TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Actions Can Be Taken to Increase Detection of Frivolous Redemption Claims

June 20, 2017

Reference Number: 2017-40-040

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Redaction Legend:
2 = Law Enforcement Techniques/ Procedures and Guidelines for Law Enforcement Investigations or Prosecutions

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ACTIONS CAN BE TAKEN TO INCREASE DETECTION OF FRIVOLOUS REDEMPTION CLAIMS

Highlights

Final Report issued on June 20, 2017

Highlights of Reference Number: 2017-40-040 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

Individuals or businesses that oppose the Federal tax laws sometimes use frivolous tax arguments to enrich themselves or evade paying tax. One such argument is a frivolous redemption claim. A frivolous redemption claim involves the filing of a return reporting false income and claiming excessive false income tax withholding. Tax returns with a frivolous redemption claim report income and the taxpayer does not calculate any tax due or claims a refund of the excessive withholding.

WHY TIGTA DID THE AUDIT

This audit was initiated to evaluate the IRS's decision to discontinue the use of the Electronic Fraud Detection System predictive modeling filters to identify individual tax returns claiming potentially frivolous Original Issue Discount (redemption claim) arguments.

WHAT TIGTA FOUND

The IRS's identification processes and procedures are contributing to the reduction in confirmed frivolous redemption claims it identifies. TIGTA's analysis of 337,273 tax returns in which the taxpayer reported excessive withholding identified 58,248 returns that were not evaluated for referral to the Frivolous Return Program because the refund fell below the IRS's processing dollar tolerance.

In addition, the IRS expanded its procedures for identifying potentially frivolous amended returns as a result of an identified frivolous amended return scheme. This scheme resulted in the issuance of $43.4 million in refunds on 207 frivolous amended returns. However, the expanded procedures still rely on IRS employees to identify potentially frivolous claims, increasing the risk that a frivolous claim will be processed. When shown an example of an IRS confirmed frivolous amended return resulting from the identified scheme, two IRS employees responsible for processing amended returns indicated they would have processed the taxpayer's claim.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, Wage and Investment Division, ensure that the annual evaluation of the error identification processes criteria includes the identification and assessment of all original and amended tax returns, regardless of dollar tolerance, that have excessive withholding. The IRS should also continue to explore opportunities to develop systemic processes to identify potentially frivolous amended returns for additional review before refunds are paid.

IRS management agreed with both recommendations. The IRS plans to modify business rules relating to potentially frivolous issues to address those returns that would otherwise avoid selection and make them available for consideration in the annual filter performance review process. The IRS also plans to continue exploring opportunities to develop systemic processes to identify for pre-refund review amended returns that claim excessive withholding.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

June 20, 2017

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael E. McKenney
Deputy Assistant Inspector General for Audit

SUBJECT: Final Audit Report – Actions Can Be Taken to Increase Detection of Frivolous Redemption Claims (Audit # 201540022.01)

This report presents the results of our review to evaluate the Internal Revenue Service's (IRS) decision to discontinue the use of the Electronic Fraud Detection System predictive modeling filters to identify individual tax returns claiming potentially frivolous Original Issue Discount (redemption claim) arguments. This audit was included in our Fiscal Year 2016 discretionary audit coverage and addresses the major management challenge of Tax Compliance Initiatives.

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

Copies of this report are also being sent to the IRS managers affected by the report recommendations. If you have any questions, please contact me or Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services).

Table of Contents

Appendices

Abbreviations

EFDS	Electronic Fraud Detection System
e-file	Electronically File
FRP	Frivolous Return Program
IRS	Internal Revenue Service
IVO	Integrity and Verification Operation
TIGTA	Treasury Inspector General for Tax Administration

Background

Individuals or businesses that oppose the Federal tax laws sometimes use frivolous[1] tax arguments to enrich themselves or evade paying tax. Generally, a frivolous tax argument is based on a frivolous or incorrect interpretation of the Federal tax laws. Individuals and businesses use these incorrect interpretations to support their claims that they are not subject to Federal tax laws. For example, an individual may claim that he or she is not required to file a tax return or pay income tax because the Federal income tax system is voluntary. These arguments can also be used to obstruct the Internal Revenue Service (IRS) in carrying out the administration of Federal tax laws. Internal Revenue Bulletin Notice 2010-33, issued on April 26, 2010, lists the 50 frivolous tax arguments identified by the IRS to date.

