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Report to the Chairman, Committee on Finance, U.S. Senate

December 1992

# TAX ADMINISTRATION

# IRS Can Improve Controls Over Electronic Filing Fraud

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**General Government Division**

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December 30, 1992

The Honorable Lloyd Bentsen
Chairman, Committee on Finance
United States Senate

Dear Mr. Chairman:

In response to your request, this report discusses steps the Internal Revenue Service can take to improve its controls over electronic filing fraud.

As arranged with the Committee, we plan no further distribution of this report until 7 days from the date of issuance. At that time, we will send copies to other congressional committees; the Secretary of the Treasury; the Commissioner of Internal Revenue; the Director, Office of Management and Budget; and other interested parties.

The major contributors to this report are listed in appendix II. Please contact me on (202) 272-7904 if you or your staff have any questions concerning the report.

Sincerely yours,

Jennie S. Stathis

for Hazel E. Edwards
Associate Director, Tax Policy
and Administration Issues

-5-

permit us to address the concerns raised by GAO. Having authority to accept an alternative to the written signature will allow us to match signatures with the return instantly.

issuance increased from 25 for all of 1991 to 71 for the first 7 months of 1992. That is still lower than the 96-percent stoppage rate for paper returns during the first 7 months of 1992. And, for the first 7 months of 1992 compared to the same period in 1991, the dollar amount of fraudulent electronic refunds that IRS identified but was unable to stop before issuance increased by 35 percent—from $6.3 million in 1991 to $8.5 million in 1992.

GAO recognizes that it may be unreasonable to attempt to devise a system of controls to prevent all electronic filing fraud or to identify and stop all fraudulent refunds before they are issued. GAO believes, however, that additional controls can be reasonably implemented to further reduce IRS' vulnerability. These controls generally involve (1) providing IRS staff with information for making a more informed decision about whether to accept a preparer or transmitter into the program and (2) providing fraud detection teams at IRS service centers with better techniques to identify and investigate questionable returns and stop the issuance of fraudulent refunds.

## Principal Findings

### IRS Can Improve Its Screening of Electronic Filing Applicants

To file electronically, taxpayers go to a person or firm that has been authorized by IRS to prepare and/or transmit electronic returns. To become authorized, a person or firm must apply to IRS and pass a suitability check. Among other things, IRS checks to see if applicants have failed to file returns or pay taxes or have been convicted of offenses such as embezzlement or stock fraud. In response to internal studies, IRS tightened its suitability screening in 1992. For example, it required that firms wishing to participate in the program identify on their applications all corporate officers and partners with at least a 5-percent interest in the business. (See pp. 17 and 18.)

District office staff responsible for suitability checks do not have access to the National Crime Information Center database maintained by the Federal Bureau of Investigation. This national database has information on federal, state, and local crime convictions. Because IRS has identified cases of electronic refund fraud by preparers or transmitters who had criminal records, the information in this database would probably be useful in making a suitability decision. However, an interagency memorandum of

-3-

wage information with electronic return data as a means of validating information on electronic returns.

Comment:

We agree with this recommendation. Refinement of computer applications has been an ongoing process over the past few years based upon the changing patterns of fraudulent filings. Criminal Investigation has developed on-line extraction parameters to identify filing schemes. For example, based on experience with fraudulent refund claims in prior years, we have identified characteristics or combinations of characteristics that we now use to identify refund returns that should be given greater scrutiny. This year we are implementing recommendations from a Quality Improvement Team to delay refunds on returns that score high on questionable characteristics to give Criminal Investigation more time to examine the returns. Other program modifications permit us to reject, for further research or contact, returns with social security numbers and names that do not match. These program modifications will be implemented in January 1993.

We are working with the Social Security Administration to find ways to expedite wage withholding information that could be used to match against amounts claimed on returns. However, this is a long-term solution that cannot be achieved within the next few years. In the meantime, we are looking at other ways to utilize computer analysis to reject returns from preparers/transmitters who show a consistent pattern of adjustments on their customers' returns. These and other proposals for up-front detection of erroneous or fraudulent returns are being considered for implementation once our computer systems are modernized.

Recommendation:

Classify electronic returns from first-time filers as questionable returns for further investigation and delay processing those returns until the validity of the filer can be established.

Comment:

We agree with this recommendation. Implementation is scheduled for the 1993 processing year. The fraudulent use of social security numbers by first-time filers has historically proven to be a major contributor to questionable refund schemes.

Recommendation:

Require that preparers/transmitters (i) obtain at least two pieces of identification from electronic filers time-consuming methods of identifying questionable returns. (See pp. 27-28.)

GAO believes that IRS can improve its screening criteria. IRS could build profiles of fraud perpetrators into the screening criteria and could give fraud detection teams more flexibility to adjust the criteria in response to newly discovered schemes. IRS could also develop the capability to electronically match wage information provided by employers with wage information claimed on electronic returns. That should become more feasible as IRS progresses with its computer modernization. (See pp. 28-29.)

IRS statistics indicated that many persons who filed fraudulent electronic returns were first-time filers who employed such techniques as the use of false names and social security numbers. For example, of a sample of 1,066 filers of fraudulent returns at one service center in 1991, 34 percent had no previous filing history. In November 1991, an IRS quality improvement team recommended that IRS make first-time filers ineligible to file electronically and that preparers and transmitters be required to verify the identity of their electronic filing clients by asking for two pieces of identification. As an alternative to making first-time filers ineligible, IRS could screen out returns from first-time filers and check them before issuing the refund. Such a procedure might delay the issuance of some refunds, but it would still allow first-time filers to file electronically. (See p. 30.)

IRS requires that preparers/transmitters mail supporting paper documents to IRS within 1 working day after IRS accepts an electronic return for processing. Those documents include one that contains the taxpayer's signature and any relevant wage documents (Forms W-2). Fraud detection teams consider the wage documents a good source for identifying refund fraud. For example, the team at one service center identified about one-third of its 1991 electronic refund schemes through this method. But detection teams are often unable to review the paper documents before the related refunds are issued. This is partly because of the speed with which electronic refunds are issued and partly because preparers do not submit the paper documents on time. In 1991, IRS rarely followed its procedures for suspending preparers/transmitters who did not submit paper documents. (See pp. 31-33.)

Another consequence of the delay in obtaining and processing paper documents is that IRS usually issued a refund before it matched the

-2-

non-filers or have other tax problems which could preclude their participation as electronic filing transmitters. These procedures will be effective for tax year 1992.

Recommendation:

Establish rejection standards for applicants who habitually fail either: (i) to pay their taxes; or (ii) to file their returns on time.

Comment:

The standards for rejection of applicants are included in the District Office Electronic Filing Coordinator's Handbook, Internal Revenue Manual 12(14)0. These standards include failure to file timely and accurate returns, as well as failure to pay tax liabilities, both business and personal. These procedures will be reviewed with field offices and appropriate service centers to emphasize the importance of taking into consideration applicants' complete tax histories when deciding to accept or reject them from the program. It should also be noted that the Automated Suitability Analysis Program reviews the complete filing history of all participants and applicants. Such review allows district management to reject applicants who habitually fail to comply with the tax laws.

Recommendation:

Establish a procedure for district office quality review staff to review electronic filing coordinator's suitability decisions.

Comment:

We agree there should be greater review of the electronic filing coordinators' suitability decisions. The procedures for the upcoming year will be enhanced by requiring the Regional Office Electronic Filing Coordinator to review the district "acceptance" decisions.

