

**MSP
#20****FRAUD DETECTION: The IRS Has Made Improvements to Its Fraud Detection Systems, But a Significant Number of Legitimate Taxpayers Are Still Being Improperly Selected by These Systems, Resulting in Refund Delays****RESPONSIBLE OFFICIALS**

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TAXPAYER RIGHTS IMPACTED¹

- *The Right to Quality Service*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Privacy*
- *The Right to a Fair and Just Tax System*

DEFINITION OF PROBLEM

The IRS uses a series of complex screening processes to detect and prevent tax refund fraud.² When a return is flagged by the IRS's fraud detection system that scrutinizes returns for characteristics of refund fraud, the refund is held until the information on the return can be verified.³ Although the IRS fraud detection system identifies illegitimate returns and prevents improper refunds from being issued, it also remains highly inaccurate, which results in unnecessary refund delays and negatively impacts taxpayers' voluntary compliance.

The National Taxpayer Advocate recognizes the need to detect and prevent refunds resulting from fraud or identity theft from being issued. However, TAS remains concerned about taxpayers whose legitimate refunds have been unreasonably delayed by the IRS. The IRS Return Review Program (RRP), the system used to detect fraud, selected 90,410 returns between January 1, 2017 and September 30, 2017, a decrease of about 25 percent from 120,884 returns selected during the same time period in 2016.⁴ This may be explained in part by the availability of third-party reporting information (Forms W-2 and Forms 1099-MISC-Nonemployee Compensation) before or on January 31; thus, providing the IRS more time to match the wage and tax information reported on the taxpayer's return against the information

1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

2 The IRS Return Integrity & Compliance Services (RICS) uses the Return Review Program (RRP) to identify returns when it suspects that the return is fraudulent.

3 The IRS has distinct screening processes for identity theft and refund fraud. For purposes of this report, we will refer to refund fraud including certain instances that have elements of identity theft but are processed in the refund fraud units. See Most Serious Problem: *Identity Theft: As Tax-Related Identity Theft Schemes Evolve, the IRS Must Continually Assess and Modify Its Victim Assistance Procedures*, *supra* MSP 19.

4 IRS response to TAS's information request (Oct. 19, 2017).

Despite the decline in the number of returns selected, the false positive rate went up from 54 percent for January 1, 2016 through September 30, 2016, to 66 percent for the same time period for 2017.

submitted by third parties.⁵ Despite the decline in the number of returns selected, the false positive rate (FPR) went up from 54 percent for January 1, 2016 through September 30, 2016, to 66 percent for the same time period for 2017.⁶

Over the past 14 years, the National Taxpayer Advocate has consistently advocated for taxpayers whose legitimate refunds have been unreasonably delayed by the IRS, and recommended improvements to reduce taxpayer burden while preventing refund fraud.⁷ Despite some improvements to the IRS's fraud detection system, the following issues remain:

- Many legitimate returns are improperly selected as possibly fraudulent because fraud detection filters are too broad, lack exactness, and are not adjusted during filing season despite the functionality to do so. The IRS has worked with other agencies to establish best practices for preventing and detecting fraud, but could benefit from broadening the types of partners it collaborates with.
- Improperly selected returns caused tens of thousands of refunds to be delayed for up to 11 weeks. TAS Research and Analysis analyzed tax year 2016 cases from the 2017 filing season, the latest data available. The analysis shows the IRS's pre-refund Income Wage Verification (IWV) Program selected approximately 65,700 tax returns where taxpayers ultimately received their refunds, but the refunds of more than 37 percent, or approximately 24,400 taxpayers, were delayed 11 weeks or beyond.⁸
- Since 2014, about 24,000 refunds were held where refund fraud was suspected and a notice of disallowance was sent to the taxpayer.⁹ These refunds were held for months — and in some

⁵ IRS response to TAS information request (Oct. 19, 2017). Section 201 of the Protecting Americans From Tax Hikes (PATH) Act of 2015 amended IRC § 6071 to require that certain information returns be filed by January 31, generally the same date as the due date for employee and payee statements, and are no longer eligible for the extended filing date for electronically filed returns under IRC § 6071(b). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 201 (2015).

