



January 2018

# TAX FRAUD AND NONCOMPLIANCE

## IRS Can Strengthen Pre-refund Verification and Explore More Uses

# GAO Highlights

Highlights of [GAO-18-224](#), a report to congressional requesters

## Why GAO Did This Study

IRS continues to confront the ongoing problems of identity theft (IDT) refund fraud. The agency estimates that at least \$1.68 billion was paid in IDT refund fraud in 2016. To help address this issue, consistent with GAO's prior reporting, the Protecting Americans from Tax Hikes Act of 2015 advanced the deadline for employers to file W-2s to SSA to January 31 (about 1 to 2 months earlier than in prior years). This change allows IRS more time to match wage information to tax returns through systemic verification, and identify any discrepancies before issuing refunds.

GAO was asked to assess how well IRS implemented systemic verification. GAO assessed IRS's performance using systemic verification and the extent to which IRS analyzed the effectiveness of the refund hold on this process. GAO analyzed IRS and SSA data and documents, observed SSA's paper W-2 process, and interviewed IRS and SSA officials. GAO compared IRS actions to laws; IRS policies; and standards for internal control, fraud risk management, and program evaluation.

## What GAO Recommends

GAO recommends IRS collect data to track late W-2 filing penalties and assess options for earlier enforcement; assess the benefits and costs of using existing authority to hold refunds longer, hold all refunds, or both, and expanding systemic verification to other areas; and take actions based on the assessments. IRS listed steps to respond to 5 of 6 recommendations, but said it could not enforce penalties earlier. GAO recognizes the challenges but clarified that assessing other options would provide benefits, as discussed in the report.

View [GAO-18-224](#). For more information, contact Jessica Lucas-Judy at (202) 512-9110 or [lucasjudyj@gao.gov](mailto:lucasjudyj@gao.gov).

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## TAX FRAUD AND NONCOMPLIANCE

### IRS Can Strengthen Pre-refund Verification and Explore More Uses

## What GAO Found

Beginning in 2017, as required by law, the Internal Revenue Service (IRS) held all refunds for taxpayers claiming the Earned Income Tax Credit (EITC) or Additional Child Tax Credit (ACTC) until February 15. IRS also took actions to verify wage and other information reported on tax returns before issuing refunds, referred to as systemic verification, but several factors limited its success. IRS received over twice as many (over 214 million) Forms W-2, *Wage and Tax Statement (W-2)* by February 15 compared to the same time in 2016, and reported that W-2 data were responsible for improving fraud detection and reducing taxpayer burden. However, IRS was unable to verify over half of the returns it held until February 15 before issuing the refunds. For example, IRS received W-2s daily but its information technology systems processed them weekly. In response to GAO's review, IRS reported it is planning to assess options for processing W-2s daily. Also, some employers submit W-2s late, but IRS did not track the extent to which late W-2s are associated with fraud or noncompliance. Further, IRS has not assessed options for enforcing late W-2 penalties earlier. Additionally, about 9 percent (about 23 million) of W-2s were filed on paper, which IRS does not begin to receive from the Social Security Administration (SSA) until March. By law, employers who file 250 or more W-2s are required to file W-2s electronically, while those who file fewer than 250 W-2s may opt to file on paper or electronically. In August 2014, GAO suggested that Congress provide the Secretary of the Treasury with the authority to lower the electronic filing requirement from 250 W-2s to 5 to 10. This action could also have the benefit of reducing SSA's W-2 paper processing costs by \$9.7 to \$11.3 million per year. These issues reduce IRS's access to timely W-2 data, limiting its ability to prevent fraud and reduce noncompliance before issuing refunds.

IRS's preliminary and final analyses of the February 15 refund hold both showed that IRS could have detected significantly more in potential fraud and noncompliance if it held all refunds until late February, when it had more W-2 data available. There are differences between these analyses. For example, the final analysis included more returns and estimated total revenue IRS could protect by extending the refund hold and expanding it to all taxpayers. In that analysis, IRS estimated that it could have protected \$100 million in fraud and noncompliance had it held all taxpayer refunds until February 15—\$35 million more than it protected by holding refunds with EITC or ACTC. IRS further estimated that moving the refund hold to March 1 for all taxpayers could protect \$895 million compared to \$533 million if it only held refunds with EITC or ACTC until that date. However, GAO found limitations to IRS's analyses. For example, while IRS has plans to further explore holding refunds longer, it does not have an evaluation plan to assess the effectiveness of the refund hold on systemic verification. Also, IRS did not fully assess the benefits and costs, including taxpayer burden, of the refund hold, nor how its analysis informs its broader fraud risk management or compliance efforts. As a result, IRS does not have sufficient information to inform a decision on potential changes to the refund hold date and those subjected to it. Finally, IRS has not assessed the benefits and costs of expanding systemic verification to use for pre-refund compliance checks in other areas such as income underreporting and employment fraud. Therefore, IRS may be missing opportunities to maximize use of early W-2 data.

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## Abbreviations

|          |   |
|----------|---|
| the Act  | Protecting Americans from Tax Hikes Act of 2015 |
| ACTC     | Additional Child Tax Credit                     |
| EITC     | Earned Income Tax Credit                        |
| IDT      | identity theft                                  |
| IRM      | Internal Revenue Manual                         |
| IRMF     | Information Return Master File                  |
| IRS      | Internal Revenue Service                        |
| IT       | Information Technology                          |
| NTA      | National Taxpayer Advocate                      |
| OCR      | optical character recognition                   |
| PII      | personally identifiable information             |
| RRP      | Return Review Program                           |
| SSA      | Social Security Administration                  |
| Treasury | Department of the Treasury                      |
| WBDOC    | Wilkes-Barre Direct Operations Center           |
| W-2      | Form W-2, Wage and Tax Statement                |

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January 30, 2018

Congressional Requesters

In recent years, the Internal Revenue Service (IRS) has faced ongoing problems with fraud and noncompliance. This includes identity theft (IDT) refund fraud, which occurs when a fraudster obtains an individual's Social Security number, date of birth, or other personally identifiable information (PII), and uses it to file a fraudulent tax return seeking a refund. IRS estimates that at least \$12.24 billion in IDT tax refund fraud was attempted in calendar year 2016—of which it prevented at least \$10.56 billion (86 percent)—but at least \$1.68 billion (14 percent) was paid.<sup>1</sup> This represents an improvement compared to prior years. Improper payments have been another costly problem, which includes both fraudulent activity and noncompliance.<sup>2</sup> IRS estimates also show that the Earned Income Tax Credit (EITC) has consistently had a high improper payment rate.<sup>3</sup> For fiscal year 2017, IRS reported that total EITC payments were \$68 billion, of which \$16.2 billion were estimated to be improper.<sup>4</sup>

To help address these issues, IRS implemented a process to verify wage and related information on all tax returns with refunds for the 2016 filing season, referred to as systemic verification.<sup>5</sup> We previously reported that

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<sup>1</sup>Because of the difficulties in estimating the amount of undetectable fraud, the actual amount could differ from these estimates. In addition, due to differences in detection and calculation methods, the numbers are not fully comparable from year to year. However, the estimates indicate an overall decline in identity theft attempts.

<sup>2</sup>As estimated and reported by federal agencies under the Improper Payments Information Act of 2002, Pub. L. No. 107-300, 116 Stat. 2350 (Nov. 26, 2002) *codified as amended* at 31 U.S.C. § 3321 note, an improper payment is any payment that should not have been made or that was made in an incorrect amount. Agencies also report as improper any payments for which they are unable to find sufficient supporting documentation.

<sup>3</sup>EITC was enacted in 1975 to encourage work by offsetting payroll taxes for low-income taxpayers. This credit is refundable in that, in addition to offsetting tax liability, any excess credit over the tax liability is refunded to the taxpayer. IRS updates EITC improper payment estimates annually.

<sup>4</sup>IRS does not estimate improper payment rates for other refundable tax credits.

<sup>5</sup>Beginning in 2016, IRS requested W-2 information from employers to validate information on returns selected by fraud filters. This provided IRS with a limited amount of W-2 data earlier in the filing season to use for pre-refund validation checks. See GAO, *Identity Theft and Tax Fraud: IRS Needs to Update Its Risk Assessment for the Taxpayer Protection Program*, [GAO-16-508](#) (Washington, D.C.: May 24, 2016).

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the information that employers report on Form W-2, *Wage and Tax Statement (W-2)*, had not been available to IRS until after it issued most refunds.<sup>6</sup> With earlier access to W-2 data, IRS could use this information to verify taxpayers' returns and identify any discrepancies before potentially issuing billions of dollars in fraudulent refunds. Such verification could also prevent some EITC improper payments. Consistent with our prior reporting, Congress enacted the Protecting Americans from Tax Hikes Act of 2015 (the Act) in 2015, which required employers to submit W-2s to the Social Security Administration (SSA) by January 31, effective beginning in 2017.<sup>7</sup>

Compared to prior years, the new deadline is 1 month earlier if filing on paper or 2 months earlier if filing electronically.<sup>8</sup> SSA then provides W-2 data to IRS for verifying employee wage and withholding data on tax returns. The Act also required IRS to hold refunds for all taxpayers claiming EITC or Additional Child Tax Credit (ACTC) until February 15.<sup>9</sup> In April 2017, we testified based on our initial review that this process holds promise for combatting IDT refund fraud and reducing improper payments, but IRS faced some implementation challenges.<sup>10</sup>

You asked us to review the 2017 filing season to determine how well IRS implemented systemic verification. We assessed (1) IRS's performance in detecting fraud and noncompliance using systemic verification, and SSA's performance providing timely W-2 data to IRS; and (2) the extent to which IRS analyzed the effectiveness of the refund hold on systemic verification as well as opportunities for IRS to apply systemic verification to other efforts to detect fraud and noncompliance.