Recommendation:

Follow through on plans to develop improved computer checks for identifying questionable electronic returns in time for the 1993 filing season. These checks should be based on analyses of the perpetrators of electronic filing schemes and not restrict service center fraud detection teams from adapting the checks as fraud schemes are identified during the filing season. As it modernizes its computer systems, IRS should also consider electronic matching of employer identify the paperwork and associate it with the related electronic submission. (See pp. 36-37.)

possible. But written signatures are legal requirements for all tax returns and should not be ignored in order to reap the benefit of the rapid refunds available from electronic filing. As long as a written signature document is required, we believe that IRS needs to ensure that this requirement is met. In that regard, we agree with IRS' own risk analysis, which concluded that refunds should not be issued until the signature document is processed and that "the lack of controls in this area and the treatment of these forms as insignificant for [the] sake of the expediency of processing the refunds quickly puts the Electronic Filing Program and the certifying officials at major risk for issuing refunds without a completed tax return." As electronic filing becomes even more popular and the number of returns filed electronically grows, we would expect that risk to escalate.

As IRS indicated in its comments, the ultimate solution to this problem rests in having authority to accept an alternative to the written signature, such as an electronic signature. It is unclear, however, if and when IRS will be authorized to use electronic signatures and how long it will take to test and fully implement such an alternative once authorized. In the meantime, there may be steps IRS can take to speed the processing of signature documents and other paper. It might be possible, for example, to have all electronic filing paperwork mailed to a separate address from other mail coming into the service center to reduce the time presently needed to identify the paperwork and associate it with an electronic submission.

The complete text of IRS' comments is included in appendix I.

adoption of a procedure to suspend the processing of electronic returns filed by first-time filers to allow further investigation before any refund is issued. We also believe that IRS should require, as recommended by one of its internal study groups, that preparers/transmitters obtain and retain suitable identification from electronic filers.

IRS must also contend with the issue of sending out refunds before it has a complete tax return. IRS' legal counsel has said that a return is not complete and a refund should not be issued until IRS has matched the electronic information with the paper signature document that preparers/transmitters are required to forward to IRS. Legislation that would have allowed IRS to test alternatives to written signatures was included in the proposed Revenue Act of 1992 that was vetoed. We believe that the use of alternatives, such as electronic signatures, is important, not just to better ensure that IRS has a complete return before issuing a refund, but also to help reduce the amount of paper involved in electronic filing.

## Recommendations to the Commissioner of Internal Revenue

We recommend that the Commissioner take the following actions:

- Follow through on plans to develop improved computer checks for identifying questionable electronic returns in time for the 1993 filing season. These checks should be based on analyses of the perpetrators of electronic filing schemes and not restrict service center fraud detection teams from adapting the checks as fraud schemes are identified during the filing season. As it modernizes its computer systems, IRS should also consider electronically matching employer wage information with electronic return data as a means of validating information on electronic returns.
- Classify electronic returns from first-time filers as questionable returns for further investigation and delay processing those returns until the validity of the filer can be established.
- Require that preparers/transmitters obtain at least two pieces of identification from electronic filers before transmitting their returns and retain the pieces of identification with taxpayers' records. One piece of identification should be a picture identification.
- Until electronic filing paper documents are no longer required, (1) follow established procedures for warning and suspending preparers/transmitters who do not submit timely paper documents and (2) discontinue issuing refunds until the associated electronic return can be matched with a corresponding taxpayer signature document.

Electronic filing offers advantages to taxpayers and IRS. One appealing advantage to taxpayers is that they can receive their refunds quicker than when filing a paper return. IRS data show that taxpayers who filed paper returns received their refunds in about 5 weeks. In 1991 (the latest data available from IRS), taxpayers who filed electronically received their refunds in about 3 weeks. In addition, electronic filers can opt to have their refunds deposited directly into their bank accounts, which enables them to get their refunds even faster—in about 2 weeks. Some preparers also arrange for electronic filers to obtain commercial loans, called refund anticipation loans, which enable taxpayers, for a fee, to get their money still faster—in about 3 days. The loan is paid to the taxpayer, and the refund goes to the financial institution for repayment of the loan. About 74 percent of electronic returns filed in 1992 involved refund anticipation loans.

Electronic returns have fewer errors than paper returns. Electronic returns are more accurate because (1) computer checks catch errors before the return is filed and (2) computer processing of electronic returns eliminates errors associated with the manual processing of paper returns. During the 1992 filing season, according to IRS data, the error rate for electronic returns was 2.8 percent compared to 18 percent for paper returns.

Electronic returns are less costly to store than paper returns. IRS has in its files and at federal record centers over 1.2 billion tax returns stored in over 1 million cubic feet of space. If those returns had been filed electronically, they could be stored on about 200 12-inch optical disk platters. The Office of Management and Budget has also estimated, on the basis of information provided by IRS, that each electronic return costs IRS about $1.62 less to process (in 1993 dollars) than a paper return.

While it was developed as an alternative to paper tax returns, electronic filing does not completely eliminate paper documents. In addition to the electronically transmitted information, preparers/transmitters must send IRS various paper documents such as Form W-2, which shows the taxpayer's wages and withheld taxes, and Form 8453, which contains the taxpayer's and preparer's signatures, selected income and tax information from the electronic return, and information needed to deposit a refund directly into a taxpayer's account at a financial institution. IRS processes the paper documents through the same system as paper income tax returns. Processing of the paper portion of the return generally takes about 2 weeks. IRS is required to match electronic return information and

To improve fraud detection, IRS needs to speed the referral of questionable wage documents to fraud detection teams, find better ways to detect fraud, or slow the processing of electronic returns until the wage information "catches up." Beginning in 1993, IRS plans to suspend for about 1 week the processing of questionable returns from taxpayers who elect direct deposit of refunds—the refunds that IRS has the least time to review. IRS' intent is to provide fraud detection staff with additional time to review questionable returns and stop the issuance of fraudulent refunds.

We agree with IRS' decision. Although some taxpayers who filed legitimate returns may find their refunds delayed by about a week as a result of IRS' decision, we believe most taxpayers will understand this effort to prevent fraud.

## IRS Is Issuing Refunds Before It Has a Complete Electronic Return

Another consequence of the delay in obtaining and processing the paper documents associated with electronic returns is that IRS often issues a refund before it has matched the electronic return information with the taxpayer's signature document. According to IRS' legal counsel, such refunds should not be issued because IRS does not have a complete tax return without a signature document. Without a signature document, according to IRS' counsel, IRS not only does not have a complete and timely filed return but also has no authority to make a direct deposit or disclose to an electronic return originator and/or transmitter whether a request for direct deposit will be honored.

IRS' counsel also pointed out that by accepting the electronic portion as a complete return, IRS is treating taxpayers who file electronically differently from those who file paper returns. If a taxpayer files a paper return without a signature, IRS sends the return back to the taxpayer for a signature and will not process it further until the taxpayer returns it. In this regard, IRS' Internal Audit reported in 1991 that

"In cases involving unsigned paper returns, the courts have held that the Service is bound by the consequences of accepting unsigned returns. For example, the Service cannot extend assessment and collection statutes because the taxpayer never signed the return, if the IRS accepted and processed the return as if it were complete."

Internal Audit also pointed out that

"Not having a signature document on file for each electronic return affects various aspects of Service compliance activities:

district director said that "it is our firm conviction that 'detected' returns greatly understate the true number of false claims made against the government." He went on to say that "Our investigative experience for multiple filer investigations tells us that between five (5) and ten (10) fictitious returns are successfully filed and refunded to perpetrators for every one return detected and stopped."

Another problem IRS faces is stopping a fraudulent refund, once detected, from being issued. Table 1.1 shows that IRS stopped a higher percentage of fraudulent refunds from being issued during the first 7 months of 1992 than it did during 1991. For 1992, IRS increased the number of fraud detection personnel by 50 staff years at the 5 service centers processing electronic returns and revised procedures to allow 2 additional days in which to stop fraudulent direct deposit refunds before they were issued. Despite the improvement, however, the dollar amount of IRS-identified fraudulent refunds that were not stopped before issuance increased from $6.3 million for the first 7 months of 1991 to $8.5 million for a comparable period in 1992.