One of these 50 tax arguments is the frivolous redemption claim. A frivolous redemption claim involves the filing of a return reporting false income (*e.g.*, "Other" or "Miscellaneous" income) and claiming excessive false income tax withholding. The IRS defines frivolous excessive withholding as withholding ****************2********** reported income. Individuals filing tax returns with a frivolous redemption claim report income and do not calculate any tax due or claim a refund of the excessive withholding. Some returns also have Form 1099-OID, *Original Issue Discount*;[2] Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*; or other false financial instruments included. However, recently, taxpayers have increasingly used other financial forms and information returns such as the Form 1099-MISC, *Miscellaneous Income*, to file frivolous redemption claims.

Identification of frivolous redemption claims

The IRS relies on employee manual review of paper-filed tax returns and correspondence as well as electronic filters to identify individual and business filings that may contain a frivolous argument. The employees who identify these types of tax returns or correspondence work in the IRS Receipt and Control, Data Transcription, Code and Edit, Accounts Management, Collection, and Examination functions. These employees are provided internal guidelines that detail how to identify and process returns with frivolous arguments. The internal guidelines also provide common examples of frivolous arguments. Identified potentially frivolous returns and correspondence are placed in receptacles called "funny boxes" for further review by campus[3] Frivolous Return Program (FRP) coordinators. Coordinators review the returns and

[1] Having no sound basis (as in fact or law); lacking in seriousness.
[2] Original Issue Discount is a form of interest. It is the excess of an obligation's stated redemption price at maturity over its issue price. Typically, taxpayers must include the amount of imputed Original Issue Discount in gross income for each year they hold the obligation.
[3] The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

correspondence and those identified as potentially frivolous are forwarded to the FRP in Ogden, Utah, for additional review. The FRP is responsible for determining if identified potentially frivolous returns meet frivolous return criteria.

Predictive modeling filters

In addition to employee reviews of tax returns and correspondence, the IRS had also developed complex electronic filters as part of its Electronic Fraud Detection System (EFDS)[4] to identify individual tax returns that claim a potentially frivolous redemption argument. Beginning with the 2012 Filing Season, the IRS began using the EFDS to identify these types of returns. The filters included in the EFDS consisted of more than 800 separate criteria that evaluate the risk that the tax return includes a frivolous redemption argument. All individual returns screened using these filters were given a risk score. All returns with a risk score above the IRS established cutoff score were required to be forwarded to the FRP for review to determine if they were in fact a frivolous claim. For example, the IRS reported that during Processing Year[5] 2014, a total of 197,527 individual tax returns were scored using the individual Original Issue Discount filters and 10,775 returns were sent to the FRP for further review. For returns confirmed as frivolous, the FRP is also responsible for contacting the taxpayer to obtain a valid return and assessing applicable penalties. Individuals who claim a frivolous tax argument are subject to a $5,000 penalty.

The IRS discontinued the use of the EFDS predictive modeling filters at the end of Calendar Year 2015. For the 2016 Filing Season, the IRS reverted back to using the computer software application it used prior to development of the EFDS models (see page 4). Beginning with the 2017 Filing Season, the IRS indicated that it will use the Return Review Program[6] to identify potentially frivolous tax arguments, including redemption claims.

Tax return processing checks and verifications

The IRS also uses normal tax return processing checks and verifications to systemically identify potentially frivolous redemption claims. For example, the IRS has developed error processes to identify at the time tax returns are processed tax returns with excessive withholding, which is the primary characteristic of a frivolous redemption claim. Identified returns are suspended and are either referred to the IRS Integrity and Verification Operation (IVO) or the FRP depending on the type of income reported on the return. For example, returns with income supported by a Form 1099-OID are referred to the FRP.

