2006,[14] the IRS worked an estimated 1,800 cases in which a taxpayer's refund was deposited into someone else's account, resulting from a taxpayer or IRS transcription error, with most being taxpayer error. Figure 3 reveals the distribution of direct deposit refunds to unique bank accounts in Calendar Year 2007.

Figure 3: Distribution of Refund Direct Deposits to Unique Bank Accounts in Calendar Year 2007

Direct Deposits per Bank Account	Number of Direct Deposit Accounts	*Cumulative Percentage of Accounts*	Number of Refunds	*Cumulative Percentage of Refunds*	Dollar Amount of Refunds In millions	*Cumulative Percentage of Dollars*
1	55,617,861	***96.0%***	55,617,861	***89.3%***	$156,302	***90.9%***
2	1,587,047	***98.8%***	3,174,094	***94.4%***	$7,425	***95.3%***
3	329,946	***99.3%***	989,838	***96.0%***	$2,351	***96.6%***
4	139,028	***99.6%***	556,112	***96.9%***	$1,342	***97.4%***
5	76,631	***99.7%***	383,155	***97.5%***	$925	***98.0%***
6 or more	163,954	***100.0%***	1,551,505	***100.0%***	$3,523	***100.0%***
Total	57,914,467		62,272,565		$171,868	

Source: Treasury Inspector General for Tax Administration analysis of IRS direct deposit data.

[14] Calendar Year 2006 is the most current year with complete information.

The inability to ensure the accuracy of direct deposits increases fraud potential

Direct deposit is frequently the payment method used by individuals who attempt to commit filing fraud. Direct deposit provides the ability to quickly receive fraudulent tax refunds without the difficulty of having to negotiate a tax refund paper check. For example, on February 7, 2008, an individual was sentenced to 36 months in prison. According to his plea agreement, the individual paid other individuals approximately $100 in exchange for their Social Security Numbers and dates of birth. The Social Security Numbers were then used to file Federal tax returns claiming false refunds. The refunds were directly deposited into one bank account. The total amount of the false refunds claimed through this conspiracy was approximately $76,869.

In another example, an income tax preparer pleaded guilty and was sentenced to more than 6 years in Federal prison for failing to file tax returns or filing false returns on behalf of himself and unwitting clients during a 3-year period. Investigators believe he prepared at least 244 false tax returns and victimized many of his clients. IRS officials accused him of altering client tax returns "to fraudulently increase the amount of certain deductions to inflate the amounts of refund" and had the refunds deposited into his business bank account.

Figure 4 provides a breakdown of the most egregious examples of multiple tax refunds being deposited to the same account. It should be noted that some of the cases in Figure 4 might relate to tax return preparers not in conformance with Refund Anticipation Loan or Refund Anticipation Check[15] guidelines. Specifically, the *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns* (Publication 1345) directs tax return preparers to work with a separate financial institution to provide these products. Financial institutions generally use the Social Security Number of the taxpayer as part of the account number to differentiate recipients and to make each account unique.

[15] A Refund Anticipation Loan is a short-term loan secured by the taxpayer's expected tax refund. A Refund Anticipation Check is the non-loan bank product that many commercial tax preparers and their bank partners offer in addition to Refund Anticipation Loans.

Figure 4: Bank Accounts with Direct Deposit Volumes greater than 1,000 in Calendar Year 2007

Direct Deposits Per Bank Account (one bank account at each volume level)	Dollar Amount of Refunds
1,056	$2,580,975
1,121	$1,498,583
1,223	$612,114
2,534	$1,326,759
2,800	$13,043,563
2,838	$7,477,791
2,942	$1,659,781
3,404	$377,560
4,572	$1,266,220
4,969	$2,581,784
12,304	$371,355
58,465	$28,621,171

Source: Treasury Inspector General for Tax Administration analysis of IRS direct deposit data.

In Calendar Year 2007, the Questionable Refund Program[16] identified approximately 243,000 potentially fraudulent cases with refund claims totaling approximately $1.46 billion, with $1.2 billion[17] reportedly stopped from being refunded. Of these 243,000 cases, approximately 147,000 cases (60 percent) requested a direct deposit of the refund.