## Detection Teams Lacked Adequate Staff in 1991 to Handle Questionable Returns

IRS studies in December 1990 and in May 1991 concluded that staffing shortfalls among service center detection teams provided the potential for significant abuse of the tax system. The studies recommended that IRS provide sufficient staffing to the centers that process electronic returns to better ensure that they are able to review, identify, and investigate questionable refunds.

In 1991, detection team staffing at the three centers totaled about 38 staff years—ranging from 9 staff years in Andover to about 17 staff years in Ogden. In addition to the electronic filing workload, the teams were also expected to investigate questionable paper returns. At the Andover Service Center, for example, detection teams reviewed 306,000 questionable returns in 1991, of which 81,000 were electronic. The 1991 staffing levels were about the same as in 1990, despite an 8-percent increase in the number of paper and electronically filed individual income tax returns received at these three centers through mid-June of each year.

IRS added 50 staff years in 1992 to the five service centers processing electronic returns (including 32 staff years at the three centers that processed electronic returns in 1991) to investigate questionable paper and electronic returns. IRS plans to reassess the staffing situation to determine whether additional increases are needed for 1993.

Although additional staffing may prove necessary in 1993, we believe that other actions discussed in this chapter could enable IRS to more effectively use existing staff. Better screening criteria, for example, could result in limiting the number of returns identified as questionable and thus reduce the workload facing detection teams. Also, as discussed next, existing staff might be more effective if they were given more time to investigate and stop questionable refunds.

## Delays in Receiving and Processing Paper Documents Hamper Detection of Fraudulent Refunds

Electronic filing preparers/transmitters are required to send various paper documents to IRS following IRS' acceptance of the electronically transmitted information. These documents include relevant W-2 forms and a signature document (Form 8453). IRS requires that preparers/transmitters mail these documents to IRS within 1 working day after IRS accepts the electronic return for processing. Upon receipt of the paper documents, service centers are required to match them with the electronic information to form a complete return. However, this matching often does not occur until after IRS issues a refund because IRS has decided not to delay refund issuance until the paper documents can be processed and matched.

According to IRS, financial institutions will not issue a refund anticipation loan without the direct deposit indicator. IRS believes that financial institutions are issuing refund anticipation loans based on the direct deposit indicator rather than an assessment of business risk. Thus, there is little or no incentive for the financial institution to question the veracity of the return and the identity of the filer.

In an effort to completely disassociate itself from refund anticipation loans, IRS has announced plans, beginning with the 1994 filing season, to discontinue issuing the direct deposit indicator. IRS hopes that financial institutions will be more careful in approving refund anticipation loans and thus make it more difficult for persons to reap financial gains from fraudulent electronic filings.

## Objective, Scope, and Methodology

Our objective was to assess IRS' techniques for preventing and stopping fraudulent refunds for electronically filed tax returns.

We did our work at IRS' National Office in Washington, D.C.; the three service centers involved in receiving and processing electronic returns during 1991 (Andover, Cincinnati, and Ogden)[3] and 8 of IRS' 63 district offices. The eight district offices—Atlanta; Cincinnati; Columbia, South Carolina; Indianapolis; Las Vegas; Philadelphia; Pittsburgh; and San Francisco—are located in four of IRS' seven regions and included districts that had high, medium, and low electronic filing participation rates during the 1991 tax filing season.[4]

We interviewed electronic filing, collection, examination, and criminal investigation staff at the offices mentioned to determine (1) how electronic filing applications are processed and how fraud detection activities operate; (2) the type and extent of problems encountered in preventing, detecting, and stopping fraudulent refunds; and (3) IRS' plans to remedy these problems. We also interviewed a Department of Justice legal counsel to determine Justice's involvement in prosecuting refund schemes. In addition, we

- reviewed guidance for screening applications to participate in the electronic filing program and the procedures for detecting questionable refunds;

[3]The Memphis and Austin service centers began processing electronic returns in 1992.

[4]A district's electronic filing participation rate is computed by dividing the number of returns filed electronically in the district by the total number of individual income tax returns filed in the district.

withheld taxes claimed, a taxpayer's name, or a taxpayer's social security number. Staff from the Cincinnati and Ogden Service Centers said that programming problems kept them from using the extraction feature during the first several months of the 1992 filing season. As a result, they could not select returns that had the same characteristics as fraudulent returns identified early in the filing season.

The staff also expressed dissatisfaction with the usefulness of the extraction feature once it became available. Cincinnati detection staff said, for example, that the extraction criteria were limited to certain information on the electronic record, which prevented them from selecting returns according to such factors as an employer's name or address and whether a taxpayer claimed childcare credits. When their own extraction criteria could not be used, they relied on computer experts from the Internal Audit staff to write new programs—a process that delayed their response time to new refund schemes. We believe the adaptability of IRS' computer screening would improve if fraud detection teams had the flexibility to select returns using any portion of, or combination of, the electronic record.

Finally, improved computer methods of detecting fraud should become available as IRS implements its Tax Systems Modernization Program—a multibillion dollar effort to upgrade IRS' computer systems that IRS expects to complete by the end of this decade. One such method would be to obtain wage information from employers in time to electronically match it with wage information on electronic tax returns. The matching could occur either before accepting the return for processing or while processing the return. Currently, employer wage information other than that provided by taxpayers is not available to IRS until after it processes taxpayers' returns because of the time it takes to verify the information and correct any errors. Under the Electronic Management System—one of many planned components of the modernization effort—IRS expects to electronically receive tax returns, tax information documents, and correspondence. Electronic transmissions of information documents, including wage documents, would enable IRS to more quickly verify and correct the information, thus offering the possibility of having that information available in time to match it with data reported on electronic returns.

# IRS Can Improve Its Screening of Electronic Filing Applicants

One way IRS attempts to prevent the filing of fraudulent electronic returns is to prevent unscrupulous persons from gaining entry into the program as preparers or transmitters. To accomplish this, IRS screens the suitability of applicants wanting to participate in the program. In response to several internal studies highlighting weaknesses in the suitability process, IRS has revised its screening procedures over the last several years.

Because the procedures in place in 1991 did not adequately protect against the entry of unscrupulous persons, IRS made improvements for 1992. However, those changes have not corrected all the flaws in the screening process. IRS staff responsible for screening applicants and judging their suitability (1) are not authorized to check national criminal history records of the applicants, (2) lack information about problems that occur after an applicant's acceptance into the program, (3) may accept applicants who habitually fail to pay their taxes, and (4) make decisions that are not subject to review.

## IRS' Process for Checking the Suitability of Electronic Filing Applicants

Because refunds from electronic returns are issued faster than refunds from paper returns, IRS is more vulnerable to fraud. Partly for this reason, IRS believes that preparers and transmitters participating in the electronic filing program should adhere to the highest professional and ethical standards and should maintain a high degree of integrity. Accordingly, IRS requires anyone wishing to prepare and/or transmit electronic returns to file an application and pass a suitability check.

Electronic filing coordinators in each of IRS' 63 districts—with the assistance of district staff in the Collection, Examination, and Criminal Investigation Divisions—are responsible for deciding whether to accept an applicant into the electronic filing program. Collection and Examination Division staff are to check an applicant's tax record for such items as a failure to file timely and accurate tax returns, a failure to pay personal and business tax liabilities, and assessments of penalties under the Internal Revenue Code. Criminal Investigation staff are responsible for checking whether an applicant has been convicted of (1) a criminal offense under revenue laws of the United States; (2) an offense involving dishonesty or breach of trust; or (3) any monetarily related offense such as money laundering, embezzlement, or stock fraud. A check is also to be made to determine whether the applicant has been disbarred or suspended from practice before IRS.

amount of fraudulent refunds IRS was unable to stop before issuance increased by 35 percent—from $6.3 million to $8.5 million. This increase is troubling because once a refund is issued there is no certainty that it will ever be recovered. Our assessment of IRS' detection procedures identified several factors that contribute to this situation.

