

*TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION*



**Increased Taxpayer Awareness and Improved
Guidance Are Needed to Ensure Accurate
Direct Deposit of Tax Refunds Claimed on
E-Filed Tax Returns**

October 2003

Reference Number: 2004-40-016

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

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INSPECTOR GENERAL
for TAX
ADMINISTRATION

October 31, 2003

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Assistant Inspector General for Audit (Small Business and
Corporate Programs)

SUBJECT: Final Audit Report - Increased Taxpayer Awareness and
Improved Guidance Are Needed to Ensure Accurate Direct
Deposit of Tax Refunds Claimed on E-Filed Tax Returns
(Audit # 200340029)

This report presents the results of our review of the direct deposit of tax refunds claimed on electronically filed (*e-filed*) tax returns. The overall objective of this review was to determine the effectiveness of controls to prevent the diversion of tax refunds claimed on *e-filed* tax returns to direct deposit¹ bank accounts not authorized by the taxpayers.

The Internal Revenue Service's (IRS) Electronic Filing (*e-file*) Program offers taxpayers an alternative to filing a traditional paper tax return. The *e-file* Program enables taxpayers to send their tax returns to the IRS in an electronic format via an IRS authorized *e-file* Provider.² *E-file* Providers can transmit tax returns they prepared and/or transmit tax returns prepared by taxpayers. *E-file* Providers include individuals or organizations that serve as volunteers in IRS-sponsored programs such as the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) Programs.³ As of July 2003, there were 154,468⁴ IRS-authorized *e-file* Providers.

¹ Direct deposit is an electronic transfer of a tax refund to an account specified by the taxpayer.

² For the purpose of this report, authorized *e-file* Providers include individuals or businesses that prepare tax returns and transmit the tax returns electronically to the IRS, or individuals or businesses that electronically transmit tax returns to the IRS from taxpayers who elect to prepare their own tax returns. This does not include TeleFile tax returns where taxpayers can *e-file* their tax returns using a telephone.

³ The VITA and TCE Programs provide free tax return preparation including *e-filing*.

⁴ The IRS provided this figure, and we did not validate it. However, it is overstated, as *e-file* Providers can be authorized to transmit *e-filed* tax returns to more than one Electronic Individual Return Submission Processing Site.

Since 1988, the IRS has offered taxpayers who *e-file* the option of having their tax refunds directly deposited. To obtain a tax refund via direct deposit, taxpayers are required to provide on their tax returns the Routing Transit Number, Deposit Account Number, and type of account (checking or savings) to which the refunds will be deposited. The tax return instructions caution taxpayers that the IRS is not responsible for a lost tax refund if the taxpayer enters the wrong account information on the tax return. During the 2002 Filing Season,⁵ the IRS processed over 39 million *e-filed* individual income tax returns, prepared and/or transmitted by an *e-file* Provider, that had claims for tax refunds totaling approximately \$90 billion, with approximately 30 million of the tax refund claims (for approximately \$75 billion) paid via direct deposit.

Opportunities exist for *e-file* Providers to change or add direct deposit account numbers on a taxpayer's tax return prior to *e-filing* the tax return to the IRS. This impropriety can result in a tax refund claimed on an *e-filed* tax return being directly deposited to a bank account not authorized by the taxpayer. For example,

***** (b)(3):26 U.S.C. 6103 (b)(7)(C) ***** . In another case, ***** (b)(3):26 U.S.C. 6103 (b)(7)(C) *****

A number of factors contribute to the weaknesses identified. One is that the instructions for completing the United States (U.S.) Individual Income Tax Return (Form 1040) do not require the taxpayer to void the direct deposit field on the tax return if he or she wants to receive a paper tax refund check. In addition, cautionary information and/or educational efforts have not been provided or undertaken to increase taxpayers' awareness of the need to obtain and retain copies of their tax returns and signature authorization documents, as well as to ensure the accuracy of direct deposits. Further, refund inquiry guidance does not contain specific steps to be followed to validate a taxpayer's intention when a tax refund is inaccurately directly deposited, and specific legal guidance does not exist regarding erroneous direct deposits for *e-filed* tax returns.

Implementation of our recommendations will reduce the risk of tax refunds claimed on *e-filed* tax returns being diverted to unauthorized bank accounts. Additionally, our recommendations will improve the consistency with which taxpayers are treated when their tax refunds are inaccurately directly deposited. We recommended that the Commissioner, Wage and Investment (W&I) Division, add a cautionary statement on *e-file* signature authorization forms⁶ alerting taxpayers to the importance of accurately providing direct deposit bank account information and retaining copies of their tax

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

⁶ Signature authorization forms are required to authenticate the electronic tax return and provide certification that the return is true, correct, and complete. These forms include the U.S. Individual Income Tax Declaration for an IRS *e-file* Return (Form 8453) and the IRS *e-file* Signature Authorization (Form 8879).

returns; undertake educational efforts to increase taxpayer and *e-file* Provider awareness of the importance of taxpayers obtaining and retaining copies of tax returns; and provide adequate resources to volunteer sites to ensure copies of tax returns are provided to taxpayers who use these services. We further recommended that the Commissioner, W&I Division, revise refund inquiry guidance, and explore whether a legislative change to address the IRS' authority to reissue a taxpayer's tax refund in the event of theft via direct deposit is appropriate.

