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TAX ADMINISTRATION

Electronic Filing Fraud

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ELECTRONIC FILING FRAUD

SUMMARY STATEMENT OF
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In 1993, IRS received about 115 million individual income tax returns. Of those, about 12 million were filed electronically--13 percent more than in 1992. By comparison, IRS identified 25,633 fraudulent electronic returns during the first 10 months of 1993 compared to 12,488 for the same period in 1992 --a 105 percent increase.

Electronic filing fraud is a problem whose true dimensions are unknown. The number of identified fraudulent electronic returns is relatively small, but the rate of growth is high and it is uncertain how much fraud might be going undetected. In the past, IRS has often appeared more interested in expanding electronic filing than in ensuring that it fully understood and adequately addressed the associated risks. As a result, IRS has been in a reactive posture--adding controls every year in the hope of effectively dealing with a problem that it did not fully understand. With IRS planning to expand to 80 million electronic returns by 2001, IRS must thoroughly assess its controls and determine what is needed to adequately protect the government's revenues.

GAO has made several recommendations directed at improving IRS' controls over electronic filing fraud. The recommendations involved (1) changes to the electronic filing system that would help prevent fraudulent returns from being filed, (2) better detection of fraudulent returns that have been filed, and (3) improved screening and monitoring of persons and firms authorized to transmit returns electronically to IRS. Some of those recommendations have not yet been implemented.

In the longer term, IRS must ensure that fraud control needs, like various up-front matching capabilities, are fully identified and considered in planning its systems modernization program. It is also important that IRS learn from its electronic filing experience by building adequate controls into the design of future systems, like TeleFile (the system that allows certain taxpayers to file their returns over the telephone), and assuring that those controls are adequate before nationwide implementation.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to participate in the Subcommittee's inquiry into refund fraud. Our statement focuses on electronic filing fraud, an area on which we have previously reported.¹

Electronic filing fraud, while an important issue today, will become even more critical as IRS moves toward its goal of 80 million electronic returns by 2001. We wholeheartedly support the need to convert IRS from a paper environment to a more modern electronic one. But the conversion must be accompanied by adequate controls against fraud. In the past, IRS has often appeared more interested in expanding electronic filing than in ensuring that it fully understood and adequately addressed the associated risks. As a result, IRS has been in a reactive posture--adding controls every year in the hope of effectively dealing with a problem that it did not fully understand.

Thus far, the number of electronic returns identified as fraudulent is relatively small. The high rate of growth in that number is of concern, however, because it could reflect an increase in fraudulent activity rather than the result of

¹Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992) and Tax Administration: Increased Fraud and Poor Taxpayer Access to IRS Cloud 1993 Filing Season (GAO/GGD-94-65, Dec. 22, 1993).

increased IRS monitoring. More troubling is the uncertainty as to how much fraud might be going undetected.

In 1993, IRS received about 115 million individual income tax returns. About 12 million of the returns were filed electronically, or 13 percent more than in 1992. By comparison, IRS identified 105 percent more fraudulent electronic returns-- 25,633 during the first 10 months of 1993 compared to 12,488 for the same period in 1992. These 25,633 fraudulent returns claimed refunds of about \$53 million, of which IRS reported stopping about \$29 million before checks were mailed or funds were transferred to a bank account. However, a recent IRS internal audit report estimated that about \$3 million of the refunds IRS reported as stopped had actually been issued.

PREVENTING FRAUD THROUGH DESIGN CHANGES

The risk of electronic filing fraud could be reduced through changes in the system's design. The system is not fully electronic. Taxpayers can file tax data electronically but must still send in paper documents with their handwritten signatures. Those signatures have been of little value in helping control fraud because IRS does not delay issuing a refund until it receives the paper signature.

Electronic signatures would not only make electronic filing more efficient by eliminating paper but, if implemented correctly, could help control fraud--especially if IRS intends to eventually allow taxpayers to file electronically from their own computers. IRS has prepared a legislative proposal that would allow it to use alternatives to paper signatures. A similar proposal was included in H.R. 11, which was passed by Congress in 1992 but was vetoed for reasons unrelated to the proposal. The proposal has not yet been resubmitted.

The one aspect of electronic filing that most attracts taxpayers is the speed with which they can get their refunds. That speed makes it difficult for IRS to effectively identify and stop questionable refunds once an electronic return has been filed. One way to deal with that problem is to prevent questionable returns from being filed.

Toward that end, IRS, in the last couple of years, has implemented some controls at the front of the electronic filing process. Before accepting an electronic transmission, for example, IRS first verifies that the taxpayer's name and Social Security number on the electronic transmission matches information in IRS' records. If there is a mismatch, IRS will not accept the filing. In 1993, this computer check resulted in IRS rejecting about 240,000 electronic returns. IRS does not know, however, how many of those returns involved attempted fraud

or how many were the result of honest errors by taxpayers or preparers in recording or transcribing names and/or Social Security numbers.