## Service Centers Need More Effective Computer Screening Criteria to Identify Fraudulent Returns

One of the first things a service center does after it accepts electronic returns for processing is to identify returns that appear questionable. For example, a questionable return might be one that claims an inordinate amount of withheld taxes relative to the taxpayer's wage income. Service centers use computerized screening criteria established by the National Office as one method of identifying questionable returns.

The screening criteria, which IRS originally developed to identify questionable returns filed on paper, did not work well with electronic returns during 1991. Service center detection team members said that the screening criteria selected more returns than the teams had time to review, forcing them to ignore most of the selections and rely on other sources of questionable returns. For example, of 420,453 questionable electronic returns identified by the screening criteria at the Andover Service Center during 1991, the detection team only had time to review 59,130. Moreover, the criteria did not seem to do a good job of identifying fraudulent returns. The detection team reviews yielded one refund scheme involving one return.

Working in cooperation with IRS' Internal Audit staff, the Ogden Service Center developed its own computer screening criteria for electronic returns during 1991. The additional criteria were adopted by the Andover and Cincinnati centers in February 1991 and were used in addition to the national criteria. According to IRS detection team officials, the Ogden criteria were an improvement over the national criteria. An Andover Service Center official said that in 1991 the Ogden criteria screened out fewer returns for review than the National Office criteria (the exact number could not be provided). During 1991, the Ogden criteria led to the identification of an additional 16 refund schemes involving 119 returns at the Andover Service Center.

Although the Ogden criteria were an improvement, the centers still needed to rely on other sources to identify most of the refund schemes. For example, the Ogden Service Center analyzed its bases for identifying 199 electronic refund schemes in 1991 and found that about 22 percent had

$430,000 in fraudulent tax refunds by altering earned income records and W-2 forms to support false tax information he transmitted electronically to IRS. Our visits to eight district offices and issues raised by IRS internal studies that have not yet been addressed by IRS suggest that further improvements in the suitability screening process are possible.

## IRS Staff Cannot Access Criminal History Records

IRS procedures call for its staff to reject electronic filing applicants who have a history that includes (1) criminal convictions involving tax law violations; (2) any offenses involving dishonesty or breach of trust; or (3) any monetarily related offenses, such as money laundering, embezzlement, or stock fraud. IRS district Criminal Investigation staff are generally responsible for checking an applicant's criminal record.

District office Criminal Investigation staff have several sources of criminal information at their disposal. These sources include local information on tax-related investigations and national information on open and closed tax-related investigations through IRS' Criminal Investigation Management Information System. Staff can also access national information on tax-related investigations through the Department of the Treasury's Enforcement Communication System. In addition, the Treasury system interfaces with other criminal investigation databases, such as the National Crime Information Center, which is a national database maintained by the Federal Bureau of Investigation that contains information on various types of federal, state, and local crime convictions.

In November 1989, the Acting Assistant Commissioner for Criminal Investigation advised field office staff to stop using criminal history records at the National Crime Information Center for suitability checks until it could be determined whether accessing these records was permissible. In February 1992, IRS' Assistant Chief Counsel for Criminal Tax told the Assistant Commissioner for Criminal Investigation that IRS staff could not use Crime Center records to do suitability checks. The Assistant Chief Counsel explained that, as agreed with the Federal Bureau of Investigation, Crime Center records are only to be used for criminal investigations and not for administrative purposes such as the background checks made during suitability screening. To change the agreement, he stated, would require a congressional exemption or the unanimous consent of all federal, state, and local signatories of the agreement—options that in his opinion appeared unlikely.

The complete text of IRS' comments is in appendix I.

## Past Participants With Problems Not Always Subject to Timely Suitability Checks

Once a preparer/transmitter is accepted into the electronic filing program, IRS does not do another suitability check unless the participant is referred to the district office electronic filing coordinator by other district office staff as potentially meeting rejection criteria or is selected as part of a random sample of active participants. During our visits to district offices, none had procedures to refer electronic program participants to the coordinator, and staff told us they had no method to identify electronic program participants.

IRS' procedures for follow-up suitability checks allow participants to continue in the program until they are selected for another suitability check even if, after being accepted into the program, they fail to file their tax returns or fail to pay their taxes. Because information on IRS' master file accounts does not include the fact that an individual or business is an electronic filing participant, IRS cannot "flag" participants who, after acceptance into the program, had problems that might adversely affect their suitability. If IRS flagged participants with problems, it could check them along with new applicants or those pulled as part of the random sample.

An IRS task force raised a similar concern in its May 1991 report. The task force recommended that electronic filing participants be identified on IRS' master file and on the Integrated Data Retrieval System—two sources of account information for IRS staff—and that district office electronic filing coordinators be made aware of information that could affect a participant's continued participation. Although officials responsible for the electronic filing program agreed with this recommendation, it was not implemented for the 1992 filing season.

## Screening Procedures Allow Acceptance of Habitual Delinquent Payers

In an effort to promote more consistent decisions by electronic filing coordinators, IRS issued procedures for 1992 that allow conditional acceptance of applicants who owe taxes exceeding the prescribed tolerance amount. The procedures allow full acceptance into the program if applicants resolve their delinquencies within a fixed time period. These procedures formalized the way some offices were already operating.

The new procedures, if properly implemented, should improve the consistency of coordinators' decisions and provide fair treatment of applicants who may have had a one-time problem. They do not, however, take into account participants who habitually fail to pay their taxes on time. Even if such participants were identified and screened every year, as

For example, electronic filing coordinators in district offices do not have all the information they need to make an informed decision about whether to accept a preparer or transmitter into the program. In particular, they cannot access National Crime Information Center records to determine whether an applicant has a criminal record, and, by relying on samples and referrals, they do not have a comprehensive method of finding out about tax problems that occur after an applicant has been accepted. In addition, (1) IRS procedures allow for the conditional acceptance of applicants who habitually fail to pay their taxes on time and (2) IRS has no procedures directed at assessing the appropriateness of coordinators' decisions to approve applications.

While we acknowledge that it may not be cost effective to implement an elaborate system of controls in an attempt to prevent every possible instance of fraud, we believe that reasonable steps can be taken to address these issues and thus reduce IRS' vulnerability.

## Recommendations to the Commissioner of Internal Revenue

To help prevent the filing of fraudulent electronic tax returns, we recommend that the Commissioner take the following actions:

- Seek approval to allow Criminal Investigation staff access to National Crime Information Center data for the purpose of checking the background of electronic filing applicants. Until that approval is obtained, district offices should use the National Law Enforcement Telecommunications System to check criminal records maintained by state and local law enforcement authorities.
- Identify electronic filing preparers/transmitters on IRS computer files so that past year electronic filing participants who did not pay taxes or file returns or who otherwise failed to meet electronic filing requirements can be included in the annual suitability screening process.
- Establish rejection standards for applicants who habitually fail to pay their taxes or file their returns on time.
- Establish a procedure to review electronic filing coordinators' suitability decisions.

