TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

A Computer Programming Change Is Needed to Delay the Erroneous Issuance of Refunds Based on Dishonored Checks

February 4, 2025

Report Number: 2025-IE-R008

TIGTACommunications@tigta.treas.gov | www.treasury.gov/tigta

HIGHLIGHTS: A Computer Programming Change Is Needed to Delay the Erroneous Issuance of Refunds Based on Dishonored Checks

Final Evaluation Report issued on February 4, 2025 **Report Number 2025-IE-R008**

Why TIGTA Did This Evaluation

This evaluation was initiated because TIGTA's [redacted]. A subsequent payment is a payment on an account for a filed, but not full paid tax return. For example, if a taxpayer filed a return and on a later date sent the IRS a payment, the payment would be referred to as a subsequent payment. [redacted]. The IRS refers to payments that are returned as unpaid by the financial institution as dishonored checks.

Because of this, we conducted this evaluation to assess the IRS's processes and procedures to identify and prevent erroneous refunds from dishonored checks that were submitted as a subsequent payment.

Impact on Tax Administration

From Jan. 1, 2023, through March 28, 2024, the IRS processed over 1.5 million dishonored checks that were submitted as subsequent payments totaling nearly $4.7 billion. Since the IRS does not have a computer program that delays refund issuance for a sufficient time to allow it to receive dishonored check information from financial institutions, the IRS is at risk of generating millions of dollars in erroneous refunds.

What TIGTA Found

We identified 7,765 individual taxpayers who may have received approximately $43.7 million in erroneous refunds based on dishonored checks that posted to their tax accounts from Jan. 1, 2023, through March 28, 2024.

In June 2024, we issued an alert to IRS management that erroneous refunds were being issued based on dishonored checks. In July 2024, the IRS provided the results of its review of 20 taxpayer accounts of the 7,765 individual taxpayers. The IRS determined that taxpayers potentially benefited from these payments due to a timing issue of the IRS's system generating the refund before the IRS received notification of the dishonored check, which is consistent with our analysis.

In September 2024, the IRS provided the results of a separate review of an additional 20 taxpayer accounts. The IRS reviewed the accounts to determine whether other internal control procedures were able to stop the refund payment before it was sent to the taxpayer. For these 20 accounts, the IRS found that it was able to stop some of the refund payments before they were sent to taxpayers or taxpayers returned the refund checks uncashed. We confirmed the results of the IRS's review. According to IRS management, although some of the refunds were likely due to unintentional errors by taxpayers, the potential for fraud and erroneous refunds remains.

In response to our alert, IRS management agreed to a computer programming change to delay refund issuance for two posting cycles to provide the IRS time to receive dishonored check information. Accordingly, we analyzed the accounts of the 7,765 taxpayers to determine the amount of potential revenue that could have been protected based on the IRS's proposed computer programming. If the computer programming had been in place, the IRS could have potentially protected approximately $22.4 million in erroneous refunds based on dishonored checks for about 56 percent of the 7,765 taxpayers.

What TIGTA Recommended

We recommended that the IRS should ensure that a computer programming change is completed to delay the issuance of refunds based on payments for two cycles to provide the IRS time to receive dishonored check information from financial institutions. IRS management agreed with the recommendation.

TREASURY INSPECTOR GENERAL
for Tax Administration

DATE: February 4, 2025

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

FROM: Nancy A. LaManna
Deputy Inspector General for Inspections and Evaluations

SUBJECT: Final Evaluation Report – A Computer Programming Change Is Needed to Delay the Erroneous Issuance of Refunds Based on Dishonored Checks (Evaluation No.: IE-24-044)

This report presents the results of our review to assess the Internal Revenue Service's processes and procedures to identify and prevent erroneous refunds from dishonored checks that were submitted as a subsequent payment. This review is part of our Fiscal Year 2025 Annual Program Plan and addresses the major management and performance challenge of *Tax Fraud and Improper Payments*.

Management's complete response to the draft report is included as Appendix III. If you have any questions, please contact me or Debra Kisler, Director, Inspections and Evaluations.

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Background

This evaluation was initiated in response to the Treasury Inspector General for Tax Administration (TIGTA) [redacted].[1] [redacted]. This evaluation assessed the IRS's processes and procedures to identify and prevent these types of erroneous refunds.