The IRS has unique challenges not faced by other Federal agencies that affect its ability to comply with Federal regulations. For example, representatives from the Social Security Administration, the Office of Personnel Management, and the Department of Agriculture's National Finance Center stated that they use identity and authentication controls prior to initiating the recurring beneficiary-type payments made by these agencies. In contrast, the IRS generally makes only one payment a year to taxpayers. The extensive processes used by other Federal agencies to validate identity and bank account information would be burdensome to taxpayers and would be difficult for the IRS to implement for tax payments.

However, to improve IRS conformance with direct deposit regulations and to help minimize fraud, we believe actions should be taken to limit the number of tax refunds being sent to the same account. While such a limit does not ensure that all direct deposits are in the name of the

[16] The Questionable Refund Program was established to detect, investigate, and prevent questionable individual and business tax return based refunds in a timely manner.
[17] Taken from the IRS Commissioner's testimony before the Senate Finance Committee on April 10, 2008.

filer, it does help limit deposits going to the account not in the name of the taxpayer and the potential for fraud. If a limit was in place, the remaining refunds would be converted to a paper refund check and sent to the taxpayers. If a fraudulent tax refund is converted (direct deposit request is denied) to a paper check, cashing the paper check would be more difficult than simply withdrawing the direct deposit amount.

When we brought the option of limiting the number of direct deposits to the same account to the attention of IRS management officials, they responded that implementing such a control is not their responsibility. They noted that the Federal direct deposit regulations do not specify that the IRS is responsible for ensuring compliance with these guidelines. They also stated that it is the taxpayer's responsibility to comply with Federal direct deposit regulations. However, IRS data clearly demonstrates there is some noncompliance with the regulations (see Figure 4). The intent of limiting the number of direct deposits to the same account is to reduce the potential for substantial refund fraud. The IRS has the responsibility to prevent refund fraud.

A consistent process has not been developed to assist taxpayers in recovering erroneously deposited tax refunds

Taxpayer refunds can be deposited into a wrong bank account as a result of the IRS not having sufficient processes to ensure that refunds are made only to an account in the name of the recipient. When direct deposits are made to the wrong account, the assistance provided to taxpayers is inconsistent. Specifically, the IRS has not established a consistent process to help taxpayers recover their erroneously deposited tax refunds. Before we brought our concern to IRS officials' attention, they were under the impression that employees were consistently assisting these taxpayers. This would include employees contacting the bank to which the tax refund was erroneously deposited to request return of the refund. Subsequently, IRS officials determined that actions taken by employees responsible for assisting taxpayers with refund traces were not consistent. Assistance provided ranged from no contact with the bank to which the refund was erroneously deposited to contacting the bank to request return of the refund.

The IRS has not established a consistent process to help taxpayers recover tax refunds deposited to the wrong bank accounts.

While the IRS has no authority to compel the banks to return erroneous tax refund deposits, IRS employees can ask the bank to return the money in an effort to help assist the taxpayer. The total number of taxpayers whose tax refunds are erroneously deposited is unknown. However, we estimate that of the 16,089 direct deposit refund trace cases in Calendar Year 2006, almost 1,800 resulted from a transcription mistake either by the taxpayer or the IRS, with most being a taxpayer error.

Direct deposit provides benefits to both the taxpayer and Federal Government. The use of direct deposit is encouraged by the IRS. Although the IRS cautions taxpayers of the need to provide accurate direct deposit information and that the taxpayer is responsible for the erroneous deposits, IRS assistance should be provided in an attempt to recover the tax refund. Representatives from the Federal Reserve Bank indicated that as more individuals choose direct deposit, mistakes will be made by taxpayers, and it would be best for all if procedures are in place to assist these taxpayers in recovering their tax refund to avoid any possible adverse media coverage. Further, our review of 26 randomly selected refund trace cases identified that the tax refund represented a significant part of the taxpayer's income, and losing the tax refund will likely present a significant burden to these taxpayers. These taxpayers were primarily lower-income taxpayers with an average Adjusted Gross Income of $19,200 and an average tax refund of $1,600.