⁶ A false positive occurs when a system selects a legitimate return and delays the refund past the prescribed review period. IRS response to TAS information request (Oct. 19, 2017). The IRS commonly refers to this as a “false detection rate” (FDR); however, throughout this Most Serious Problem, we will be using the term “false positive rate” (FPR). IRS response to TAS fact check (Dec. 26, 2017).

⁷ See, e.g., National Taxpayer Advocate 2015 Annual Report to Congress, 45-55, 180-87; National Taxpayer Advocate 2014 Annual Report to Congress vol. 2, 44-90; National Taxpayer Advocate 2013 Annual Report to Congress 75-83; National Taxpayer Advocate 2012 Annual Report to Congress 42-67, 95-110; National Taxpayer Advocate 2011 Annual Report to Congress 48-73; National Taxpayer Advocate 2009 Annual Report to Congress 307-17; National Taxpayer Advocate 2008 Annual Report to Congress 79-94; National Taxpayer Advocate 2007 Annual Report to Congress 96-115; National Taxpayer Advocate 2005 Annual Report to Congress 25-54, 180-91; National Taxpayer Advocate 2004 Annual Report to Congress 133-36; and National Taxpayer Advocate 2003 Annual Report to Congress 175-81.

⁸ TAS Research and Analysis, IRS Compliance Data Warehouse (CDW), Individual Master File (IMF) Transaction History Table and Individual Returns Transaction File Table for tax module 2016. See also footnote 30, *infra*.

⁹ TAS Research and Analysis, IRS CDW, IMF Transaction History Table, Individual Returns Transaction File Table and Notice Delivery System Notice Table for Calendar Years (CYs) 2014-2017. See also footnote 31, *infra*.

cases, even years — before the notice of disallowance was issued to the taxpayer.¹⁰ On average, the notice of disallowance was sent to the taxpayer about 31 weeks after the refund was held by the IWV Program.¹¹ Further, since 2014, about 5,800 refunds have been held and no notice of disallowance has ever been issued to the taxpayer.¹²

- Legitimate taxpayers who get entangled in the IRS refund fraud filters are subjected to poor customer service. For example, when the taxpayer reaches an IRS employee to inquire about his or her refund, he or she will find the customer service representative (CSR) does not have access to the case history which is stored on the IRS's Electronic Fraud Detection System (EFDS), and therefore cannot give specific responses to taxpayer inquiries.¹³

ANALYSIS OF PROBLEM

Background

In an effort to combat refund fraud, the IRS uses pre-refund IWV to freeze a taxpayer's refund when it detects potentially false income or withholding. The Return Integrity & Compliance Services (RICS) Integrity & Verification Operation (IVO) — a part of the Wage and Investment (W&I) Division — uses data mining models and manual reviews to identify potentially false returns, usually through income documents reported by third parties.¹⁴ The system that is primarily used for detecting possible refund fraud is the RRP.¹⁵

The IRS's EFDS was previously used to detect possible refund fraud. However, for over a decade the IRS has been attempting to retire this system because of its limitations and it is now largely used as a case management system.¹⁶ The retirement of EFDS for detecting possible refund fraud and the implementation of RRP has allowed the IRS to modernize its fraud detection program by enhancing its ability to create custom inquiries and modify models, which should improve stability if all the capabilities of the RRP system are properly used.

The IRS has taken other steps to improve its fraud detection and prevention, including:

- establishing the Security Summit to collaborate with other government agencies and the private sector to identify the best techniques to detect, prevent, and anticipate identity theft fraud activity; and
- comparing third-party documentation prior to releasing a refund, ensuring the information matches what is reported on the return.