Management's Response: Management agreed to implement the majority of our recommendations, which will reduce the risk of tax refunds claimed on *e-filed* tax returns being diverted to unauthorized bank accounts and improve the consistency with which taxpayers are treated when their tax refunds are inaccurately direct deposited. Specifically, the IRS is adding a statement to the IRS *e-file* Signature Authorization (Form 8879) to remind taxpayers that they should get a copy of their return. The IRS will develop messages for filing season and practitioner communications and will advise taxpayers of the need to retain copies of returns and signature forms in national print and broadcast media in the 2004 *e-file* marketing campaign. To ensure volunteer tax preparation sites provide copies of returns to taxpayers, the IRS will include the requirement in guidance provided to volunteers and site coordinators when establishing volunteer sites and include the requirement as part of the volunteer training. The IRS revised guidance to instruct employees to obtain copies of the taxpayer's return and compare it with the electronically transmitted data. The IRS will work with the National Taxpayer Advocate to determine if current procedures for forged checks could be applied when a theft of a direct deposit has been verified.

Management disagreed with our recommendation to add a cautionary statement to the U.S. Individual Income Tax Declaration for an IRS *e-file* Return (Form 8453). Management cited that the *e-file* Provider signs a statement on the Form 8453 agreeing to provide the taxpayer with copies of all forms and information filed with the IRS. Taxpayers sign Form 8453 declaring that the information given to the *e-file* Provider agrees with the electronic return; therefore, the taxpayer would have reviewed the direct deposit information for accuracy and would receive a copy of the Form 8453 showing the direct deposit information.

In addition, management acknowledges the outcome measure we reported as being "potential" revenue protection; however, they do not believe that our outcome measure reflects a realistic representation of the risk associated with improprieties by *e-file* Providers. Further, management indicated that they realize that there are risks associated with direct deposit; however, existing safeguards minimize these risks. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment: While we still believe our recommendation regarding the inclusion of a cautionary statement on Form 8453 is worthwhile, we do agree that improved safeguards will minimize the risk of improprieties by *e-file* Providers. We do

not intend to elevate our disagreement concerning this matter to the Department of Treasury for resolution.

As we indicated in our audit report, the outcome is provided in quantifiable terms to demonstrate the value that our audit recommendations will have on tax administration and business operations and to show the number of taxpayers who are potentially at risk when filing an electronic tax return with the assistance of an *e-file* Provider and the estimated refund dollars claimed.

The Treasury Inspector General for Tax Administration (TIGTA) has designated this report as Limited Official Use (LOU) pursuant to Treasury Directive TD P-71-10, Chapter III, Section 2, "Limited Official Use Information and Other Legends" of the Department of Treasury Security Manual. Because this document has been designated LOU, it may only be made available to those officials who have a need to know the information contained within this report in the performance of their official duties. This report must be safeguarded and protected from unauthorized disclosure; therefore, all requests for disclosure of this report must be referred to the Disclosure Section within the TIGTA's Office of Chief Counsel.

Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

TD P 15-71
**Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate
Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns**

Table of Contents

Background Page 1

Opportunities Exist for E-File Providers to Change or Add
Direct Deposit Account Numbers on a Taxpayer’s Tax
Return Prior to E-Filing..... Page 3

Recommendation 1:Page 8

Recommendations 2 and 3:Page 9

Recommendation 4:Page 10

Appendix I – Detailed Objective, Scope, and Methodology..... Page 11

Appendix II – Major Contributors to This Report Page 13

Appendix III – Report Distribution List Page 14

Appendix IV – Outcome Measures..... Page 15

Appendix V – Management’s Response to the Draft Report Page 18

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

Background

The Internal Revenue Service's (IRS) Electronic Filing (*e-file*) Program offers taxpayers an alternative to filing a traditional paper tax return. The *e-file* Program enables taxpayers to send their tax returns to the IRS in an electronic format via an IRS-authorized *e-file* Provider.¹ *E-file* Providers can transmit tax returns they prepared and/or transmit tax returns prepared by taxpayers. *E-file* Providers include individuals or organizations that serve as volunteers in IRS-sponsored programs such as the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) Programs.² As of July 2003, there were 154,468³ IRS-authorized *e-file* Providers.

Since 1988, the IRS has offered taxpayers who *e-file* the option of having their tax refunds directly deposited.⁴ Tax refunds paid via direct deposit provide benefits to both the taxpayer and the IRS, including:

- Faster and more convenient receipt of the tax refund.
- Security of tax refund payment – no paper check to lose.
- Reduced tax refund issuance cost for the IRS when compared with issuing a paper tax refund check.

