The External Leads Program Results in the Recovery of Erroneously Issued Tax Refunds; However, Improvements Are Needed to Ensure That Leads Are Timely Verified

August 7, 2014

Reference Number: 2014-40-057

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THE EXTERNAL LEADS PROGRAM RESULTS IN THE RECOVERY OF ERRONEOUSLY ISSUED TAX REFUNDS; HOWEVER, IMPROVEMENTS ARE NEEDED TO ENSURE THAT LEADS ARE TIMELY VERIFIED

Highlights

Final Report issued on August 7, 2014

Highlights of Reference Number: 2014-40-057 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

The External Leads Program is an IRS program that receives leads about questionable tax refunds identified by a variety of partner organizations that include financial institutions, brokerage firms, government and law enforcement agencies, State agencies, tax preparation entities, *etc*. The questionable tax refunds include Treasury checks, direct deposits, and prepaid debit cards. The program helps to recover erroneous tax refunds, thus saving tax dollars.

WHY TIGTA DID THE AUDIT

This audit was initiated because the External Leads Program has grown from 10 partner financial institutions returning $233 million in Calendar Year 2010 to 258 partner financial institutions and partner organizations returning more than $576 million in Calendar Year 2013. The overall objective of this review was to assess the effectiveness of the IRS's External Leads Program in recovering questionable tax refunds.

WHAT TIGTA FOUND

Since taking over the External Leads Program in January 2010, the Wage and Investment Division has performed outreach in an effort to continuously increase the number of organizations participating in this program. Participation and the number of questionable refunds returned and dollars associated have grown significantly. The IRS measures the External Leads Program's success by volume and dollars associated with questionable returned refunds.

However, the IRS is not always verifying leads timely, and verification time frame goals differ significantly based on the lead type. The timely verification goals do not take into consideration the burden on legitimate taxpayers whose refund is being held until the verification is completed.

In addition, leads are inconsistently tracked in multiple inventory systems, and the inventory systems do not provide key information such as how the lead was resolved, *i.e.,* refund confirmed as erroneously issued or legitimate.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS establish more consistent time frames to verify leads based on analysis of current and historical lead verification data and, once established, communicate these verification time frames with external partners; develop a process to ensure that leads are verified within established time frames; and consolidate the current four lead inventory tracking systems into a single tracking system and ensure that key information is captured as to how each lead is resolved.

The IRS agreed with our recommendations. The IRS is evaluating the treatment streams and work processes associated with the various types of referrals received in the External Leads Program to identify appropriate time frames; completing other systemic and procedural enhancements to improve the effectiveness of existing reporting capabilities in evaluating program quality and timeliness; and evaluating the feasibility and potential benefits of consolidating the four independent inventory tracking databases into one system.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 7, 2014

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The External Leads Program Results in the Recovery of Erroneously Issued Tax Refunds; However, Improvements Are Needed to Ensure That Leads Are Timely Verified (Audit # 201340028)

This report presents the results of our review to assess the effectiveness of the Internal Revenue Service's (IRS) External Leads Program in recovering questionable tax refunds. This audit is included in our Fiscal Year 2014 Annual Audit Plan and addresses the major management challenge of Fraudulent Claims and Improper Payments.

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

Copies of this report are also being sent to the IRS managers affected by the report recommendations. If you have any questions, please contact me or Russell P. Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services).

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Abbreviations

ACH	Automated Clearing House
CY	Calendar Year
IRS	Internal Revenue Service
RICS	Return Integrity and Correspondence Services

Background

The External Leads Program is an Internal Revenue Service (IRS) program that receives external communications (leads) about questionable tax refunds identified by a variety of partner organizations that include financial institutions, brokerage firms, government and law enforcement agencies, State agencies, tax preparation entities, and others. The questionable tax refunds identified by these organizations include Treasury checks, direct deposits, and prepaid debit cards. Characteristics used by stakeholders to identify questionable Federal tax refunds include a mismatch between the name and account number of the direct deposit and the partner financial institution's records, unusual deposit amounts, or suspicions of false information used to request a refund. Once a questionable refund is identified, a referral (the IRS refers to these as "leads") is sent to the IRS to research the validity of the refund.