10 The IRS uses different types of notices, some of which are required by statute, to tell taxpayers their claims are disallowed. If the IRS disallows any portion of a claim for refund or credit of an overpayment, IRC § 6532(a) requires it to mail to the taxpayer, by certified or registered mail, a notice of claim disallowance in order to commence the two-year statute of limitations on filing suit to challenge the disallowance in a United States District Court or the Court of Federal Claims. For more information on notices of disallowance, see National Taxpayer Advocate 2014 Annual Report to Congress, 172-84 (Most Serious Problem: *Notices: Refund Disallowance Notices Do Not Provide Adequate Explanations*).

11 TAS Research and Analysis, IRS CDW, IMF Transaction History Table, Individual Returns Transaction File Table and Notice Delivery System Notice Table for CYs 2014-2017. See also footnote 31, *infra*.

12 *Id.*

13 Internal Revenue Manual (IRM) 21.5.6.4.35.3 (Oct. 1, 2015).

14 IRM 25.25.1.1(1), *Revenue Protection, Return Integrity and Verification Revenue Protection Programs, Overview* (Feb. 19, 2015); IRM 25.25.2.1(1), *Program Scope and Objectives* (Mar. 29, 2017).

15 IRM 25.25.2.1(1) (Mar. 29, 2017).

16 Wage and Investment (W&I), *Business Performance Review (BPR) 21* (May 11, 2017). Currently, the IRS's RRP program is the system used for detecting possible fraudulent returns.

TAS's inventory of IVO cases indicates that taxpayers come to TAS more often for pre-refund wage verification than for any other issue except identity theft. For Fiscal Year (FY) 2017, TAS closed 20,238 IVO cases and of those, 77 percent received full or partial relief.¹⁷

Despite Improvements to Its Fraud Detection System, the IRS's Processes for Revising Filters Do Not Sufficiently Minimize Harm to Legitimate Taxpayers

The IRS has accepted high FPRs of 50 percent or more, rather than leveraging the full capacity of its fraud detection system. In October 2016, the case selection functionality of EFDS was replaced by the RRP, which is a real-time application, and has the flexibility to allow the IRS to adjust filters virtually in real-time. Changes to the filters that do not require new code to be written can typically be implemented within 48 hours from the time the change was approved. Changes that require new code to be written typically take up to three weeks.¹⁸ Notably, the IRS did not make any fraud filter changes between January 1, 2017 and September 30, 2017.¹⁹

In contrast, fraud detection systems used by tax administration agencies in several states are nimble and are regularly adjusted. For example, the Iowa Department of Revenue (DOR) has developed a fraud detection system with filters and models that are adjusted spontaneously, even in the midst of the filing season.²⁰ The Maryland DOR introduced a new set of algorithms that proved successful in identifying 65 to 70 percent of fraudulent returns last year — a significant increase from the 55 percent success rate in 2015.²¹ The success was largely due to shifting from an algorithm that proved too far-reaching and overwhelmed fraud analysts to a more narrow and refined model that could better zero in on instances of fraud.²²

The IRS has accepted high false positive rates of 50 percent or more, rather than leveraging the full capacity of its fraud detection system.

The IRS Has Worked With Other Agencies to Establish Best Practices for Preventing and Detecting Refund Fraud, But Should Expand the Types of Agencies It Consults With

In recognition of escalating challenges related to identity (ID) theft refund fraud, the Commissioner of Internal Revenue convened a Security Summit meeting in Washington, D.C. on March 19, 2015. IRS officials and state tax administrators came together with the chief executive officers of the leading tax preparation firms, software developers, and payroll and tax financial product processors, to discuss common challenges and ways to leverage collective resources and efforts.

17 Data obtained from Taxpayer Advocate Management System (TAMIS) (Oct. 1, 2017).

18 IRS response to TAS information request (May 23, 2017).

19 IRS response to TAS information request (Oct. 19, 2017). The IRS does have an annual meeting prior to the upcoming filing season in which it reviews prior year filters and discusses possible modifications to the filters for the upcoming filing season.

20 Meeting between TAS, Joshua R. Beck, Senior Advisor to the Executive Director of Systemic Advocacy, and Iowa Department of Revenue, Courtney M. Kay-Decker, Director (Aug. 29, 2017).