To obtain a tax refund via direct deposit, the taxpayer is required to provide on the tax return the Routing Transit Number, Deposit Account Number, and type of account (checking or savings) to which the refund will be deposited. The tax return instructions caution the taxpayer that the IRS

¹ For the purpose of this report, authorized *e-file* Providers include individuals or businesses that prepare tax returns and transmit the tax returns electronically to the IRS, or individuals or businesses that electronically transmit tax returns to the IRS from taxpayers who elect to prepare their own tax returns. This does not include TeleFile tax returns where taxpayers can *e-file* their tax returns using a telephone.

² The VITA and TCE Programs provide free tax return preparation including *e-filing*.

³ The IRS provided this figure, and we did not validate it. However, it is overstated, as *e-file* Providers can be authorized to transmit electronically filed tax returns to more than one Electronic Individual Return Submission Processing Site.

⁴ Direct deposit is an electronic transfer of a tax refund to an account specified by the taxpayer.

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

is not responsible for a lost tax refund if the taxpayer enters the wrong account information on the tax return.

During the 2002 Filing Season,⁵ over 39 million electronically filed (*e-filed*) tax returns were prepared and/or transmitted by an *e-file* Provider and had claims for tax refunds totaling approximately \$90 billion. Approximately 30 million of the tax refund claims (for approximately \$75 billion) were paid via direct deposit.

Tax Refunds Issued During 2002 Filing Season by E-File Providers

Type of Tax Refund	Volume of Tax Refunds Issued	Dollars Claimed in Tax Refunds
Paper Check	9,655,103	\$14,735,202,248
Direct Deposit	29,923,547	\$75,350,244,407
Total	39,578,650	\$90,085,446,655

Source: Wage and Investment Division Electronic Tax Administration Final Tax Year 2001 National Service Center Report Through October 20, 2002, and IRS personnel.

The IRS generally processes an *e-filed* tax return and issues the tax refund within 3 weeks from the date the tax return is received. Subsequent to the 3-week period, taxpayers who do not receive their tax refunds can contact any of the various IRS Customer Service functions to inquire about their missing tax refunds. The IRS' Customer Service options include calling the toll-free telephone service, using the automated tax refund inquiry system, visiting a Taxpayer Assistance Center, sending in correspondence, and contacting the Taxpayer Advocate Service.⁶ The identification of missing tax refunds is based solely on taxpayers contacting the IRS, as the IRS has no process to proactively identify missing tax refunds.

Contacting the IRS through the above Customer Service options initiates the IRS' tax refund inquiry process. The

⁵ The period from January through mid-April when most individual tax returns are filed.

⁶ "Lost or stolen refunds" was ranked 8th of 25 reasons why taxpayers contacted the Taxpayer Advocate Service for Fiscal Year 2002, based on the Taxpayer Advocate Management Information System receipts from October 1, 2001, to September 30, 2002.

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

IRS' Refund Inquiry Unit will work with the taxpayers to obtain pertinent information and perform research to determine what may have happened to the missing refunds.

Audit work was performed at the National Headquarters for Electronic Tax Administration (Washington, D.C.) and the five Electronic Individual Return Submission Processing Sites⁷ that accept and process *e-filed* individual income tax returns. Audit work was performed from October 2002 through June 2003 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.

Opportunities Exist for E-File Providers to Change or Add Direct Deposit Account Numbers on a Taxpayer's Tax Return Prior to E-Filing

Opportunities exist for *e-file* Providers to change or add direct deposit account numbers on a taxpayer's tax return prior to *e-filing* the tax return with the IRS. This impropriety can result in tax refunds claimed on *e-filed* tax returns being directly deposited to bank accounts not authorized by the taxpayers. Specifically, instances have occurred where *e-file* Providers and volunteers participating in the IRS' VITA Program have altered direct deposit information on *e-file* tax returns prior to transmitting the tax returns to the IRS. These alterations, whether intentional or inadvertent, have resulted in tax refunds being directly deposited to bank accounts not authorized by the taxpayers. For example:

- *****(b)(3):26 U.S.C. 6103 (b)(7)(C)*****

- *****(b)(3):26 U.S.C. 6103 (b)(7)(C)*****

⁷ Electronic Individual Return Submission Processing Sites are located at the Andover, Massachusetts; Austin, Texas; Cincinnati, Ohio; Memphis, Tennessee; and Ogden, Utah IRS campuses. The campuses are the data processing arms of the IRS; they process submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

***** (b)(3):26 U.S.C. 6103

(b)(7)(C)*****

Furthermore, the IRS policy is not consistent in how it resolves stolen tax refund checks and fraudulently diverted direct deposits of tax refunds. In situations that involve inaccurate direct deposits, the burden is on the taxpayer to show that the refund was deposited to a bank account *other* than the bank account he or she designated on the tax return. An IRS Chief Counsel Advice⁸ dated September 6, 2002, stated that in the context of direct deposit, the IRS satisfies its burden of proof by showing that the tax refund was sent to the bank account designated on the tax return. If the taxpayer does not show that the tax refund was deposited to an account other than the bank account he or she designated on the return, then the IRS does not have authority to replace the incorrectly deposited tax refund.