The IRS reports that in Calendar Year 2013, questionable tax refunds totaling more than $576 million were returned as a result of the External Leads Program.

Lead notification and return of questionable refund methods

The majority of the questionable refund leads the IRS receives are via a secure e-mail address that the IRS set up for the External Leads Program. For leads submitted via e-mail, the IRS requires the referring organization to prepare and include a spreadsheet with key information relating to the questionable refund identified. The information includes the name and Social Security Number of the refund recipient and the tax year, which helps the IRS associate the refund with the originating tax return and tax account. A second referral process allows the U.S. Department of Health and Human Services to notify the IRS of offsets of questionable tax refunds to State agencies for the payment of an individual's back owed child support. Finally, partner organizations can also systemically reject direct deposit refunds back to the IRS. Systemically rejected refunds are returned to the taxpayer's account and held until the IRS completes its verification of the refund.

The IRS categorizes leads based on the method that the IRS receives the returned questionable refund. Figure 1 provides information showing the lead types, along with a description of how the refunds are returned, and the amount of questionable refunds returned during Calendar Year (CY) 2013.

Figure 1: Method Leads Received and the Amounts of Tax Refunds Returned for CY 2013

Lead Type	Method Questionable Refund Returned	Amount of Refunds Returned
Secure E-Mail	Electronic transfer of returned refund to an IRS account or paper check mailed to the IRS.	$ 421,451,514
Offset	U.S. Department of Health and Human Services Office of Child Support Enforcement notifies the IRS of questionable tax refunds offset to State child support agencies.	$ 76,541,383[1]
Systemic Reject – (Opt-In R17)[2]	Systemically rejected back to the IRS.	$ 67,877,112
Systemic Reject – (Automated Clearing House)[3]	Systemically rejected back to the IRS.	$ 11,107,799
	Total	**$ 576,977,808**

Source: IRS Return Integrity and Correspondence Services, External Leads Program.

Processing of questionable refund leads

The IRS's Wage and Investment Division Return Integrity and Correspondence Services (RICS) Unit is responsible for processing leads that are received to determine if the refund issued by the IRS was erroneous. The leads are processed by RICS Unit staff located in Fresno, California; Covington, Kentucky; and Brookhaven, New York.

When a lead is received, a tax examiner performs research to determine if the tax refund was issued erroneously. Research includes a review of third-party reported income and withholding information, if it is available, or contact with employers to confirm the validity of wages and withholding reported on the tax return. If the tax examiner cannot verify the income and withholding, the tax refund is considered as being erroneously issued, and the tax examiner will request the referring organization to return the erroneous tax refund if the funds were not

[1] This represents amounts returned to the IRS and can include amounts returned during CY 2013 for CY 2012 offsets.
[2] Beginning in January 1, 2013, participating institutions can return refunds when the names on the tax refund and bank account do not match or the deposit has been identified as questionable. When this occurs, an automatic hold is placed on the refund to prevent the issuance of a paper check.
[3] This process is similar to the Opt-In process; however, a tax examiner must place a hold on the refund within 24 hours of receiving the lead to try and prevent reissuance as a paper check since a paper check would be sent out within five days of the Automated Clearing House reject.

previously returned when the lead was initially submitted. The tax examiner will also coordinate with employees in the IRS's Submission Processing function to adjust the tax accounts associated with the confirmed erroneously issued tax refund, including posting the refund back to the taxpayer's account.