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[4] A fraud detection system used by the Wage and Investment Division, Integrity and Verification Operation, and the IRS Criminal Investigation to detect fraudulent refund claims.
[5] The calendar year in which the tax return or document is processed by the IRS.
[6] An automated system used to enhance the IRS's capabilities to detect, resolve, and prevent criminal and civil tax noncompliance and identity theft, thereby reducing issuance of fraudulent tax refunds.

A prior Treasury Inspector General for Tax Administration (TIGTA) report raised concerns with the effectiveness of processes and procedures for identifying potentially frivolous tax arguments

In August 2016, we reported that IRS processes and procedures do not ensure that all tax returns claiming a potentially frivolous tax argument are identified.[7] Specifically, the IRS's processes to evaluate the adequacy of these filters, including the EFDS predictive modeling filters, do not include an assessment of tax returns that fall below the IRS case selection tolerances. Our analysis of the IRS systemic frivolous return filters for individual and business tax returns identified 222,844 tax returns with characteristics of a frivolous return filing that were not identified for further review. The IRS confirmed that 1,938 of the 222,844 returns we identified were in fact frivolous. These taxpayers received refunds totaling $27.7 million. Of the 1,938 returns, 1,219 returns with refunds totaling $10.5 million were below the IRS's processing tolerances.

We also reported that although the IRS relies on its employees to identify 40 of the 50 identified frivolous tax arguments, the IRS has not ensured that its employees are adequately trained in applying those procedures. We recommended that the IRS ensure that the annual evaluation of the FRP filter criteria includes the identification and assessment of all original and amended tax returns, regardless of dollar tolerance, that meet the filter criteria. In addition, the IRS should ensure that all employees receive annual training on the processes for identifying potentially frivolous tax returns. IRS management agreed with all of TIGTA's recommendations.

This review was performed with information from the IRS Small Business/Self-Employed Division, Collection function; the Information Technology Division's Applications Development Data Delivery Services function; and the Wage and Investment Division, Return Integrity and Compliance Services and Submission Processing functions during the period May through November 2016. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

[7] TIGTA, Ref. No. 2016-40-069, *Actions Are Needed to Better Identify and Address Individuals Who File Tax Returns Using Frivolous Arguments* (Aug. 2016).

Results of Review

Predictive Modeling Filters Were Not Used for the 2016 Filing Season to Detect Potential Frivolous Redemption Claims

Prior to the 2012 Filing Season, the IRS used a computer software application to identify potentially frivolous redemption claims. The software application provided users with the ability to query and analyze datasets. These queries were based on business rules developed by FRP staff within the IRS and evaluated the risk that a tax return included a potentially frivolous redemption claim. IRS management stated that the use of this software application required IRS employees to manually review approximately 180,000 returns each year which was time consuming.

To improve the efficiency and accuracy of the process to detect potentially frivolous redemption claims, the IRS developed and incorporated predictive modeling filters into the EFDS beginning with the 2012 Filing Season. The new filters allowed the IRS to systemically analyze incoming returns more quickly and accurately than previous software application business rule queries. All individual refund returns were screened using these filters. For example, the predictive modeling filters used for the 2014 Filing Season were based on more than 800 separate criteria to evaluate the risk that a tax return includes a frivolous redemption argument.[8]

