

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



Processes Exist to Assist Taxpayers With Misdirected Refunds, but Additional Controls Could Further Help to Prevent Them

January 13, 2021

Report Number: 2021-40-012

HIGHLIGHTS: Processes Exist to Assist Taxpayers With Misdirected Refunds, but Additional Controls Could Further Help to Prevent Them

Final Audit Report issued on January 13, 2021

Report Number 2021-40-012

Why TIGTA Did This Audit

This audit was initiated from a TIGTA Office of Investigations referral that was the result of an investigation that identified a program weakness that facilitated an IRS employee being able to divert and steal taxpayer refunds.

The audit also evaluated the IRS's efforts to implement Section 1407 of the Taxpayer First Act. This section requires the IRS to establish procedures for taxpayers to report instances when a direct deposit refund was not transferred to the taxpayers' bank account.

The overall objective of this review was to evaluate IRS processes and procedures to address misdirected refunds.

Impact on Taxpayers

When a paper tax return is received at the IRS tax processing site, the paper tax return goes through several areas where unscrupulous IRS employees would have the opportunity to alter the direct deposit fields of the tax return.

What TIGTA Found

In May 2003, TIGTA reported control weaknesses in the procedures for processing paper tax returns when taxpayers were requesting a paper refund check. The IRS implemented corrective actions in response to our recommendations. However, in January 2006, the IRS removed from the Internal Revenue Manual the previously recommended procedures that had employees mark out blank direct deposit fields. The procedures were added back into the Internal Revenue Manual on September 25, 2019, after TIGTA made a subsequent recommendation. The IRS also agreed to coordinate with software developers to modify their programs so that direct deposit fields do not display or cannot be altered if a taxpayer requests a paper refund check. However, our review of a judgmental sample identified five software vendors that did not complete the direct deposit field modifications.

Section 1407 of the Taxpayer First Act requires the IRS to establish procedures to assist taxpayers when a direct deposit refund was not transferred to the taxpayers' bank account. Our review of the IRS's current processes and proposed regulations found that the processes comply with the Section 1407 requirements.

IRS guidelines indicate that misdirected refunds should be resolved "as soon as possible." However, current processing procedures do not enable the IRS to measure the timeliness of the resolution of a misdirected refund nor ensure that misdirected refunds are reissued when required.

What TIGTA Recommended

TIGTA made three recommendations: to contact software vendors that are not currently preventing the direct deposit fields from being altered, develop a process to annually review software vendors to make sure the direct deposit fields cannot be altered, and create a closing code that would identify when the refund inquiry was completed as well as provide the cause of the misdirected refund on the tax account.

IRS management agreed with all three recommendations. IRS management plans to establish a default standard of populating the bank routing and account number fields on electronically filed tax returns with a repeating capital X when taxpayers claim refunds without providing direct deposit information. The IRS plans to communicate this information to software developers on a continual basis and include it in Publication 4164, *Modernized e-File (MeF) Guide for Software Developers and Transmitters*, and Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*. IRS management also plans to create a closing code that will identify when the refund inquiry is completed as well as provide the cause of the misdirected refund on the tax account.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

January 13, 2021

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Processes Exist to Assist Taxpayers With
Misdirected Refunds, but Additional Controls Could Further Help to
Prevent Them (Audit # 202040028)

This report presents the results of our review to evaluate the Internal Revenue Service's (IRS) processes and procedures to address misdirected refunds. This review was based on a referral from our Office of Investigations based on a case in which an IRS employee was found to have added bank account and routing numbers to paper tax returns in order to divert the refund. The review addresses the major management and performance challenge of *Addressing Emerging Threats to Tax Administration*.

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

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, Assistant Inspector General for Audit (Returns Processing and Account Services).

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Background

In August 2019, the Treasury Inspector General for Tax Administration (TIGTA) Office of Audit received a referral from the Office of Investigations. The referral was the result of an investigation that identified a program weakness that facilitated an Internal Revenue Service (IRS) employee's theft of taxpayer refunds. The employee altered handwritten paper-filed tax returns, in which the taxpayer requested a paper refund check, by fraudulently adding direct deposit information to the blank bank account fields on the return. This in turn caused the taxpayer's refund to be deposited into a bank account controlled by the employee.