This advice differs significantly from the IRS' policy related to stolen tax refund checks. For example, if a taxpayer's tax refund check is stolen, the IRS will reissue the refund. In comparison, if a tax refund is fraudulently directly deposited to an unauthorized bank account, in most cases the IRS will not reissue the tax refund. The IRS' position is that the tax refund was deposited to the account specified on the tax return. This does not take into account possible manipulation of the direct deposit information prior to the tax return being transmitted to the IRS.

In many cases involving theft of tax refunds via direct deposit, the IRS functions assisting a taxpayer with a tax refund inquiry may obtain a legal opinion from the IRS Chief Counsel to determine if the IRS has the authority to replace the taxpayer's tax refund. Varied responses have been received and have led to inconsistent treatment of taxpayers even when the circumstances involved in the cases are identical. For example, one taxpayer could be

⁸ A Chief Counsel Advice is written advice or instruction prepared by the Office of Chief Counsel that is issued to IRS employees. It conveys legal interpretation of internal revenue law either in general or as applied to specific taxpayers or groups of specific taxpayers.

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

informed by the IRS that he or she is not entitled to a reissuance of the tax refund, while another taxpayer may have already had his or her tax refund reissued by the IRS.

Contributing factors

Several factors present opportunities for inaccurate direct deposit of tax refunds by *e-file* Providers and inconsistent treatment of taxpayers:

Instructions for completing the United States (U.S.) Individual Income Tax Return (Form 1040) do not require the taxpayer to void the direct deposit fields if the taxpayer does not use them (i.e., elects to receive a paper check tax refund). Specifically, the instructions do not require the taxpayer to take any preventive steps to ensure the direct deposit fields on the tax return cannot be manipulated prior to the transmission of the tax return to the IRS (e.g., place “x’s” in the direct deposit fields, thereby voiding them rather than leaving them blank).

In response to a previously issued Treasury Inspector General for Tax Administration (TIGTA) report,⁹ IRS management agreed to coordinate with the tax software developers to initiate modifications to their Tax Year (TY) 2003 software programs. These modifications will eliminate direct deposit fields on *e-filed* tax returns if a taxpayer elects to receive a paper tax refund check. Therefore, we did not include a specific recommendation to address this issue.

***E-file* signature authorization forms do not contain cautionary statements alerting taxpayers of the need to ensure the direct deposit information is accurate and to obtain and retain copies of their tax returns.** *E-file* signature authorization forms authenticate the *e-filed* tax returns and provide certification from the taxpayers that the tax returns are true, correct, and complete. Cautionary information is not provided on two *e-file* signature authorization forms, the U.S. Individual Income Tax Declaration for an IRS *e-file* Return (Form 8453) and the

⁹ *Controls Need to Be Improved to Ensure Accurate Direct Deposit of Tax Refunds* (Reference Number 2003-40-108, dated May 2003).

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

IRS *e-file* Signature Authorization (Form 8879). A cautionary statement is needed for taxpayers to ensure direct deposit information is accurate and to ensure they obtain and retain copies of their tax returns.

Instructions for completing these forms do caution taxpayers to verify the accuracy of their tax returns. However, the cautionary statement is included as part of the Form 1040 instruction package, which the taxpayers will most likely not have read since they are using a paid tax return preparer and are not preparing the returns themselves.

Taxpayers may not be adequately educated as to the need to obtain and retain copies of their tax returns.

Educational efforts have not been made to alert taxpayers of the need to obtain and retain copies of their returns and signature authorization forms. These documents are the sole support the taxpayers have to validate their intention as to how and where their refunds should have been issued.

For those taxpayers who have their tax returns prepared by VITA/TCE volunteers at VITA/TCE sites, resources may not be adequate to ensure these taxpayers are provided copies of their tax returns. During TY 2002, a total of 12,975 VITA/TCE sites prepared over 1.4 million tax returns, of which approximately 922,000 (66 percent) were *e-filed*. IRS management has acknowledged the shortage of equipment, which affects the IRS' ability to provide taxpayers who use VITA/TCE sites with copies of their tax returns and signature authorization forms.

Guidance used by the IRS function that assists taxpayers with refund inquiries does not contain specific steps to be followed to validate a taxpayer's intention when a tax refund is inaccurately directly deposited. Specifically, the guidance does not require a comparison of the direct deposit information as provided by the taxpayer on his or her copy of the *e-filed* tax return to information transmitted to the IRS. In addition, guidance does not provide steps to be taken subsequent to the TIGTA Office of Investigations' processing of diverted direct deposit tax refund cases.

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

Guidance has not been not clearly established to reissue tax refunds regarding erroneous direct deposits, to ensure consistent treatment of taxpayers. Internal Revenue Code (I.R.C.) Section (§) 6402¹⁰ provides guidance on the authority of the IRS to issue a tax refund. However, the I.R.C. addresses only those instances involving the theft of a paper tax refund check by forgery; it does not address theft of a tax refund via direct deposit. In summary, there is no clear legal guidance addressing the IRS' legal authority to reissue direct deposit tax refunds.