Processing of taxpayer payments

In Fiscal Years 2022 and 2023, the IRS received, on average, approximately $4.2 trillion in payments related to individual tax revenue.[2] According to internal guidelines, the IRS deposits these payments daily in Federal Reserve Banks or other financial institutions. In addition, payment information (*e.g.*, the amount of the payment, the tax return period for which the payment is associated, and the date the payment was received) is entered into the taxpayer's tax account. However, in some instances, the payment cannot be successfully processed by the financial institution. This includes paper check and electronic payments where there may not be sufficient funds to cover the taxpayer's payment. The IRS refers to a payment that cannot be successfully processed and is returned as unpaid by the financial institution as a "dishonored check."[3]

An overpayment occurs when the amount of a taxpayer's payment exceeds what was owed by the taxpayer. According to internal guidelines, once the financial institution notifies the IRS that the payment was dishonored, IRS employees are required to review the taxpayer's account to determine if a refund has been generated.[4] However, sometimes the overpayment is erroneously refunded to the taxpayer even though the payment was dishonored. Figure 1 provides an overview of the IRS's dishonored check process from the time the taxpayer sends in the payment until the IRS records the dishonored check on the taxpayer's tax account.

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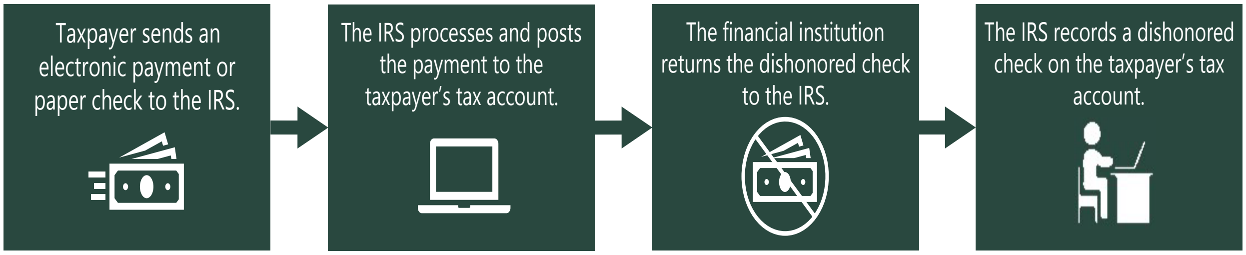
[1] See Appendix IV for glossary of terms.

[2] Government Accountability Office, GAO-24-106472, *Financial Audit: IRS's FY 2023 and FY 2022 Financial Statements* (November 2023).

[3] A dishonored payment is an electronic payment unpaid by the financial institution and a dishonored check is a check returned unpaid by the financial institution. We use the term "dishonored check" to include both dishonored electronic payments and checks. Although our review focused solely on subsequent payments, dishonored checks can also occur for the following types of payments: payments submitted with a return, installment or advanced payments, payments submitted as a Federal Tax Deposit, and designated payments of interest or penalties.

[4] The IRS generates refund transactions in a taxpayer's account. These transactions must then post to its Master File and a request for issuance of the refund is sent to the Bureau of the Fiscal Service. The Bureau of the Fiscal Service issues the refund to the taxpayer.

Figure 1: Overview of the Dishonored Check Process



Source: TIGTA analysis of IRS internal guidelines and interviews with IRS officials.

Dishonored checks that were submitted as subsequent payments

From Jan. 1, 2023, through March 28, 2024, the IRS processed over 1.5 million dishonored checks that were submitted as subsequent payments totaling nearly $4.7 billion. A "subsequent payment" is a term used by the IRS to refer to a payment on an account for a filed, but not full paid tax return. For example, if a taxpayer filed a return and on a later date sent the IRS a payment, the payment would be referred to as a subsequent payment. Our review focused solely on dishonored checks that were submitted as subsequent payments and met certain conditions.[5]

Results of Review

In June 2024, we issued an alert to IRS management that erroneous refunds were being issued based on dishonored checks. IRS management acknowledged that although some of the refunds were likely due to unintentional errors by taxpayers, the potential for fraud and erroneous refunds remains. Because the IRS does not have computer programming that delays refund issuance for a sufficient time to allow the IRS to receive dishonored check information from financial institutions, the IRS is at risk of generating millions of dollars in erroneous refunds.