A prior TIGTA review included recommendations to address this control weakness

In May 2003,¹ we reported that control weaknesses existed in the instructions for completing the Form 1040, *U.S. Individual Income Tax Return*, and the procedures for processing paper tax returns when the direct deposit fields are left blank. These control weaknesses expose taxpayers to the risk that an IRS employee can divert their tax refunds via direct deposit to an unauthorized bank account. We recommended that the IRS:

- Revise the Form 1040 instructions to require the taxpayer to line through the direct deposit fields on the paper-filed tax returns when the fields are left blank, and develop procedures to address tax returns where the taxpayer does not line through blank direct deposit fields.
- Work with tax software preparation companies to initiate modifications in how direct deposit fields are printed on computer-prepared tax returns that are mailed to the IRS as a paper tax return. These modifications should eliminate the printing of the direct deposit fields when the taxpayer elects to receive a paper tax refund check.



Implementation of previous TIGTA recommendations would have reduced the risk that IRS employees could divert taxpayer refunds.

The IRS agreed with our recommendations. Implementation of our recommendations reduces the risk of diversion and enables detection of employees who may be involved in future improprieties.

The Taxpayer First Act² assists taxpayers with direct deposit refund errors

Section 1407 of the Taxpayer First Act of 2019, enacted on July 1, 2019, requires the IRS to establish procedures to allow taxpayers to report when direct deposit refunds were not deposited into their bank accounts. Once reported, the IRS is required to coordinate with financial institutions to identify the account where the refund was deposited and recover the refund, as well as initiate the deposit of the refund into the correct account of the taxpayer.

¹ TIGTA, Ref. No. 2003-40-108, *Controls Need to Be Improved to Ensure Accurate Direct Deposit of Tax Returns* (May 2003).

² Pub. L. No. 116-25, 133 Stat. 981 §1407 (2019).

These procedures were to be implemented within six months of the date the law was enacted (January 1, 2020).

Results of Review

Our review identified that the IRS took actions to address the recommendations made in our May 2003 report in an effort to prevent the diversion of refunds claimed on paper-filed tax returns. These actions included:

- Revising the Form 1040 instructions to tell the taxpayer to cross out the direct deposit fields when requesting a paper check.
- Updating Submission Processing function internal guidelines to instruct tax examiners when processing paper tax returns to line through the direct deposit fields when a paper check is requested.
- Requesting software developers to modify their programs so that the direct deposit fields do not appear or cannot be altered when requesting a paper check.

However, we found that in January 2006, the IRS removed procedures from its internal guidelines that required employees to line through the direct deposit fields when a paper check was requested. Further, although the IRS requested that electronic filing (e-file) software vendors restrict the use of direct deposit fields when a paper refund check is requested, the IRS did not ensure that the vendors complied with the request. As a result, direct deposit fields on paper-filed tax returns are being left blank, which enabled an IRS employee to divert tax refunds via direct deposit to an unauthorized bank account.

We used the characteristics associated with the theft of taxpayer refunds by the IRS employee in the referral we received from our Office of Investigations to identify other tax returns that may have been altered. We identified 211 Tax Year 2017 and 2018 returns that met the characteristics of the Office of Investigations case. To date, we have been able to review 189 of the 211 tax returns. As of October 21, 2020, we have not received the remaining 22 (10 percent) returns. Our review of the 189 paper tax returns we have received identified 13 additional tax returns that had the same characteristics as the returns related to the referral we received. We provided these returns to our Office of Investigations for further review. We plan to review the additional 22 returns when received and perform this same analysis on Tax Year 2019 tax returns after the completion of the 2020 Filing Season³ to identify any additional fraudulently altered returns.

Finally, the IRS is taking steps to implement Section 1407 of the Taxpayer First Act. For example, on December 23, 2019, the IRS issued proposed regulations. These proposed regulations provide guidance on section 6402(n) of the Internal Revenue Code concerning the procedures to identify and recover a misdirected direct deposit refund. The regulations reflect changes to the law made by the Taxpayer First Act. The proposed regulations affect taxpayers who have made a claim for refund, requested the refund be issued as a direct deposit, but did not receive a refund in the account designated on their tax return.

³ The period from January through mid-April when most individual income tax returns are filed.

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vendors who did not make requested modifications to the direct deposit fields to prevent employees from altering paper tax returns to fraudulently obtain the refund.

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Contact the five software vendors TIGTA identified and request they modify their programs so direct deposit fields do not appear or cannot be altered when a taxpayer requests a paper refund check when using their software package to prepare their return and print out and mail it to the IRS.

Management's Response: The IRS agreed with this recommendation and plans to establish a default standard of populating the bank routing and account number fields on e-filed tax returns with a repeating capital X when taxpayers claim refunds without providing direct deposit information. IRS management plans to communicate this information to software developers and add this information to Publication 4164, *Modernized e-File (MeF) Guide for Software Developers and Transmitters*, and Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*.