Impact of control weaknesses

If controls are not strengthened, the opportunity for *e-file* Providers to divert tax refunds claimed on *e-filed* tax returns to unauthorized bank accounts remains high. At risk is the potential revenue protection of over \$75 billion in tax refunds claimed by 30 million individuals who filed electronic tax returns using an *e-file* Provider and elected to receive their tax refunds via direct deposit.¹¹

Therefore, it is important that taxpayers who elect to *e-file* ensure they obtain and retain copies of their tax returns and associated signature authorization documents. These documents are the sole support for the taxpayers in situations that involve inaccurate direct deposits to unauthorized bank accounts. Further, the tax return preparer is required by law¹² to provide a completed copy of the original tax return to the taxpayer.

Recommendations

Implementation of our recommendations will reduce the risk of tax refunds claimed on *e-filed* tax returns being diverted to unauthorized bank accounts. Additionally, our recommendations will improve the consistency with which taxpayers are treated when their tax refunds are inaccurately directly deposited.

¹⁰ I.R.C. § 6402 (2002).

¹¹ For more details on the calculation, see Appendix IV.

¹² I.R.C. § 6107 (2002) – Income tax return preparer must furnish a copy of the return to the taxpayer and must retain a copy or record.

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

The Commissioner, Wage and Investment (W&I) Division, should:

1. Include a cautionary statement on *e-file* signature authorization forms explaining the need for the taxpayer to ensure direct deposit information is accurate and to obtain and retain a copy of his or her tax return and signature authorization form. The Commissioner should also design and execute an education campaign to increase taxpayer and *e-file* Provider awareness of the need for taxpayers to obtain and retain copies of their tax returns and signature authorization forms.

Management's Response: The IRS agreed in part with this recommendation. For the first part, the IRS is adding a statement to Form 8879 to remind taxpayers that they should get a copy of their return. The reminder will be prominently displayed in bold face type beside the Part II caption, Taxpayer Declaration and Authorization Statement, on the front of the form. However, the IRS does not agree that additional cautionary statements are needed on Forms 8879 or 8453. The IRS believes that sufficient cautionary statements are already present.

To address the second part of this recommendation, the IRS will develop messages for filing season and practitioner communications. It will alert taxpayers to the need to retain copies of returns and signature forms in national print and broadcast media in the 2004 *e-file* marketing campaign and on a more personal level through community based coalitions.

While IRS management agreed with the accuracy of our figures as "potential" revenue protection, they did not believe that our outcome reflects a realistic representation of the risk associated with improprieties by *e-file* Providers. Further, management indicated that they realize that there are risks associated with direct deposit; however, existing safeguards minimize these risks.

Office of Audit Comment: While we still believe our recommendation regarding the inclusion of a cautionary statement on Form 8453 is worthwhile, we do agree that

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

improved safeguards will minimize the risk of improprieties by *e-file* Providers. Further, as we indicated in our audit report, the outcome is provided in quantifiable terms to demonstrate the value that our audit recommendations will have on tax administration and business operations and to show the number of taxpayers who are potentially at risk when filing an electronic tax return with the assistance of an *e-file* Provider and the estimated refund dollars claimed.

2. Ensure that VITA and TCE sites have the resources to provide taxpayers who elect to *e-file* their tax returns with copies of their completed tax returns and signature authorization forms.

Management's Response: Since the inception of *e-file* into IRS' volunteer programs, volunteers have been required to supply a copy of the tax return and the signature authorization form to each taxpayer assisted. Computer equipment and printers are provided to volunteer tax preparation sites in order to e-file returns and to print copies of the necessary documents for taxpayers.

To ensure volunteer tax preparation sites provide copies of returns to taxpayers, the IRS will include the requirement in guidance provided to volunteers and site coordinators when establishing volunteer sites and include the requirement as part of the volunteer training.

3. Revise refund inquiry guidance to ensure copies of *e-filed* tax returns are obtained from the taxpayers and compared to what was transmitted to the IRS, and include the specific steps to be taken subsequent to the TIGTA Office of Investigations' review of referred cases.

Management's Response: Guidance was revised to instruct employees to obtain copies of the taxpayer's return and compare it with the electronically transmitted data. Procedures include forwarding copies of the return and the Integrated Data Retrieval System¹³ prints of the transmitted data to the TIGTA Office of Investigations for review. The

¹³ IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

IRS is coordinating with the TIGTA Office of Investigations on the processing of completed cases and will include additional instructions concerning the processing of completed cases in a revision to the Internal Revenue Manual 21.4, Refund Inquiry.

4. Develop interim procedures and work with the National Taxpayer Advocate to explore whether a legislative change to the I.R.C. to address the IRS' authority to reissue a taxpayer's tax refund in the event of theft via direct deposit is appropriate.