## Agency Comments and Our Evaluation

In an October 27, 1992, letter commenting on a draft of this report, the Commissioner of Internal Revenue agreed that Criminal Investigation should have access to National Crime Information Center data to check the background of electronic filing applicants. She said that IRS, in conjunction with the Department of the Treasury and the Office of

For example, electronic filing coordinators in district offices do not have all the information they need to make an informed decision about whether to accept a preparer or transmitter into the program. In particular, they cannot access National Crime Information Center records to determine whether an applicant has a criminal record, and, by relying on samples and referrals, they do not have a comprehensive method of finding out about tax problems that occur after an applicant has been accepted. In addition, (1) IRS procedures allow for the conditional acceptance of applicants who habitually fail to pay their taxes on time and (2) IRS has no procedures directed at assessing the appropriateness of coordinators' decisions to approve applications.

While we acknowledge that it may not be cost effective to implement an elaborate system of controls in an attempt to prevent every possible instance of fraud, we believe that reasonable steps can be taken to address these issues and thus reduce IRS' vulnerability.

## Recommendations to the Commissioner of Internal Revenue

To help prevent the filing of fraudulent electronic tax returns, we recommend that the Commissioner take the following actions:

- Seek approval to allow Criminal Investigation staff access to National Crime Information Center data for the purpose of checking the background of electronic filing applicants. Until that approval is obtained, district offices should use the National Law Enforcement Telecommunications System to check criminal records maintained by state and local law enforcement authorities.
- Identify electronic filing preparers/transmitters on IRS computer files so that past year electronic filing participants who did not pay taxes or file returns or who otherwise failed to meet electronic filing requirements can be included in the annual suitability screening process.
- Establish rejection standards for applicants who habitually fail to pay their taxes or file their returns on time.
- Establish a procedure to review electronic filing coordinators' suitability decisions.

## Agency Comments and Our Evaluation

In an October 27, 1992, letter commenting on a draft of this report, the Commissioner of Internal Revenue agreed that Criminal Investigation should have access to National Crime Information Center data to check the background of electronic filing applicants. She said that IRS, in conjunction with the Department of the Treasury and the Office of

## Past Participants With Problems Not Always Subject to Timely Suitability Checks

Once a preparer/transmitter is accepted into the electronic filing program, IRS does not do another suitability check unless the participant is referred to the district office electronic filing coordinator by other district office staff as potentially meeting rejection criteria or is selected as part of a random sample of active participants. During our visits to district offices, none had procedures to refer electronic program participants to the coordinator, and staff told us they had no method to identify electronic program participants.

IRS' procedures for follow-up suitability checks allow participants to continue in the program until they are selected for another suitability check even if, after being accepted into the program, they fail to file their tax returns or fail to pay their taxes. Because information on IRS' master file accounts does not include the fact that an individual or business is an electronic filing participant, IRS cannot "flag" participants who, after acceptance into the program, had problems that might adversely affect their suitability. If IRS flagged participants with problems, it could check them along with new applicants or those pulled as part of the random sample.

An IRS task force raised a similar concern in its May 1991 report. The task force recommended that electronic filing participants be identified on IRS' master file and on the Integrated Data Retrieval System—two sources of account information for IRS staff—and that district office electronic filing coordinators be made aware of information that could affect a participant's continued participation. Although officials responsible for the electronic filing program agreed with this recommendation, it was not implemented for the 1992 filing season.

## Screening Procedures Allow Acceptance of Habitual Delinquent Payers

In an effort to promote more consistent decisions by electronic filing coordinators, IRS issued procedures for 1992 that allow conditional acceptance of applicants who owe taxes exceeding the prescribed tolerance amount. The procedures allow full acceptance into the program if applicants resolve their delinquencies within a fixed time period. These procedures formalized the way some offices were already operating.

The new procedures, if properly implemented, should improve the consistency of coordinators' decisions and provide fair treatment of applicants who may have had a one-time problem. They do not, however, take into account participants who habitually fail to pay their taxes on time. Even if such participants were identified and screened every year, as

The complete text of IRS' comments is in appendix I.

$430,000 in fraudulent tax refunds by altering earned income records and W-2 forms to support false tax information he transmitted electronically to IRS. Our visits to eight district offices and issues raised by IRS internal studies that have not yet been addressed by IRS suggest that further improvements in the suitability screening process are possible.

## IRS Staff Cannot Access Criminal History Records

IRS procedures call for its staff to reject electronic filing applicants who have a history that includes (1) criminal convictions involving tax law violations; (2) any offenses involving dishonesty or breach of trust; or (3) any monetarily related offenses, such as money laundering, embezzlement, or stock fraud. IRS district Criminal Investigation staff are generally responsible for checking an applicant's criminal record.

District office Criminal Investigation staff have several sources of criminal information at their disposal. These sources include local information on tax-related investigations and national information on open and closed tax-related investigations through IRS' Criminal Investigation Management Information System. Staff can also access national information on tax-related investigations through the Department of the Treasury's Enforcement Communication System. In addition, the Treasury system interfaces with other criminal investigation databases, such as the National Crime Information Center, which is a national database maintained by the Federal Bureau of Investigation that contains information on various types of federal, state, and local crime convictions.

In November 1989, the Acting Assistant Commissioner for Criminal Investigation advised field office staff to stop using criminal history records at the National Crime Information Center for suitability checks until it could be determined whether accessing these records was permissible. In February 1992, IRS' Assistant Chief Counsel for Criminal Tax told the Assistant Commissioner for Criminal Investigation that IRS staff could not use Crime Center records to do suitability checks. The Assistant Chief Counsel explained that, as agreed with the Federal Bureau of Investigation, Crime Center records are only to be used for criminal investigations and not for administrative purposes such as the background checks made during suitability screening. To change the agreement, he stated, would require a congressional exemption or the unanimous consent of all federal, state, and local signatories of the agreement—options that in his opinion appeared unlikely.

amount of fraudulent refunds IRS was unable to stop before issuance increased by 35 percent—from $6.3 million to $8.5 million. This increase is troubling because once a refund is issued there is no certainty that it will ever be recovered. Our assessment of IRS' detection procedures identified several factors that contribute to this situation.

## Service Centers Need More Effective Computer Screening Criteria to Identify Fraudulent Returns

One of the first things a service center does after it accepts electronic returns for processing is to identify returns that appear questionable. For example, a questionable return might be one that claims an inordinate amount of withheld taxes relative to the taxpayer's wage income. Service centers use computerized screening criteria established by the National Office as one method of identifying questionable returns.

The screening criteria, which IRS originally developed to identify questionable returns filed on paper, did not work well with electronic returns during 1991. Service center detection team members said that the screening criteria selected more returns than the teams had time to review, forcing them to ignore most of the selections and rely on other sources of questionable returns. For example, of 420,453 questionable electronic returns identified by the screening criteria at the Andover Service Center during 1991, the detection team only had time to review 59,130. Moreover, the criteria did not seem to do a good job of identifying fraudulent returns. The detection team reviews yielded one refund scheme involving one return.

Working in cooperation with IRS' Internal Audit staff, the Ogden Service Center developed its own computer screening criteria for electronic returns during 1991. The additional criteria were adopted by the Andover and Cincinnati centers in February 1991 and were used in addition to the national criteria. According to IRS detection team officials, the Ogden criteria were an improvement over the national criteria. An Andover Service Center official said that in 1991 the Ogden criteria screened out fewer returns for review than the National Office criteria (the exact number could not be provided). During 1991, the Ogden criteria led to the identification of an additional 16 refund schemes involving 119 returns at the Andover Service Center.

Although the Ogden criteria were an improvement, the centers still needed to rely on other sources to identify most of the refund schemes. For example, the Ogden Service Center analyzed its bases for identifying 199 electronic refund schemes in 1991 and found that about 22 percent had

# IRS Can Improve Its Screening of Electronic Filing Applicants

One way IRS attempts to prevent the filing of fraudulent electronic returns is to prevent unscrupulous persons from gaining entry into the program as preparers or transmitters. To accomplish this, IRS screens the suitability of applicants wanting to participate in the program. In response to several internal studies highlighting weaknesses in the suitability process, IRS has revised its screening procedures over the last several years.