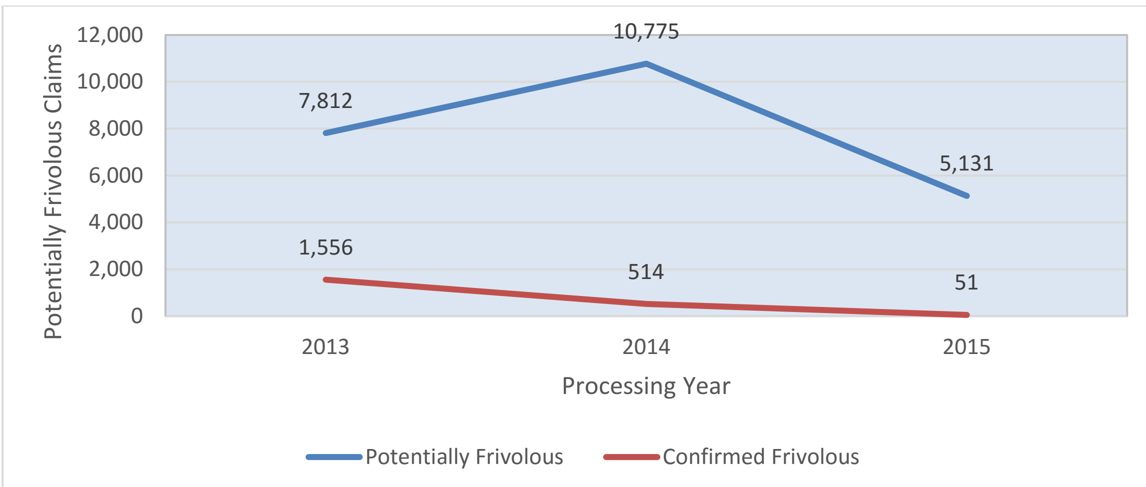
However, to remain effective, predictive analytic models need continual refinement. Prior to each filing season, the IRS would identify samples of confirmed frivolous and non-frivolous tax returns filed during the current processing year. These samples were needed to refine or "train" the predictive model for the upcoming year. For example, the returns selected are loaded into the predictive analytics modeling software for analysis of the characteristics of each return. The process is repeated multiple times using different sample sets thereby enabling the computer to identify characteristic differences between frivolous and non-frivolous redemption returns. Once this is completed, the final model, which includes the predictive filters, is loaded into the EFDS for use in identifying potentially frivolous redemption arguments on returns filed during the upcoming filing season.

The number of tax returns required to train a model depends on a variety of factors, including total population size, model type, and fraud patterns. According to IRS management, the volume of potentially frivolous and confirmed frivolous redemption claims identified by the IRS in Processing Year 2015 was not sufficient to train the predictive models for use in the 2016 Filing Season. For example, in Processing Year 2014, the IRS identified 10,775 potentially frivolous

[8] Depending on the results of the predictive analytics model, the number of criteria could vary between Filing Seasons.

claims of which 514 returns with refunds totaling $5.1 billion were confirmed as frivolous. However, in Processing Year 2015, the IRS identified only 5,131 potentially frivolous returns of which 51 returns with refunds totaling $18.9 million were confirmed as frivolous. Figure 1 shows the decline in returns with frivolous redemption claims identified in Processing Year 2015.

Figure 1: Potentially Frivolous and Confirmed Redemption Returns Identified



Source: IRS Frivolous Redemption Claim statistics as of October 22, 2016.

Because the IRS was unable to train the EFDS predictive modeling filters for the 2016 Filing Season, it reverted back to using the computer software application it used prior to the 2012 Filing Season to identify potentially frivolous claims. The IRS reported that, using the software application, it identified 144,754 potentially frivolous tax returns for additional review during Processing Year 2016 through October 22, 2016. As of October 22, 2016, the IRS had reviewed all of the 144,754 potentially frivolous returns and confirmed 12 returns with refunds totaling $7.5 million as a frivolous argument. As we previously detailed, the IRS is using the Return Review Program for the 2017 Filing Season to identify potentially frivolous tax arguments, including redemption claims.

Ineffective Frivolous Redemption Claim Identification Processes Contribute to Decline in Identified Returns

The IRS indicated that the continued decline in the number of confirmed frivolous redemption claims resulted in its inability to continue to use the EFDS predictive modeling filters. The IRS attributes this decline to taxpayers not submitting as many of these types of claims as in prior years. However, our review identified that the IRS's processes and procedures are contributing to the reduction in claims it identifies. Specifically, we found:

- Refund dollar tolerances applied to returns with excessive withholding cause the IRS to exclude some returns from being reviewed as a potential frivolous redemption claim filing.
- Processes do not ensure that employees who review amended returns identify and refer tax returns with questionable excessive withholding for additional review.