Management's Response: The IRS will work with the National Taxpayer Advocate to determine if current procedures for forged refund checks could be applied when a theft of a direct deposit has been verified. If current procedures are determined to be inadequate, the IRS will support efforts to improve the process through policy directives or legislative remedy, if appropriate.

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

Appendix I**Detailed Objective, Scope, and Methodology**

The overall objective of this review was to determine the effectiveness of controls to prevent the diversion of tax refunds claimed on electronically filed (*e-filed*) tax returns to direct deposit bank accounts¹ not authorized by the taxpayers. To accomplish this objective, we:

- I. Obtained and reviewed the Internal Revenue Service's (IRS) guidance relating to the processing of *e-filed* tax returns.
- II. Identified the process followed for processing *e-filed* tax returns.
 - A. Identified the filing requirements for taxpayers who request a direct deposit of their individual income tax return refunds.
 - B. Held discussions with representatives from the Submission Processing function² to identify controls in place for processing *e-filed* tax returns.
- III. Determined if the IRS had controls in place to ensure that all *e-filed* tax returns requesting a tax refund were not directly deposited to unauthorized bank accounts.
 - A. Identified tax refunds claimed on *e-filed* individual income tax returns that were potentially being diverted to unauthorized bank accounts.
 - B. Calculated the number of tax returns with direct deposits as well as the amount of the tax refunds issued.
- IV. Interviewed management to identify factors that contributed to the inadequate IRS controls to prevent unauthorized direct deposit tax refunds and what actions the IRS had taken to improve controls.
- V. Identified the process to assist taxpayers who experience losses due to tax refund fraud.
 - A. Identified the Refund Inquiry Unit process to assist taxpayers whose tax refunds were either inadvertently or intentionally diverted to incorrect bank accounts via direct deposit.
 - B. Performed a walk-through at the Andover Submission Processing Site to determine how taxpayers are assisted in obtaining a replacement tax refund.

¹ Direct deposit is an electronic transfer of a tax refund to an account specified by the taxpayer.

² Electronic Individual Return Submission Processing Sites are located at the Andover, Massachusetts; Austin, Texas; Cincinnati, Ohio; Memphis, Tennessee; and Ogden, Utah IRS Campuses. The campuses are the data processing arms of the IRS. The campuses process submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

TD P 15-71

**Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate
Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns**

- C. Held discussions with representatives from the Accounts Management function to identify controls to identify potential cases of tax refunds diverted via direct deposit to bank accounts not authorized by the taxpayers.

**Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate
Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns**

Appendix II

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**Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate
Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns**

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Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

Appendix IV**Outcome Measures**

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

This issue is of interest to Internal Revenue Service (IRS) and Department of the Treasury executives, the Congress, and the taxpaying public and is expressed in quantifiable terms to provide further insights to the value of the entity affected and potential impact of the issue. The value of entity measure is presented to express in quantifiable terms the number of taxpayers who file an electronic return with the assistance of an authorized electronic filing (*e-file*) Provider¹ and estimated refund dollars claimed. While we cannot determine the specific number of taxpayers or refund dollars that may be affected through improprieties by authorized *e-file* Providers, the risk exists if controls are not strengthened.

Type and Value of Outcome Measure:

Revenue protection is used here to demonstrate the value of our audit recommendations on tax administration and business operations.

- Revenue Protection (Value of Entity) – Potential; an estimated 30 million taxpayers who file an individual electronic tax return with the assistance of an authorized *e-file* Provider and use the direct deposit option (see page 3).
- Revenue Protection – Potential; an estimated \$75 billion in tax refunds claimed by taxpayers who file an individual electronic tax return with the assistance of an authorized *e-file* Provider and use the direct deposit option (see page 3).

Methodology Used to Measure the Reported Benefit:

We determined the number of taxpayers claiming tax refunds on electronically filed (*e-filed*) individual income tax returns filed by an *e-file* Provider by identifying the number of Tax Year (TY) 2001² *e-filed* individual income tax returns based on the final TY 2001 Service Center Report.³ We then subtracted the number of balance due *e-filed* tax returns (no tax refund issued

¹ An authorized *e-file* Provider originates the electronic submission of income tax returns to the IRS.

² TY 2001 tax returns were processed in the Electronic Individual Return Submission Processing Sites located at the Andover, Massachusetts; Austin, Texas; Cincinnati, Ohio; Memphis, Tennessee; and Ogden, Utah IRS Campuses starting January 11, 2002. The campuses are the data processing arms of the IRS. The campuses process submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

³ Final TY 2001 Service Center Report dated October 20, 2002.

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

to the taxpayer) and subtracted the number of TeleFiled⁴ tax returns (no *e-file* Provider required to *e-file* tax return) based on the same report (see page 16).

We determined the amount of tax refunds on *e-filed* individual income tax returns filed by an *e-file* Provider based on information provided by the Electronic Tax Administration (ETA) function, since the TY 2001 Service Center Report does not identify dollars. We subtracted the tax refund dollars for all TeleFiled tax returns obtained from the ETA Analyst, from the tax refund dollars for all *e-filed* tax returns, to obtain tax refunds on *e-filed* tax returns filed by an *e-file* Provider for the taxpayers (see page 16).

