



*Late Receipt of Wage Reporting Documents  
Reduces Fraud Detection Capabilities and  
Increases Taxpayer Burden*

**March 26, 2018**

**Reference Number: 2018-40-025**

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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2 = Law Enforcement Techniques/ Procedures and Guidelines for Law Enforcement Investigations or Prosecutions.

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## HIGHLIGHTS

### LATE RECEIPT OF WAGE REPORTING DOCUMENTS REDUCES FRAUD DETECTION CAPABILITIES AND INCREASES TAXPAYER BURDEN

## Highlights

### Final Report issued on March 26, 2018

Highlights of Reference Number: 2018-40-025 to the Internal Revenue Service Chief Information Officer and Commissioner for the Wage and Investment Division.

#### IMPACT ON TAXPAYERS

For Processing Year 2017, the IRS began using the Return Review Program (RRP) as its primary individual tax refund fraud identification and selection system. The IRS replaced the Electronic Fraud Detection System with the RRP based on testing that identified the RRP as having identified more fraudulent tax returns at a lower false detection rate. The RRP also has real-time filtering capabilities and is designed to improve the IRS's ability to detect, resolve, and prevent fraud.

#### WHY TIGTA DID THE AUDIT

This audit was initiated to assess the IRS's Processing Year 2017 tax refund fraud detection activities to ensure that Electronic Fraud Detection System capabilities were adequately addressed by other fraud systems.

#### WHAT TIGTA FOUND

TIGTA found that the IRS ensured that fraud detection capabilities included in the Electronic Fraud Detection System were built into the RRP. In addition, our review found that the IRS implemented processes to use employer submitted wage and withholding documents to detect potentially fraudulent tax returns. For example, the RRP includes systemic processes to match Forms W-2, *Wage and Tax Statement*, submitted by employers to income and withholding information reported on tax returns at the time tax returns are processed. However, third-party Forms W-2 are not always available at the time the tax return is filed. Our analysis

showed that the IRS processed almost 244 million Tax Year 2016 Forms W-2 through July 27, 2017. Of these, more than 29 million (12 percent) Forms W-2 from more than 2.4 million (37 percent) employers were processed by the IRS after February 16, 2017.

TIGTA's review of 1.6 million tax returns selected by the RRP and the Dependent Database during Processing Year 2017 also identified 3,253 tax returns for which the required transaction code to delay the processing of the tax return did not post as required due to Master File programming issues. Of these tax returns, 1,146 returns had potentially erroneous refunds issued totaling \$7.7 million.

Further, TIGTA's review of 55,701 paper-filed tax returns selected by the RRP in Processing Year 2017 identified 1,033 tax returns selected for potential fraud that were not controlled in the case management system. As a result, the tax returns were not being worked for income and withholding verification.

Finally, TIGTA identified 278 tax returns claiming refunds totaling \$404,926 with a full-year prisoner indicator that were not selected by the RRP for fraud treatment as required because of programming issues.

#### WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS ensure that the 1,033 tax returns not tracked by the case management system are worked, develop a process to ensure that all potentially fraudulent tax returns identified are tracked by the case management system for income and withholding verification, and ensure that programming changes are made to require RRP models and rules to complete processing before making fraud selections.

The IRS agreed with all four recommendations and stated that it plans to take action or has implemented programming changes that address the issues identified by TIGTA.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

March 26, 2018

**MEMORANDUM FOR** CHIEF INFORMATION OFFICER  
COMMISSIONER, WAGE AND INVESTMENT DIVISION

**FROM:** Michael E. McKenney  
Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – Late Receipt of Wage Reporting Documents  
Reduces Fraud Detection Capabilities and Increases Taxpayer Burden  
(Audit # 201740029)

This report presents the results of our review to assess the Internal Revenue Service's Processing Year 2017 tax refund fraud detection activities to ensure that Electronic Fraud Detection System capabilities were adequately addressed by other fraud systems. This audit is included in our Fiscal Year 2018 Annual Audit Plan and addresses the major management challenge of Reducing Fraudulent Claims and Improper Payments.

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

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



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*Abbreviations*

DDb	Dependent Database
EFDS	Electronic Fraud Detection System
IRS	Internal Revenue Service
PY	Processing Year
RRP	Return Review Program
TPP	Taxpayer Protection Program
TY	Tax Year



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### *Background*

The Internal Revenue Service (IRS) began using the Return Review Program (RRP) as its primary individual tax refund fraud identification and selection system in Processing Year (PY) 2017. The IRS replaced the Electronic Fraud Detection System (EFDS) with the RRP based on testing that found that the RRP identified more fraudulent tax returns at a lower false detection rate. The RRP uses predictive analytics, models, filters, clustering, a scoring system, business rules, selection groups, and prisoner identification data to identify potentially fraudulent tax returns including identity theft. The RRP also has real-time filtering capabilities and is designed to improve the IRS's ability to detect, resolve, and prevent fraud.