Recommendation 2: Develop a process to annually review and work with approved software vendors whose packages do not include steps to ensure that direct deposit fields do not appear or cannot be altered to request these modifications.

Management's Response: The IRS agreed with this recommendation. Beginning with the November 2020 Modernized e-File Working Group meeting and continuing with subsequent meetings, IRS management plans to communicate to software developers the default standard for populating bank routing and account number fields with a repeating capital X when taxpayers do not request a direct deposit of their refund.

Actions Are Being Taken to Implement the Taxpayer First Act Provision Requiring the IRS to Provide Assistance to Taxpayers With Direct Deposit Errors

Section 1407 of the Taxpayer First Act requires the IRS to establish procedures to assist taxpayers when a direct deposit refund was not transferred to the taxpayer's bank account. The proposed regulations issued in December 2019 generally adopt the IRS's current procedures for the reporting, identification, recovery, and delivery of misdirected direct deposit refunds. Our review of the IRS's current processes and the proposed regulations found that the processes comply with the Section 1407 requirements. Figure 2 shows that the IRS is in compliance with Section 1407 of the Taxpayer First Act.

Figure 2: IRS Procedures Comply With Section 1407 of the Taxpayer First Act

Requirement in the Taxpayer First Act		IRS Procedures
Reporting 	Requires that taxpayers have a method of reporting when a direct deposit refund was not transferred to the account of the taxpayer.	Taxpayers can request a refund trace on direct deposit refunds by submitting Form 3911, <i>Taxpayer Statement Regarding Refund</i>. This form can be submitted by mailing the form to the IRS, calling an IRS customer service representative, visiting a Taxpayer Assistance Center, or contacting the Taxpayer Advocate Service.
Coordination 	Requires coordination with the financial institutions to identify the account to which the direct deposits were made as well as coordination for the recovery of the amount transferred to the bank.	When a refund trace is initiated, the IRS notifies the Bureau of the Fiscal Service of the need to research the refund. The Bureau of the Fiscal Service works with the financial institution to obtain information about the account where the refund was deposited. The financial institution will also determine whether the funds are still in the account. If the financial institution is unable or unwilling to return the funds to the IRS, the IRS can contact the institution directly to request assistance in the recovery of the funds.
Delivery 	Delivery of the refund to the correct account of the taxpayer.	When the direct deposit refund was misdirected because of an IRS error, the IRS will reissue the refund to the taxpayer. However, the IRS generally reissues the refund as a paper check, not as a direct deposit to the taxpayer's correct bank account.

Source: TIGTA review of current IRS procedures and proposed regulations.

IRS procedures state that misdirected refunds should be reissued as soon as possible, and the IRS acknowledges that direct deposit is the fastest method to receive a tax refund. However, it is the IRS's policy to reissue unsuccessful direct deposit refunds as a paper check and mail the check to the address on the taxpayer's tax account. When we asked IRS management why they reissue the refund as a paper check, they indicated that the IRS's Master File programming currently does not permit subsequent payments, after the initial refund claimed on the return, to go out as direct deposits. In addition, IRS management indicated that the statute does not specify that the refund must be done by direct deposit and that disbursement of the refund by check satisfies the statutory requirement. Upon receipt, the taxpayer may deposit the funds into the "correct account."

Processes and Procedures Are Needed to Ensure That Refund Inquiries Are Timely Resolved and Misdirected Refunds Are Reissued When Required

Our review identified that processes and procedures are needed to measure timeliness of the resolution of misdirected refunds and to require tax examiners to document steps taken to resolve a refund inquiry. These processes and procedures are needed in an effort to ensure improved service is provided to taxpayers in compliance with Section 1407 of the Taxpayer First Act.

IRS guidelines state that misdirected refunds should be resolved "*as soon as possible*." Along with not having established a time frame goal for resolution, these guidelines also do not require tax examiners to document the cause of the misdirected refund, *i.e.*, IRS error, bank error, or taxpayer error. The cause of a misdirected direct deposit refund is a key element of Section 1407 of the Taxpayer First Act as it relates to refunds that are misdirected because of an IRS error. In addition, internal guidelines do not require tax examiners to document when a refund trace is completed. For example, a specific code is entered on a taxpayer's account when a trace is initiated. However, a subsequent code is not required to be entered on a taxpayer's account when the trace is completed.