⁴ The TeleFile Program allows taxpayers to file their tax returns electronically using a telephone.

TD P 15-71

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

Table 1 - Calculation of Revenue Protection Numbers

	Number of Tax Returns	Dollar Amount of Tax Refunds
Total E-Filed Tax Returns Accepted	46,890,813	
Less: Balance Due Returns (no tax refund due)	3,326,778	
Total E-Filed Tax Returns Claiming a Tax Refund	43,564,035	\$92,422,294,124
Less: TeleFiled Tax Returns Claiming a Tax Refund	3,985,385	\$2,336,847,469
Total E-Filed Tax Returns Claiming a Tax Refund Filed by an E-File Provider	39,578,650	\$90,085,446,655
Total E-Filed Tax Returns Requesting a Paper Check Tax Refund	9,655,103	\$14,735,202,248
Total E-Filed Tax Returns Requesting a Direct Deposit Tax Refund	29,923,547	\$75,350,244,407

Source: Wage and Investment Division Electronic Tax Administration Final Tax Year 2001 National Service Center Report through October 20, 2002, and IRS personnel.

TD P 15-71

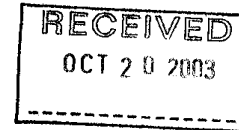
Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

Appendix V

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308



OCT 16 2003

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: Henry O. Lamar Jr. *Henry O. Lamar, Jr.*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Increased Taxpayer Awareness and Improved Guidance Is Needed To Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-filed Tax Returns (Audit No. 200340029)

One of our primary goals for electronic filing is to protect the privacy of taxpayer information. Taxpayers have the right to expect the IRS will collect, maintain, and use identifiable personal information and data only as authorized by law and as necessary to carry out the agency's responsibilities.

As such, we are committed to reducing the risk of tax refunds claimed on e-filed tax returns from being diverted to unauthorized bank accounts and improving the consistency with which taxpayers are treated when their tax refunds are inaccurately direct deposited. To address these concerns, we will modify our forms and instructions to increase taxpayer awareness of the use of personal information. We will also review our procedures for any inconsistencies and make modifications, as necessary. However, we do not believe that an additional cautionary statement on the e-file signature authorization form is needed. As noted in your report, there are laws to prohibit third parties from misusing tax information. Section 7216 of the Internal Revenue Code requires tax practitioners to ensure the privacy of tax information and they are subject to civil and criminal penalties if they fail to do so.

We acknowledge that the outcome measure is stated as "potential" Revenue Protection. However, we believe that your statement regarding the inability to determine the number of taxpayers or refund dollars that may be affected by improprieties by authorized e-file providers is a more pertinent point. While we realize that there are risks associated with direct deposit, they are minimized by our existing safeguards. We do not believe that your Outcome Measure reflects a realistic representation of the risk associated with improprieties by e-file providers.

TD P 15-71
**Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate
Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns**

2

If you have any questions, please contact Terence H. Lutes, Director, Electronic Tax Administration, at (202) 622-7990.

Attachment

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

Attachment

RECOMMENDATION 1a

The Commissioner, Wage and Investment Division should:
Include a cautionary statement on e-file signature authorization forms explaining the need for the taxpayer to ensure direct deposit information is accurate and to obtain and retain a copy of his/her tax return and signature authorization.

CORRECTIVE ACTION

We agree in part with of this recommendation:

Form 8879 – IRS e-file Signature Authorization

We have added a statement to Form 8879, IRS e-file Signature Authorization, to remind taxpayers that they should get a copy of their return. The reminder will be prominently displayed in bold face type beside the Part II caption, Taxpayer Declaration and Authorization Statement, on the front of the form.

We do not agree an additional cautionary statement is needed on Form 8879 to address the need for accurate direct deposit information. Direct deposit information is included as part of the taxpayers electronic return. Form 8879 includes several statements cautioning taxpayers to verify the accuracy of their return. The statement on Form 8879 signed by the taxpayer under penalties of perjury declares that they have examined the copy of their electronic return. In addition, the first item listed under "Taxpayer Responsibilities", of Form 8879 instruction, informs the taxpayer to verify the accuracy of the prepared income tax return. We have not revised Form 8879 to include any specific guidance regarding direct deposit information.

Form 8453 – U.s. Individual Income Tax Declaration for and IRS e-file Return

Instructions for Form 8453 in Publication 1345, IRS e-file Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns, require the Electronic Return Originators (EROs) provide a complete copy of the return to the taxpayer. Publication 1345, page 45, specifically states that Form 8453 is considered part of the return. The statement of Form 8453 signed by the ERO under penalty of perjury indicates that they will give the taxpayer a copy of all forms and information to be filed with the IRS.

Taxpayers sign Form 8453 under penalties of perjury declaring that the information given to the ERO agrees with the electronic return. Since the direct deposit information is included in the electronic return provided for taxpayer review, we have not added a specific statement on Form 8453 regarding accuracy of direct deposit information.