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<sup>6</sup>GAO, *2017 Filing Season: New Wage Verification Process Holds Promise but IRS Faced Implementation Challenges*, [GAO-17-525T](#) (Washington, D.C.: Apr. 26, 2017).

<sup>7</sup>Consolidated Appropriations Act, 2016, (the Protecting Americans from Tax Hikes Act of 2015 was included as a provision of the Consolidated Appropriations Act, 2016), Pub. L. No. 114-113, div. Q, Title II, § 201(a), 129 Stat. 2242, 3076 (Dec. 18, 2015) (*codified at* 26 U.S.C. § 6071(c)).

<sup>8</sup>Prior to enactment of the amending provisions of the Protecting Americans from Tax Hikes Act of 2015, paper W-2s were due on or before the last day of February and electronically-filed W-2s were due March 31.

<sup>9</sup>Pub. L. No. 114-113, § 201(b), *codified at* 26 U.S.C. § 6402(m). ACTC is the refundable portion of the Child Tax Credit and provides tax relief to low-income families with children.

<sup>10</sup>[GAO-17-525T](#).

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To assess IRS's performance detecting fraud and noncompliance using systemic verification, we reviewed preliminary 2017 filing season data and analyses of systemic verification results. We also reviewed applicable laws, IRS documentation, and policies, and we interviewed IRS officials. We compared IRS's actions to IRS's Strategic Plan, which includes objectives to strengthen refund fraud prevention by using third-party data and analytics for timely, informed decision making, and to innovate technology systems to support IRS's business needs.<sup>11</sup> We also compared IRS's actions to the *Standards for Internal Control in the Federal Government*, which call for management to design and implement internal controls within programs based on the related benefits and costs.<sup>12</sup> To assess SSA's performance providing timely data to IRS, we compared IRS and SSA data to SSA's goals. We also observed paper W-2 processing and interviewed staff and managers at SSA's paper W-2 processing facility in Wilkes-Barre, Pennsylvania.

To assess the extent to which IRS conducted analyses on the effectiveness of the refund hold and opportunities to improve systemic verification and apply it to other efforts to detect fraud and noncompliance, we assessed IRS data for 2017 and analyses of verification outcomes under different scenarios against overarching concepts and leading practices provided in our Fraud Risk and Management Framework and Program Evaluation guidance.<sup>13</sup> We also determined whether IRS conducted a complete economic analysis of the effects on taxpayer burden based on interviews with IRS and Department of the Treasury (Treasury) officials, and three economic experts. We identified key elements experts reported that IRS should consider. We selected these three economists based on their expertise in the field of tax policy and refundable tax credits, and to ensure variation in perspectives on tax issues. The views of these experts are not generalizable. In addition, we interviewed IRS officials on the benefits and costs of systemic verification.

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<sup>11</sup>IRS, *Strategic Plan: Fiscal Year 2014-2017*.

<sup>12</sup>GAO, *Standards for Internal Control in the Federal Government*, [GAO-14-704G](#) (Washington, D.C.: September 2014).

<sup>13</sup>See GAO, *A Framework for Managing Fraud Risks in Federal Programs*, [GAO-15-593SP](#) (Washington, D.C.: July 2015) and *Designing Evaluations: 2012 Revision*, [GAO-12-208G](#) (Washington, D.C.: January 2012).



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To assess the reliability of the data we used for this report, we reviewed IRS and SSA reports on W-2 data, and IRS reports on systemic verification and its results. We also reviewed IRS reports on the performance of its fraud filters. We examined systemic verification data to identify obvious errors or outliers or potential data limitations that would affect how we use the data, and we found no such problems. We also interviewed IRS officials about their data quality procedures and the data and their limitations. We determined that the data presented in this report are sufficiently reliable for the purposes of our reporting objectives. More information on our scope and methodology can be found in appendix I.

We conducted this performance audit from March 2017 to January 2018 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

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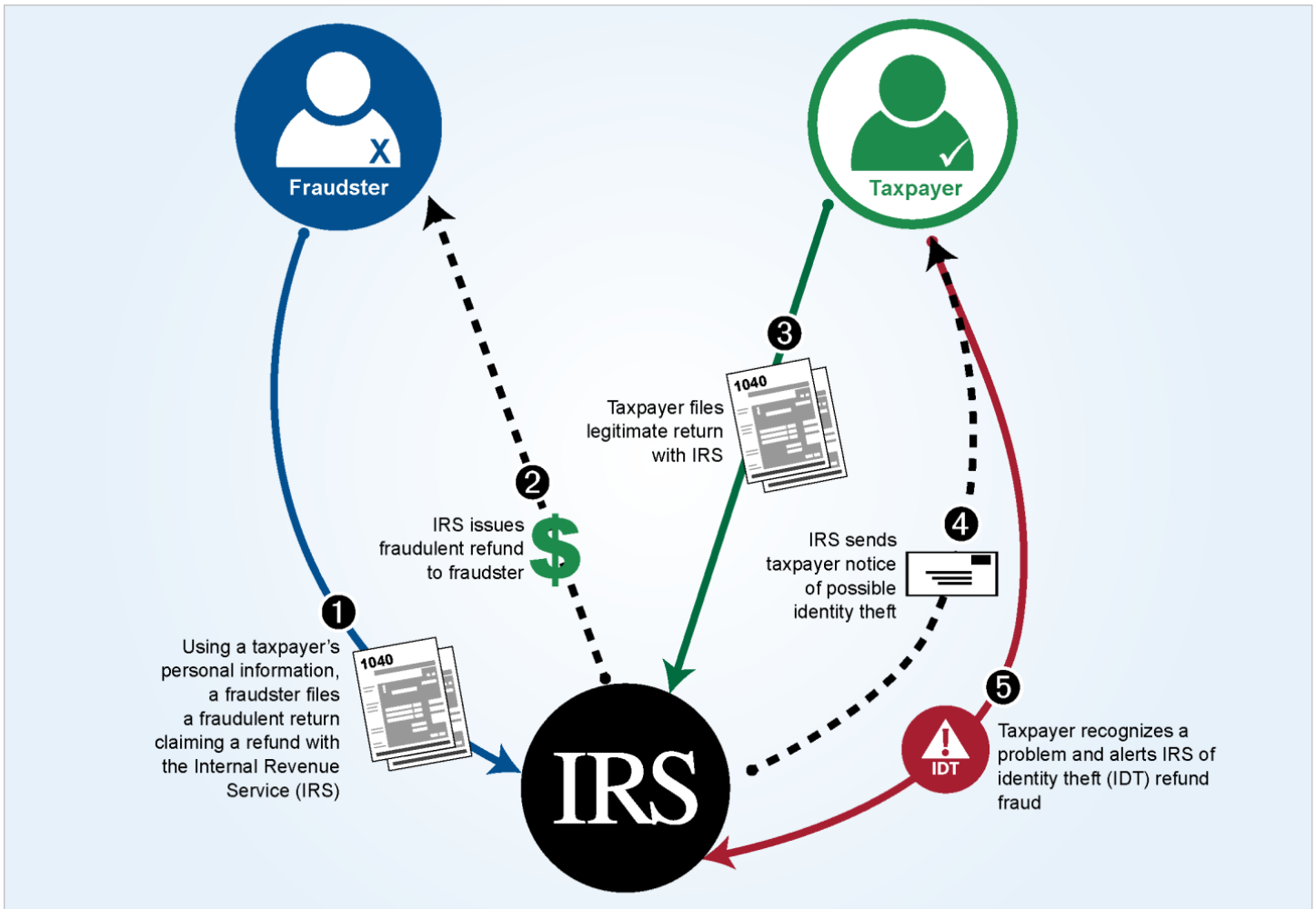
### IDT Refund Fraud

Viewed broadly, IDT refund fraud is composed of two crimes: (1) the theft or compromise of PII, and (2) the use of stolen (or otherwise compromised) PII to file a fraudulent tax return and collect a fraudulent refund. Figure 1 presents an example of how fraudsters may use stolen PII and other information, real or fictitious (e.g., sources and amounts of income), to complete and file a fraudulent tax return and successfully receive a refund. In this example, a taxpayer may alert IRS of IDT refund fraud. Alternatively, IRS can detect IDT refund fraud through its automated filters that search for specific characteristics as well as through other reviews of taxpayer returns. IRS reported that, through September 2017, the number of taxpayers reporting that they were a victim of IDT refund fraud had decreased by about 40 percent compared to the same period in 2016 (from 348,650 to 208,503).<sup>14</sup> IRS officials attribute this decline to improved fraud filters.