The IRS provides financial institutions identifying information that could be used to ensure that refunds are deposited only into an account in the name of the taxpayer

Information that could be used to ensure that tax refunds are deposited into an account in the recipient's name is provided by the IRS to the FMS, which then transmits the information to financial institutions. This information includes the taxpayer's Social Security Number, name, address, and spouse's Social Security Number. Regulations developed by the FMS specify that the financial institution is not responsible for matching on any identifying information other than the deposit account number. FMS guidance also states that the financial institution is not liable for any loss when deposits are made in accordance with the instructions from the IRS (refund deposited into account specified by the IRS).

Information is provided to financial institutions that could be used to ensure that tax refunds are deposited in accounts in the name of the filer.

Representatives from the FMS indicated that some banks, possibly those with fewer direct deposits, do match on more than the deposit account number. The FMS did not have data identifying the specific financial institutions that match on more than the account number. Banking officials indicated that financial institutions would face a number of obstacles if they were to develop a process to match on more than the account number. Of greatest concern is that not all financial institutions have the capability to perform such a match using an automated process. Consequently, expenses would be incurred to either upgrade the automated systems or to manually process the tax refund transactions.

The FMS previously considered making changes to require better matching of account information at financial institutions. The FMS proposed regulations in 1998 that would have provided a means of validating financial institution recipient identity on a case-by-case basis. The proposed regulations were never implemented, but would have required financial institutions to verify that the account number and one other item of information in a pre-notification[18] entry both related to the same account. The pre-notification process, then as now, generally only matches on the account number and verifies that the account exists at the financial institution, but does not provide assurance that the account belongs to the intended recipient. The FMS proposal only related to pre-notifications submitted by Federal agencies.

While several Federal agencies supported such a regulation change, financial institutions were opposed. Financial institutions raised concerns that pre-notification would result in additional costs to match on more than the bank account number, along with system constraints that would have made the matching process problematic. Federal Reserve Bank officials strongly encouraged the adoption of regulations similar to those proposed by the FMS, but noted that regulatory changes would be required. They suggested that if such regulations could be put in place, the IRS could apply them to only certain transactions–such as deposits in which the IRS does not have previous year information to match–in order to minimize effort and expense.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Coordinate with responsible Federal agencies and banking institutions to develop a process to ensure that direct deposit payments are made only to a deposit account in the name of the recipient. In addition, until a process is in place, the IRS should limit the number of direct deposits being sent to the same account to help the IRS comply with Federal regulations and to help reduce the potential for fraud.

> ***Management's Response:*** IRS management partially agreed that coordination between the IRS, responsible Federal agencies, and banking institutions is necessary to develop a process to ensure that direct deposit payments are made only to a deposit account in the name of the recipient. Issuance of any rules or regulations related to verification of depositor identity by financial institutions more properly falls within the jurisdiction of the FMS, which is responsible for the administration of Government-wide direct deposit requirements on behalf of the Department of the Treasury. As such, the IRS will forward a copy of the report to the FMS with the suggestion that they consider this recommendation. The FMS proposed a regulation in 1998 that would have required financial institutions to match account numbers against names for direct deposit payments they receive. It is their understanding that these regulations were not implemented due to the overwhelming number of negative comments on the proposal because it would have added a substantial manual process to the otherwise automated

[18] A pre-notification is a non-dollar entry sent through the electronic payments system which contains the same information (with the exception of the dollar amount and an accounting code) that will be carried on subsequent entries.

system used for Federal payments. To the extent the FMS opts to pursue any such regulations, the IRS will be available to assist. However, IRS officials believe that coordinating a recommendation of this type is beyond their jurisdiction.

The IRS carefully considered limiting the number of direct deposits being sent to the same account. Their first concern is that limiting the number of direct deposits being sent to the same account would not verify that the refunds are deposited in an account in the taxpayer's name, as required by 31 Code of Federal Regulations Part 210. Second, a similar proposal was previously implemented by the IRS in an attempt to reduce the opportunity for filing fraud. Unfortunately, it had to be withdrawn due to the number of circumstances where multiple deposits to a single account were legitimate and acceptable because the accounts were held in the names of multiple individuals. In addition, there is a burden issue for taxpayers who, for historic reasons or for reasons related to considerations outside the tax law, have maintained shared bank accounts, such as Native American groups or religious orders. These situations exist in an even greater number now and prevent implementation of this recommendation. The Criminal Investigation Division Fraud Detection Centers use pre-established criteria to run queries, one of which can identify multiple deposits into the same bank account. If criminal potential exists, the information will be forwarded to the field office for further investigation.