Refund dollar tolerances applied to returns with excessive withholding cause the IRS to exclude some returns from being reviewed as potential frivolous redemption claim filings

Our analysis of Tax Year[9] 2015 tax returns processed between January 1, 2016, and May 26, 2016, identified 337,273 tax returns in which the taxpayers reported excess withholding (*i.e.*, withholding reported *********2************ of the income they reported on their tax return). As such, these returns met the IRS's error identification criteria for excessive withholding. Returns identified with excessive withholding and that have a refund above a certain dollar tolerance are suspended from processing and, depending on the characteristics of the tax return, the returns are required to be referred to either the IVO or the FRP for additional review. Of the 337,273 returns, 178,808 (53 percent) met the IRS's refund dollar tolerance for referral to either the IVO or FRP. Our review identified that returns with refunds above the dollar tolerance are being referred to the IVO or FRP for additional review as required.

The remaining 158,465 (47 percent) returns had a refund dollar tolerance below the amount at which IRS requires the return to be sent either to the IVO or FRP for additional review. Further analysis of these returns found that:

- 86,868 (55 percent) returns were identified for IVO or FRP review by some other IRS program.
- 71,597 (45 percent) returns with refunds totaling $89 million were not evaluated for possible referral to the FRP despite having met the IRS's error identification for an excessive withholding claim.

When we discussed the results of our analysis with IRS management, they confirmed that a return that falls below the refund dollar tolerance would not be referred for additional review. However, IRS management stated that many of the 71,597 returns we identified had subsequent activity that resulted in the refund being stopped or reversed. The IRS noted that all tax returns are evaluated for potential fraud identification and if they meet IRS criteria will be sent to the IVO for screening. Our review of the information provided by IRS management found that the

[9] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

IRS in fact took additional action on 13,349 of the 71,597 returns. The remaining 58,248 returns were not identified for additional review.

Fraud patterns are constantly evolving. As such, the IRS needs to continuously adapt its detection processes to include evaluating the use of specific dollar tolerances that may be known to fraudsters. For example, in August 2016 we reported that the IRS did not identify 221,771 potentially frivolous tax returns as the result of the use of dollar tolerances in its systemic frivolous return detection processes.[10] Subsequent to our identification and referral of these tax returns to the IRS, the IRS confirmed that 1,219 of the 221,771 returns were in fact frivolous. These returns had claims totaling $10.5 million. In response to our recommendations, IRS management indicated that all returns that meet the EFDS FRP filter criteria, regardless of dollar tolerance, will be reviewed to identify schemes and opportunities to refine existing filters and determine if additional filters are needed. Similar actions are needed with regard to those returns with excessive withholding that do not meet the IRS's case selection dollar tolerances.

Processes do not ensure that employees who review amended returns identify and refer tax returns with questionable excessive withholding for additional review

Internal guidelines require tax examiners to refer returns with excessive withholding that meet specific criteria to the FRP or IVO for additional review. In April 2016, the IRS issued an Alert to all functions notifying them that taxpayers were using fraudulent Forms 1099-MISC to support frivolous redemption claims on original and amended tax returns. The Alert cautioned employees that in some instances frivolous or fraudulent information returns had been filed with the IRS and instructed employees to not rely on these documents when verifying reported income and withholding. The Alert also instructed employees to forward all returns meeting the criteria in the Alert to the FRP for additional review. Examples of the referral criteria included in the Alert were returns that had inflated withholding that is excessive to miscellaneous income reported, such as high withholding to fraudulent income ************2****************
2************************************
***************************2**********************************. The IRS also incorporated these instructions into its internal guidelines for identifying potentially frivolous tax arguments on amended tax returns.

The IRS informed us in June 2016 that it had identified a frivolous redemption claim scheme in which individuals were filing amended tax returns to claim excessive withholding. As of August 5, 2016, the IRS identified 207 confirmed cases with frivolous withholding. However, despite the issuance of the Alert to employees processing amended tax returns with excessive withholding claims, the amended tax return processing procedures still rely on IRS employees' manual review of the amended tax return to identify a potentially frivolous claim. For each of

[10] TIGTA, Ref. No. 2016-40-069, *Actions Are Needed to Better Identify and Address Individuals Who File Tax Returns Using Frivolous Arguments* (Aug. 2016).

the 207 confirmed cases, the returns were not identified as a potentially frivolous redemption claim at the time the amended tax returns were processed. As such, the IRS issued refunds totaling more than $43.4 million.