In addition to the RRP, the IRS continues to use the Dependent Database (DDb) to identify potentially fraudulent tax returns. The DDb is a rules-based system that incorporates information from many sources, including the Department of Health and Human Services, the Social Security Administration, and the IRS. The IRS originally implemented the DDb in March 2000 to identify taxpayer noncompliance with the Earned Income Tax Credit. In PY 2012, the IRS expanded the DDb's potentially fraudulent tax return identification capabilities by adding identity theft filters within the DDb. These filters identify potentially fraudulent tax returns involving identity theft.

Although the IRS retired EFDS fraud detection capabilities, it continues to use the EFDS as its case management system to track and control tax returns selected as potential fraud. The IRS did not develop case management capabilities within the RRP because it intended to incorporate the case management needs into a Service-wide solution for case management, referred to as the Enterprise Case Management System. However, in February 2017, the IRS suspended the Enterprise Case Management System project because the software that the IRS chose could not be modified to meet its various case management needs. The IRS is currently conducting an enterprise case management product assessment with industry participants. We have an ongoing audit of the Enterprise Case Management System project.

### *Process to identify potentially fraudulent tax returns*

Paper-filed and electronically filed tax returns claiming refunds are systemically evaluated for potential fraud using both the RRP and the DDb at the time tax returns are processed and prior to issuing a refund.<sup>1</sup> For those tax returns identified and selected as *potential identity theft*, the IRS places a hold on the tax account preventing the tax return from posting to the IRS's Master File<sup>2</sup> and the refund from being issued. Selected tax returns are sent to the Taxpayer Protection

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<sup>1</sup> The IRS also uses analysts from the Fraud Referral and Evaluation department to identify patterns and trends that potentially have not been identified in the RRP or the DDb.

<sup>2</sup> The IRS database that stores various types of taxpayer account information.



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Program (TPP) which sends a letter to the filers requiring them to verify their identity. When the TPP confirms the taxpayer's identity, the TPP removes the refund hold from the tax account allowing the tax return to continue processing and the refund to be issued. However, for those tax returns for which the identity is not confirmed, the IRS considers the tax return to be identity theft and removes the tax return from further processing (*i.e.*, the tax return does not post to the taxpayer's account and the refund is not issued). The IRS also places an identity theft indicator on the taxpayer's account for future reference.

A separate process exists for those tax returns identified and selected as *potential individual tax refund fraud*. For electronically filed tax returns, the IRS places a two-week hold on the tax account, preventing the tax return from posting so that it can be sent to screening. For paper-filed tax returns, a similar hold is placed on the tax account. However, unlike the electronically filed hold, the paper tax return hold is an indefinite hold. Once the hold is placed on the tax account, the selected tax returns are sent to the Integrity and Verification Operation function for screening and verification by a tax examiner.

- **Screening** - A tax examiner reviews the income and withholding information reported on the tax return. Based on this review, if the tax examiner concludes that the tax return is potentially fraudulent, the tax examiner sends the tax return for verification and places an indefinite refund hold on the tax account through the EFDS. However, if the tax examiner determines that the tax return is legitimate, the tax examiner removes the refund hold on the tax account through the EFDS. This process either removes the refund hold or allows the two-week refund hold to expire.
- **Verification** - A tax examiner attempts to confirm income and/or withholding reported on the potentially fraudulent tax return. For example, the tax examiner may contact the employer. If the tax examiner verifies the income and/or withholding with the employer, the examiner removes the hold from the tax account to allow the refund to be issued. If income and/or withholding is not verified, the tax return is considered fraudulent and the refund is permanently frozen to prevent it from being issued.

This review was performed at the Information Technology organization Headquarters in Lanham, Maryland, and with information obtained from the Wage and Investment Division Headquarters in Atlanta, Georgia, during the period April through December 2017. 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.