This review was performed at RICS Unit External Leads teams in Fresno, California, and Covington, Kentucky, and with information obtained from the Wage and Investment Division's RICS Unit Headquarters organization in Atlanta, Georgia, and Austin, Texas, during the period May 2013 through February 2014. 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 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

The External Leads Program Results in the Return of Millions of Dollars in Questionable Tax Refunds

Since taking over responsibility for the External Leads Program in January 2010, the Wage and Investment Division has performed outreach in an effort to continually increase the number of organizations participating in this program. Participation and the number of questionable refunds returned and dollars associated have grown significantly from CY 2010 to CY 2013. The IRS measures this Program's success by volume and dollars associated with questionable returned refunds. Figure 2 provides a multiyear comparison of partner organizations participating in the program as well as the volume and dollars associated with questionable tax refunds returned.

Figure 2: External Leads Program Statistics - CY 2010 Through CY 2013

CY	Participating Partner Organizations	Refunds Returned	Dollar Total Refunds Returned
2010	10	53,252	$233,209,075
2011	31	43,175	$331,536,348
2012	126	264,536	$896,927,634[4]
2013	286	195,550	$576,977,808

Source: IRS RICS Unit, External Leads Program.

Figure 2 shows that since CY 2010 there has been a dramatic growth in program participation and the volume of returned questionable tax refunds. In response to this growth, the Wage and Investment Division allocated additional resources to the program. For example, when the Wage and Investment Division took over responsibility for the program, there were eight employees (four permanent and four seasonal)[5] assigned to review and process leads. Currently, there are 84 employees (41 permanent and 43 seasonal), as well as eight leads and seven managers

[4] The volume of refunds returned and dollars associated with CY 2012 were higher than other calendar years as a result of a year-long effort during CY 2012 to recover erroneously issued tax refunds related to debit cards and the implementation of additional fraud filters in CY 2013 that stopped fraudulent refunds from being issued.
[5] Seasonal means annually recurring periods of work that are less than 12 months each year.

assigned to this program. In addition, the IRS continues to implement more efficient methods for returning questionable tax refunds to the IRS. For example, the IRS worked with the Department of the Treasury's Bureau of the Fiscal Service[6] to establish an electronic method (the Credit Gateway) for banks to return questionable funds to the IRS. This process allows banks to return questionable tax refunds, with the refund credited back within 24 hours.

The IRS also recognizes that returned refunds equate to an erroneously issued tax refund. As such, the IRS has established processes to research leads in an attempt to identify trends that can be used to improve its fraud detection filters. Fraud detection filters are used to identify questionable tax refunds at the time tax returns are processed and before refunds are erroneously issued. For example, by analyzing leads, the IRS identified a trend that involved fraudulent tax returns with a filing status of married filing joint and the tax returns were prepared using a specific electronic tax preparation package. The IRS adjusted its fraud detection filters to identify questionable tax returns with these types of characteristics when tax returns are processed.

Leads Are Not Always Timely Verified

Our review identified that the IRS is not always verifying leads timely, and verification time frame goals differ significantly based on the lead type. Figure 3 provides the results of our analysis of verification timeliness by external lead type.

[6] Formerly the Department of the Treasury Financial Management Service.

Figure 3: Analysis of Timeliness of Lead Verifications

Lead Type	Verification Goal	Leads Reviewed[7]	Leads Not Verified Timely	Percentage of Leads Not Verified Timely
E-Mail	10 Days	50	35[8]	70%
Offset	30 Days	50	32	64%
Automated Clearing House (ACH)	10 Days[9]	26[10]	6	23%
Opt-In R17	70 Days	17,756	1,124	6%

Source: Treasury Inspector General for Tax Administration review of external leads, analysis of the external lead inventory data maintained by the IRS, and the Master File.

Specific characteristics relating to the four categories of leads we reviewed include:

- **E-Mail –** For the 35 leads that we identified as not verified timely, we found that it took tax examiners an average of 66 days to verify these leads, with a verification range from 16 days to 180 days.[11]
- **Offset –** For the 32 leads that we identified as not verified timely, we found that it took tax examiners an average of 70 days to verify these leads, with a verification range from 38 days to 152 days.