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<sup>14</sup>Earlier in 2017, IRS reported that the number of IDT victims had decreased by 47 percent. Since that time, IRS had received additional claims from taxpayers.

**Figure 1: Example of a Successful Identity Theft Refund Fraud Attempt**



Source: GAO analysis. | GAO-18-224

## Pre-refund Compliance Checks

We have long highlighted the importance of pre-refund compliance checks as a means to improve compliance while minimizing taxpayer burden. As we testified in 2011, pre-refund compliance checks help IRS to confirm taxpayers' identity, quickly and efficiently correct some errors with virtual certainty, and identify and audit some returns before refunds

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are issued.<sup>15</sup> They also have the potential to deter billions of dollars in erroneous refunds, especially for refundable tax credits. These credits have complex eligibility requirements and are often overclaimed. IRS's ability to match tax returns to information provided by third parties, including from financial institutions, can help enforce compliance with the tax laws. Pre-refund checks benefit taxpayers directly when IRS identifies underclaimed benefits.

Pre-refund compliance checks can reduce the tax gap created when taxpayers file returns that, for example, underreport their tax liability. In 2016, IRS estimated that the average annual gross tax gap was \$458 billion for tax years 2008 to 2010.<sup>16</sup> IRS estimated that through late payments and enforcement actions, it would collect an additional \$52 billion annually for those tax years, resulting in an average net tax gap of \$406 billion.<sup>17</sup> Because of the importance of improving voluntary compliance and addressing the tax gap, we continued to include Enforcement of Tax Laws as a high-risk area in our 2017 High-Risk Report.<sup>18</sup>

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## Systemic Verification

As noted previously, beginning in 2017 the Protecting Americans from Tax Hikes Act of 2015 requires employers to submit W-2s to SSA by January 31 (about 1 to 2 months earlier than in prior years, depending on the method of filing). It also requires IRS to hold refunds for all taxpayers claiming EITC or ACTC until February 15. In October 2017, IRS reported that, among the 13.4 million refunds subjected to this hold, it had completed processing 10.3 million refunds totaling \$51.2 billion. Although IRS has authority to hold additional refunds until it receives more W-2 data, IRS, in consultation with Treasury, decided not to exercise this

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<sup>15</sup>GAO, *Tax Refunds: Enhanced Prerefund Compliance Checks Could Yield Significant Benefits*, [GAO-11-691T](#) (Washington, D.C.: May 25, 2011).

<sup>16</sup>GAO, *Tax Gap: IRS Needs Specific Goals and Strategies for Improving Compliance*, [GAO-18-39](#) (Washington, D.C.: Oct. 31, 2017).

<sup>17</sup>Underreporting of tax liabilities accounted for most of the tax gap estimate for these tax years, making up 84 percent of the entire estimated gross tax gap. Individual income taxes made up the largest portion of underreporting, followed by employment taxes and corporation income taxes.

<sup>18</sup>We designated enforcement of tax laws as a high-risk area in 1990 because of its susceptibility to fraud, waste, and mismanagement. See GAO, *High-Risk Series: Progress on Many High-Risk Areas, While Substantial Efforts Needed on Others*, [GAO-17-317](#) (Washington, D.C.: Feb. 15, 2017).

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authority in 2017.<sup>19</sup> IRS officials explained that they did not do more than required by the law because it would be a major shift in refund issuance causing a strain on the economy, industry partners, taxpayers, and IRS telephone and other operations. Officials said that they expect to learn from their experience during the 2017 filing season and will continue to consider changes for future filing seasons as they have for 2018. However, all returns—with EITC or ACTC and without EITC or ACTC—were subject to systemic verification as well as other fraud filters.

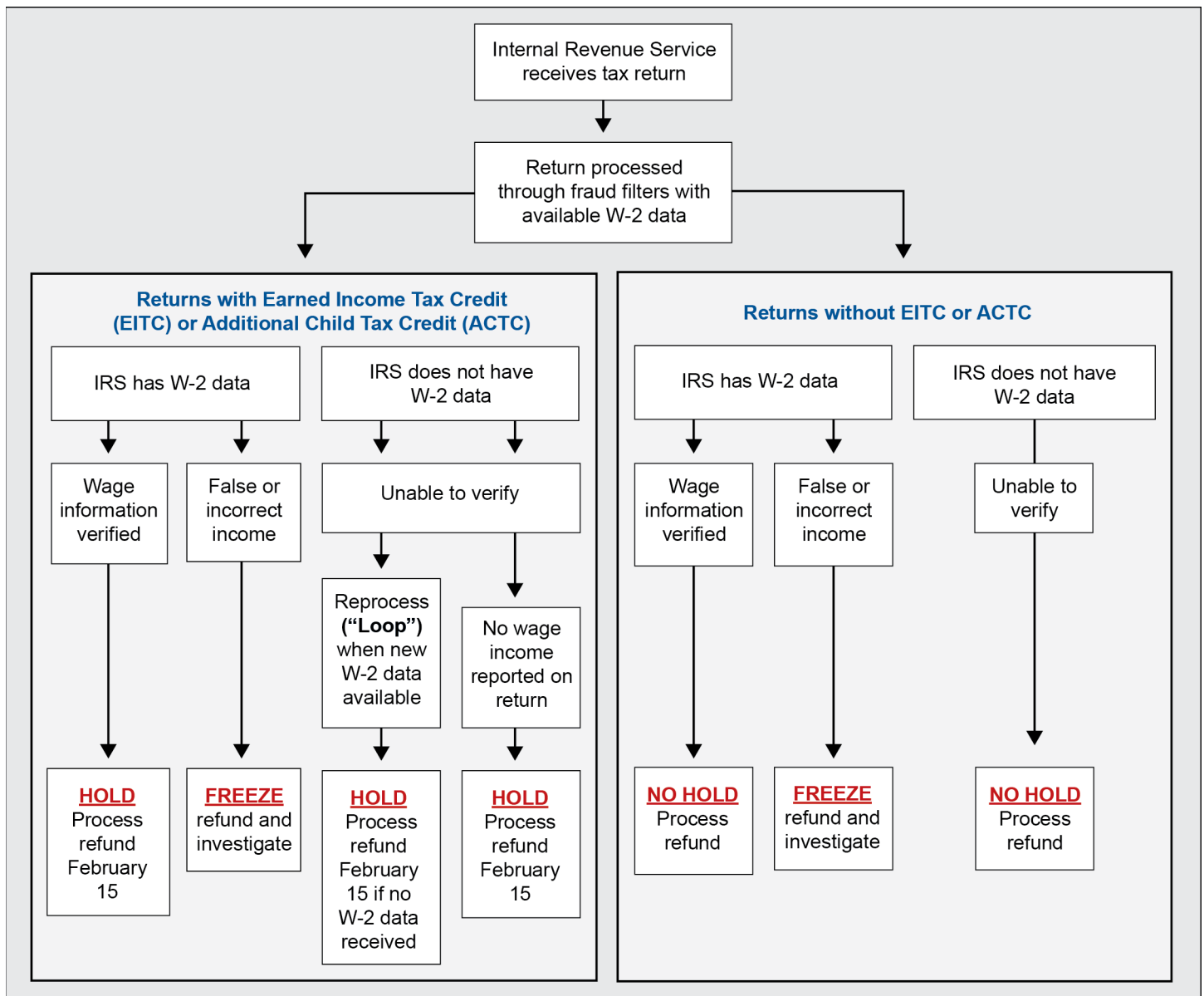
Systemic verification is one element of IRS's Return Review Program (RRP), its primary system to detect fraud and noncompliance. RRP is a platform that runs individual tax returns through a comprehensive set of rules and models to detect potential taxpayer fraud and other noncompliance, then selects returns for various treatment options. Systemic verification categorized taxpayer returns in one of three outcomes to detect potentially fraudulent or noncompliant returns (see figure 2):

1. **Wage information verified:** Income and withholding on the return matches W-2 data within the allowed threshold.
2. **False or incorrect income:** Information on the return is not valid when compared to W-2 data. This mismatch can include income, withholding, employer identification number, or other characteristics.
3. **Unable to verify:** Unable to verify income or withholding on the return because W-2 data are unavailable or the taxpayer did not report wage income but had other types of income such as Social Security or self-employment. IRS reprocessed (looped) all returns that reported wage income through RRP when new third-party data became available. For EITC or ACTC returns that IRS was required to hold until February 15, IRS had additional time to reprocess these returns before releasing the refund.

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<sup>19</sup>Under section 6201 of the Internal Revenue Code, IRS is authorized and required to make the inquiries, determinations, and assessments of all taxes as necessary. 26 U.S.C. § 6201. IRS has the authority to hold refunds in conjunction with those determinations.

**Figure 2: Systemic Verification for Returns with and without Earned Income and Additional Child Tax Credits**



Source: GAO analysis of IRS information. | GAO-18-224

Note: IRS holds any refunds (including those for which W-2 data are not available) for which the return is flagged for further review by its identity theft fraud filters or other pre-refund filters.