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*Results of Review*

**Processes Have Been Implemented to Use Employer Submitted Wage and Withholding Documents to Detect Potentially Fraudulent Tax Returns**

Our review determined that the IRS ensured that fraud detection capabilities included in the EFDS were built into the RRP. In addition, in response to provisions included in the Protecting Americans From Tax Hikes Act of 2015<sup>3</sup> which requires employers to submit Forms W-2, *Wage and Tax Statement*, on or before January 31, the IRS implemented processes and procedures to better detect potentially fraudulent tax returns. For example, the RRP includes systemic processes to match Forms W-2 submitted by employers to income and withholding information reported on tax returns at the time tax returns are processed.<sup>4</sup> Based on the results of this verification match, the RRP classifies the income and withholding information reported on the tax return. For example:

- **False Income** – The income and/or withholding reported on the tax return is not valid. This includes tax returns for which reported income does not match Forms W-2 submitted by employers, and tax returns for which no matching Forms W-2 were submitted by employers for this taxpayer.
- **Incorrect Dollar** – The amount of income and/or withholding reported on the tax return differs from Forms W-2 submitted by employers by more than the established dollar amount threshold.
- **Good Income** – The income and/or withholding reported on the tax return matches Forms W-2 submitted by employers within an established dollar amount threshold.
- **Cannot Verify** – The income and/or withholding reported on the tax return cannot be verified because Forms W-2 submitted by employers is not available at the time the tax return is processed.

The RRP uses the results of the systemic match, in conjunction with RRP fraud models, to then select tax returns as potentially fraudulent for authentication, screening, and/or verification.

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<sup>3</sup> Consolidated Appropriations Act of 2016, Pub. L. No. 114-113 (2015).

<sup>4</sup> The IRS's systemic verification process also includes Forms W-2G, *Certain Gambling Winnings*; and Forms 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*



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**The IRS received many third-party Forms W-2 after the January 31<sup>st</sup> due date**

Our analysis showed that the IRS received from the Social Security Administration<sup>5</sup> and processed almost 244 million Tax Year (TY) 2016 Forms W-2 through July 27, 2017. Of these, more than 29 million (12 percent) Forms W-2 from more than 2.4 million (37 percent) employers were processed by the IRS after February 16, 2017.<sup>6</sup> To account for the delay in receiving Forms W-2, the IRS programmed the RRP to continue to perform a systemic match for tax returns with income and withholding classified as “cannot verify.” The IRS continued this systemic match until the IRS eventually received and processed Forms W-2 or concluded that the income and withholding remains as “cannot verify.” For those tax returns that remain “cannot verify” as of June 15, 2017, the IRS considered the income and withholding information reported on the tax return to be “false income.” IRS management noted that the systemic match continues after the tax return is processed as the results from this verification will be used by the IRS to improve RRP fraud detection.

The IRS does not hold tax returns from processing, including any associated tax refund, because the income and withholding are classified as “cannot verify.” However, these tax returns may still be identified as potentially fraudulent by the RRP fraud models during processing which can result in the tax return being selected for fraud treatment.

**Availability of Forms W-2 at the time of tax return filing**

Our analysis of TY 2016 tax returns that reported wages and a tax refund identified that more than 11.6 million (12 percent) of the more than 94.4 million tax returns did not have at least one Form W-2 available at the time the IRS processed the tax return. Figure 1 summarizes the timing of the receipt of Forms W-2 compared with the filing of tax returns for TY 2016 through June 15, 2017.

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<sup>5</sup> The IRS stores Forms W-2 data records received from the Social Security Administration on the Information Return Master File. The Information Return Master File is an IRS database that contains third-party information return documents for taxpayers, such as Form W-2, Form SSA-1099, *Social Security Benefit Statement, etc.*

<sup>6</sup> Our analysis is based upon February 16, 2017, to allow for IRS processing times of Forms W-2 received by January 31.



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**Figure 1: Timing of Forms W-2 Compared to Filing of the Tax Return<sup>7</sup>**

Filing Period	Tax Returns Filed	Forms W-2 Available at Time of Tax Return Processing <sup>8</sup>	Percent of Tax Returns	Forms W-2 Available After Processing	Percent of Tax Returns	Total Tax Returns With a Form W-2	Percent of Tax Returns
January 23 to February 2	11,249,701	5,501,889	49%	5,653,144	50%	11,155,033	99%
February 3 to February 16	19,270,837	16,152,107	84%	2,973,088	15%	19,125,195	99%
February 17 to April 20	56,218,819	52,982,909	94%	2,797,655	5%	55,780,564	99%
April 21 to May 18	6,321,191	6,053,928	96%	180,592	3%	6,234,520	99%
May 19 to June 15	1,435,991	1,385,374	96%	19,450	1%	1,404,824	98%
Total	94,496,539	82,076,207	87%	11,623,929	12%	93,700,136	99%

Source: TIGTA analysis of the IRS's Individual Return Transaction File<sup>9</sup> and Information Returns Master File.