When we provided examples of the 207 frivolous amended tax returns that the IRS confirmed as a frivolous redemption claim to two employees who are responsible for processing amended returns, the employees indicated they would have processed the amended return not identifying the fact that they were a frivolous redemption claim. One employee indicated the return would be processed because it was a simple adjustment to income and the other employee indicated the return would be processed if the income on the return could be verified to the Form 1099. This is despite the updated guidance the IRS issued cautioning employees that individuals are filing frivolous amended returns using false or fraudulent Forms 1099-MISC and instructing them to forward returns such as the ones we showed them to the FRP.

Manual processing of amended tax returns continues to result in the issuance of potentially erroneous tax refunds

In April 2014, we reported that the IRS needed to modernize amended tax return processing to use the same extensive systemic error identification and fraud detection processes it has developed for original tax returns.[11] We recommended the IRS develop processes to allow individuals to electronically file (e-file) amended returns so that it can use its systemic error identification processes. In response to our report, IRS management indicated that the IRS plans to consider the ability to e-file amended tax returns based on available funding and resources. However, the IRS has not yet developed processes to allow taxpayers to e-file an amended tax return.

While we understand the IRS may be unable to develop processes to enable taxpayers to e-file amended tax returns at this time, we believe the IRS can develop systemic processes to identify potentially frivolous redemption claims on amended tax returns. For example, the IRS can develop processes similar to those used for original tax returns that would prevent amended returns with excessive withholding from posting to the Master File.[12] Once identified, the IRS can review the returns to ensure the withholding is supported and refer potentially frivolous claims to the FRP for additional review.

When we discussed our concerns that employees are not effectively identifying amended returns with frivolous redemption claims, IRS management agreed that identification of these claims was an issue and that a systemic process to prevent them from being processed would be beneficial. However, IRS management indicated they are unable to develop processes at this time due to computer system limitations. For example, the IRS can systemically compare

[11] TIGTA, Ref. No. 2014-40-028, *Amended Tax Return Filing and Processing Needs to Be Modernized to Reduce Erroneous Refunds, Processing Costs, and Taxpayer Burden* (April 2014).
[12] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

withholding to Adjusted Gross Income. However, a systemic comparison of amended withholding to amended Adjusted Gross Income would not be effective because *****2**** ***************************2**********************************.

It should be noted that IRS management informed us that as a result of their identification of the Form 1099-MISC return scheme, the IRS implemented processes in May 2016 to identify suspicious Forms 1099-MISC as part of its Filing Informational Returns Electronically system. According to management, this system analyzes incoming Forms 1099-MISC, Forms 1099-OID, Forms 1099-A, *Acquisition or Abandonment of Secured Property*, and Forms 1099-C, *Cancellation of Debt*, for specific criteria including excessive withholding. Finally, management indicated that lists of suspicious forms identified by the Filing Informational Returns Electronically system are generated daily and provided to the IRS Return Integrity and Compliance Services and Collection functions for review.

We plan to conduct a separate review to evaluate the effectiveness of the IRS's efforts to validate third-party information documents.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Ensure that the annual evaluation of the error identification processes criteria used to identify potentially frivolous redemption claims on original and amended tax returns includes the identification and assessment of all original and amended tax returns, regardless of dollar tolerance, that have excessive withholding. The annual assessment should include analysis to ensure that individuals, including promoters, are not using knowledge of IRS dollar tolerances to successfully submit frivolous returns.

> ***Management's Response:*** The IRS agreed with this recommendation. The IRS will request modifications to the Return Review Program business rules evaluating returns for potentially frivolous issues. The changes will address those returns that would otherwise avoid selection by existing processes and make them available for consideration in the annual filter performance review process. The IRS expects this change will be completed and in place for the 2018 Filing Season; however, it is dependent on programming modifications, which are subject to budgetary and resource constraints and competing priorities.