More up-front checks are needed. In that regard, we recommended in 1992 that IRS work toward electronically matching employer wage information with electronic return data.² That kind of match is currently beyond IRS' capabilities. Currently, employer wage information other than that provided by taxpayers is not available to IRS until after it has processed taxpayers' returns. This is 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 IRS' multibillion dollar systems modernization effort--IRS expects to electronically receive tax returns, tax information documents (like W-2s), and correspondence.

Electronic transmission of W-2s would enable IRS to more quickly verify and correct the information, thus offering the possibility of having that information available to match with data being reported on electronic returns.

²GAO/GGD-93-27.

BETTER DETECTING FRAUDULENT RETURNS

Once an electronic return is filed, IRS' primary means of detecting fraud involves manual reviews of electronic return data by analysts in IRS' service centers. After accepting an electronic return, IRS uses computerized screening criteria to identify questionable returns for possible review by an analyst. As we reported in December 1992, problems with those criteria resulted in more returns being identified as questionable than service center staff could review.

Even after IRS revised the criteria, as we reported in December 1993 to this Subcommittee, the computer screening/manual review process was still labor intensive and inefficient.³ We noted, for example, that of the approximately 3 million potentially fraudulent returns IRS reviewed in 1993, less than 1 percent were determined to be fraudulent.

Because IRS data showed that many fraudulent electronic returns had been filed by first-time filers (persons who had no filing history that IRS could check names and Social Security numbers against), we recommended in 1992 that IRS revise its computer screening criteria to specifically identify electronic returns from first-time filers as questionable returns for further investigation. IRS has since done that and has implemented

³GAO/GGD-94-65.

procedures to give itself more time to assess the credibility of a first-time filer's return before releasing the refund.

As of April 23, 1993, IRS had identified about 157,000 returns submitted by first-time filers. IRS' Internal Audit recently reported, however, that 44 percent of those returns were mistakenly identified because IRS' computer program did not check to see if the person had filed in prior years as a secondary taxpayer on a joint return. As a result, those taxpayers had their refunds delayed unnecessarily.

BETTER SCREENING AND MONITORING OF PREPARERS
AND TRANSMITTERS OF ELECTRONIC RETURNS

To file electronically, taxpayers can have an IRS-approved practitioner prepare and submit the return or they can take a return that they have prepared to an individual or business that IRS has approved as a transmitter. Because some preparers and transmitters have been involved in schemes involving fraudulent electronic returns, we recommended in 1992 that IRS do more to check the backgrounds of these persons when they apply to participate in the electronic filing program.

One step we recommended was that IRS obtain access to the National Crime Information Center database. That national database, maintained by the Federal Bureau of Investigation (FBI), contains information on various types of federal, state,

and local crime convictions. In a December 1993 memorandum to the Assistant Commissioner for Criminal Investigation, IRS' Assistant Chief Counsel for Criminal Tax noted, after consulting with the FBI, that use of this database for suitability checks would require either an executive order or legislation. We understand that Criminal Investigation will be asking Chief Counsel to draft proposed legislation.

Because we believe that the many honest providers of electronic filing services also have a responsibility to help protect against fraud, we recommended that IRS require return preparers and transmitters to obtain and retain copies of two forms of identification, one with a photo, from persons wanting to file electronically. At the time of our report, IRS said that it would revise its procedures to include such a requirement for the 1994 filing season. IRS has since decided not to require but only recommend that two forms of identification be obtained. IRS concluded that it would not have resources to effectively monitor compliance with such a requirement. We believe that IRS should impose this requirement even if it is only able to monitor the activities of a small number of preparers and transmitters. IRS should also consider whether an increase in monitoring resources is warranted as a step toward improving fraud control.

CONCLUSIONS

Electronic filing fraud is a problem that requires urgent IRS attention, and IRS has a number of ongoing efforts. We continue to believe that our open recommendations, which are listed in the appendix, have merit and should be implemented as part of those efforts.

In the longer term, it is critical that IRS thoroughly assess its controls and determine what is needed to adequately protect the government's revenues. With a goal of 80 million electronic returns by 2001, IRS must ensure that fraud control needs, like various up-front matching capabilities, are fully identified and considered in planning its systems modernization program. It is also important that IRS learn from its electronic filing experience by building adequate controls into the design of future systems, like TeleFile (which allows certain taxpayers to file their returns over the telephone), and assuring that those controls are adequate before nationwide implementation.

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That concludes my statement. We welcome any questions you may have.

STATUS OF GAO RECOMMENDATIONS

In our report entitled Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992), we made several recommendations. A list of the recommendations and our understanding of IRS' status in implementing them follows.

RECOMMENDATION 1

IRS should 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.