Forms W-2 that are not available at the time of tax return filing can result in the IRS selecting legitimate tax returns as potentially fraudulent which increases taxpayer burden. For example, we analyzed the 11,623,929 tax returns with Forms W-2 on file after the tax return was filed and identified that 56,610 (0.5 percent) tax returns were selected for fraud treatment, of which 41,993 (74 percent) were determined to be a legitimate taxpayer and not fraudulent. If the IRS had the Forms W-2 at the time the tax returns were filed, these tax returns would likely have not been selected for fraud treatment. We have initiated a separate review that includes an evaluation of the IRS's efforts to address delays in receiving Forms W-2. In addition, we are continuing to measure the timeliness of receipt of Forms W-2 as part of our 2018 Filing Season review.

**Refunds Were Erroneously Issued for Tax Returns Identified as Potentially Fraudulent Due to a Programming Error**

Our review of 1.6 million tax returns selected by the RRP and the DDb during PY 2017 as of April 22, 2017, identified 3,253 tax returns for which the required transaction code to delay the processing of the tax return did not post to the Master File as required. This resulted in \$7.7 million in potentially erroneous refunds being issued prior to authentication, screening, or verification processes being completed. Specifically, we identified:

<sup>7</sup> All percentages are rounded to the nearest whole number.

<sup>8</sup> The IRS had at least one third-party Form W-2 on file prior to processing of the tax return.

<sup>9</sup> An IRS file that contains data transcribed from initial input of the original individual tax return during tax return processing.



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- 1,526 tax returns selected by the RRP and the DDb as potential identity theft. Of these tax returns, 236 tax returns had potentially erroneous refunds issued totaling \$2 million.
- 1,727 tax returns selected by the RRP for potential individual tax refund fraud or frivolous filers.<sup>10</sup> Of these tax returns, 910 tax returns had potentially erroneous refunds issued totaling more than \$5.7 million.

Required transaction codes were not placed on the tax accounts as a result of a mismatch between the taxpayer's name control<sup>11</sup> per the tax return and the taxpayer's name control per the Master File. For example, this can occur when an individual is divorced and the Master File shows the married name while the tax return shows the maiden name. The following provides a hypothetical example:

*Taxpayer A has a last name of "Smith" which is a name control of "SMIT" on the IRS's Master File. Taxpayer A gets divorced and changes her last name back to her maiden name of "Jones," which would be a name control of "JONE." Taxpayer A files a tax return with the last name "Jones" so the name control on the tax return is "JONE;" however, the IRS Master File name control is "SMIT." The IRS will not post transaction codes to the tax account because of the differences in the name control.*

When we brought our concerns to management's attention in March 2017, IRS management stated that the current Master File programming does not add a transaction code to delay the processing of an identified potentially fraudulent tax return in which the name control on the tax return does not match the name control on the associated Master File tax account. In response, the IRS submitted a programming change to eliminate the name control match which will allow these transaction codes to post when the name control does not match from the tax return to the Master File. IRS management noted that a programming change was implemented and tested in June 2017. As such, we will not be making any further recommendations.

### **Potentially Fraudulent Tax Returns Selected for Review Were Not Always Controlled on the Case Management System**

Our review of 55,701 PY 2017 paper-filed tax returns selected by the RRP as potential individual tax refund fraud as of April 22, 2017, identified 1,033 tax returns that the RRP selected that were not controlled in the EFDS case management system. As a result, these tax returns were not subjected to income and withholding screening and/or verification. Further review identified that these tax returns, at the time they were processed, reported that \*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*. However, during processing of the tax return, the IRS made

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<sup>10</sup> A frivolous tax argument is based on a frivolous or incorrect interpretation of the Federal tax law. The IRS continues to identify frivolous tax arguments and reports these arguments annually on the "Dirty Dozen Tax Scams" list. Individuals and businesses use these frivolous tax arguments to support their claims that they are not subject to Federal tax laws.

<sup>11</sup> The name control is the first four characters of the taxpayer's last name.



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adjustments to the tax return which then resulted in \*\*\*\*2\*\*\*\*. When the corrected tax return continued to be processed through the RRP, the tax return was selected as potentially fraudulent. Because the tax return was originally identified as reporting \*\*\*\*\*2\*\*\*\*, programming prevented these tax returns from being added and controlled on the EFDS case management system, even though they were selected by the RRP as potential fraud.

When we brought our concerns to management's attention on May 17, 2017, they stated that until they could implement a more permanent solution, they would reconcile the tax returns selected by the RRP to ensure that they were accounted for in the EFDS case management system. It should be noted that as of July 31, 2017,<sup>12</sup> the 1,033 tax returns we identified were still not controlled in the EFDS. As such, innocent taxpayers' refunds may be needlessly held until verification is performed to determine if the tax return is legitimate.