  Discussions with three State Child Support Enforcement office directors confirmed what we identified. These individuals indicated that on average it takes the IRS from 60 to 80 days to respond as to whether the offset referred back as questionable is a valid refund or was erroneously issued. However, one director described waiting for the IRS's determination for six to eight months. For example, it was not until the end of January 2014 that this office received the last of the IRS's determination for offset leads submitted during CY 2012.

[7] The results of E-Mail, Offset, and Automated Clearing House leads are based on our review of a statistical random sample of these leads. The results of Opt-In leads are based on 100 percent analysis. Limitations with the external leads inventory tracking systems prevented us from addressing timeliness for the entire population of E-Mail, Offset, and Automated Clearing House leads.
[8] Sixteen of the 35 E-Mail lead accounts reviewed were from a single large lead involving 27,153 accounts.
[9] The IRS's verification time frame goal for ACH leads is to immediately put a refund hold on the taxpayer's account. However, because leads related to ACH rejects are received through e-mail, we used the same time frame goal established for E-Mail leads.
[10] For 24 of the 50 ACH rejects, we could not determine if the leads were timely worked because resolution information was not captured by the IRS.
[11] The 180 days related to the one lead with thousands of accounts.

- **ACH Rejects** – For the six leads that we identified as not verified timely, we found that it took tax examiners an average of 64 days to verify these leads, with a verification range from 26 days to 130 days.
- **Opt-In R17 Rejects** – For the 1,124 leads that we identified as not verified timely, we found that it took examiners an average of 95 days to verify these leads, with a verification range from 71 days to 153 days.

The IRS has not established processes to monitor lead verifications to ensure that the leads are timely verified. When we discussed our results with IRS management, management stated that they established verification timeliness goals as the program evolved and stated that stronger documentation and the establishment of program measures would allow management to better evaluate the program.

Lead verification timeliness goals are inconsistent

Although the IRS established timeliness goals, our review identified that these goals vary considerably by lead type. For example, the Internal Revenue Manual states that, in most cases, leads should be reviewed, screened, verified, and a response as to the validity of the refund sent to the referring organizations within 10 business days. However, according to management, the 10-day standard applies only to those leads received by e-mail, whereas the verification goal established for Opt-In leads is within 70 days, and the goal for Offset leads is within 30 days.

The questionable refunds associated with the Opt-In leads and Offset leads are protected from being issued, *i.e.*, the refunds are automatically frozen, until a tax examiner can complete the verification process. However, the time frames established for verification of these leads does not take into consideration the burden on legitimate taxpayers whose refund is being held until the verification is completed. When we questioned IRS management as to their basis for establishing a verification time frame for Opt-In leads of 70 days, management indicated that the processes needed to resolve the account are extensive (adjusting the account, waiting for the adjustments to properly post, *etc.*).

IRS management's explanation does not appear to justify the establishment of the much longer verification time frame goal, because the actions needed to resolve an account associated with Opt-In leads are similar to the actions needed to resolve the accounts associated with the other types of leads. In addition, our analysis of the Opt-In leads received by the IRS during the period February 6 to July 19, 2013, determined that 42 percent were verified within 10 business days, and that the average time to verify all 17,756 leads was 24 days, well below the current 70-day time frame.

The more likely explanation for the difference in time frames is the risk involved. The risk of erroneous issuance of a refund associated with Opt-In and Offset leads is low because those refunds are automatically held until verification is complete. Whereas, the risk of erroneous issuance of a refund associated with ACH and E-Mail leads is high because the IRS needs to initiate actions to prevent the release of the questionable refund. Notwithstanding, taxpayer burden should also be considered in establishing the verification time frames. As such, we believe the IRS should establish more consistent verification time frames for the different types of leads.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Establish more consistent time frames to verify leads. The time frames should be based on analysis of current and historical lead verification data. Once established, communicate verification time frames with external partner organizations.