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After systemic verification is completed, IRS either continues processing the refunds for release or holds the refunds for additional review. For returns where IRS either verified or was unable to verify the wage information, the refunds were processed (beginning February 15 for returns with EITC or ACTC) unless selected by the fraud filters for review.<sup>20</sup> However, IRS does not have the authority to correct a taxpayer's return based on W-2 data, so it must initiate a correspondence audit which, as we have reported, is more costly to IRS, more burdensome on the taxpayer, and more time consuming for both.<sup>21</sup> Therefore, for returns with false or incorrect income, IRS froze the refund and directed it to various units for review depending on the results of systemic verification and fraud filters. For example, if IRS suspected that the return was IDT refund fraud, it directed it to the Taxpayer Protection Program to verify the taxpayer. For returns where IRS suspected potential noncompliance, it directed the return to the Integrity and Verification Operations group.

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<sup>20</sup>If a tax return is not selected by fraud filters for review, additional compliance checks might affect a refund being released, for example, if the taxpayer owes taxes from prior years.

<sup>21</sup>We have previously reported that the authority to correct a taxpayer's return based on reliable third-party data, referred to as math error authority or correctible error authority, has the potential to reduce costly burdensome audit processes for both IRS and the taxpayer, and improve compliance. See GAO, *Refundable Tax Credits: Comprehensive Compliance Strategy and Expanded Use of Data Could Strengthen IRS's Efforts to Address Noncompliance*, [GAO-16-475](#) (Washington, D.C.: May 27, 2016).

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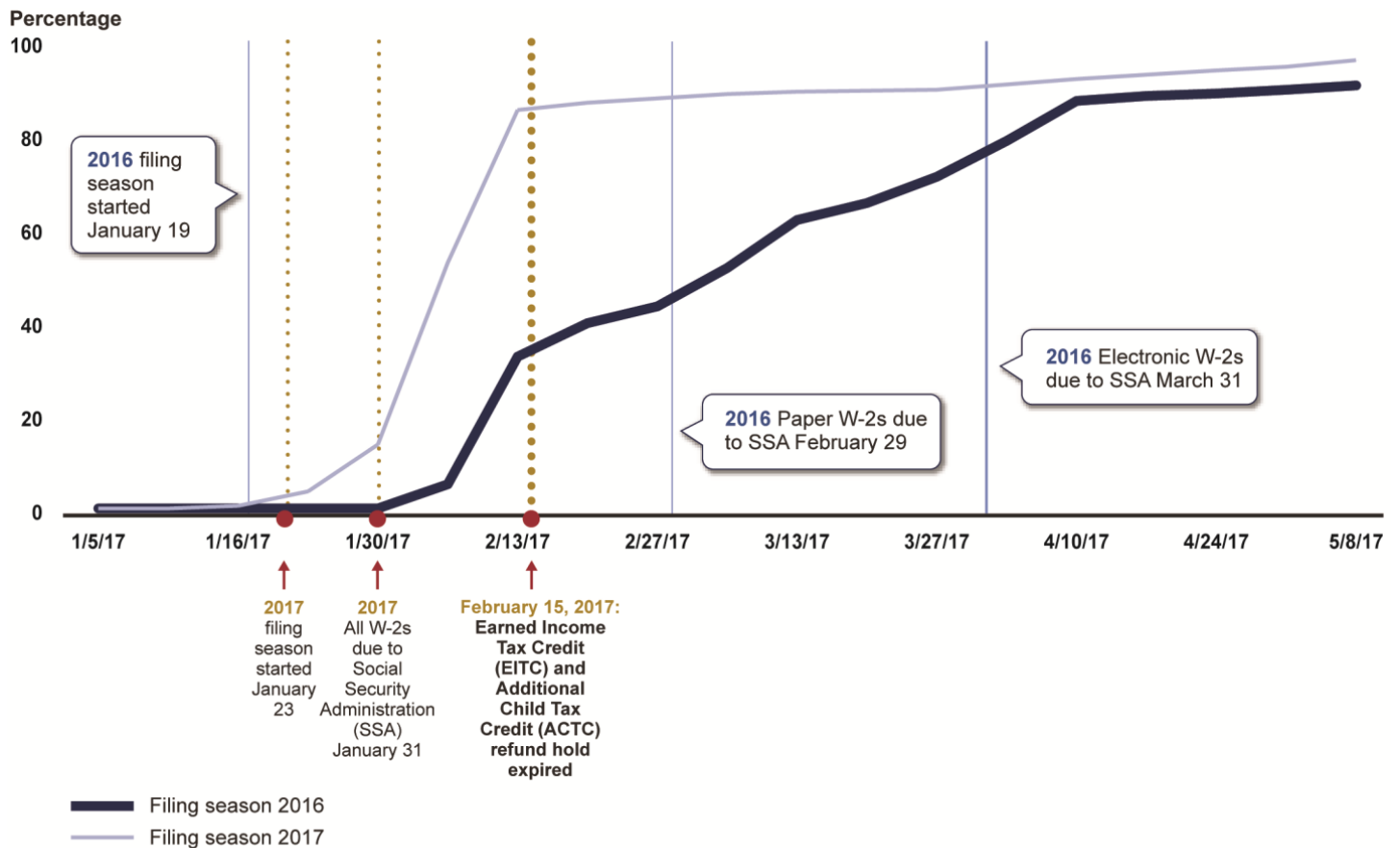
**Systemic Verification Shows Promise but Legacy Information Technology and Issues with Employer W-2 Filing Limit Its Success**

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**Early W-2 Data and the Refund Hold Helped IRS Prevent Fraud and Noncompliance for a Limited Number of Tax Returns**

By mid-February 2017, 2 weeks following the new W-2 filing deadline and about when the refund hold expired, IRS had received more than twice as many (over 214 million) W-2s than SSA provided at a similar time in 2016 (see figure 3). Nevertheless, IRS did not have all W-2 data in time to conduct pre-refund checks of wages, withholding, and other information before issuing refunds, especially early in the filing season.

**Figure 3: Percentage of W-2s Available for Systemic Verification for the 2016 and 2017 Filing Seasons**



Source: GAO analysis of Internal Revenue Service and Social Security Administration information. | GAO-18-224

Note: Percentages were calculated using total number of W-2s received and processed through October 10, 2017.

Despite not having all W-2 data, IRS was able to identify and prevent some fraud and noncompliance before issuing refunds. IRS received and initially processed through systemic verification a total of about 35.1 million individual tax returns through February 14, representing nearly \$200 billion in refunds.<sup>22</sup>

<sup>22</sup>This amount is higher than typical at this point in the filing season because it included a substantially large refund, which IRS held for review due to the amount.



As shown in table 1, nearly 13.4 million (38 percent) of those returns claiming about \$115 billion in refunds were filed by taxpayers who claimed EITC, ACTC, or both, and were subject to the refund hold. Using systemic verification, as of February 14, 2017, IRS determined that nearly 150,000 of these 13.4 million returns (1 percent) were potentially fraudulent because they included false or incorrect income. The returns represented approximately \$800 million in refunds. IRS also verified wage and other information for approximately 4.72 million (35 percent) of those returns filed and processed through February 14, representing \$73.5 billion in refunds.<sup>23</sup> However, IRS was unable to verify 7.79 million (58 percent) of these returns before it released refunds because W-2 data were unavailable, as described later in this report. Finally, table 1 also notes that, as of October 2017, IRS reported that, among those returns filed and processed through February 14, 10.3 million had completed processing and \$51.2 billion in refunds had been issued.

**Table 1: Pre-refund Systemic Verification Results for Returns with the Earned Income Tax Credit or Additional Child Tax Credit Initially Processed through February 14, 2017**

|                           | Number of returns (millions) | Percent of returns | Refund amount (billions of dollars) | Percent of refunds |
|---------------------------|------------------------------|--------------------|-------------------------------------|--------------------|
| Wage information verified | 4.72                         | 35                 | 73.5                                | 63                 |
| False or incorrect income | 0.15                         | 1                  | 0.8                                 | 1                  |
| Unable to verify          | 7.79                         | 58                 | 38.4                                | 33                 |
| No wage income reported   | 0.72                         | 5                  | 2.9                                 | 3                  |
| <b>Total</b>              | <b>13.4<sup>a</sup></b>      | <b>100</b>         | <b>115.6</b>                        | <b>100</b>         |

Source: GAO analysis of Internal Revenue Service data. | GAO-18-224

Notes: Percentages may not total to 100 due to rounding. These numbers represent initial systemic verification results as of February 14, 2017. These figures do not reflect the final number of returns or refund amounts issued after undergoing all compliance checks.

<sup>a</sup>As of October 2017, IRS reported that, among these returns, 10.3 million had completed processing and \$51.2 billion refunds had been issued. IRS continues to process the remaining returns and have indicated that at least some are confirmed fraudulent.

As the February 15 refund hold expiration approached, IRS continued to reprocess (loop) returns through systemic verification as more W-2 data became available. In doing so, IRS staff identified 12,000 more returns, in addition to the 150,000 initially identified, that they suspected to be

<sup>23</sup>IRS may select a return for review even if it cleared systemic verification because it triggered other fraud filters.