Our review of 3,294 refund inquiries associated with Tax Year 2018 paper-filed tax returns with a direct deposit refund found that the IRS reissued 1,777 refunds. The IRS had not reissued the remaining 1,517 refunds at the time of our review. However, we were unable to determine whether the IRS correctly worked these 1,517 refund inquiries. For example, we could not tell if the refund inquiry was closed from our analysis of the associated tax accounts nor could we identify the cause of the misdirected refund because this information is not required to be included on the associated individuals' tax account.

When we discussed our concerns with IRS management, they indicated that there are no requirements for tax examiners to document actions taken to resolve a refund inquiry. Management noted that there should be a paper case file maintained in the Refund Inquiry Unit that should include the Form 3911 or the correspondence that prompted the refund trace as well as the history of actions taken. IRS management also stated that when the refund trace is open, the current status and case history is temporarily available on IRS computer systems. However, once the action is taken, the information is no longer available for review.

Although the actions taken on each refund inquiry are to be documented in paper case files, adding specific actions to the associated tax account would allow IRS management to more efficiently monitor the timeliness and accuracy of the IRS's resolution of refund inquiry cases. Currently, IRS management would have to obtain and manually review each case to determine whether they are in compliance with Section 1407 of the Taxpayer First Act.

Recommendation 3: The Commissioner, Wage and Investment Division, should create a closing code to be entered onto a tax account when a refund inquiry is closed that denotes the cause of the refund being misdirected, *i.e.*, IRS error, taxpayer error, or bank error. The addition of this code would enable the IRS to monitor compliance with Section 1407 of the Taxpayer First Act.

Management's Response: The IRS agreed with this recommendation and plans to request Master File programming changes to establish a closing code that will be

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entered when a direct deposit refund trace is closed on an account where the refund was deposited to an incorrect bank account. The closing code will indicate whether the refund was deposited to an incorrect bank account due to an IRS error, taxpayer error, or bank error.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to evaluate the IRS processes and procedures to address misdirected refunds. To accomplish our objective, we:

- Determined whether the IRS implemented corrective actions to address our prior recommendations.
- Determined what policies and procedures are used by the Refund Inquiry Unit to recover misdirected refunds.
- Determined the steps that the IRS takes to ensure compliance by the software vendors to ensure that the blank direct deposit fields are filled with Xs.
- Reviewed a judgmental sample of 111 paper tax returns from the population of 224,065 Tax Year 2019 paper tax returns prepared using tax preparation software as of July 16, 2020, in the Kansas City, Missouri, Tax Processing Center. The sample was reviewed to determine if the software vendor made the direct deposit fields unusable.
- Used information on the TIGTA Data Center Warehouse to identify Tax Years 2017 and 2018 paper tax returns that had indications that the taxpayer contacted the IRS indicating the refund was not received. We reviewed the returns for signs they had been altered and referred all potentially altered returns to the TIGTA Office of Investigations.
- Used information on the TIGTA Data Center Warehouse to identify Tax Year 2018 paper tax returns that had a refund inquiry on a direct deposit refund to determine if the IRS had reissued the refund to the taxpayer or if the refund inquiry was closed or still being worked by the IRS.
- Evaluated the policies and procedures the IRS is developing or has implemented to assist taxpayers, coordinate with financial institutions, recover misdirected direct deposit refunds, and provide taxpayers their refunds to determine whether they comply with the requirements of Section 1407.

Performance of This Review

This review was performed with information obtained from the Wage and Investment Division Headquarters in Atlanta, Georgia, and the Wage and Investment Division Submission Processing function offices in Covington, Kentucky, during the period November 2019 through August 2020. 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.

Major contributors to the report were Russell P. Martin, Assistant Inspector General of Audit (Returns Processing and Account Services); Deann Baiza, Director; Sharla Robinson, Audit Manager; and Cally Sessions, Lead Auditor.

Validity and Reliability of Data From Computer-Based Systems

During this review, we pulled data from TIGTA's Data Center Warehouse on the Individual Master File, Individual Return Transaction File, Direct Deposit File, and the Refund File for Tax Years 2017 and 2018. Before relying on the data from the Data Center Warehouse, we ensured that each file contained the specific fields we requested. In addition, we selected random samples of each Data Center Warehouse pull and verified that the data in the pull were the same as what was entered into the Integrated Data Retrieval System. Based on the results of our tests, 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: Refund Inquiry Unit policies and procedures on refund traces. We evaluated these controls by reviewing Internal Revenue Manuals, reviewing training materials, and interviewing management.

Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

December 15, 2020

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kenneth C. Corbin ^{David P. Alito}
Commissioner, Wage and Investment Division

Digitally signed by David P. Alito
Date: 2020.12.15 15:48:47 -05'00'

SUBJECT: Draft Audit Report – Processes Exist to Assist Taxpayers With Misdirected Refunds, but Additional Controls Could Further Help to Prevent Them (Audit # 202040028)

Thank you for the opportunity to review and comment on the subject draft report. We acknowledge the concerns related to employment misconduct that are referenced in the report and await the findings of the Office of Investigations related to the remaining returns under review. We take such misconduct very seriously and note that employees found to be abusing their public trust are subject to termination, prosecution, fine, and/or imprisonment. We strive to eliminate all opportunities for employee theft and will continue our joint efforts with the Treasury Inspector General for Tax Administration to respond and act accordingly when such incidences are identified.

We appreciate your acknowledgement of the updates to our internal guidance with respect to the 'X' entry in the blank direct deposit fields. As indicated in the report, we have also previously requested that software companies update their programming to modify the direct deposit fields when taxpayers do not request a direct deposit. We will work with the developers of non-conforming software to ensure their compliance with the standard for populating blank bank routing and account number fields on printed copies of those returns.

We also appreciate the report stating that our procedures related to direct deposit errors are following the Taxpayer First Act. However, the report mentions that we have not established a timeframe goal for resolving the misdirected refunds but without providing the rationale behind that lack of timeframe. The resolution of misdirected refunds requires coordination with the Bureau of the Fiscal Service (BFS) and the timeframe to complete the process is dependent upon the final disposition of the payment by the BFS. The dependency on final actions by the BFS, and the variability of actions that need to be completed for different types of disposition, prevent the adoption of a single

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processing timeframe for all inquiries. Our internal procedures document the expected resolution timeframes for the various inquiry disposition scenarios.

Attached are our comments and proposed actions to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Dietra Grant, Director, Customer Account Services, Wage and Investment Division, at (470) 639-3504.

Attachment

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Attachment

Recommendations

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 1

Contact the five software vendors TIGTA identified and request they modify their programs so direct deposit fields do not appear or cannot be altered when a taxpayer requests a paper refund check when using their software package to prepare their return and printout and mail to the IRS.

CORRECTIVE ACTION

We have reviewed the related publications and identified a discrepancy between the instructions for paper filers and electronic filers concerning how to line through or cross out direct deposit information. We are adding text to Publication 4164, *Modernized e-File (MeF) Guide for Software Developers and Transmitters*, and Publication 1345, *Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns*, to establish a default standard of populating the bank routing and account number fields with a repeating capital X when taxpayers claim refunds without providing direct deposit information. Beginning with the November 2020 MeF Working Group meeting, we will communicate to software developers the default standard for populating bank routing and account number fields with a repeating capital X when taxpayers do not request a direct deposit of their refund.

IMPLEMENTATION DATE

February 15, 2021

RESPONSIBLE OFFICIAL

Director, Submission Processing, Customer Account 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 annually review and work with approved software vendors whose packages do not include steps to ensure that direct deposit fields do not appear or cannot be altered to request these modifications.

CORRECTIVE ACTION

Beginning with the November 2020 MeF Working Group meeting, and continuing with subsequent meetings, we will communicate to software developers the default standard for populating bank routing and account number fields with a repeating capital X when taxpayers do not request a direct deposit of their refund.

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IMPLEMENTATION DATE

February 15, 2021

RESPONSIBLE OFFICIAL

Director, Submission Processing, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 3

The Commissioner, Wage and Investment Division, should create a closing code to be entered onto a tax account when a refund inquiry is closed that denotes the cause of the refund being misdirected, *i.e.*, IRS error, taxpayer error, or bank error. The addition of this code would enable the IRS to monitor compliance with Section 1407 of the Taxpayer First Act.

CORRECTIVE ACTION

We will request Masterfile programming changes to establish a closing code that will be entered when a direct deposit refund trace is closed on an account where the refund was deposited to an incorrect bank account. The closing code will indicate whether the refund was deposited to an incorrect bank account due to an IRS error, taxpayer error, or bank error. The requisite programming is subject to budgetary constraints, limited resources, and competing priorities. Consequently, we cannot provide an implementation date.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

Director, Accounts Management, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.



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By Web:

www.treasury.gov/tigta/

Or Write:

Treasury Inspector General for Tax Administration

P.O. Box 589

Ben Franklin Station

Washington, D.C. 20044-0589

Information you provide is confidential, and you may remain anonymous.