21 Juliet Van Wagenen, *How States are Using Tech to Stop Tax Fraud*, STATETECH MAGAZINE (March 24, 2017), <https://statetechmagazine.com/article/2017/03/how-states-are-using-tech-spot-tax-fraud>.

22 *Id.*

Although the Security Summit is primarily focused on ID theft, it is concerned with reducing refund fraud generally. The National Taxpayer Advocate, along with the Electronic Tax Administration Advisory Committee (ETAAC), recommended that the Security Summit broaden the types of partners to include entities from:

- the financial sector;
- the banking sector;
- the commercial sector; and
- the consumer and privacy advocate sectors.²³

Expanding the Security Summit to include these partners will ensure it is aware of the most advanced tactics being used to detect and prevent ID theft and fraud in all sectors. Further, the Security Summit should consider amending its charter to reflect its interest in reducing all refund fraud and not just ID theft related refund fraud.

The IRS's Fraud Detection System Still Has a High False Positive Rate (FPR) and a Number of Legitimate Refunds Are Delayed for an Excessive Period of Time

The National Taxpayer Advocate is pleased that the IRS is now conducting monthly tracking of FPRs, and has decided to reverse its earlier position and set aspirational FPR goals for both its ID theft and refund fraud filters.²⁴ The IRS has set an FPR goal for its ID theft filters of 50 percent, but has not yet set any goals for its refund fraud filters, stating that it is waiting for a full year of data from its RRP

When and if the IRS does set goals for its non-ID theft filters, it should consider a more ambitious goal than the 50 percent false positive rate set for its identity theft filters.

23 See National Taxpayer Advocate 2016 Annual Report to Congress 151-60 (Most Serious Problem: *Fraud Detection: The IRS's Failure to Establish Goals to Reduce High False Positive Rates for Its Fraud Detection Programs Increases Taxpayer Burden and Compromises Taxpayer Rights*); Electronic Tax Administration Advisory Committee (ETAAC) 2017 Annual Report to Congress (June 2017), <https://www.irs.gov/pub/irs-pdf/p3415.pdf>. See also National Taxpayer Advocate Fiscal Year 2018 Objectives Report to Congress, vol. 2, 82. Security Summit's efforts were institutionalized through the auspices of the ETAAC in 2016 when an amendment to ETAAC's charter expanded its scope to include identity theft. On an ongoing basis, ETAAC engages with the Security Summit through the attendance and participation of its members in work group activities. Additionally, ETAAC members proactively engage with Security Summit work group co-leads to keep abreast of Security Summit initiatives and Identity Theft Tax Refund Fraud (IDTTRF) developments.

24 The National Taxpayer Advocate recommended establishing target false positive rates for each process and filter. National Taxpayer Advocate 2015 Annual Report to Congress 45-55. The IRS did not initially adopt this recommendation: "The establishment of precise target false detection rates per Fraud Model ("Non-Identity Theft Model") would be challenging to implement because specific FDR are typically not available until several months into the filing season." National Taxpayer Advocate Fiscal Year 2017 Objectives Report to Congress, vol. 2, 18, 20 (*IRS Responses and National Taxpayer Advocate's Comments Regarding Most Serious Problems Identified in the 2015 Annual Report to Congress*). However, the IRS reversed course in 2017: "The FDR goal for the 2017 processing year is 49% for the identity theft (IDT) filters. Due to a change from moving non-IDT filters from the Electronic Fraud Detection System (EFDS) to the Return Review Program (RRP), we are baselining the FDR for non-IDT for 2017." National Taxpayer Advocate Fiscal Year 2018 Objectives Report to Congress, vol. 2, 78-81 (*IRS Responses and National Taxpayer Advocate's Comments Regarding Most Serious Problems Identified in the 2015 Annual Report to Congress*).

system from which it will base its goal.²⁵ When and if the IRS does set goals for its non-ID theft filters, it should consider a more ambitious goal than the 50 percent FPR set for its ID theft filters.²⁶