> **Management's Response:** The IRS agreed with the recommendation. The IRS is evaluating the treatment streams and work processes associated with the various types of referrals received in the External Leads Program to identify appropriate time frames for each process and opportunities where gains in consistency may be achieved. The time frames established for the verification processes will be clearly communicated to its external partners.

Recommendation 2: Develop a process to ensure that leads are verified within established time frames.

> **Management's Response:** The IRS agreed with the recommendation. It has implemented procedural changes that are having positive effects on the timeliness of lead identification and verification activities. The IRS is completing other systemic and procedural enhancements to improve the effectiveness of existing reporting capabilities in evaluating program quality and timeliness.

Leads Are Inconsistently Tracked and Information Is Not Available Regarding Lead Resolution

Our review of 50 E-Mail leads found that the IRS's lead inventory tracking system accurately accounted for these leads.[12] However, the process for tracking the leads is inconsistent and does not provide key information such as how the lead was resolved, *i.e.*, refund confirmed as erroneously issued or legitimate. For example, the IRS tracks leads received from partner organizations using four different systems. Offset and Opt-In leads are tracked in separate systems by individual questionable tax refund and provide detailed information relating to the returned refund, including the individual's name and Social Security Number. The ACH and E-Mail leads are tracked in another system by an aggregated total number of questionable tax

[12] We reviewed a random sample of 50 E-Mail leads between January 2, 2013, and August 17, 2013. See Appendix I for details on our sampling methodology.

refunds the organization is referring to the IRS because the leads, when sent, include information for multiple individuals. Individual taxpayer account information associated with the ACH and E-Mail leads is then maintained in yet another system and can be cross-referenced using the ACH/E-Mail lead number assigned by the IRS to the original aggregate lead received.

The IRS indicated that multiple tracking systems are used because the leads are received from different sources. E-Mail and ACH leads are provided in spreadsheets that contain information for multiple accounts, Opt-In leads are identified individually because they are received individually, and Offset leads are identified by each questionable tax refund. While we were able to account for the leads we sampled, maintaining multiple lead tracking systems results in the inconsistent capture of lead information. For example, tax examiners working Offset leads update the inventory tracking system for each refund indicating whether the refund was confirmed as erroneously issued. However, tax examiners working E-Mail leads do not update the E-Mail lead tracking system for each refund to indicate whether a refund was determined to have been erroneously issued.

In addition, our review of a statistical random sample of 50 questionable tax refunds returned through the ACH process identified 25 questionable tax refunds totaling more than $81,000 that were systemically rejected back to the IRS and then subsequently reissued as a paper refund check. However, information was not captured as to how these leads were resolved. As a result, we could not determine if the refund was a valid refund that should have been reissued or it was reissued in error. Consistently capturing information as to how leads are resolved would improve management's ability to identify trends and patterns that would allow them to refine the upfront fraud filters and adjust case processing standards to further strengthen the External Leads Program.

Recommendation

Recommendation 3: The Commissioner, Wage and Investment Division, should consolidate the current four lead inventory tracking systems into a single tracking system and should ensure that key information is captured as to how each lead is resolved.

> ***Management's Response:*** The IRS agreed with the recommendation. It is evaluating the feasibility and potential benefits of consolidating the four independent inventory tracking databases into one system. The data recorded in the tracking systems are also being reviewed to determine if additional information is needed to improve monitoring and reporting capabilities.

Offsets of Erroneously Issued Tax Refunds Cause Significant Burden to States

Representatives from the U.S. Department of Health and Human Services' Office of Child Support Enforcement noted that approximately $2 billion in tax refunds are offset for individuals who owe back child support payments each year.[13] Representatives from this office raised concern regarding the increase in the number of tax refund offsets that the IRS subsequently reverses, months or even years later, as an erroneously issued tax refund. This creates a financial burden on the States when they have already distributed the amount from the tax refund offset to the individual owed the funds. For the reversed refunds, the IRS's actions result in a reduction of the next month's disbursement of offsets to the State by the amount of the refunds reversed.[14] However, there is no assurance that the States will recover the funds from the individuals to whom the money was paid and, even if the funds are recovered, there may be a substantial delay between the disbursement and the repayment. This is resulting in significant budget shortfalls for the States because they have to use money from their own budgets to cover the losses associated with the refunds the IRS initially offsets and then subsequently reverses.