### ***Recommendations***

The Commissioner, Wage and Investment Division, should:

**Recommendation 1:** Ensure that the 1,033 tax returns we identified are controlled on the EFDS and sent for screening and/or verification. This should include identifying additional paper-filed tax returns that were selected as potentially fraudulent subsequent to April 22, 2017, to ensure that they are all controlled on the EFDS case management system.

**Management's Response:** The IRS agreed with this recommendation and is taking action to control the identified tax returns and any other affected tax returns that were filed after April 22, 2017.

**Recommendation 2:** Develop a process to ensure that all potentially fraudulent tax returns identified by the RRP are tracked in the EFDS case management system for income and withholding verification.

**Management's Response:** The IRS agreed with this recommendation and developed a process that reconciles RRP selections with the EFDS's case management system. Controls are established on those tax returns that do not reconcile on the two systems.

### **Programming Changes Are Needed to Properly Handle Prisoner Tax Returns**

Our review of PY 2017 tax returns through April 22, 2017, identified 278 tax returns with a full-year prisoner indicator that were not selected by the RRP for fraud treatment. Refunds claimed on these 278 tax returns totaled \$404,926. When we brought this to IRS management's attention on July 26, 2017, management indicated that:

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<sup>12</sup> We received the EFDS case management information through July 31, 2017.



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- 153 of the tax returns claiming refunds totaling \$294,017 were not selected because of a processing error. According to the IRS, on February 9, 2017, the RRP did not produce model scores which resulted in the RRP not selecting all appropriate potentially fraudulent tax returns. The IRS estimates that 341,998 tax returns<sup>13</sup> were processed on this date without a model score, including the 153 tax returns we identified. IRS management stated that on February 12, 2017, the IRS deployed a permanent programming fix to require model scores before making selections.
- 125 of the tax returns claiming refunds totaling \$110,909 were not selected because the RRP rules, including the assignment of prisoner indicators and systemic income verification determinations, did not complete processing. The IRS established a daily cut-off for making selections in the RRP. This required the RRP to identify fraud selections even though the tax returns were not evaluated by all of the RRP rules. The IRS estimated that between January 8, 2017, and July 30, 2017, the RRP rules did not complete processing for 677,361 tax returns.<sup>14</sup> As a result, the IRS estimated that 385 fraudulent tax returns were not selected by the RRP due to this programming issue. IRS management stated that they have changed the programming for PY 2018 to require the RRP rules to finish processing before making fraud selections.

### ***Recommendations***

The Commissioner, Wage and Investment Division, should:

**Recommendation 3:** Confirm that the programming change made for PY 2018 ensures that the RRP produces a model score for all processed tax returns.

**Management's Response:** The IRS agreed with this recommendation and implemented requisite programming changes on February 12, 2017, to ensure that the RRP produces a model score for all processed tax returns. The programming performance is also evaluated periodically throughout the year to ensure that it is working as expected.

**Recommendation 4:** Confirm that the programming change made for PY 2018 ensures that tax returns complete evaluation by all RRP rules before the tax returns are identified and selected as potentially fraudulent.

**Management's Response:** The IRS agreed with this recommendation and implemented programming changes on December 22, 2017, to ensure that the RRP models and rules complete processing before making fraud selections. The programming performance is also evaluated periodically throughout the year to ensure that it is working as expected.

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<sup>13</sup> This includes non-prisoner tax returns as well as the 153 prisoner returns we identified.

<sup>14</sup> This includes non-prisoner tax returns as well as the 125 prisoner returns we identified.



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## **Appendix I**

### *Detailed Objective, Scope, and Methodology*

Our overall objective was to assess the IRS's PY 2017 tax refund fraud detection activities to ensure that EFDS capabilities were adequately addressed by other fraud systems. To accomplish this objective, we:

- I. Evaluated the IRS's plans for the development of a case management system for fraud selections made by the RRP.
  - A. Determined the IRS's plans for the development of a case management system specific to the replacement of EFDS case management capabilities.
  - B. Discussed plans and time frames for implementing the new Enterprise Case Management System.
- II. Assessed the IRS's efforts to incorporate known fraud selection criteria into the RRP for PY 2017.
  - A. Obtained identity theft filters, individual refund fraud filters, frivolous filer filters, and other characteristics of fraud filters for the RRP for PY 2017.
  - B. Determined whether all the RRP PY 2017 individual refund fraud selection models are making selections.
  - C. Determined whether the RRP is properly identifying prisoner tax returns filed in PY 2017.
    1. Identified how the RRP is using the Prisoner File in PY 2017.
    2. Reviewed the RRP's assignment of prisoner indicators to identify potentially fraudulent prisoner tax returns.
    3. Verified whether the RRP's prisoner list is complete and properly loaded into the RRP.
    4. Identified undetected PY 2017 tax returns filed on prisoner Social Security Numbers.
  - D. Evaluated the effectiveness of the IRS's frivolous filer filter capabilities and determined whether the RRP frivolous filer filters were making selections for PY 2017.
- III. Determined whether required actions were taken on potential fraud case selections in PY 2017.