Office of Audit Comment: Although IRS management agreed that coordination between responsible Federal agencies and banking institutions is necessary to develop a process to ensure that direct deposit payments are made only to an account in the name of the recipient, IRS management does not believe they should initiate this coordination. In addition, the IRS disagreed with the recommendation to limit the number of direct deposits being sent to the same account. However, IRS management offered no alternative actions to reduce the potential fraud associated with multiple direct deposits to the same account. The IRS noted that a similar proposal was previously implemented in which it completed programming to identify direct deposits being sent to the same account. For those accounts with more than five deposits, the refund was converted to a paper check. However, the IRS used this process for only one cycle (1 week). Subsequent to receiving a number of complaints from small tax return preparers who were initiating Refund Anticipation Loans and Refund Anticipation Checks, the IRS cancelled this process. If the preparers had established unique accounts for the Refund Anticipation Loans and Refund Anticipation Checks as required, they would not have encountered a problem.

We believe that rather than cancelling this new process after 1 week, the IRS should have taken steps to refine the process and advise tax preparers and taxpayers to follow the regulations. As it stands, individuals use direct deposit to commit refund fraud, and there are instances in which thousands of refunds were sent to the same account in violation of the Code of Federal Regulations. As the use of direct deposit grows, the risk of potential large-scale fraud will increase.

Recommendation 2: Develop an education campaign to clearly alert taxpayers and tax return preparers of the requirement that direct deposits only be made to accounts in the name of a recipient. In addition, include a statement in the individual income tax return instructions or on the tax return cautioning taxpayers that they cannot request a deposit of their refund to an account that is not in their name (such as their tax preparer's account).

> ***Management's Response:*** IRS management agreed that for taxpayers served by the Volunteer Income Tax Assistance and Tax Counseling for the Elderly programs, the Stakeholder Partnerships, Education and Communication function will continue to alert its taxpayers and volunteers that direct deposits only are made to accounts in the name of a recipient. It currently covers direct deposit in all of its volunteer training materials for use by its community partnering organizations and their volunteers. The *Volunteer Student Guide* (Publication 678), the online Link and Learn Taxes training, and the new Process-Based Training to be rolled out nationwide in Fiscal Year 2009, all contain language instructing volunteers to advise taxpayers that their refunds may only be directly deposited into their own accounts. Management also agreed to include the following statement in the instructions for Form 1040: "You cannot request a deposit of your refund to an account that is not in your own name (such as your tax preparer's own account)." The IRS will also explore additional opportunities to highlight this requirement for taxpayers and tax professionals, such as on IRS.gov and in its communications with tax software providers and electronic return originators.

Recommendation 3: Improve procedures for assisting taxpayers in recovering their erroneously deposited tax refunds. Improvements should include the IRS contacting the banks to ask them to return the refund.

> ***Management's Response:*** IRS management will update the procedures in Internal Revenue Manual Section 21.4.1.4.7.3, Non-Receipt of Direct Deposited Refunds – "Refund Inquiry Employees," to include instructions for assisting taxpayers whose direct deposit refunds were sent to an incorrect bank account due to an error by the taxpayer or their representative. The revised procedures will include instructions for Refund Inquiry function employees to complete the following actions:
>
> - Contact the financial Institution by telephone and request their assistance in recovering the funds.
> - If the bank recovers the direct deposit refund, request that they return it to the FMS through normal procedures.
> - If the bank does not respond within 15 calendar days, contact the bank again and allow an additional 15 calendar days for the bank to respond.

- If the bank does not respond or refuses to return the credit, send a letter to the taxpayer explaining what happened to the direct deposit.
- Inform the taxpayer that he or she must contact the financial institution to resolve the erroneous deposit because the IRS does not have the authority to demand the return of the refund from the designated financial institution and explain that the refund was deposited into the account listed on the taxpayer's tax return.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the IRS processes and controls over the direct deposit of refunds into taxpayer bank accounts are adequate to ensure that the deposits are accurate and to identify potentially misrouted or fraudulent direct deposits. To accomplish our objective, we:

I. Determined whether controls are effective to prevent a taxpayer's refund from being direct deposited into the wrong account in the event of a transcription error by the taxpayer.