According to the Office of Child Support Enforcement, further compounding the losses to the States is that once the IRS identifies a current fraudulent tax filing, it will often review prior filed tax returns to determine if these were also fraudulent. When the IRS determines that fraudulent tax refunds were offset for child support in prior years, the refunds are also reversed, and the amount of disbursement to the State is reduced despite the fact that the money was already issued by the State some years earlier.

For example, according to statistics provided by the State of Florida, the amount of IRS offset reversals dramatically increased in CY 2013 to more than $8.5 million, with the majority of the reversals (about $5.5 million) relating to offsets from Tax Year 2010. Since the offset reversals are from a prior year, the State of Florida has previously distributed the funds to individuals owed the child support. As a result, the State is required to either attempt to collect the funds back from these individuals or has to absorb the costs itself.

The financial burden resulting from the IRS's offset of erroneously issued tax refunds has necessitated the States to develop processes to assume what should be the IRS's responsibility of identifying potentially questionable tax refunds that were offset by the IRS in error before the States distribute the funds. About 43 states have established processes in an attempt to identify questionable child support offset payments and, once identified, refer the offset back to the IRS. For example, during CYs 2012 and 2013, States referred more than $237.7 million in child

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[13] The Internal Revenue Code sections 6402 (a), (c), (d) and (e) require a taxpayer's overpayment to be applied to any outstanding nontax child support prior to crediting the overpayment to a future tax or making a refund. This application of a tax overpayment is called a refund offset.

[14] We could not determine if the prior year offset reversals were the direct result of the actions of the External Leads program or a result of another function at the IRS.

support offsets that they identified as being questionable tax refunds. Figure 4 provides the number of questionable tax refund child support offsets for CYs 2012 and 2013 that the U.S. Department of Health and Human Services referred to the IRS, the number of offsets the IRS deemed to have been erroneously issued, and the total amount of tax refund offsets associated with these erroneously issued refunds.

Figure 4: Office of Child Support Enforcement Referrals of Questionable Tax Refund Child Support Offsets – CYs 2012 and 2013

CY	Offsets Referred As Questionable		Offsets Confirmed by the IRS As Erroneous	
	Number	Amount	Number	Amount
2012	42,311	$145,488,314	20,415	$ 99,928,790
2013	32,590	$ 92,214,528	16,928	$ 52,944,469
Total	74,901	$237,702,842	37,343	$152,873,259

Source: IRS RICS Unit, External Leads Program.

The Internal Revenue Code requires the IRS to apply taxpayers' overpayments, *i.e.*, refunds, to any outstanding Federal tax, nontax child support, Federal agency nontax debt, *e.g.*, student loan, or State income tax obligation prior to refunding the overpayment to the taxpayer. Based on the concerns raised during our review, we plan to conduct a subsequent audit to review the IRS's offset program.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to assess the effectiveness of the IRS's External Leads Program in recovering questionable tax refunds. To accomplish this objective, we:

I. Assessed the effectiveness of the IRS's strategy to promote the External Leads Program to increase institution and agency participation.

II. Determined if the IRS has an effective process to track and control leads and ensure that leads are timely resolved.

A. Identified and evaluated the IRS's process for tracking and controlling leads by reviewing applicable Internal Revenue Manual guidance and interviewing IRS personnel.

B. Identified a population of 2,080 E-Mail leads from the e-mail inbox that were received by the External Leads Program between January 2, 2013, and August 17, 2013. We selected a random sample of 50 E-Mail leads from the population of 2,080. A random sample was used to ensure that each E-Mail lead had an equal chance of being selected, which enabled us to obtain sufficient evidence to support our results. For the sample selected, we determined if the E-Mail leads were accounted for on the inventory tracking spreadsheet.