As stated above, FPRs for fraud detection rose from 54 to 66 percent for the period from January 1, 2017 through September 30, 2017, compared to the same period in 2016.²⁷ This means that 66 percent or about 60,000 out of the 90,410 returns selected by the system were legitimate returns.²⁸ Despite the RRP selecting two thirds of its IWV inventory in error, the IRS RRP monthly report stated, “All Filters are operating as expected; No filter changes are recommended at this time.”²⁹

High FPRs result in many legitimate taxpayers having their refunds held unnecessarily. As noted earlier, TAS Research analyzed tax year 2016 returns from the 2017 filing season, the latest data available. Of the about 65,700 returns selected for IVO review in which taxpayers ultimately received their refunds, nearly 63 percent took ten or fewer weeks to process, but about 37 percent of these refunds were held 11 weeks or longer.³⁰ Prior to October 2015, the IRS was required to take action, such as manually freezing or releasing a refund, if it was to hold refunds beyond 11 weeks. However, after October 2015, the IRS changed its policy, holding all refunds indefinitely until a determination is made.

Despite the Return Review Program selecting two thirds of its Income Wage Verification inventory in error, the IRS Return Review Program monthly report stated, “All Filters are operating as expected; No filter changes are recommended at this time.”

The IRS Holds Refunds for Months Before Issuing a Notice of Disallowance, and in Some Cases, a Notice of Disallowance Has Never Been Issued

Since 2014 through September 30, 2017, the IRS held about 24,000 refunds for which a notice of disallowance was sent to the taxpayer on average 31 weeks after the return was selected by the IWV program (this is about 20 weeks beyond an 11-week time period in which the IRS previously had to

25 National Taxpayer Advocate Fiscal Year 2018 Objectives Report to Congress, vol. 2, 82.

26 *See Id.*

27 IRS response to TAS information request (Oct. 19, 2017).

28 *Id.*

29 IRS, Identify Theft (IDT) & Integrity & Verification Operation (IVO) Selections Performance Report, PowerPoint slide 5, (Sept. 6, 2017).

30 TAS Research and Analysis, IRS CDW IMF Transaction History Table and Individual Returns Transaction File Table for tax module 2016. The computation of these numbers is based on a population of IVO returns that were identified by having an initial IVO posting transaction code and action code and having a refund due. Then these returns were filtered to exclude any returns with reversed credit for withheld taxes, any returns with additional tax assessment or carryback allowance or carryback disallowance, any returns with overpayment interest transfer, and any returns with posted duplicate return or posted amended return, posted consolidated generated amended return, late reply, or Department of Labor referral.

Holding refunds for an extended period of time before sending a notice of disallowance, or holding the refund and never sending a notice of disallowance, resembles the practices under the highly criticized IRS Questionable Refund Program and raises significant taxpayer rights and due process concerns.

either release the refund or take action on the return).³¹ For about 5,800 refunds held during the same period the IRS has not yet issued a notice of disallowance.³² Holding refunds for an extended period of time before sending a notice of disallowance, or holding the refund and never sending a notice of disallowance, resembles the practices under the highly criticized IRS Questionable Refund Program (QRP) and raises significant taxpayer rights and due process concerns.³³ To avoid the problems experienced as a result of the QRP, it is essential that the IRS reinstate the 11-week limitation on holding refunds, which required the IRS to either release the refund after 11 weeks or take action on it.³⁴ This would properly observe the taxpayer's *right to finality* and the taxpayer's *right to challenge the IRS's position and be heard*.