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fraudulent. This brought the total number of potentially fraudulent or noncompliant returns to about 162,000 with nearly \$863 million in refunds. IRS manually held these refunds and referred the suspicious returns for further screening to the Integrity and Verification Operations group. IRS later cleared approximately 150,000 (93 percent) of these returns and released about \$797 million in refunds. IRS confirmed that approximately 12,000 (7 percent) of the returns that it had not cleared were fraudulent, eventually protecting \$65 million, which included \$51 million in EITC or ACTC claims.

To reduce false positives (when legitimate tax returns are erroneously selected for review), an IRS working group made several changes to how IRS's fraud filters make selections based on W-2 data and other information. For 2018, IRS plans to automatically select returns that it had held manually in 2017. However, officials noted that while verifying wage information is important, the complexity of determining EITC and ACTC eligibility remains a challenge.<sup>24</sup>

We reviewed IRS's systemic verification results and found that IRS improved its selections of potentially fraudulent returns with W-2 data contributing to its fraud filters. As of February 15, returns selected for review by systemic verification comprised 14,618 (6 percent) of all paper and electronic returns selected as potential identity theft by the fraud filters. By September 15, selections from systemic verification increased to nearly 78,369 (about 10 percent) of all returns selected as potential identity theft. Moreover, we found that if more W-2 data were available earlier, IRS could have excluded more returns from review, thereby reducing or eliminating work and reducing taxpayer burden by not delaying legitimate taxpayers' returns. For example, systemic verification allowed IRS to exclude about 321,000 electronically-filed tax returns out of more than 700,000 that had been selected for review by the fraud filters.<sup>25</sup>

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<sup>24</sup>The complexity of eligibility requirements and lack of third-party data complicate IRS's ability to administer these credits. For example, for EITC and ACTC, each child must meet certain age, residency, and relationship tests. However, third-party data for IRS to use in verifying these requirements are not easy to identify. IRS generally conducts a correspondence audit to verify that a taxpayer meets the requirements for income and that their children meet both residency and relationship requirements.

<sup>25</sup>The number of paper-filed tax returns excluded from selection as potential identity theft due to W-2 data was unavailable.

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## IRS's Ability to Process W-2s Was Limited by Its Information Technology Systems and Issues with Employer W-2 Filing

We found that IRS's ability to verify information on tax returns early in the filing season was limited because of its Information Technology (IT) systems and issues with employers filing W-2s on paper or after the filing deadline.

**IT systems.** IRS receives and maintains validated taxpayer data, including W-2 and 1099-MISC forms, through the Information Return Master File (IRMF) system.<sup>26</sup> IRS received W-2 data from SSA daily but only loads the data onto IRMF weekly due to the legacy design of this system. This contributed to IRS's inability to verify more than half (7.79 million or 58 percent) of tax returns with EITC or ACTC claiming \$38.4 billion in refunds when the February 15 refund hold expired. IRS officials stated that due to the system's legacy design, adding new or updating existing information return documents requires the agency to reload its entire file, which contains billions of information returns.<sup>27</sup>

Officials reported that this process can take up to 3 days or more to complete, depending on the file size of the incoming and existing data, and has prevented IRMF from processing and making the W-2 data available for use, as it is received from SSA. Consequently, while IRS had received a total of about 210.9 million W-2s by February 13, it received an additional 3.9 million W-2s between February 13 and 20 that IRS was unable to use in systemic verification before the February 15 refund hold expired.

In October 2017, IRS officials told us several reasons why they were not addressing IT limitations. At that time, they said they had discussed various options to make W-2 data available faster, but they had not assessed whether IRMF processing could occur more than once weekly. Further, these officials said IRS developed a plan to modernize IRMF, which would allow for faster processing, but officials told us that this effort is on hold because of competing priorities and funding shortages.<sup>28</sup> These officials also said they had not considered the potential financial benefits

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<sup>26</sup>Form 1099-MISC is an information return used to report miscellaneous income, such as from royalties of \$10 or more or nonemployee services of \$600 or more.

<sup>27</sup>As of October 2017, IRS had loaded approximately 3.6 billion documents into the IRMF file.

<sup>28</sup>IRS's plan to modernize IRMF is called the Information Return System Modernization program.

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of either modifying existing procedures or continuing to pursue modernizing IRMF to process W-2 data more frequently for use in systemic verification.

However, in response to our discussions, in November 2017, IRS officials reported they had started to assess the possibility of processing W-2 data on IRMF daily. Specifically, IRS is planning to assess daily processing for the months of January and February during the 2019 filing season when the number of information returns is lower and the file is less time consuming to load. They noted they would not have time to assess their options and make necessary changes to process W-2s daily for the 2018 filing season.

As we reported in October 2017, IRS faces challenges with managing its aging legacy systems, and with establishing a process for prioritizing its modernization efforts.<sup>29</sup> IRS's planned action is consistent with its strategic plan, which includes objectives to strengthen refund fraud prevention by using third-party data and analytics for timely, informed decision making, and to innovate technology systems to support IRS's business needs.<sup>30</sup> It is also consistent with *Standards for Internal Control in the Federal Government*, which calls for management to design and implement internal controls within programs based on the related benefits and costs.<sup>31</sup> By taking its planned action to assess processing W-2 data more frequently, IRS would be in a better position to make informed decisions about the future of IRMF and its modernization efforts.

**Paper W-2 processing.** Of the 253 million W-2s that SSA received by December 1, 2017, about 23 million (9 percent) were paper. SSA receives and processes paper W-2s at the Wilkes-Barre Direct Operations Center (WBDOC) in Wilkes-Barre, Pennsylvania. Beginning in October or November of each year, WBDOC programs and tests its systems for transmitting transcribed paper W-2 data. The majority of W-2s that WBDOC receives are in optical character recognition (OCR) format, which SSA can scan into its systems instead of manually entering the data. Officials stated that W-2s that are not in OCR format require

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<sup>29</sup>GAO, *Information Technology: Management Attention Is Needed to Successfully Modernize Tax Processing Systems*, [GAO-18-153T](#) (Washington, D.C.: Oct. 4, 2017).

<sup>30</sup>IRS, *Strategic Plan: Fiscal Year 2014 - 2017*.

<sup>31</sup>[GAO-14-704G](#).

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more time and effort to process.<sup>32</sup> This process of developing, testing, scanning, or entering data manually occurs between October and March before WBDOD begins transmitting the paper W-2 data to SSA's Baltimore facility. Beginning in March, SSA continually transmits all paper and electronic W-2 data to IRS.<sup>33</sup>

By law, employers who file 250 or more W-2s are required to file W-2s electronically, while those who file fewer than 250 W-2s may opt to file on paper or electronically.<sup>34</sup> This requirement has not changed since 1989 when employers filed electronically using magnetic media or other machine-readable forms.<sup>35</sup> Since then, technological advancements allow employers to file for free using SSA's website or other software packages. Consequently, even though not required, by July 28, 2017, SSA had received approximately 69 million electronically filed W-2s from about 4.4 million employers who filed fewer than 250 W-2s.

In August 2014, we reported that lowering the electronic W-2 filing requirement would not only contribute to IRS's ability to verify employment information on tax returns, but it could reduce administrative costs for SSA.<sup>36</sup> According to SSA estimates, the cost to transcribe and process a total of 24.2 million paper W-2s in 2016 was about \$13.3 million, or \$0.55 per paper W-2. In addition to the cost savings from lowering the electronic filing requirement, as we reported in August 2014, there would be fewer transcription errors and fewer W-2s subject to the longer paper W-2 processing time.<sup>37</sup> In that report, we suggested that Congress should consider providing the Secretary of Treasury with the regulatory authority to lower the requirement for electronic filing of W-2s

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<sup>32</sup>W-2s that are not in OCR format include hand-printed W-2 forms and/or forms in non-standard format. SSA has a process to encourage employers to resubmit their W-2s electronically or in the proper paper format.

<sup>33</sup>For the 2017 filing season, electronic W-2 data were transmitted to IRS beginning in December 2016.

<sup>34</sup>26 U.S.C. § 6011(e)(2)(A).

<sup>35</sup>Omnibus Budget Reconciliation Act of 1989 (the Improved Penalty Administration and Compliance Tax Act) was included as a provision of the Omnibus Budget Reconciliation Act of 1989), Pub. L. No. 101-239, title VII, § 7713(a), 103 Stat. 2106, 2394 (Dec. 19, 1989).

<sup>36</sup>GAO, *Identity Theft: Additional Actions Could Help IRS Combat the Large, Evolving Threat of Refund Fraud*, [GAO-14-633](#) (Washington, D.C.: Aug. 20, 2014).

<sup>37</sup>[GAO-14-633](#).

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from 250 returns annually to between 5 to 10 returns, as appropriate. In August 2017, SSA officials estimated that SSA can save between \$9.7 and \$11.3 million per year if the W-2 paper filing requirement is lowered to 10 or fewer W-2s. These officials reported that this estimate is based on a projected increase of 17.6 million to 20.6 million in electronically filed W-2s and a decrease of paper W-2s by more than two-thirds.