C. Assessed the effectiveness of the IRS process to ensure that external leads are timely worked by reviewing a statistically valid random sample of 200 external leads (50 each of ACH, E-Mail, Offset, and Opt-In leads) from a population of 158,713 leads. We used a 95 percent confidence level, a ± 5 percent precision rate, and a 15 percent error rate. We made the sample selection with the assistance of a contracted statistician. For our review of timeliness of the Opt-In R17 rejects, we were able to perform analysis on 100 percent of the leads (17,756) instead of using the sample of 50 leads. We identified the Opt-In leads by obtaining an Individual Master File[1] extract of taxpayer accounts with a Transaction Code 841 with Document Locator Number Blocking Series 77711 (indicating an Opt-In reject) in Tax Years[2] 2011 and 2012.

III. Determined if the IRS has an effective process to use the results of the external leads to improve fraud detection filters. We did this by interviewing External Leads Program and

[1] The Master File is the IRS's database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[2] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

RICS Unit management to determine if analysis was performed on tax returns identified as fraudulent through the External Leads Program. We assessed whether the IRS was effectively using the tax return information from fraudulent tax refunds identified and returned by partner financial institutions to improve fraud detection within IRS processes.

IV. Evaluated the effectiveness of the IRS's process for working child support offsets by interviewing IRS personnel, representatives from the U.S. Department of Health and Human Services' Office of Child Support Enforcement, and representatives from the child support offices of three States.

V. Determined the method used to measure the success of the External Leads Program and whether those measures effectively measure the success of the program.

Data validation methodology

During this review, we relied on data from the IRS's Individual Master File for Processing Year[3] 2013 provided by the Treasury Inspector General for Tax Administration Office of Investigations' Strategic Data Services and also performed additional extracts of the Individual Master File located on the Treasury Inspector General for Tax Administration Data Center Warehouse. We selected random samples of the data and validated the results using the IRS's Integrated Data Retrieval System.[4] Through our testing, we determined that the data used in our review were reliable.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: the IRS processing of external leads submitted by partner financial institutions via e-mail, direct deposit tax refunds rejected by partner financial institutions, and child support offsets questioned by the States. We evaluated these controls by interviewing IRS management, performing a case review of a random sample of questioned tax refunds submitted to the IRS, and performing data analysis of Master File information for the transactions relating to these tax refunds.

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[3] The calendar year in which the tax return or document is processed by the IRS.
[4] IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

Appendix II

Major Contributors to This Report

Russell P. Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services)
Diana M. Tengesdal, Acting Director
Kathleen Hughes, Audit Manager
David Robben, Lead Auditor
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Tracy Hernandez, Auditor
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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Operations, Wage and Investment Division SE:W
Director, Return Integrity and Correspondence Services, Wage and Investment Division SE:W:RICS
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Appendix IV

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

COMMISSIONER
WAGE AND INVESTMENT DIVISION

JUL 16 2014

MEMORANDUM FOR MICHAEL E. MCKENNEY
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Debra Holland Debra S. Holland
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – The External Leads Program Results in the Recovery of Erroneously Issued Tax Refunds; However, Improvements Are Needed to Ensure Leads Are Timely Verified (Audit# 201340028)

Thank you for the opportunity to review and respond to the subject draft report. We appreciate your acknowledgement that the External Leads Program has secured the return of millions of dollars in questionable tax refunds. The IRS is committed to the proactive detection of fraudulent refund claims and preventing their payment from occurring. Unfortunately, those individuals who commit fraud against the U.S. taxpayers continually modify their tactics to evade or avoid detection, which sometimes results in the issuance of erroneous refunds. Since 2010, the IRS has reached out to financial institutions, government entities, federal agencies, software providers, and other stakeholders to develop processes whereby those partners may alert the IRS to suspected refund fraud, and return those funds to the Treasury when the suspected fraud is confirmed.