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

2

IMPLEMENTATION DATE

The reminder statement for taxpayers on Form 8879 will be completed November 7, 2003

RESPONSIBLE OFFICIAL

Director, Submission Processing Division

CORRECTIVE ACTION MONITORING PLAN

Implementation will be monitored through our internal control system and managerial oversight. We will ensure the 2003 version of Form 8879 includes the updated information.

RECOMMENDATION 1b

The Commissioner, Wage and Investment Division, should:
Design and execute an education campaign to increase taxpayer and e-file provider awareness of the need for the taxpayer to obtain and retain a copy of his/her tax return and signature authorization form.

CORRECTIVE ACTION

We agree with this recommendation. Wage and Investment Divisions' Communications and Liaison (C&L) will coordinate with Stakeholder Partnerships, Education and Communication (SPEC) Small Business and Self-Employed Divisions' C&L and Taxpayer Education (TEC) Offices to develop messages for filing season and practitioner communications. We will disseminate taxpayers' need to retain copies of return and signature forms in national print and broadcast media in our 2004 e-file marketing campaign, and on a more personal level through community based coalitions.

IMPLEMENTATION DATE

July 1, 2004

RESPONSIBLE OFFICIAL

Director, Communications and Liaison, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

Implementation of these corrective actions will be monitored through our internal control system and managerial oversight.

RECOMMENDATION 2

The Commissioner, Wage and Investment Division, should:
Ensure that volunteer sites have the resources to provide taxpayers who elect to e-file their tax return with copies of the completed tax returns and signature authorization forms.

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

3

CORRECTIVE ACTION

We agree with this recommendation. Since the inception of e-file into our volunteer programs, volunteers have been required to supply a copy of the tax return and the signature authorization form to each taxpayer assisted. SPEC loans computer equipment and printers to volunteer tax preparation sites in order to e-file returns and to print copies of the necessary documents for taxpayers.

To ensure volunteer tax preparation sites provide copies of returns to taxpayers, SPEC will include the requirement in guidance provided to volunteers and site coordinators when establishing volunteer sites and include the requirement as part of the volunteer training.

IMPLEMENTATION DATE

December 31, 2003

RESPONSIBLE OFFICIALS

Director, Stakeholder Partnerships, Education and Communications

CORRECTIVE ACTION MONITORING PLAN

Monitoring will be incorporated during annual review visits.

RECOMMENDATION 3a

The Commissioner, Wage and Investment Division, should:

Revise refund inquiry guidance to ensure copies of e-file tax returns are obtained from the taxpayers and compared to what was transmitted to the IRS.

CORRECTIVE ACTION

We agree with this recommendation. Refund Inquiry IRM 21.4.1.4.7.4 was revised to instruct employees to obtain copies of the taxpayers' return and compare it with the electronically transmitted data. Procedures include forwarding copies of the return and Integrated Data Retrieval System (IDRS) prints of the transmitted data to the TIGTA Office of Investigation for review.

IMPLEMENTATION DATE

Completed October 1, 2003

RESPONSIBLE OFFICIAL

Director, Accounts Management

CORRECTIVE ACTION MONITORING PLAN

Implementation of these corrective actions will be monitored through our internal control system and managerial oversight.

Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns

4

RECOMMENDATION 3b

The Commissioner, Wage and Investment Division, should:
Revise refund inquiry guidance to include the specific steps to be taken subsequent to TIGTA Office of Investigations review of referred cases.

CORRECTIVE ACTION

We agree with this recommendation. We are coordinating with the TIGTA Office of Investigations on the processing of completed cases. We will include additional instructions concerning the processing of completed cases in a revision to the IRM 21.4., Refund Inquiry.

IMPLEMENTATION DATE

February 4, 2004

RESPONSIBLE OFFICIAL

Director, Accounts Management

CORRECTIVE ACTION MONITORING PLAN

Implementation of these corrective actions will be monitored through our internal control system and managerial oversight.

RECOMMENDATION 4

The Commissioner, Wage and Investment Division, should:
Develop interim procedures and work with the Taxpayer Advocate to explore whether a legislative change to the Internal Revenue Code (IRC) to address the IRS' authority to re-issue a taxpayer's tax refund in the event of theft via direct deposit is appropriate.

CORRECTIVE ACTION

We agree with this recommendation. We will work with the Taxpayer Advocate to determine if current procedures for forged refund checks could be applied when a theft or a direct deposit had been verified. If current procedures are determined to be inadequate, we will support efforts to improve the process through policy directives or legislative remedy, if appropriate.

IMPLEMENTATION DATE

January 1, 2005

RESPONSIBLE OFFICIALS

National Taxpayer Advocate
Director, Accounts Management Division

**Increased Taxpayer Awareness and Improved Guidance Are Needed to Ensure Accurate
Direct Deposit of Tax Refunds Claimed on E-Filed Tax Returns**

5

CORRECTIVE ACTION MONITORING PLAN

Implementation of these corrective actions will be monitored through our internal control system and managerial oversight.