**Late W-2 filing.** IRS began publicizing the change in the W-2 deadline in June 2016. Nevertheless, about 260,000 employers missed the January 31 filing deadline, accounting for late filing of about 7.9 million W-2s in 2017.<sup>38</sup> IRS officials stated that, of the 27,764 employers who had requested an extension for time to file W-2s, as discussed below, IRS approved approximately 6,500 (23.4 percent), which account for approximately 1.1 million W-2s (13.9 percent) of the 7.9 million late filed W-2s. Because IRS has not yet started to assess penalties, it does not yet know how many of these will be subjected to a penalty.

Generally, an employer must pay a penalty for failing to file an information return timely or correctly unless an exception applies, such as being granted an extension. However, IRS has changed how it enforces late filing penalties by not mailing some proposed penalty notices to employers who fail to file W-2s timely. For example, IRS mailed all penalty notices to employers who failed to timely file in 2014. However, it did not mail all penalty notices for 2015 and 2016 to employers who failed to file W-2s timely. IRS officials told us that, due to a lack of resources to manage all the penalty cases, they began applying a risk-based selection process to prioritize compliance efforts. Moreover, officials told us they did not collect data to track how many penalty notices IRS did or did not mail for late-filed W-2s, nor the associated penalties IRS proposed to assess for 2015 and 2016.

By law, there are some exceptions to the enforcement of penalties on those who fail to file correct information on or before the required filing date, and who fail to include all of the information required to be shown on

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<sup>38</sup>This does not include employers that do not file W-2s, but are required to do so.

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the return, or include incorrect information, without correction.<sup>39</sup> However, by not mailing all penalty notices, as it did in the past, IRS is not using a tool to collect, at the least cost, the proper amount of tax revenue, is not enhancing or promoting voluntary compliance, and it is missing an opportunity to educate and help the employer understand his or her legal obligations and rights.<sup>40</sup> Additionally, without timely W-2 data to complete pre-refund checks against filed returns, IRS risks releasing fraudulent and noncompliant refunds or burdening legitimate taxpayers whose returns could be cleared with the W-2 data. IRS officials told us that they are monitoring the effect of not mailing all notices on the number of late filings. However, as of November 2017, IRS did not have plans to track and evaluate the extent to which the late W-2s are associated with fraudulent or noncompliant refunds.

In addition, IRS does not mail penalty notices until up to a year and a half after the missed deadline. For example, IRS will not assess and mail penalty notices for the approximately 260,000 employers who filed W-2s or other information returns late in 2017 until summer 2018. In part, this is because IRS waits to compile all late-filed information returns, not just W-2s, some of which are not due until April. Further, late-filing penalty amounts increase incrementally until August 1 for employers who file or correct information returns after the filing deadline. Finally, for 2017, IRS did not finish transcribing and processing the more than 40 million paper-filed information returns until about late September. However, IRS officials have not assessed the options for mailing penalty notices for late W-2s earlier or communicating with the employers earlier in the process. These officials told us that the penalty notice process is consistent with IRS's enforcement procedures. They further added that mailing multiple penalty notices could increase burden and cost for both the taxpayer and IRS. However, quickly responding to employers that filed late increases the potential for compliance, thereby increasing the availability of W-2

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<sup>39</sup>26 U.S.C. § 6721 (a)(1)-(2). See also, 26 U.S.C. §§ 6722-24. IRS has procedural requirements that must be met before a penalty is assessed. For example, an initial determination of a penalty must be personally approved (in writing) by the immediate supervisor of the individual making the initial assessment determination prior to being assessed, unless an exception applies. 26 U.S.C. § 6751(b) and Internal Revenue Manual (IRM) Part 20, Chapter 1, Section 1, 2.3. There are exceptions to penalty assessments as well, such as if it is shown that any failure is due to reasonable cause and not to willful neglect. 26 U.S.C. § 6724(a). Other exceptions resulting in a waiver include statutory exceptions, administrative waivers, or correction of IRS error. IRM Part 20, Chapter 1, Section 1.3.

<sup>40</sup>IRM Part 20, Chapter 1, Section 7, 1.1, 1.3, and 1.4.

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data for systemic verification to detect and prevent fraud and noncompliance. Finally, because it takes up to a year and a half for IRS to identify the late filing and mail the penalty notice, it is possible that the employer could have filed W-2s late two years in a row without IRS notifying him/her of the first late filing.

**W-2 extensions.** In 2017, IRS received 27,764 employer requests for an extension of time to file W-2s, which is substantially higher compared to prior years. IRS officials attribute the increase in extension requests to the new early filing deadline. IRS also began requiring employers to provide reasonable cause and only file their requests on paper.<sup>41</sup> Prior to 2017, employers could file for an automatic 30-day request for extension, electronically or on paper. Because IRS manually processed all requests to determine if the cause was reasonable, IRS did not complete its processing until November 2017. Consequently, employers would not know until after the extended deadline whether IRS granted them the extension.

IRS officials told us that, for 2017, they notified about 10,000 employers who requested but were not granted an extension that they would not be penalized this year. Officials also notified these employers that they would be penalized next year under the same conditions. In November 2017, IRS officials said that they are reviewing the extent to which extension requests made in 2017 affected systemic verification. For 2018, IRS plans to continue requiring employers to file extension requests on paper.

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<sup>41</sup>Employers request extensions of time to file W-2s by filing Form 8809, *Application for Extension of Time To File Information Returns*.



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## IRS's Analyses of the Refund Hold Are Limited, Hampering Their Usefulness for Decision Making and IRS Has Not Explored Additional Uses of Systemic Verification

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### IRS Completed Its Analyses of Potential Changes to the Refund Hold but Did Not Fully Assess the Benefits and Costs and Taxpayer Burden

IRS officials examined the effectiveness of the February 15 refund hold by analyzing how systemic verification results differ under several hypothetical scenarios. For example, IRS could extend the refund hold date beyond February 15 when more W-2 data are available for systemic verification before issuing refunds. While the law states that IRS cannot release refunds with EITC or ACTC before February 15,<sup>42</sup> IRS has discretion to continue to hold all refunds until it can verify W-2 data, and has the authority to expand the refund hold to all taxpayers, not just those who claimed EITC or ACTC.<sup>43</sup> Further, the law does not preclude IRS from releasing refunds with EITC or ACTC on a rolling basis after February 15, or in conjunction with an extension of the refund hold.<sup>44</sup>

In October 2017, the National Taxpayer Advocate (NTA) told us that she supports potential modifications to the refund hold.<sup>45</sup> In addition, in a June

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<sup>42</sup>Pub. L. No. 114-113, § 201(b), *codified at* 26 U.S.C. § 6402(m).

<sup>43</sup>26 U.S.C. § 6201. Under Section 6201 of the Internal Revenue Code, IRS is authorized and required to make the inquiries, determinations, and assessments of all taxes as necessary. IRS has the authority to hold refunds in conjunction with those determinations. However, Section 6611(e) of the Code generally requires the payment of interest on refunds if any overpayment of tax is not refunded within 45 days after the last day prescribed for filing the return tax (determined without regard to any extension of time for filing the return). 26 U.S.C. § 6611(e).

<sup>44</sup>See, 26 U.S.C. § 6402(m).

<sup>45</sup>The National Taxpayer Advocate is the leader of the Taxpayer Advocate Service, an independent organization inside IRS that assists taxpayers in resolving problems and works for systemic changes to mitigate taxpayer problems.

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2017 annual report to Congress, the NTA stated that holding the refunds for all taxpayers longer so that IRS can verify W-2 data could help IRS prevent tax refund fraud before refunds are issued.<sup>46</sup> The NTA also recommended that IRS research the benefits and costs of delaying refund payments.

During the 2017 filing season, IRS reviewed limited preliminary systemic verification data to assess potential changes to the February 15 refund hold. In October 2017, IRS completed its final analysis, which included more data on taxpayers who filed after the February 15 refund hold and estimated potential amounts of protected refunds. However, both analyses have limitations.

### **Preliminary Analysis**

We assessed IRS's preliminary analysis of the 35.7 million returns filed by all taxpayers (those who claimed EITC or ACTC and those who did not) before February 15 and which were subjected to systemic verification.<sup>47</sup> IRS's analysis included actual results from systemic verification for these tax returns for each week between February 15 and March 15 after reprocessing the returns when new W-2 data became available. Our assessment of IRS's preliminary analysis showed that by both extending the refund hold date beyond February 15 and expanding the refund hold to all returns:

- **IRS could have verified more than twice as many returns.** By March 15, IRS could have verified wage information for more than twice as many returns before issuing refunds—30.5 million compared to 14.3 million verified by February 15. By only holding returns until February 15, IRS would be unable to verify W-2 data for 20.2 million (56 percent) tax returns, representing \$66.6 billion in refunds, before releasing the refunds.
- **IRS could have detected about \$3 billion—twice as much—in potential fraud and noncompliance.** If IRS had held all taxpayers' refunds until late February or early March, it could have detected

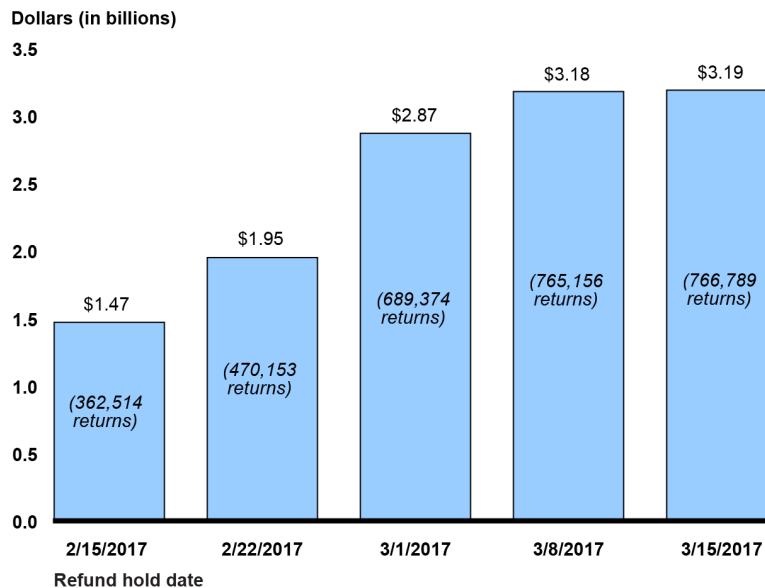
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<sup>46</sup>National Taxpayer Advocate, *Objectives Report to Congress, Fiscal Year 2018, Volume 2*, June 28, 2017.