Recommendation 2: Continue to explore opportunities to develop systemic processes to identify amended returns that claim excessive withholding for additional review before refunds are paid.

> ***Management's Response:*** The IRS agreed with this recommendation. IRS management plans to continue exploring opportunities for systemic processing to identify for pre-refund review those amended filings that claim excessive withholding.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to evaluate the IRS's decision to discontinue the use of the EFDS predictive modeling filters to identify individual tax returns claiming potentially frivolous Original Issue Discount (redemption claim) arguments. To accomplish this objective, we:

I. Obtained information related to the IRS's decision to discontinue use of the EFDS predictive modeling filters at the end of Calendar Year 2015 including information as to how the filters are trained and the reasons for decreasing volumes of identified potentially frivolous returns.

II. Determined if IRS processes resulted in undetected potentially frivolous returns that could have been used to train the EFDS predictive modeling filters.

   A. Evaluated the IRS's at-filing error identification processes for Tax Year[1] 2015 returns filed between January 1, 2016, and May 26, 2016, with excessive withholding to determine if these processes effectively identify potentially frivolous redemption claims for additional review by the FRP.

      1. Obtained Tax Year 2015 returns from the IRS Individual Return Transaction File[2] and analyzed them to identify those claiming excessive withholding. We used these data to determine if returns with excessive withholding are being referred to the FRP and the IVO. We validated the reliability of the fields extracted as well as the accuracy of our analysis by selecting a judgmental sample[3] and verifying the return information to the IRS Master File.[4] We determined the data were sufficiently reliable for our intended purposes.

   B. Evaluated Tax Year 2014 Forms 1099-MISC, *Miscellaneous Income*, and Forms 1099-OID, *Original Issue Discount*, with excessive withholding to determine if individuals are using these forms to file original and amended tax returns with a potentially frivolous redemption claim.

[1] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
[2] Contains data transcribed from initial input of the original individual tax returns during return processing.
[3] A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.
[4] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

1. Obtained Tax Year 2014 Forms 1099-MISC and Forms 1099-OID from the IRS Information Returns Master File[5] and analyzed them to identify forms reporting excessive withholding. We validated the reliability of the fields extracted as well as the accuracy of our analysis by selecting a judgmental sample and verifying the return information to the IRS Master File. We determined the data were sufficiently reliable for our intended purposes.
2. Using information from the Individual Return Transaction File, determined if the taxpayers associated with the Forms 1099-MISC and Forms 1099-OID with excessive withholding had filed a Tax Year 2014 original or amended tax return and reported the Form 1099 income. We validated the reliability of the fields extracted as well as the accuracy of our analysis by selecting a judgmental sample and verifying the return information to the IRS Master File. We determined the data were sufficiently reliable for our intended purposes.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: the IRS's policies and procedures for training the EFDS predictive modeling filters, identifying tax returns with excessive withholding, and using third-party information documents to detect potential frivolous arguments. We evaluated these controls by interviewing IRS management, reviewing key program documentation related to the identification and processing of potentially frivolous redemption claims, and performing an independent analysis of tax returns and information returns claiming excessive withholding.

[5] A computer file of current tax year information returns; a record of income paid to an individual or organization for a given tax year.

Appendix II

Major Contributors to This Report

Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services)
Deann L. Baiza, Director
Levi J. Dickson, Audit Manager
Frank J. O'Connor, Acting Audit Manager
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Appendix III

Report Distribution List

Commissioner
Office of the Commissioner – Attn: Chief of Staff
Deputy Commissioner for Services and Enforcement
Director, Customer Account Services, Wage and Investment Division
Director, Return Integrity and Compliance Services, Wage and Investment Division
Director, Submission Processing, Wage and Investment Division
Director, Office of Audit Coordination

Appendix IV

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

WAGE AND INVESTMENT DIVISION

MAY 3 1 2017

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kenneth C. Corbin
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Actions Can Be Taken to Increase Detection of Frivolous Redemption Claims (Audit # 201540022.01)

Thank you for the opportunity to review the subject draft report and provide comments. We appreciate the Treasury Inspector General for Tax Administration's observations and acknowledgement of our efforts in preventing the issuance of improper refunds associated with frivolous claims. A frivolous claim is one based on an unfounded legal or constitutional argument to avoid or reduce tax liability and/or increase refunds by fraudulent or frivolous means. The IRS has identified 50 arguments or methods that are considered frivolous.