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- A. Reviewed the processes and procedures to identify and stop potentially fraudulent tax returns selected by the DDb and the RRP.
  - B. Performed a walkthrough of the processes to identify and stop a potentially fraudulent tax return for the RRP, the EFDS, and the DDb in PY 2017.
  - C. Determined whether the transaction codes used to hold refunds for case selections in the various systems were always posting.
    1. Identified cases selected by the RRP as potential identity theft and determined whether all tax accounts had the appropriate transaction codes.
    2. Identified cases selected by the RRP as potential individual tax fraud and determined whether all tax accounts had the appropriate transaction codes.
    3. Identified cases selected by the DDb as potential identity theft and determined whether all tax accounts had the appropriate transaction codes.
    4. For each of the tests in Step C., quantified how many tax accounts did not receive the appropriate transaction code and identified the amount of refunds that were not protected.
  - D. Determined whether case selections were routed to the appropriate treatment stream.
    1. Identified cases selected by the RRP as potential identity theft and determined if the tax account was routed to the EFDS for tracking and the TPP for case evaluation.
    2. Identified if cases selected by the RRP as potential individual tax fraud were routed to the EFDS for tracking and case management.
    3. Identified cases selected by the DDb as potential identity theft and determined if the tax account was routed for tracking and to the TPP for case evaluation.
    4. Identified cases selected by the RRP as having other characteristics of fraud and determined if the tax account was identified with the required transaction code.
- IV. Evaluated the extent that the IRS is using income documents in its detection of potentially fraudulent tax returns.
- A. Identified and evaluated the availability, *i.e.*, received dates, of Forms W-2, *Wage and Tax Statement*, during PY 2017.
  - B. Identified how the IRS used income documents in its fraud detection efforts in PY 2017. This included determining if the IRS used any kind of thresholds when matching income documents and how it handled situations when multiple Forms W-2 were present and income from one of the Forms W-2 was not supported.
  - C. Assessed the use of the income documents on fraud detection in the RRP.



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1. Determined the number of tax returns in which the IRS had Forms W-2 available, and the number of tax returns in which the amounts on Forms W-2 do not match.
2. Determined the number of tax returns in which the IRS did not have Forms W-2 available.

### **Data validation methodology**

During this review, we relied on data extracted by the Treasury Inspector General for Tax Administration's Strategic Data Services for TY 2016 tax return data from the IRS's Individual Return Transaction File<sup>1</sup> for PY 2017, TY 2016 Form W-2 data from the IRS's Information Returns Master File, taxpayer tax account transactions from the Individual Master File<sup>2</sup> for PY 2017, and the IRS's Prisoner File for PY 2017. We relied on IRS-provided data from the RRP, the EFDS, and the DDb systems for PY 2017. To assess the reliability of computer-processed data, programmers within the Treasury Inspector General for Tax Administration's Strategic Data Services validated the data extract files, while we ensured that each data extract contained the specific data elements we requested and that the data elements were accurate. In addition, we selected random samples of each extract and verified that the data in the extracts were the same as the data captured in the IRS's Integrated Data Retrieval System.<sup>3</sup>

To assess the reliability of the data received from the IRS on the RRP, the EFDS, and the DDb, we compared the data to the IRS's Master File<sup>4</sup> transaction codes and selected random samples of each extract to verify against the IRS's Integrated Data Retrieval System. Based on the results of our testing, we believe 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: RRP procedures used to select tax returns for identity theft and individual tax refund fraud treatment, DDb procedures used to select tax returns for identity theft, and IRS processing procedures on posting transaction codes to the Master File. We evaluated these controls by reviewing Internal Revenue Manuals, interviewing management, and reviewing program reports.

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<sup>1</sup> An IRS file that contains data transcribed from initial input of the original individual tax return during tax return processing.

<sup>2</sup> The IRS database that maintains transactions or records of individual tax accounts.

<sup>3</sup> IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

<sup>4</sup> The IRS database that stores various types of taxpayer account information.