Because the procedures in place in 1991 did not adequately protect against the entry of unscrupulous persons, IRS made improvements for 1992. However, those changes have not corrected all the flaws in the screening process. IRS staff responsible for screening applicants and judging their suitability (1) are not authorized to check national criminal history records of the applicants, (2) lack information about problems that occur after an applicant's acceptance into the program, (3) may accept applicants who habitually fail to pay their taxes, and (4) make decisions that are not subject to review.

## IRS' Process for Checking the Suitability of Electronic Filing Applicants

Because refunds from electronic returns are issued faster than refunds from paper returns, IRS is more vulnerable to fraud. Partly for this reason, IRS believes that preparers and transmitters participating in the electronic filing program should adhere to the highest professional and ethical standards and should maintain a high degree of integrity. Accordingly, IRS requires anyone wishing to prepare and/or transmit electronic returns to file an application and pass a suitability check.

Electronic filing coordinators in each of IRS' 63 districts—with the assistance of district staff in the Collection, Examination, and Criminal Investigation Divisions—are responsible for deciding whether to accept an applicant into the electronic filing program. Collection and Examination Division staff are to check an applicant's tax record for such items as a failure to file timely and accurate tax returns, a failure to pay personal and business tax liabilities, and assessments of penalties under the Internal Revenue Code. Criminal Investigation staff are responsible for checking whether an applicant has been convicted of (1) a criminal offense under revenue laws of the United States; (2) an offense involving dishonesty or breach of trust; or (3) any monetarily related offense such as money laundering, embezzlement, or stock fraud. A check is also to be made to determine whether the applicant has been disbarred or suspended from practice before IRS.

withheld taxes claimed, a taxpayer's name, or a taxpayer's social security number. Staff from the Cincinnati and Ogden Service Centers said that programming problems kept them from using the extraction feature during the first several months of the 1992 filing season. As a result, they could not select returns that had the same characteristics as fraudulent returns identified early in the filing season.

The staff also expressed dissatisfaction with the usefulness of the extraction feature once it became available. Cincinnati detection staff said, for example, that the extraction criteria were limited to certain information on the electronic record, which prevented them from selecting returns according to such factors as an employer's name or address and whether a taxpayer claimed childcare credits. When their own extraction criteria could not be used, they relied on computer experts from the Internal Audit staff to write new programs—a process that delayed their response time to new refund schemes. We believe the adaptability of IRS' computer screening would improve if fraud detection teams had the flexibility to select returns using any portion of, or combination of, the electronic record.

Finally, improved computer methods of detecting fraud should become available as IRS implements its Tax Systems Modernization Program—a multibillion dollar effort to upgrade IRS' computer systems that IRS expects to complete by the end of this decade. One such method would be to obtain wage information from employers in time to electronically match it with wage information on electronic tax returns. The matching could occur either before accepting the return for processing or while processing the return. Currently, employer wage information other than that provided by taxpayers is not available to IRS until after it processes taxpayers' returns because of the time it takes to verify the information and correct any errors. Under the Electronic Management System—one of many planned components of the modernization effort—IRS expects to electronically receive tax returns, tax information documents, and correspondence. Electronic transmissions of information documents, including wage documents, would enable IRS to more quickly verify and correct the information, thus offering the possibility of having that information available in time to match it with data reported on electronic returns.

According to IRS, financial institutions will not issue a refund anticipation loan without the direct deposit indicator. IRS believes that financial institutions are issuing refund anticipation loans based on the direct deposit indicator rather than an assessment of business risk. Thus, there is little or no incentive for the financial institution to question the veracity of the return and the identity of the filer.

In an effort to completely disassociate itself from refund anticipation loans, IRS has announced plans, beginning with the 1994 filing season, to discontinue issuing the direct deposit indicator. IRS hopes that financial institutions will be more careful in approving refund anticipation loans and thus make it more difficult for persons to reap financial gains from fraudulent electronic filings.

## Objective, Scope, and Methodology

Our objective was to assess IRS' techniques for preventing and stopping fraudulent refunds for electronically filed tax returns.

We did our work at IRS' National Office in Washington, D.C.; the three service centers involved in receiving and processing electronic returns during 1991 (Andover, Cincinnati, and Ogden)[3] and 8 of IRS' 63 district offices. The eight district offices—Atlanta; Cincinnati; Columbia, South Carolina; Indianapolis; Las Vegas; Philadelphia; Pittsburgh; and San Francisco—are located in four of IRS' seven regions and included districts that had high, medium, and low electronic filing participation rates during the 1991 tax filing season.[4]

We interviewed electronic filing, collection, examination, and criminal investigation staff at the offices mentioned to determine (1) how electronic filing applications are processed and how fraud detection activities operate; (2) the type and extent of problems encountered in preventing, detecting, and stopping fraudulent refunds; and (3) IRS' plans to remedy these problems. We also interviewed a Department of Justice legal counsel to determine Justice's involvement in prosecuting refund schemes. In addition, we

- reviewed guidance for screening applications to participate in the electronic filing program and the procedures for detecting questionable refunds;

[3]The Memphis and Austin service centers began processing electronic returns in 1992.

[4]A district's electronic filing participation rate is computed by dividing the number of returns filed electronically in the district by the total number of individual income tax returns filed in the district.

## Detection Teams Lacked Adequate Staff in 1991 to Handle Questionable Returns

IRS studies in December 1990 and in May 1991 concluded that staffing shortfalls among service center detection teams provided the potential for significant abuse of the tax system. The studies recommended that IRS provide sufficient staffing to the centers that process electronic returns to better ensure that they are able to review, identify, and investigate questionable refunds.

In 1991, detection team staffing at the three centers totaled about 38 staff years—ranging from 9 staff years in Andover to about 17 staff years in Ogden. In addition to the electronic filing workload, the teams were also expected to investigate questionable paper returns. At the Andover Service Center, for example, detection teams reviewed 306,000 questionable returns in 1991, of which 81,000 were electronic. The 1991 staffing levels were about the same as in 1990, despite an 8-percent increase in the number of paper and electronically filed individual income tax returns received at these three centers through mid-June of each year.

IRS added 50 staff years in 1992 to the five service centers processing electronic returns (including 32 staff years at the three centers that processed electronic returns in 1991) to investigate questionable paper and electronic returns. IRS plans to reassess the staffing situation to determine whether additional increases are needed for 1993.

Although additional staffing may prove necessary in 1993, we believe that other actions discussed in this chapter could enable IRS to more effectively use existing staff. Better screening criteria, for example, could result in limiting the number of returns identified as questionable and thus reduce the workload facing detection teams. Also, as discussed next, existing staff might be more effective if they were given more time to investigate and stop questionable refunds.

## Delays in Receiving and Processing Paper Documents Hamper Detection of Fraudulent Refunds

Electronic filing preparers/transmitters are required to send various paper documents to IRS following IRS' acceptance of the electronically transmitted information. These documents include relevant W-2 forms and a signature document (Form 8453). IRS requires that preparers/transmitters mail these documents to IRS within 1 working day after IRS accepts the electronic return for processing. Upon receipt of the paper documents, service centers are required to match them with the electronic information to form a complete return. However, this matching often does not occur until after IRS issues a refund because IRS has decided not to delay refund issuance until the paper documents can be processed and matched.

district director said that "it is our firm conviction that 'detected' returns greatly understate the true number of false claims made against the government." He went on to say that "Our investigative experience for multiple filer investigations tells us that between five (5) and ten (10) fictitious returns are successfully filed and refunded to perpetrators for every one return detected and stopped."