<sup>47</sup>This total includes an additional 600,000 returns that IRS had received before February 15, but had yet to process. Therefore, it is different from the 35.1 million returns discussed earlier in this report, which only include the returns IRS had processed through February 14, 2017.

about twice as much potential fraud or noncompliance before issuing refunds, as shown in figure 4, because it had more W-2 data available at that time compared to February 15. For example, if IRS held all taxpayers' refunds until March 1, it could have identified \$2.87 billion compared to \$1.47 billion as of February 15, about a 95 percent increase. If IRS held all taxpayers' refunds until March 8, it could have identified even more in potentially fraudulent or noncompliant refunds before issuing them (\$3.18 billion compared to \$1.47 billion as of February 15, an increase of about 116 percent). However, these potential fraudulent or noncompliant refunds do not represent potential refunds that IRS could protect. This is because IRS limits the number of cases it selects for review due to the large volume of work this represents and limited staff available. Further, some returns that IRS selects for review are false positives—legitimate tax returns erroneously selected for review.

**Figure 4: Effect of Different Refund Hold Dates on Amount of Potentially Fraudulent or Noncompliant Refunds Detected with Systemic Verification among 35.7 Million Electronic Returns Filed before February 15**



Source: GAO analysis of IRS data. | GAO-18-224

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Our Fraud Risk Framework provides a comprehensive set of overarching concepts of fraud risk management and leading practices that serve as a guide for agency managers to use when developing efforts to combat fraud in a strategic, risk-based way.<sup>48</sup> For example, a leading practice in the Fraud Risk Framework emphasizes risk-based preventive activities for strategically managing fraud risk to help avoid a costly and inefficient “pay and chase” model. Additional leading practices call for federal agencies to continuously monitor and evaluate the effectiveness of preventive activities and to consider the benefits and costs of its control activities. Further, key concepts in the Fraud Risk Framework highlight the importance of measuring outcomes to adapt fraud detection and prevention activities. Additionally, we have reported that program evaluation provides agencies with objective information on program effectiveness and efficiency.<sup>49</sup> Program evaluation is necessary to inform and improve IRS’s fraud risk management activities.

However, when we compared IRS’s preliminary analysis to the Fraud Risk Framework and program evaluation standards, we found that it was limited in several areas:

- **IRS has not documented an evaluation plan, goals, or strategy related to the refund hold.** To ensure an evaluation’s credibility, agencies should develop evaluation plans with clearly defined program goals and researchable evaluation questions. However, IRS did not have documentation detailing an evaluation plan or program goals that includes the purpose of the analysis and the research questions it is assessing. Moreover, IRS plans to continue assessing the effectiveness of the refund hold on systemic verification.

In May 2016, we recommended that IRS develop an overall compliance strategy that includes refundable credits, such as EITC and ACTC.<sup>50</sup> In February 2017, IRS reported that it is taking steps to implement this recommendation. However, it is unclear how IRS plans to incorporate the results of its analysis of systemic verification into its overall compliance and fraud risk management strategy.

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<sup>48</sup>[GAO-15-593SP](#).

<sup>49</sup>GAO, *Designing Evaluations: 2012 Revision*, [GAO-12-208G](#) (Washington, D.C.: January 2012).

<sup>50</sup>[GAO-16-475](#).

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- **IRS did not determine how many potentially fraudulent or noncompliant refunds it issued before verifying against W-2 data.** A key benefit of obtaining W-2 data early in the filing season is to verify that the information matches before issuing the refund. In its preliminary results, IRS reported the number and amount of refunds it identified as potentially fraudulent or noncompliant before issuance only for taxpayers that claimed EITC or ACTC and whose refunds IRS held until February 15. Of the 22.1 million taxpayers who filed before February 15 and did not claim these credits, IRS identified approximately 196,000 returns filed by taxpayers claiming nearly \$580 million in refunds as potentially fraudulent or noncompliant. IRS did not report the number of refunds that were issued before IRS had identified them as potentially fraudulent.
  - **IRS has not fully assessed the burden on the taxpayers who were subjected to the refund hold date.** We have reported that a key concept in tax administration is reducing unnecessary taxpayer burden, which is the direct time and money that taxpayers spend to comply with tax laws, including costs for paid tax preparation.<sup>51</sup> Three economic experts we interviewed cited key factors that IRS could consider in assessing the burden to taxpayers as a result of the refund hold.<sup>52</sup> For example, experts told us that IRS could examine changes in taxpayer behavior, such as waiting to file a return later, or shifting from using Free File to paid preparation that can offer refund-related financial products such as an advance on their refund.<sup>53</sup> These experts also indicated that IRS could compare the amount of fraud or noncompliance that IRS prevented among taxpayers claiming EITC or ACTC against taxpayers who do not claim these credits. All experts we interviewed agreed that more than 1 year of data might be needed to assess short-term and long-term effects of the refund hold on taxpayer behavior and patterns of fraud and noncompliance.

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<sup>51</sup>GAO, *IRS Correspondence Audits: Better Management Could Improve Tax Compliance and Reduce Taxpayer Burden*, [GAO-14-479](#) (Washington, D.C.: June 2014).

<sup>52</sup>See appendix I for a description of our methodology and selection of economic experts.

<sup>53</sup>The Free File program is public-private partnership between IRS and the Free File Alliance. Free File is a consortium of 12 leading tax software providers who make their products available exclusively at IRS.gov. Each Free File software provider sets its own criteria for eligibility, generally based on income, age, state residency, or military service. A refund anticipation loan is an example of a refund-related financial product that taxpayers can use when they do not want to wait for their tax refunds. This loan is borrowed from a lender based on the taxpayer's anticipated tax refund.

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IRS officials told us that they have added a question to IRS's customer satisfaction survey to determine how taxpayers got their information about the refund hold. They have also indicated they are analyzing taxpayer behaviors related to the timing of filing and taxpayers' use of refund-related financial products. However, IRS has not provided us with the revised survey or its results, nor provided documentation of what is included in the analyses. IRS officials told us that they have limited resources to conduct research and have not completed the work because they are prioritizing other research efforts.

The limitations of IRS's preliminary analysis prevent IRS from fully understanding the effectiveness of systemic verification and refund hold, and hampers IRS's broader fraud risk management and compliance efforts. IRS officials stated that they did not document an evaluation plan, include key data, determine how many refunds were issued before detecting potential fraud and noncompliance, nor assess taxpayer burden. Without a documented evaluation plan that includes key data to assess the success of preventing fraud and noncompliance before issuing refunds, IRS risks relying on insufficient information to make decisions on potential changes to the refund hold date and those subjected to it. For example, by not assessing taxpayer burden, IRS does not understand how taxpayers are affected by the current hold date or whether extending the hold or expanding it to all taxpayers would increase taxpayer burden.

### **Final Analysis**

IRS completed its final analysis of the refund hold in October 2017 and provided us with a draft. Based on our initial review, IRS's findings correspond with those in the preliminary analysis discussed above in that IRS could detect much more potential fraud and noncompliance if it held refunds longer. However, there were key differences between the preliminary analysis and IRS's final analysis. First, IRS assessed two potential refund hold dates after February 15—February 28 and March 1, when IRS receives the majority of W-2s. Second, IRS included all returns that would be affected by the two extended refund hold dates rather than only those that filed before February 15. Third, IRS estimated the total amount of fraud and noncompliance that it could protect under these two extended refund hold dates. Finally, IRS based its estimates on returns

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that had completed final processing rather than returns that had not completed processing.<sup>54</sup>

In its final analysis, IRS estimated that it could detect about \$7.1 billion in potential fraud and noncompliance if it held refunds with EITC or ACTC until March 1, of which it could protect about \$533 million. This is about \$468 million more than what IRS protected by holding refunds with EITC or ACTC until February 15. Further, IRS estimated that it could have protected \$100 million in fraud and noncompliance had it held all taxpayer refunds until February 15—\$35 million more than it protected with the current hold and verification process. IRS further estimated that by holding all refunds until March 1, it could protect about \$895 million.