A. Interviewed IRS staff in the Wage and Investment Division and Taxpayer Advocate offices to determine the current and past direct deposit policies, previous findings related to the IRS study[1] of misdirected direct deposits, and contacts at the Department of the Treasury's FMS and the Federal Reserve Bank.

B. Interviewed officials from the FMS and the Federal Reserve Bank to determine what direct deposit information is transmitted to financial institutions, what the industry standards and best practices are for controlling direct deposit transmissions, and whether changes could be made to prevent direct deposits of tax refunds from going to incorrect accounts.

C. Interviewed officials from other Federal Government agencies that have direct deposit programs—such as the Social Security Administration, the Office of Personnel Management, and the Department of Agriculture's National Finance Center—to determine 1) what the agencies do to prevent benefit recipients' direct deposits from going to incorrect accounts, 2) if the agencies require that the receiving financial institutions match on name or other identifying information, and 3) what procedures the agencies follow to address incorrect direct deposits.

D. Interviewed private sector banking industry officials to determine 1) standard practices in the industry to ensure that incorrect accounts are not accidentally credited, 2) whether the financial institutions receive identifying information with direct deposit transmissions and, if so, whether they currently match on the information being sent to them, and 3) current financial institution procedures to address incorrect direct deposits.

[1] *Direct Deposit Review*, IRS Wage and Investment Division Customer Account Services function, dated June 2005.

E. Measured the number of taxpayers affected and dollar amounts of errors committed by taxpayers in transcribing account information on their tax returns (to the extent they contacted the IRS). We used an IRS-supplied direct deposit refund trace database containing 16,089 cases to select a statistical sample of 242 cases (20 percent expected error rate and 95 +/- 5 percent confidence level) to analyze whether the taxpayer submitted a wrong account number that resulted in the misdirected refund. We did not conduct any reliability or validity testing on this IRS-supplied database. We identified 26 data transposition or transcription errors caused by taxpayers from our statistical sample of 242 and determined the income and filing characteristics of the 26 taxpayers. This analysis was conducted only to provide information on taxpayers who requested refund trace cases and was not used for any projections.

II. Determined whether controls are effective to prevent a taxpayer's refund from being misdirected into an employee, accomplice, or otherwise unauthorized bank account.

A. Interviewed IRS officials, including those in the Wage and Investment Division Customer Account Services function and the Criminal Investigation Division, regarding current and past procedures to prevent purposeful misdirection of direct deposits, identify fraudulent returns requesting a refund using direct deposit, and/or prevent the issuance of the refund.

B. Interviewed Treasury Inspector General for Tax Administration investigators who have worked on direct deposit diversion cases to get their perspective on control weaknesses and what could be done to improve controls.

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs)
Russell P. Martin, Director
Richard J. Calderon, Audit Manager
Mary Jankowski, Lead Auditor
Kenneth L. Carlson, Senior Auditor
John L. Hawkins, Senior Auditor
John B. Mansfield, Senior Auditor
Steven D. Stephens, Senior Auditor
Jennie G. Choo, Auditor
Jane G. Lee, Auditor

Appendix III

Report Distribution List

Commissioner C
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Audit Liaisons:
    Chief, Customer Liaison, Small Business/Self-Employed Division SE:S:COM
    Senior Operations Advisor, Wage and Investment Division SE:W:S

Appendix IV

Management's Response to the Draft Report

COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

RECEIVED
SEP - 9 2008

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MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard Byrd, Jr.
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Processes Are Not Sufficient to Minimize Fraud and Ensure the Accuracy of Tax Refund Direct Deposits (Audit # 200840007)