Another problem IRS faces is stopping a fraudulent refund, once detected, from being issued. Table 1.1 shows that IRS stopped a higher percentage of fraudulent refunds from being issued during the first 7 months of 1992 than it did during 1991. For 1992, IRS increased the number of fraud detection personnel by 50 staff years at the 5 service centers processing electronic returns and revised procedures to allow 2 additional days in which to stop fraudulent direct deposit refunds before they were issued. Despite the improvement, however, the dollar amount of IRS-identified fraudulent refunds that were not stopped before issuance increased from $6.3 million for the first 7 months of 1991 to $8.5 million for a comparable period in 1992.

To improve fraud detection, IRS needs to speed the referral of questionable wage documents to fraud detection teams, find better ways to detect fraud, or slow the processing of electronic returns until the wage information "catches up." Beginning in 1993, IRS plans to suspend for about 1 week the processing of questionable returns from taxpayers who elect direct deposit of refunds—the refunds that IRS has the least time to review. IRS' intent is to provide fraud detection staff with additional time to review questionable returns and stop the issuance of fraudulent refunds.

We agree with IRS' decision. Although some taxpayers who filed legitimate returns may find their refunds delayed by about a week as a result of IRS' decision, we believe most taxpayers will understand this effort to prevent fraud.

## IRS Is Issuing Refunds Before It Has a Complete Electronic Return

Another consequence of the delay in obtaining and processing the paper documents associated with electronic returns is that IRS often issues a refund before it has matched the electronic return information with the taxpayer's signature document. According to IRS' legal counsel, such refunds should not be issued because IRS does not have a complete tax return without a signature document. Without a signature document, according to IRS' counsel, IRS not only does not have a complete and timely filed return but also has no authority to make a direct deposit or disclose to an electronic return originator and/or transmitter whether a request for direct deposit will be honored.

IRS' counsel also pointed out that by accepting the electronic portion as a complete return, IRS is treating taxpayers who file electronically differently from those who file paper returns. If a taxpayer files a paper return without a signature, IRS sends the return back to the taxpayer for a signature and will not process it further until the taxpayer returns it. In this regard, IRS' Internal Audit reported in 1991 that

"In cases involving unsigned paper returns, the courts have held that the Service is bound by the consequences of accepting unsigned returns. For example, the Service cannot extend assessment and collection statutes because the taxpayer never signed the return, if the IRS accepted and processed the return as if it were complete."

Internal Audit also pointed out that

"Not having a signature document on file for each electronic return affects various aspects of Service compliance activities:

Electronic filing offers advantages to taxpayers and IRS. One appealing advantage to taxpayers is that they can receive their refunds quicker than when filing a paper return. IRS data show that taxpayers who filed paper returns received their refunds in about 5 weeks. In 1991 (the latest data available from IRS), taxpayers who filed electronically received their refunds in about 3 weeks. In addition, electronic filers can opt to have their refunds deposited directly into their bank accounts, which enables them to get their refunds even faster—in about 2 weeks. Some preparers also arrange for electronic filers to obtain commercial loans, called refund anticipation loans, which enable taxpayers, for a fee, to get their money still faster—in about 3 days. The loan is paid to the taxpayer, and the refund goes to the financial institution for repayment of the loan. About 74 percent of electronic returns filed in 1992 involved refund anticipation loans.

Electronic returns have fewer errors than paper returns. Electronic returns are more accurate because (1) computer checks catch errors before the return is filed and (2) computer processing of electronic returns eliminates errors associated with the manual processing of paper returns. During the 1992 filing season, according to IRS data, the error rate for electronic returns was 2.8 percent compared to 18 percent for paper returns.

Electronic returns are less costly to store than paper returns. IRS has in its files and at federal record centers over 1.2 billion tax returns stored in over 1 million cubic feet of space. If those returns had been filed electronically, they could be stored on about 200 12-inch optical disk platters. The Office of Management and Budget has also estimated, on the basis of information provided by IRS, that each electronic return costs IRS about $1.62 less to process (in 1993 dollars) than a paper return.

While it was developed as an alternative to paper tax returns, electronic filing does not completely eliminate paper documents. In addition to the electronically transmitted information, preparers/transmitters must send IRS various paper documents such as Form W-2, which shows the taxpayer's wages and withheld taxes, and Form 8453, which contains the taxpayer's and preparer's signatures, selected income and tax information from the electronic return, and information needed to deposit a refund directly into a taxpayer's account at a financial institution. IRS processes the paper documents through the same system as paper income tax returns. Processing of the paper portion of the return generally takes about 2 weeks. IRS is required to match electronic return information and adoption of a procedure to suspend the processing of electronic returns filed by first-time filers to allow further investigation before any refund is issued. We also believe that IRS should require, as recommended by one of its internal study groups, that preparers/transmitters obtain and retain suitable identification from electronic filers.

IRS must also contend with the issue of sending out refunds before it has a complete tax return. IRS' legal counsel has said that a return is not complete and a refund should not be issued until IRS has matched the electronic information with the paper signature document that preparers/transmitters are required to forward to IRS. Legislation that would have allowed IRS to test alternatives to written signatures was included in the proposed Revenue Act of 1992 that was vetoed. We believe that the use of alternatives, such as electronic signatures, is important, not just to better ensure that IRS has a complete return before issuing a refund, but also to help reduce the amount of paper involved in electronic filing.

## Recommendations to the Commissioner of Internal Revenue

We recommend that the Commissioner take the following actions:

- Follow through on plans to develop improved computer checks for identifying questionable electronic returns in time for the 1993 filing season. These checks should be based on analyses of the perpetrators of electronic filing schemes and not restrict service center fraud detection teams from adapting the checks as fraud schemes are identified during the filing season. As it modernizes its computer systems, IRS should also consider electronically matching employer wage information with electronic return data as a means of validating information on electronic returns.
- Classify electronic returns from first-time filers as questionable returns for further investigation and delay processing those returns until the validity of the filer can be established.
- Require that preparers/transmitters obtain at least two pieces of identification from electronic filers before transmitting their returns and retain the pieces of identification with taxpayers' records. One piece of identification should be a picture identification.
- Until electronic filing paper documents are no longer required, (1) follow established procedures for warning and suspending preparers/transmitters who do not submit timely paper documents and (2) discontinue issuing refunds until the associated electronic return can be matched with a corresponding taxpayer signature document.

possible. But written signatures are legal requirements for all tax returns and should not be ignored in order to reap the benefit of the rapid refunds available from electronic filing. As long as a written signature document is required, we believe that IRS needs to ensure that this requirement is met. In that regard, we agree with IRS' own risk analysis, which concluded that refunds should not be issued until the signature document is processed and that "the lack of controls in this area and the treatment of these forms as insignificant for [the] sake of the expediency of processing the refunds quickly puts the Electronic Filing Program and the certifying officials at major risk for issuing refunds without a completed tax return." As electronic filing becomes even more popular and the number of returns filed electronically grows, we would expect that risk to escalate.

As IRS indicated in its comments, the ultimate solution to this problem rests in having authority to accept an alternative to the written signature, such as an electronic signature. It is unclear, however, if and when IRS will be authorized to use electronic signatures and how long it will take to test and fully implement such an alternative once authorized. In the meantime, there may be steps IRS can take to speed the processing of signature documents and other paper. It might be possible, for example, to have all electronic filing paperwork mailed to a separate address from other mail coming into the service center to reduce the time presently needed to identify the paperwork and associate it with an electronic submission.

The complete text of IRS' comments is included in appendix I.

identify the paperwork and associate it with the related electronic submission. (See pp. 36-37.)

-2-

non-filers or have other tax problems which could preclude their participation as electronic filing transmitters. These procedures will be effective for tax year 1992.