A Computer Programming Change Is Needed to Delay the Issuance of Refunds for Two Cycles to Provide the IRS Time to Receive Dishonored Check Information From Financial Institutions

[redacted], our analysis of payments and refunds posted to taxpayers' tax accounts from Jan. 1, 2023, through March 28, 2024, identified 7,765 individual taxpayers who may have received approximately $43.7 million in erroneous refunds based on dishonored checks.[6] An IRS official informed us

[5] See Appendix I for the specific conditions we used to identify the population of subsequent payments for this review.

[6] Our analysis identified tax accounts with dishonored checks whereby the IRS generated a refund to the taxpayer for an overpayment resulting from the dishonored check. Our analysis did not determine whether the refund was, in fact, issued to the taxpayer. Our analysis found that there was not a direct correlation between the amount of the dishonored check and the amount of the refund generated. This is because the taxpayer's account balance at the time the original payment posted determines the amount of the refund that will be issued.

that, on average, it takes 10 to 14 days from receipt of the original paper check until the financial institution returns the dishonored check to the IRS. Although financial institutions have up to five business days to return electronic payments for insufficient funds, an IRS official stated that most institutions do so within one business day.

The *Standards for Internal Control in the Federal Government* states that managers should use quality information to achieve the entity's objectives.[7] To do so, managers identify information requirements, obtain relevant data from reliable internal and external sources, and process data into information that is appropriate, current, complete, accurate, accessible, and provided on a timely basis. A leading practice that can help enable managers to effectively use data to achieve the objective of mitigating the likelihood and impact of fraud is to apply computer programming (*i.e.*, system edit checks) to help ensure that certain requirements are met before refunds are issued.[8]

However, the IRS does not have computer programming that delays refund issuance for a sufficient time (*i.e.*, 10 to 14 days) to allow the IRS to receive dishonored check information from financial institutions. As a result, the IRS is at risk of generating millions of dollars in erroneous refunds based on dishonored checks.

In June 2024, we issued an alert to IRS management that erroneous refunds were being issued based on dishonored checks. We recommended that the IRS implement a computer programming change to address this concern. In a July 2024 response to our email alert, IRS Submission Processing reviewed 20 taxpayer accounts of the 7,765 individual taxpayers and determined that taxpayers potentially benefited from these payments due to a timing issue of the IRS's system generating the refund before the IRS received notification of the dishonored check, which is consistent with our analysis.

In September 2024, the IRS provided the results of separate review of an additional 20 taxpayer accounts. The IRS reviewed the accounts to determine whether other internal control procedures were able to stop the refund payment before it was sent to the taxpayer. For these 20 accounts, the IRS found that either the IRS was able to stop some of the refund payments before they were sent to taxpayers or taxpayers returned the refund checks uncashed. We confirmed that for all 20 records the IRS either stopped or the taxpayers returned the refunds.

IRS management acknowledged that although some of the refunds were likely due to unintentional errors by taxpayers, the potential for fraud and erroneous refunds remains. Accordingly, IRS management agreed to a computer programming change to delay refund issuance for two posting cycles to provide the IRS time to receive dishonored check information. As mentioned previously, an IRS official informed us that, on average, it takes 10 to 14 days (i.e., two posting cycles) from receipt of the original paper check until the financial institution returns the dishonored check to the IRS. The IRS official also stated that although implementation of a delay for two posting cycles could potentially allow for additional refund interest to be paid to taxpayers, the amount of interest should be negligible in comparison to the costs associated with issuing an erroneous refund.

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[7] Government Accountability Office, GAO-14-704G, *Standards for Internal Control in the Federal Government* (September 2014).

[8] Government Accountability Office, GAO-15-593SPG, *A Framework for Managing Fraud Risks in Federal Programs* (July 2015).

Accordingly, we analyzed the accounts of the 7,765 taxpayers to determine the amount of potential revenue that could have been protected based on the IRS's proposed computer programming to delay refund issuance for two posting cycles. If the computer programming had been in place, the IRS could have potentially protected approximately $22.4 million in erroneous refunds based on dishonored checks for about 56 percent of the 7,765 taxpayers. IRS management stated that the programming change is scheduled to be implemented in March 2025.

Recommendation 1: The Chief, Taxpayer Services, should ensure that the computer programming is completed to delay the issuance of refunds based on payments for two cycles to provide the IRS time to receive dishonored check information from financial institutions.