Thank you for the opportunity to comment on the above mentioned draft report regarding the IRS processes and controls over direct deposits of refunds into taxpayer's bank accounts. The IRS takes the risk of fraudulent filing seriously. We are equally concerned with the potential burden a misdirected direct deposit can place on a taxpayer expecting a refund. We agree that making certain direct deposit payments only to a deposit account in the name of the recipient would limit the opportunity for fraud. It would also increase the accuracy of tax refund direct deposits by ensuring that deposits are made to the account of the taxpayer as required in the Code of Federal Regulations (CFR), specifically, 31 CFR Part 210. We also agree that tax refunds are subject to these regulations. However, there is currently no regulatory method for enforcement of these regulations, nor a practical means for the IRS to do so. Any requirements or enforcement efforts related to verification of depositor identity by financial institutions would more properly fall within the jurisdiction of the Financial Management Service (FMS). The FMS establishes the protocols and directly administers government-wide direct deposit requirements on behalf of the Treasury Department.

Currently, the IRS efforts in this regard are limited to clearly informing taxpayers that they may not request a direct deposit of a tax refund into an account that is not in their name. Form 8888, *Direct Deposit of Refund to More Than One Account*, specifically states that, "You cannot request a deposit of your refund to an account that is not in your name (such as your tax preparer's own account)." We will include a similar statement in the Form 1040 instructions and continue to emphasize this requirement in our training and other materials used by Volunteer Income Tax Assistance and Tax Counseling for the Elderly volunteers. We will also explore additional opportunities to

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highlight this requirement for taxpayers and tax professionals, such as on IRS.gov and in our communications with tax software providers and electronic return originators

While we cannot prevent taxpayer mistakes or intentional disregard of our instructions, we currently take steps to ensure deposit accuracy by verifying bank routing numbers and the formatting of bank account numbers during processing. The Form 1040, U.S. Individual Income Tax Return instructions also emphasize the importance of accurately entering routing and account numbers on tax returns and recommends taxpayers check with their financial institutions to verify this information and to make sure a direct deposit will be accepted.

We agree with your ideas to improve procedures for assisting taxpayers in recovering their erroneously deposited tax refunds. We are taking several positive steps to update and improve our procedures, while minimizing expense and burden for the taxpayer.

Attached are our specific comments to your recommendations. If you have any questions, please contact me at (404) 338-7060, or members of your staff may contact Peter J. Stipek, Director, Customer Account Services, at (404) 338-8910.

Attachment

Attachment

RECOMMENDATION 1

The Commissioner, Wage and Investment Division, should coordinate with responsible Federal agencies and banking institutions to develop a process to ensure that direct deposit payments are made only to a deposit account in the name of the recipient. In addition, until a process is in place, the IRS should limit the number of direct deposits being sent to the same account to help the IRS comply with Federal regulations and to help reduce the potential for fraud.

CORRECTIVE ACTION

We partially agree with this recommendation.

a) We partially agree with the first part of this recommendation that coordination between the IRS, responsible Federal agencies, and banking institutions is necessary to develop a process to ensure that direct deposit payments are made only to a deposit account in the name of the recipient. Issuance of any rules or regulations related to verification of depositor identity by financial institutions more properly falls within the jurisdiction of the Financial Management Service (FMS), which is responsible for the administration of government-wide direct deposit requirements on behalf of the Treasury Department. As a result, we will forward a copy of your report to the FMS with the suggestion that they consider this recommendation. As the report discusses, FMS proposed a regulation in 1998 that would have required financial institutions to match account numbers against names for direct deposit payments they receive. We understand these regulations were not implemented due to the overwhelming negative comment on the proposal because it would have added a substantial manual process to the otherwise automated system used for Federal payments. To the extent FMS opts to pursue any such regulations, the IRS will be available to assist; however, coordinating a recommendation of this type is beyond the jurisdiction of the IRS.

b) We disagree with the second part of this recommendation. We carefully considered your recommendation that the IRS immediately limit the number of direct deposits being sent to the same account. Our first concern is that limiting the number of direct deposits being sent to the same account will not verify that the refunds are deposited into an account in the taxpayer's name, as required by 31 Code of Federal Regulations (CFR) 210. Secondly, a similar proposal was previously implemented by the IRS in an attempt to reduce the opportunity for filing fraud. Unfortunately, it had to be withdrawn due to the number of circumstances where multiple deposits to a single account were legitimate and acceptable because the accounts were held in the names of multiple individuals. For example, when more than two family members have their names on an account. In addition, there is a burden issue for taxpayers who, for historic reasons or for reasons related to considerations outside the tax law, have maintained shared bank accounts, such as Native American groups or religious orders. These situations exist in an even greater numbers now and prevent implementation of this recommendation. The Criminal Investigation Fraud Detection Centers use pre-established criteria to run queries; one of which can identify multiple deposits into the same bank account. If criminal potential exists, the information will be forwarded to the field office for further investigations.