We agree with your recommendations and, as the External Leads Program has evolved, have taken actions that, when complete, will address them. We are in the process of defining optimal timeframes for lead verification and improving reporting metrics to ensure the program is meeting those goals. Actions already taken to reduce processing time and improve the efficiency of lead verification include increased staffing for the program, providing training to employees, and developing automation tools for employee use that replaced manual processes they previously performed. Program accountability was improved with the establishment of a general fund used in recording the recovery of funds. We are also evaluating the development of a single inventory tracking system that will consolidate the separate systems now in use.

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We believe the manner in which the Treasury Offset Program (TOP) is presented in the report may be confusing to outside readers, and we would like to offer the following clarifications. First, the TOP is administered by the U.S. Treasury Bureau of the Fiscal Service, and is not, as indicated in the report, an IRS offset program. Second, as correctly noted in the report, the agencies participating in the TOP are lead sources, and have returned more than $76 million in stopped refunds during calendar years 2012 and 2013. However, it is important to note that the funds returned through the External Leads Program had been stopped by the respective agencies and remained in their accounts until they were returned to the IRS. These funds were not subject to reversal in subsequent periods. When victims of identity theft seek assistance from the IRS, and it is confirmed identity theft has occurred, any TOP offset that claimed a portion of the erroneous refund to satisfy an outstanding debt of the victim would be subject to recapture and reversal in a subsequent period. As we explained during the audit, reversals occur only for the tax years in which the individual claimed and was found to be a victim of identity theft; not when the agencies participating in the TOP identify questionable payments. Finally, the report indicates that the States have had to develop processes to assume the IRS's responsibility of identifying questionable tax refunds that were erroneously offset. That statement is inaccurate insofar as it deems that responsibility to be solely the IRS's. The identification, detection and prevention of identity theft refund fraud is a top priority for the IRS, but all of government, Federal, State and local, shares in that important responsibility.

Attached is our response to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Jodi L. Patterson, Director, Return Integrity and Correspondence Services, Wage and Investment Division, at (404) 338-8961.

Attachment

Attachment

Recommendations

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 1
Establish more consistent time frames to verify leads. The time frames should be based on analysis of current and historical lead verification data. Once established, communicate verification time frames with external partner organizations.

CORRECTIVE ACTION
We are evaluating the treatment streams and work processes associated with the various types of referrals received in the External Leads Program to identify appropriate time frames for each process and opportunities where gains in consistency may be achieved. The time frames established for the verification processes will be clearly communicated to our external partners.

IMPLEMENTATION DATE
December 15, 2014

RESPONSIBLE OFFICIAL
Director, Return Integrity and Correspondence Services, Wage and Investment Division

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

RECOMMENDATION 2
Develop a process to ensure leads are verified within established time frames.

CORRECTIVE ACTION
We have implemented procedural changes that are having positive effects on the timeliness of lead identification and verification activities. We are completing other systemic and procedural enhancements to improve the effectiveness of existing reporting capabilities in evaluating program quality and timeliness.

IMPLEMENTATION DATE
December 15, 2014

RESPONSIBLE OFFICIAL
Director, Return Integrity and Correspondence Services, Wage and Investment Division

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

2

Recommendation

RECOMMENDATION 3
The Commissioner, Wage and Investment Division, should consolidate the current four lead inventory tracking systems into a single tracking system and should ensure that key information is captured as to how each lead is resolved.

CORRECTIVE ACTION
We are evaluating the feasibility and potential benefits of consolidating the four independent inventory tracking databases into one system. The data recorded in the tracking systems is also being reviewed to determine if additional information is needed to improve monitoring and reporting capabilities.

IMPLEMENTATION DATE
March 15, 2015

RESPONSIBLE OFFICIAL
Director, Return Integrity and Correspondence Services, Wage and Investment Division

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