> **Management's Response:** IRS management agreed with our recommendation. On Oct. 7, 2024, the IRS submitted a request to update Master File programming to delay refunds, offsets, and/or credit elects for two cycles when a subsequent payment creates a credit balance on all Individual Master File and Business Master File accounts. The programming change is scheduled for implementation in March 2025.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this evaluation was to assess the IRS's processes and procedures to identify and prevent erroneous refunds from dishonored checks that were submitted as a subsequent payment. Specifically, our review focused on identifying individual taxpayer accounts that had the following activity:

1. One dishonored subsequent payment that posted to the taxpayer's account from Jan. 1, 2023, through March 28, 2024.
2. A refund that posted to the taxpayer's account between the time the IRS initially received the payment and prior to the IRS receiving notification that the payment was dishonored.

To accomplish our objective, we:

- Interviewed an IRS official and determined the extent the IRS is aware that erroneous refunds can be generated from dishonored checks.
- Reviewed internal guidelines and discussed with an IRS official whether the IRS has a control procedure in place to delay the payment of refunds generated from dishonored checks until the IRS receives notification that the check is dishonored.
- Determined the extent of potential tax benefits generated by dishonored checks that were submitted as a subsequent payment that may have been paid to individual taxpayers.

Performance of This Review

This review was performed with information obtained from IRS Submission Processing Headquarters located in Covington, Kentucky during the period July through November 2024. We conducted this evaluation in accordance with the Council of the Inspectors General for Integrity and Efficiency Quality Standards for Inspection and Evaluation. Those standards require that the work adheres to the professional standards of independence, due professional care, and quality assurance and followed procedures to ensure accuracy of the information presented. We believe that the evidence obtained provides a reasonable basis for our finding and conclusion.

Major contributors to the report were Debra Kisler, Director; Malissa Livingston, Senior Evaluator; and Chris Messier, Evaluator.

Data Validation Methodology

We evaluated the data by performing tests to assess the reliability of data obtained from the IRS's Individual Master File system. Specifically, we evaluated the data by performing electronic testing of required data elements. We determined that the data were sufficiently reliable for purposes of this report.

Appendix II

Outcome Measure

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

Type and Value of Outcome Measure:

- Revenue Protection – Potential; $22,420,845 in erroneous refunds received by 4,325 individual taxpayers based on $31,767,956 in dishonored checks (see Recommendation 1).

Methodology Used to Measure the Reported Benefit:

We identified 1,511,512 Transaction Code (TC) 671s that posted to individual taxpayer accounts from Jan. 1, 2023, through March 28, 2024. From this population, we identified the subset of taxpayer accounts that had the following account activity from Jan. 1, 2023, through March. 28, 2024:

- Only one TC 671 posted to the tax account.
- A TC 673 that had the same date and transaction amount as the TC 671 posted to the tax account.
- At least one TC 846 posted between the TC 673 and the TC 671 posting cycles.

Based on the above criteria, we determined that 7,765 individual taxpayers may have potentially received $43,652,187 in erroneous refunds. We then calculated the number of posting cycles between the TC 673 and TC 671. We reduced the population of individual taxpayers to those whose accounts had a posted refund and dishonored check within two posting cycles after the posting cycle of the original payment. We determined that 4,325 individual taxpayers may have potentially received $22,420,845 in erroneous refunds based on $31,767,956 in dishonored checks.

Management's Response: IRS management disagreed with the determination or calculation of potential losses for this outcome. IRS management stated that TIGTA's analysis excluded subsequent account data indicating the refunds were either later cancelled or returned uncashed. Specifically, out of the 40 cases the IRS reviewed, the IRS found that 15 refund requests were cancelled through internal control processes and 5 refund checks were returned to the IRS unnegotiated, thereby reducing the potential losses in the 40 cases by 50 percent. While this does not eliminate the risk, it does mitigate the impact.

Office of Inspections and Evaluations Comment: While the IRS identified a small sample of cases where checks were either subsequently cancelled or returned, they acknowledged the risk for loss still exists. We believe our estimate is reasonable as we did not report on the actual revenue protected, but instead reported the amount of potential erroneous refunds received by taxpayers based on the number of dishonored checks.