IMPLEMENTATION DATE

a) October 15, 2008
b) N/A

RESPONSIBLE OFFICIAL(S)

a) Director, Accounts Management, Wage and Investment Division
b) N/A

CORRECTIVE ACTION MONITORING PLAN

a) We will monitor this corrective action as part of our internal management control system.
b) N/A

RECOMMENDATION 2

The Commissioner, Wage and Investment Division, should develop an education campaign to clearly alert taxpayers and tax return preparers of the requirement that direct deposits only be made to accounts in the name of a recipient. In addition, include a statement in the individual income tax return instructions or on the tax return cautioning taxpayers that they cannot request a deposit of their refund to an account that is not in their name (such as their tax preparer's account).

CORRECTIVE ACTION

We agree with this recommendation.

a) For the taxpayers served by the Volunteer Income Tax Assistance and Tax Counseling for the Elderly (VITA/TCE) programs, the Stakeholder Partnerships, Education and Communication (SPEC) function will continue to alert its taxpayers and volunteers that direct deposits only are made to accounts in the name of a recipient. The SPEC function currently covers direct deposit in all its volunteer training materials for use by its community partnering organizations and their volunteers. Publication 678 (Volunteer Student Guide), the online Link and Learn Taxes training, and the new Process-Based Training to be rolled out nationwide in Fiscal Year 2009, all contain language instructing volunteers to advise taxpayers that their refunds may only be deposited directly into their own accounts.

b) We agree to include the following statement in the instructions for the U.S. Individual Income Tax Return (Form 1040), "You cannot request a deposit of your refund to an account that is not in your own name (such as your tax preparer's own account)."

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c) We will also explore additional opportunities to highlight this requirement for taxpayers and tax professionals, such as on IRS.gov and in our communications with tax software providers and electronic return originators.

IMPLEMENTATION DATE(S)

a) April 15, 2009
b) November 15, 2008
c) March 15, 2009

RESPONSIBLE OFFICIAL(S)

a) Director, SPEC, Wage and Investment Division
b) Director, Media and Publications, Wage and Investment Division
c) Director, Accounts Management, Wage and Investment Division

CORRECTIVE ACTION(S) MONITORING PLAN

We will monitor these corrective actions as part of our internal control system.

RECOMMENDATION 3

The Commissioner, Wage and Investment Division, should improve procedures for assisting taxpayers in recovering their erroneously deposited tax refunds. Improvements should include the IRS contacting the banks to ask them to return the refund.

CORRECTIVE ACTION

We agree with your recommendation and will update the procedures in Internal Revenue Manual 21.4.1.4.7.3, *Non-Receipt of Direct Deposited Refunds – "Refund Inquiry Employees,"* to include instructions for assisting taxpayers whose direct deposit refunds were sent to an incorrect bank account due to an error by the taxpayer or their representative.

The revised procedures will include instructions for Refund Inquiry employees to complete the following actions:

- Contact the financial institution by telephone and request their assistance in recovering the funds.
- If the bank recovers the direct deposit refund, request they return it to FMS through normal procedures.
- If the bank does not respond within 15 calendar days, contact the bank again. Allow an additional 15 calendar days for the bank to respond.
- If the bank does not respond or refuses to return the credit, send a letter to the taxpayer explaining what happened to the direct deposit.

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- Inform the taxpayer he/she must contact the financial institution to resolve the erroneous deposit because the IRS does not have the authority to demand the return of the refund from the designated financial institution and explain that the refund was deposited into the account listed on the taxpayer's return.

IMPLEMENTATION DATE
October 15, 2008

RESPONSIBLE OFFICIAL
Director, Accounts Management, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.