Legitimate Taxpayers Who Get Entangled in the IRS Refund Fraud Filters Are Subjected to Poor Customer Service

Nearly sixty thousand taxpayers with legitimate returns who ultimately received their refunds were subjected to a frustrating and often elusive process when attempting to determine the cause of their refund delay.³⁵ If the IRS is scrutinizing the return for possible refund fraud, the taxpayer will be instructed to contact the IRS's general Accounts Management (AM) Customer Service line, which did not answer about one out of every four calls during FY 2017.³⁶

When taxpayers reach a CSR, he or she will find the CSR does not have access to the case history which is stored on the IRS's EFDS system, and therefore cannot give specific responses to taxpayer inquiries.³⁷ CSRs take down information and refer it to the IWV group in IVO. IVO, however, does not call back

31 TAS Research and Analysis, IRS CDW, IMF Transaction History Table, Individual Returns Transaction File Table and Notice Delivery System Notice Table for CYs 2014-2017. The computation of these numbers is based on a population of IVO returns that were identified by having an initial IVO posting transaction code and action code and having a refund due and a subsequent posting of transaction code and action code for identified to meet OMM criteria or identified to be potentially fraudulent or identified to need additional time to complete the review. These returns were filtered to exclude any returns receiving refunds, any returns with additional tax assessment or carryback allowance or carryback disallowance, and any returns with posted duplicate return or posted amended return, posted consolidated generated amended return, late reply, or Department of Labor referral. These filtered returns were matched to the notice file with disallowance letters and any unmatched returns were excluded. Weeks of delay measured from date of initial IVO posting transaction code and action code to date of disallowance letter.

32 TAS Research and Analysis, IRS CDW IMF Transaction History Table, Individual Returns Transaction File Table and Notice Delivery System Notice Table for CYs 2014-2017. See also footnote 31, *supra*.

33 National Taxpayer Advocate 2005 Annual Report to Congress 25-54.

34 IRM 25.25.11.2, *Wage/Withholding Only (WOW) (Notice CP05A) Overview* (Oct. 10, 2017). The IRS may send the taxpayer a notice requesting additional information regarding their withholdings. However, this notice is not necessarily sent within an 11-week time period from when the return was selected by the Income Wage Verification (IWV) Program, and does not provide any information regarding the taxpayer's right to file a refund suit in federal court.

35 IRS response to TAS information request (Oct. 19, 2017).

36 W&I, *BPR* (Nov. 9, 2017).

37 IRM 21.5.6.4.35.3 (Oct. 1, 2015).

or correspond with a taxpayer based on the referral from a CSR. If the information forwarded by the CSR is not verifiable, IVO will simply close out the referral on an Account Management Services (AMS) application, without contacting the taxpayer.³⁸ If a taxpayer tries to get information from the “Where’s My Refund” application, he or she will receive a generic message prompting a call to the IRS. As we previously recommended, the IRS should establish a direct line to reach IVO so that affected taxpayers can resolve refund issues with an employee knowledgeable of his or her return issues. This would decrease resolution time and save resources downstream since the taxpayer would not need to call the general AM line.

CONCLUSION

The National Taxpayer Advocate recognizes the need to detect and prevent refunds resulting from fraud from being issued, and acknowledges the important steps the IRS has taken to improve its fraud detection program. However, reducing fraud must be accomplished while respecting and protecting the taxpayer’s right to a *fair and just tax system*. This means the IRS is obligated to design and implement systems that impact as few legitimate taxpayers as possible and allow legitimate taxpayers to reach an IRS employee to resolve any discrepancies, thereby avoiding unnecessary and prolonged refund delays.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS:

1. Expand the Security Summit by including participants from the financial sector, the banking sector, the commercial sector, and consumer and privacy advocate sectors.
2. Revise the Security Summit’s charter to broaden its scope to include non-identity theft refund fraud.
3. Reinstate the 11-week process thereby requiring the IRS to either release the refund or to take some other action on the account, such as requesting additional information from the taxpayer or sending a notice of disallowance.
4. Establish a direct phone line to the IVO unit and provide information via “Where is my Refund” application to those taxpayers whose refunds are held because of suspected fraud.

³⁸ IVO does not correspond with a taxpayer based on a referral from a customer service representative (CSR). To the contrary, if it is just a refund status inquiry not associated with any verifiable information, IVO employees will just close out the referral on Account Management Services (AMS). IRM 25.25.5.2 (May 17, 2016); IRM 25.25.5.4 (Dec. 10, 2015); IRM 25.25.5.4.1 (May 17, 2016).