*Late Receipt of Wage Reporting Documents Reduces Fraud  
Detection Capabilities and Increases Taxpayer Burden*

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**Appendix II**

*Major Contributors to This Report*

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**Appendix III**

*Report Distribution List*

Commissioner  
Office of the Commissioner – Attn: Chief of Staff  
Deputy Commissioner for Operations Support  
Deputy Commissioner for Services and Enforcement  
Deputy Chief Information Officer for Operations  
Deputy Commissioner, Wage and Investment Division  
Associate Chief Information Officer, Applications Development  
Director, Return Integrity and Compliance Services, Wage and Investment Division  
Director, Office of Audit Coordination



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## Appendix IV

### Outcome Measures

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

#### **Type and Value of Outcome Measure:**

- Revenue Protection – Actual; \$7,710,335 from 1,146 tax returns selected for fraud treatment that did not receive the required transaction codes to protect the refund (see page 5).

#### **Methodology Used to Measure the Reported Benefit:**

Our review of 1.6 million tax returns selected by the RRP and the DDb during PY 2017 as of April 22, 2017, identified 3,253 tax returns for which the required transaction code to delay the processing of the tax return did not post to the Master File as required. The transaction codes allow the IRS additional time to conduct taxpayer authentication and/or income and withholding verification on systemically verified potentially fraudulent tax returns. Of the 3,253 tax returns, 1,146 tax returns resulted in a refund being issued totaling \$7,710,335.

#### **Type and Value of Outcome Measure:**

- Taxpayer Burden – Potential; 1,033 taxpayer tax returns selected but not worked for income and withholding verification (see page 6).

#### **Methodology Used to Measure the Reported Benefit:**

Our comparison of 55,701 PY 2017 paper-filed tax returns selected by the RRP for potential fraud treatment as of April 22, 2017, to the EFDS case management inventory identified 1,033 tax returns not controlled in the EFDS case management system. The IRS uses the EFDS case management system to track the status of the income and withholding verification for tax returns selected for individual tax refund fraud. Because these paper-filed tax returns are not present in the EFDS, the taxpayer's refund is held from processing without being worked for income and withholding verification.



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**Appendix V**

*Management's Response to the Draft Report*



COMMISSIONER  
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
ATLANTA, GA 30308

MAR 08 2018

MEMORANDUM FOR MICHAEL E. MCKENNEY  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kenneth C. Corbin   
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Late Receipt of Wage Reporting Documents  
Reduces Fraud Detection Capabilities and Increases Taxpayer  
Burden (Audit # 201740029)

Thank you for the opportunity to review the subject draft report and provide comments. The IRS is committed to protecting U.S. taxpayers by proactively detecting potentially fraudulent refund claims and preventing their payment. These protection processes save billions of dollars annually by stopping the issuance of potentially fraudulent refunds. A significant achievement in our ability to identify potentially fraudulent tax refund claims has been the development of the Return Review Program (RRP). The RRP was designed as the replacement for the Electronic Fraud Detection System (EFDS), a legacy system that, due to age and design, presents a challenge in our ability to quickly adapt to the emerging and ever-evolving tactics used to attempt refund fraud. We appreciate the report's recognition that the RRP has matched the fraud detection capabilities that had been available in the EFDS. In fact, the capabilities of the RRP far exceed those of the EFDS and have permitted us to develop new processes for identifying potential fraud and other indications of noncompliance with the tax law.

For the 2016 filing season, the IRS began using the systemic verification process within the RRP to assess the fraud potential of all individual income tax returns claiming refunds. Systemic verification compares available wage and other income data provided by third-party reporters on information returns to the information reported on tax returns. With systemic verification, we leverage the data from information returns to make better-informed decisions on the risk level of potential fraud on each tax return. The effectiveness of systemic verification for detecting potential fraud was further enhanced in the 2017 filing season when the due date for filing Form W-2, *Wage and Tax Statement*, and Form W-3, *Transmittal of Wage and Tax Statements*, was changed to January 31 by the Protecting Americans from Tax Hikes (PATH) Act of 2015.<sup>1</sup>

<sup>1</sup> Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, 129 Stat. 2242 (2015).



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## *Late Receipt of Wage Reporting Documents Reduces Fraud Detection Capabilities and Increases Taxpayer Burden*

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The January 31 due date became effective for the applicable information returns required to be filed for the 2016 tax year. We worked with the Social Security Administration (SSA) to ascertain that Forms W-2 could be filed by employers as early as December 2016 and would be transmitted daily to the IRS. Recognizing the significant impact the change of the filing due date could have on the payor community, the IRS also engaged stakeholders with educational outreach and communications. This ensured employers were aware well ahead of the end of the tax year that their information returns would be due by January 31, 2017. These actions led to the IRS, by February 15, 2017, receiving data from the SSA for more than 214 million Form W-2 filings. That represents a more than two-fold increase over the number received at the same point in time the previous year. We continued educational outreach throughout 2017 and, in comparison, the number of Forms W-2 received for the 2018 filing season, as of February 15, 2018, exceeds 221 million. This is an increase of three percent and represents almost 87 percent of the total number of Forms W-2 received in 2017.