Status (Open)

In a December 1993 memorandum to the Assistant Commissioner for Criminal Investigation, IRS' Assistant Chief Counsel for Criminal Tax noted, after consulting with the FBI, that use of this database for suitability checks would require either an executive order or legislation. We understand that Criminal Investigation will be asking Chief Counsel to draft proposed legislation. In May 1993, in response to the second part of our recommendation, the Assistant Commissioner for Criminal Investigation sent a memo to all regions telling them that each district office "should determine with their respective states if the information [in the National Law Enforcement Telecommunications System] can be used for the suitability checks." We do not know how many district offices, if any, have contacted the states and/or gotten access to that system.

RECOMMENDATION 2

IRS should 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.

Status (Implemented)

Our recommendation anticipated that IRS would identify electronic filing preparers/transmitters on its Master File so that those who become delinquent in their tax responsibilities after being accepted into the electronic filing program can be automatically identified for follow up. Instead, according to IRS, it is

achieving the same end by bumping a separate file of preparers/transmitters against the Master File. What happens to those preparers/transmitters identified by such matching depends on the type and severity of the problem. IRS' actions appear responsive to our recommendation; we have done no audit work to verify it.

RECOMMENDATION 3

IRS should establish rejection standards for preparers and transmitters applying to participate in the electronic filing program who habitually fail to pay their taxes or file their returns on time.

Status (Open)

IRS said that it has standards and will review them with field office staff and emphasize their importance. We are not convinced that the standards of which IRS speaks meet the intent of our recommendation.

RECOMMENDATION 4

IRS should establish a procedure to review electronic filing coordinators' suitability decisions.

Status (Open)

According to IRS, regional electronic filing coordinators are reviewing district office electronic filing coordinators' decisions. However, IRS is still developing a specific procedure spelling out just what is to be covered in those reviews. Although having regional coordinators review district office coordinators' decisions is an improvement over the condition that existed at the time of our review, we believe that it would be more appropriate to have the reviews done by persons not involved in promoting the electronic filing program so as to avoid conflicts of interest. That is why we had suggested that the reviews be done by district office quality review staff.

RECOMMENDATION 5

IRS should 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.

Status (Partially Implemented)

IRS modified the computer checks used in 1993 and planned further changes for 1994, including enabling service center teams to adapt those checks to meet local conditions. It also plans to eventually use artificial intelligence. In the longer term, IRS said it is working with the Social Security Administration to find ways to expedite wage withholding information to match against amounts claimed on tax returns.

RECOMMENDATION 6

IRS should 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.

Status (Implemented)

In 1993, IRS implemented special procedures for electronic returns filed by first-time filers that, in effect, provided investigative staff with more time to assess the validity of the filer and/or the return. IRS has implemented additional procedures for 1994 that will preclude first-time filers from getting a direct deposit (and thus a Refund Anticipation Loan). This will give IRS more time to assess the return's validity before issuing the refund.

RECOMMENDATION 7

IRS should 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.

Status (Open)

Because it was too late to do anything differently for 1993, IRS only recommended that two pieces of identification be obtained that year. IRS said that it would require this in 1994. IRS has since changed its mind, we are told, because it would not have had resources available to monitor compliance with such a requirement.

RECOMMENDATION 8

Until electronic filing paper documents are no longer required, IRS should (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.

Status (Partially Implemented)

According to IRS officials in Washington and the field, IRS has been sending out warning notices and suspending some preparers/transmitters. We were told that a notice went out in October 1993 to all preparers/transmitters who had not submitted required documentation for 5 percent or more of the electronic returns they submitted telling them that they are being suspended from the program. Staff at one service center told us that the center has since suspended about 60 preparers and transmitters.

IRS did not agree with the second part of our recommendation, saying it would defeat the purpose of electronic filing.

We also had a recommendation in our December 22, 1993, report to the Oversight Subcommittee (Tax Administration: Increased Fraud and Poor Taxpayer Access to IRS Cloud 1993 Filing Season) that was directed at further enhancing IRS' computer screening criteria.

RECOMMENDATION 9

IRS' Criminal Investigation Division should (1) analyze the fraud cases IRS identified from information provided by banks that provide Refund Anticipation Loans (RALs) to see if those cases involve unique features that should be included in IRS' computer screening criteria and (2) determine which RAL banks were used for fraudulent refunds to see if special attention should be given to banks that do not use the Fraud Service Bureau.

Status (Open)

IRS agreed with our recommendation but has not yet begun these analyses.

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RELATED GAO PRODUCTS

Internal Revenue Service: Opportunities to Reduce Taxpayer Burden Through Return-Free Filing (GAO/GGD-92-88BR, May 8, 1992).

Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992).

Tax Administration: Opportunities to Increase the Use of Electronic Filing (GAO/GGD-93-40, Jan. 22, 1993).

Tax Administration: IRS' Test of Tax Return Filing by Telephone (GAO/GGD-93-91BR, Apr. 26, 1993).

Tax Administration: Increased Fraud and Poor Taxpayer Access to IRS Cloud 1993 Filing Season (GAO/GGD-94-65, Dec. 22, 1993).

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