Appendix III

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

CHIEF
TAXPAYER SERVICES

December 13, 2024

MEMORANDUM FOR RUSSELL P. MARTIN
DEPUTY INSPECTOR GENERAL FOR INSPECTIONS AND EVALUATIONS

FROM: Kenneth C. Corbin Kenneth Corbin Date: 2024.12.13 13:58:54 -05'00'
Chief, Taxpayer Services Division

SUBJECT: Draft Evaluation Report – A Computer Programming Change Is Needed to Delay the Erroneous Issuance of Refunds Based on Dishonored Checks (Evaluation No.: IE-24-044)

Thank you for the opportunity to review and provide comments on the subject draft report. Ensuring the integrity of taxpayer payment processing is a priority for the IRS. Unfortunately, there are instances where a taxpayer's payment to the IRS is dishonored by their financial institution. A payment may be dishonored if there are insufficient funds, the account is reported as closed, the account number is invalid, or the account holder has requested a stop-payment. Financial institutions may also, at their discretion, place a hold on checks submitted for payment thereby delaying notification if an issue is detected. The IRS is not able to confirm the validity of bank information or availability of funds on paper checks. We must rely on the depository bank to send notification that the payment was invalid, or funds were not available and return the paper check to the IRS.

Once notification from the financial institution, in the form of a debit voucher, is received, the credit to the tax account is reversed and a code is placed on the tax account to prevent refunds from being issued from that tax account. We research reports to prevent potential erroneous refunds stemming from dishonored payments. However, due to the timing of the original credit on the tax account and the notification of a check returned by the bank, there have been instances of erroneous refunds being issued after a bank has dishonored the payment.

While we agree there have been erroneous refund losses, we do not agree with your determination or calculation of potential losses in your outcome measures. Your analysis of the 7,765 accounts excluded subsequent account data indicating a cancellation of the refund or the return of uncashed checks. As you stated in your report, out of the 40 cases we reviewed from your sample, we found 15 refund requests were cancelled through internal control processes and five refund checks were returned to us unnegotiated, thereby reducing the potential losses in the sample by 50 percent. While this does not eliminate the risk, it does mitigate the impact and we are more attuned to the risk following your review.

We submitted a change in system programming that will delay individual and business tax account overpayment refunds occurring from a subsequent payment for a period of approximately two-weeks. The delay will allow more time to elapse between the credit of taxpayer payments and the time the IRS is notified if a payment has been dishonored, thereby reducing the risk of issuing an erroneous refund. The programming change is scheduled for implementation in March 2025.

Our responses to your specific recommendations are enclosed. If you have any questions, please contact me, or a member of your staff may contact Joseph Dianto, Director, Customer Account Services, at 470-639-3504.

Attachment

Attachment

Recommendations:

The Chief, Taxpayer Services should:

RECOMMENDATION 1
The Chief, Taxpayer Services, should ensure that the computer programming is completed to delay the issuance of refunds based on payments for two cycles to provide the IRS time to receive dishonored check information from financial institutions.

CORRECTIVE ACTION
We agree. On October 7, 2024, we submitted a Unified Work Request (UWR) 996022 to update Master File programming to delay refunds, offsets, and/or credit elects for two cycles when a subsequent payment creates a credit balance on all Individual Master File and Business Master File accounts. The programming change is scheduled for implementation in March 2025.

IMPLEMENTATION DATE
April 15, 2025

RESPONSIBLE OFFICIAL
Director, Submission Processing, Customer Account Services, Taxpayer Services Division.

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

Appendix IV

Glossary of Terms

Term	Definition
Fiscal Year	Any yearly accounting period, regardless of its relationship to a calendar year. The federal government's fiscal year begins on Oct. 1 and ends on Sept. 30.
Individual Master File	The IRS database that maintains transactions or records of individual tax accounts.
Master File	The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
Posting Cycle	The week that a transaction posts to the Master File.
Subsequent Payment	A payment on an account for a filed, but not full paid tax return.
System Edit Checks	Instructions programmed into an information-processing system to help assure that data are complete, accurate, valid, and recorded in the proper format, such as checks to identify missing data, incorrect data, or erroneous dates. System edit checks can be used to compare data entries to requirements, and automatically deny entries that do not meet requirements or flag them for further review.
Transaction Code	A three-digit code used to identify actions being taken on a taxpayer's account.
Transaction Code 671	Indicates a dishonored subsequent payment.
Transaction Code 673	Indicates an original payment that was subsequently reversed.
Transaction Code 846	Indicates a refund of overpayment owed to the taxpayer.

Appendix V

Abbreviations

IRS	Internal Revenue Service
TC	Transaction Code
TIGTA	Treasury Inspector General for Tax Administration

**To report fraud, waste, or abuse,
contact our hotline on the web at
https://www.tigta.gov/reportcrime-misconduct.**

To make suggestions to improve IRS policies, processes, or systems affecting taxpayers, contact us at www.tigta.gov/form/suggestions.

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