Over the course of each filing season, we review the results of programming and processes implemented to detect suspicious returns and to stop any refunds associated with them. As noted in the report, the tax accounts for 3,253 out of 1.6 million returns selected by the RRP and the Dependent Database as potentially fraudulent did not receive the transaction needed to delay return processing. We had noticed this condition in 2016 and found the cause to be the unintended effect of longtime validation routines. These checks were designed to prevent the posting of transactions to taxpayer accounts when data mismatches between the pending transaction and existing account information conflicted. In July 2017, programming was revised to permit certain transactions, including those initiating the processing hold, to post despite minor data point differences.

During return processing, corrections may be made to returns downstream. Some returns may not have initially met criteria for being loaded into the EFDS case management system at the time they were evaluated by the RRP. A process was developed in 2017 to control returns identified as potentially fraudulent or non-compliant and track in EFDS. New programming was also implemented to address situations where processing terminates unexpectedly by ensuring all returns processed by the RRP are scored and all rules are evaluated. For the 2018 filing season, we corrected the model scoring of full-year prisoner tax returns. We eliminated the daily cut-off previously established to require the RRP rules to complete processing prior to making fraud selections. Additionally, programming was updated to ensure the incarceration dates of all prisoner records are prior to the release dates.

Attached are our comments and proposed actions to your recommendations. If you have any questions, please contact Michael Beebe, Director, Return Integrity and Compliance Services, Wage and Investment Division, at (470) 639-3250.

Attachment



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Attachment

**Recommendations**

The Commissioner, Wage and Investment Division, should:

**RECOMMENDATION 1**

Ensure that the 1,033 tax returns we identified are controlled on the EFDS and sent for screening and/or verification. This should include identifying additional paper-filed tax returns that were selected as potentially fraudulent subsequent to April 22, 2017, to ensure they are all controlled on the EFDS case management system.

**CORRECTIVE ACTION**

We agree with this recommendation and are taking appropriate action to control the identified returns and any other affected returns that were filed after April 22, 2017.

**IMPLEMENTATION DATE**

September 15, 2018

**RESPONSIBLE OFFICIAL**

Director, Return Integrity Operations, Return Integrity and Compliance 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 that all potentially fraudulent tax returns identified by the RRP are tracked in the EFDS case management system for income and withholding verification.

**CORRECTIVE ACTION**

We agree with this recommendation. A process has been developed that reconciles Return Review Program (RRP) selections with the Electronic Fraud Detection System's case management system. Controls are established on those returns that do not reconcile on the two systems.

**IMPLEMENTATION DATE**

Implemented

**RESPONSIBLE OFFICIAL**

Director, Return Integrity Operations, Return Integrity and Compliance Services, Wage and Investment Division



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**CORRECTIVE ACTION MONITORING PLAN**

N/A

**RECOMMENDATION 3**

Confirm that the programming change made for PY 2018 ensures the RRP produces a model score for all processed tax returns.

**CORRECTIVE ACTION**

We agree with this recommendation. The requisite programming changes to ensure the RRP produces a model score for all processed tax returns were implemented on February 12, 2017. The programming performance is evaluated periodically throughout the year to ensure it is working as expected.

**IMPLEMENTATION DATE**

Implemented

**RESPONSIBLE OFFICIAL**

Director, Return Integrity Operations, Return Integrity and Compliance Services, Wage and Investment Division

**CORRECTIVE ACTION MONITORING PLAN**

N/A

**RECOMMENDATION 4**

Confirm that the programming change made for PY 2018 ensures that tax returns complete evaluation by all RRP rules before the tax returns are identified and selected as potentially fraudulent.

**CORRECTIVE ACTION**

We agree with this recommendation. Programming changes were implemented on December 22, 2017 to ensure the RRP models and rules complete processing before making fraud selections. The programming performance is evaluated periodically throughout the year to ensure it is working as expected.

**IMPLEMENTATION DATE**

Implemented

**RESPONSIBLE OFFICIAL**

Director, Return Integrity Operations, Return Integrity and Compliance Services, Wage and Investment Division

**CORRECTIVE ACTION MONITORING PLAN**

N/A