The IRS' Frivolous Return Program (FRP) screens returns for frivolous arguments and addresses those found to contain such positions. When the IRS detects returns with frivolous positions, the taxpayers are contacted and given an opportunity to correct the returns. When taxpayers continue to maintain frivolous positions, in addition to accuracy-related penalties that can reach 20 percent of the unreported tax amount, or the civil fraud penalty that may reach 75 percent of the unreported tax, returns or other correspondence filed using one of the 50 identified frivolous tax arguments may also be subject to a $5,000 frivolous return penalty.

The Electronic Fraud Detection System (EFDS), which had been used to screen potentially frivolous returns, employed a predictive modeling process to score returns and refer them to the FRP. As returns filed with the Original Issue Discount (redemption claim) arguments sharply declined in 2015, the number found to be frivolous were too few to effectively train the predictive model for continued use during 2016. When it became apparent there were an insufficient number of returns available to train the models and achieve acceptable performance by the EFDS in 2016, it was too late to add the frivolous return business rules programming to the Return Review Program (RRP), which is the successor to the EFDS. Consequently, for 2016 only, the FRP reverted to a manual process for identifying potentially frivolous returns. This was accomplished with commercial software provided by the manufacturer of the EFDS database system. In 2017, the process for detecting frivolous returns was incorporated into the operations of the RRP.

We agree with the recommendation to include returns that fall below selection criteria in our annual analysis of filter performance. During the 2017 filing season, the RRP, which has performed all fraud scoring and identity theft detection tasks, has performed well. We will use its advanced analytics platform to evaluate those returns that may otherwise avoid detection of frivolous characteristics when below-tolerance conditions are present. With its sophisticated analytics and machine learning algorithms that can identify potentially frivolous returns, we believe better results will be achieved in selecting returns for review than by having them manually screened and selected by Tax Examiners. We also agree with the recommendation to continue our on-going practice of exploring opportunities to develop systemic processes to identify amended returns that claim excessive withholding for additional review before refunds are paid.

Attached are our comments and proposed actions to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Michael Beebe, Director, Return Integrity and Compliance Services, Wage and Investment Division, at (470) 639-3505.

Attachment

Attachment

Recommendations

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 1

Ensure that the annual evaluation of the error identification processes criteria used to identify potentially frivolous redemption claims on original and amended tax returns includes the identification and assessment of all original and amended tax returns, regardless of dollar tolerance, that have excessive withholding. The annual assessment should include analysis to ensure that individuals, including promoters, are not using knowledge of IRS dollar tolerances to successfully submit frivolous returns.

CORRECTIVE ACTION

We agree with this recommendation. We will request modifications to the Return Review Program business rules evaluating returns for potentially frivolous issues. The changes will address those returns that would otherwise avoid selection by existing processes and make them available for consideration in the annual filter performance review process. We expect this change will be completed and in place for the 2018 filing season; however, it is dependent on programming modifications, which are subject to budgetary and resource constraints and competing priorities. Consequently, we cannot commit to an implementation date at this time.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

Director, Return Integrity and Compliance Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

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

RECOMMENDATION 2

Continue to explore opportunities to develop systemic processes to identify amended returns that claim excessive withholding for additional review before refunds are paid.

CORRECTIVE ACTION

We agree with this recommendation and will continue exploring opportunities for systemic processing to identify for pre-refund review those amended filings that claim excessive withholding.

IMPLEMENTATION DATE

Implemented

RESPONSIBLE OFFICIAL

Director, Return Integrity and Compliance Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

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