<u>Recommendation:</u>

Establish rejection standards for applicants who habitually fail either: (i) to pay their taxes; or (ii) to file their returns on time.

<u>Comment:</u>

The standards for rejection of applicants are included in the District Office Electronic Filing Coordinator's Handbook, Internal Revenue Manual 12(14)0. These standards include failure to file timely and accurate returns, as well as failure to pay tax liabilities, both business and personal. These procedures will be reviewed with field offices and appropriate service centers to emphasize the importance of taking into consideration applicants' complete tax histories when deciding to accept or reject them from the program. It should also be noted that the Automated Suitability Analysis Program reviews the complete filing history of all participants and applicants. Such review allows district management to reject applicants who habitually fail to comply with the tax laws.

<u>Recommendation:</u>

Establish a procedure for district office quality review staff to review electronic filing coordinator's suitability decisions.

<u>Comment:</u>

We agree there should be greater review of the electronic filing coordinators' suitability decisions. The procedures for the upcoming year will be enhanced by requiring the Regional Office Electronic Filing Coordinator to review the district "acceptance" decisions.

<u>Recommendation:</u>

Follow through on plans to develop improved computer checks for identifying questionable electronic returns in time for the 1993 filing season. These checks should be based on analyses of the perpetrators of electronic filing schemes and not restrict service center fraud detection teams from adapting the checks as fraud schemes are identified during the filing season. As it modernizes its computer systems, IRS should also consider electronic matching of employer time-consuming methods of identifying questionable returns. (See pp. 27-28.)

GAO believes that IRS can improve its screening criteria. IRS could build profiles of fraud perpetrators into the screening criteria and could give fraud detection teams more flexibility to adjust the criteria in response to newly discovered schemes. IRS could also develop the capability to electronically match wage information provided by employers with wage information claimed on electronic returns. That should become more feasible as IRS progresses with its computer modernization. (See pp. 28-29.)

IRS statistics indicated that many persons who filed fraudulent electronic returns were first-time filers who employed such techniques as the use of false names and social security numbers. For example, of a sample of 1,066 filers of fraudulent returns at one service center in 1991, 34 percent had no previous filing history. In November 1991, an IRS quality improvement team recommended that IRS make first-time filers ineligible to file electronically and that preparers and transmitters be required to verify the identity of their electronic filing clients by asking for two pieces of identification. As an alternative to making first-time filers ineligible, IRS could screen out returns from first-time filers and check them before issuing the refund. Such a procedure might delay the issuance of some refunds, but it would still allow first-time filers to file electronically. (See p. 30.)

IRS requires that preparers/transmitters mail supporting paper documents to IRS within 1 working day after IRS accepts an electronic return for processing. Those documents include one that contains the taxpayer's signature and any relevant wage documents (Forms W-2). Fraud detection teams consider the wage documents a good source for identifying refund fraud. For example, the team at one service center identified about one-third of its 1991 electronic refund schemes through this method. But detection teams are often unable to review the paper documents before the related refunds are issued. This is partly because of the speed with which electronic refunds are issued and partly because preparers do not submit the paper documents on time. In 1991, IRS rarely followed its procedures for suspending preparers/transmitters who did not submit paper documents. (See pp. 31-33.)

Another consequence of the delay in obtaining and processing paper documents is that IRS usually issued a refund before it matched the wage information with electronic return data as a means of validating information on electronic returns.

Comment:

We agree with this recommendation. Refinement of computer applications has been an ongoing process over the past few years based upon the changing patterns of fraudulent filings. Criminal Investigation has developed on-line extraction parameters to identify filing schemes. For example, based on experience with fraudulent refund claims in prior years, we have identified characteristics or combinations of characteristics that we now use to identify refund returns that should be given greater scrutiny. This year we are implementing recommendations from a Quality Improvement Team to delay refunds on returns that score high on questionable characteristics to give Criminal Investigation more time to examine the returns. Other program modifications permit us to reject, for further research or contact, returns with social security numbers and names that do not match. These program modifications will be implemented in January 1993.

We are working with the Social Security Administration to find ways to expedite wage withholding information that could be used to match against amounts claimed on returns. However, this is a long-term solution that cannot be achieved within the next few years. In the meantime, we are looking at other ways to utilize computer analysis to reject returns from preparers/transmitters who show a consistent pattern of adjustments on their customers' returns. These and other proposals for up-front detection of erroneous or fraudulent returns are being considered for implementation once our computer systems are modernized.

Recommendation:

Classify electronic returns from first-time filers as questionable returns for further investigation and delay processing those returns until the validity of the filer can be established.

Comment:

We agree with this recommendation. Implementation is scheduled for the 1993 processing year. The fraudulent use of social security numbers by first-time filers has historically proven to be a major contributor to questionable refund schemes.

Recommendation:

Require that preparers/transmitters (i) obtain at least two pieces of identification from electronic filers issuance increased from 25 for all of 1991 to 71 for the first 7 months of 1992. That is still lower than the 96-percent stoppage rate for paper returns during the first 7 months of 1992. And, for the first 7 months of 1992 compared to the same period in 1991, the dollar amount of fraudulent electronic refunds that IRS identified but was unable to stop before issuance increased by 35 percent—from $6.3 million in 1991 to $8.5 million in 1992.

GAO recognizes that it may be unreasonable to attempt to devise a system of controls to prevent all electronic filing fraud or to identify and stop all fraudulent refunds before they are issued. GAO believes, however, that additional controls can be reasonably implemented to further reduce IRS' vulnerability. These controls generally involve (1) providing IRS staff with information for making a more informed decision about whether to accept a preparer or transmitter into the program and (2) providing fraud detection teams at IRS service centers with better techniques to identify and investigate questionable returns and stop the issuance of fraudulent refunds.

# Principal Findings

## IRS Can Improve Its Screening of Electronic Filing Applicants

To file electronically, taxpayers go to a person or firm that has been authorized by IRS to prepare and/or transmit electronic returns. To become authorized, a person or firm must apply to IRS and pass a suitability check. Among other things, IRS checks to see if applicants have failed to file returns or pay taxes or have been convicted of offenses such as embezzlement or stock fraud. In response to internal studies, IRS tightened its suitability screening in 1992. For example, it required that firms wishing to participate in the program identify on their applications all corporate officers and partners with at least a 5-percent interest in the business. (See pp. 17 and 18.)

District office staff responsible for suitability checks do not have access to the National Crime Information Center database maintained by the Federal Bureau of Investigation. This national database has information on federal, state, and local crime convictions. Because IRS has identified cases of electronic refund fraud by preparers or transmitters who had criminal records, the information in this database would probably be useful in making a suitability decision. However, an interagency memorandum of

-5-

permit us to address the concerns raised by GAO. Having authority to accept an alternative to the written signature will allow us to match signatures with the return instantly.

GAO United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-248989

December 30, 1992

The Honorable Lloyd Bentsen
Chairman, Committee on Finance
United States Senate

Dear Mr. Chairman:

In response to your request, this report discusses steps the Internal Revenue Service can take to improve its controls over electronic filing fraud.

As arranged with the Committee, we plan no further distribution of this report until 7 days from the date of issuance. At that time, we will send copies to other congressional committees; the Secretary of the Treasury; the Commissioner of Internal Revenue; the Director, Office of Management and Budget; and other interested parties.

The major contributors to this report are listed in appendix II. Please contact me on (202) 272-7904 if you or your staff have any questions concerning the report.

Sincerely yours,

Jennie S. Stathis

for Hazel E. Edwards
Associate Director, Tax Policy
and Administration Issues

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Report to the Chairman, Committee on Finance, U.S. Senate

December 1992

# TAX ADMINISTRATION

# IRS Can Improve Controls Over Electronic Filing Fraud

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