Various factors account for the differences between what IRS could detect as potential fraud and noncompliance and what it estimated that it could protect. First, IRS limits the number of cases it selects for review due to the large volume of work required to review all returns flagged by systemic verification and other fraud filters and limited staff available. Second, some returns that IRS selects for review are false positives—legitimate tax returns erroneously selected for review—so not all the returns will be confirmed as fraud or noncompliant.

In its final analysis, IRS had not addressed the limitations noted above for the preliminary analysis. However, IRS expects to further explore the possibility of holding refunds beyond February 15. IRS also plans to complete additional analyses, including the effect of W-2 extension requests on systemic verification and taxpayers' use of refund-related financial products. As IRS continues analyzing the effectiveness of the refund hold date on systemic verification, the limitations we outlined above will continue to prevent IRS from fully understanding the effectiveness of systemic verification and refund hold, and hamper IRS's broader fraud risk management and compliance efforts.

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<sup>54</sup>Not all returns will complete processing for various reasons such as those returns that are confirmed as fraudulent or duplicate.

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## IRS Has Not Analyzed the Benefits and Costs of Additional Uses of Early W-2 Data and Systemic Verification

As noted, the Fraud Risk Framework emphasizes the use of fraud prevention activities to help federal agencies avoid the costly and inefficient “pay-and-chase” model. However, IRS has not assessed the benefits and costs of additional uses of early W-2 data to prevent fraud and noncompliance before issuing refunds. For example, IRS has not determined the value of using W-2 data to address employment fraud or underreporting prior to issuing refunds. Employment fraud is a type of identity theft refund fraud that occurs when an identity thief uses a taxpayer’s name and Social Security number to obtain a job and claims a refund. Underreporting occurs when a taxpayer underreports income or claims unwarranted deductions or tax credits. With its Automated Underreporter program, which is utilized after the filing season and after refunds have been issued, IRS electronically matches income information reported to IRS by third parties, such as banks and employers, against the information that taxpayers report on their tax returns.

With earlier W-2 information, IRS can detect more possible employment fraud or underreporting before issuing refunds. For example, if IRS has two W-2s reporting wage income for a taxpayer, but that taxpayer did not report both on his or her tax return, the taxpayer may have underreported his or her income or could be a victim of employment fraud. IRS officials stated that they are not using systemic verification to review such instances before issuing a refund because it would require them to follow the deficiency process.<sup>55</sup> IRS typically begins this process when it has completed all of its compliance checks later in the filing season when it has most third-party data available for verification. IRS then sends the taxpayer a notice that informs him or her that IRS has proposed an adjustment to taxes owed because the third-party data IRS received does not match what the taxpayer reported on his or her tax return. The notice also informs the taxpayer of his or her right to challenge any resultant tax increase with the U.S. Tax Court.

IRS officials told us they do not want to issue the notice earlier because that could encourage taxpayers to file in Tax Court before IRS has completed its review. IRS officials stated that they did not see the

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<sup>55</sup>26 U.S.C. § 6212. The deficiency process includes sending the taxpayer a “statutory notice of deficiency” or “90 day letter,” which is a legal notice in which the Commissioner determines the taxpayer’s tax deficiency. IRS is required to issue a notice of deficiency before assessing additional income tax, estate tax, gift tax, and certain excise taxes unless the taxpayer agrees to the additional assessment.



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potential benefits of taking intermediate steps before sending a notice of deficiency, such as holding the refunds and corresponding with the taxpayer to resolve the discrepancy. However, while IRS had not explored this or other potential uses of W-2 data, IRS officials acknowledged that it would be worthwhile to consider additional opportunities of earlier W-2 data.

Earlier availability of W-2s and other information returns can help IRS identify and prevent fraud and noncompliance before issuing refunds.<sup>56</sup> However, without assessing the benefits and costs, IRS does not know the extent to which it can use earlier W-2 data for other pre-refund compliance checks.

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## Conclusions

During the 2017 filing season, IRS's ability to detect and prevent fraud and noncompliance improved because it received significantly more W-2 data earlier and utilized it to verify wage, withholding, and other information on millions of tax refunds. Based on these results, systemic verification shows promise for preventing fraudulent refunds and reducing noncompliance. Nevertheless, the agency faced challenges that limited its success in implementing systemic verification.

Similar to taking action to assess the potential for processing more W-2s early in the filing season, IRS can take additional steps to increase the availability of more W-2 data. By not collecting data to track late W-2 filings, IRS could not measure the extent to which late W-2 filings are associated with fraud and noncompliance. Further, by not taking earlier action to improve enforcement of penalties for late W-2 filings, IRS is missing an opportunity to encourage compliance with the W-2 filing deadline and verify more wage information before releasing refunds. As a result, IRS risks releasing fraudulent and noncompliant refunds. We have also previously identified action Congress could take to increase the availability of W-2 data to IRS early in the filing season. In August 2014, we suggested that Congress provide the Secretary of the Treasury with

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<sup>56</sup>These pre-refund compliance checks are consistent with IRS's earlier vision of a Real Time Tax system. We found that Real Time Tax had the potential to provide substantial benefits, including reducing taxpayer burden and improving compliance, but it could require significant and possibly costly changes and impose new burdens on third parties. However, in April 2016, IRS officials stated the agency had no plans to continue pursuing Real Time Tax due to a lack of resources and competing priorities. See GAO, *Tax Refunds: IRS Is Exploring Verification Improvements, but Needs to Better Manage Risks*, [GAO-13-515](#) (Washington, D.C.: June 4, 2013).

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the authority to lower the electronic filing requirement from 250 W-2s to 5 to 10 W-2s. This action would also have the benefit of reducing SSA's W-2 paper processing costs by millions of dollars each year.

In addition, the February 15 refund hold for EITC and ACTC claims afforded IRS an opportunity to verify return information with early W-2 data before issuing refunds. IRS took steps to collect and assess preliminary data on systemic verification and the refund hold during the filing season. In addition, IRS completed its final analysis that considers different scenarios for holding refunds longer and the potential revenue it could protect. However, IRS's efforts are not guided by an evaluation plan to assess the results of systemic verification in preventing fraud and noncompliance before issuing refunds. Developing and implementing an evaluation plan that fully assesses the benefits and costs of that hold date would help IRS determine the effectiveness of systemic verification, its fraud risks, and the effect of the refund hold on taxpayer burden. IRS would then be in a better position to modify the refund hold under its existing authority and balance detecting and preventing fraud and noncompliance with taxpayer burden. Further, it is not clear how the analysis informs IRS's broader fraud risk management efforts and other compliance strategies. Finally, with these data, IRS has the potential to improve tax enforcement in other areas such as for underreporting or employment fraud. While IRS has measures in place to address these issues after paying refunds, taking action before issuing refunds can prevent fraud and noncompliance and save IRS time and resources.

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## Recommendations for Executive Action

We are making the following six recommendations to IRS.

The Acting Commissioner of Internal Revenue should collect data to track late W-2 filing penalty notices and the extent to which they are associated with fraud and noncompliant returns. (Recommendation 1)

The Acting Commissioner of Internal Revenue should assess options for improving enforcement of late W-2 filing penalties, for example, by mailing notices before the next filing deadline. (Recommendation 2)

The Acting Commissioner of Internal Revenue should develop an evaluation plan to fully assess the benefits and costs, including taxpayer burden, of modifying the February 15 refund hold, and determine how this effort informs IRS's overall compliance strategy for refundable tax credits and fraud risk management. (Recommendation 3)

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Based on the benefits and costs assessment in Recommendation 3, the Acting Commissioner of Internal Revenue should use IRS's existing authority to modify the refund hold such that it minimizes the risk of releasing fraudulent or noncompliant refunds. (Recommendation 4)

The Acting Commissioner of Internal Revenue should assess the benefits and costs of additional uses and applications of W-2 data for pre-refund compliance checks, such as addressing underreporting, employment fraud, and other fraud or noncompliance before issuing refunds. (Recommendation 5)

Based on the assessment in Recommendation 5, the Acting Commissioner of Internal Revenue should implement any identified changes to improve pre-refund compliance checks. (Recommendation 6)

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## Agency Comments and Our Evaluation

We provided a draft of this product to Treasury and SSA for review and comment. IRS provided written comments, which are summarized below and reproduced in appendix II. SSA responded in writing with no comments (see appendix III). SSA and Treasury provided technical comments, which we incorporated as appropriate.

In its written comments, IRS did not state whether it agreed or disagreed with our recommendations, but outlined planned steps to address five of the six recommendations. If implemented as planned, IRS's proposed actions for recommendations 1, 4, 5 and 6, could meet the intent of the recommendations. However, for the third recommendation to develop an evaluation plan to fully assess the costs and benefits of modifying the February 15 refund hold, it is not clear whether IRS's planned actions will fully satisfy the recommendation. IRS stated that it would assess and evaluate options for improvements to its refundable tax credits and fraud risk management strategies. However, IRS did not specify whether this evaluation would fully assess the benefits and costs, including taxpayer burden, of modifying the February 15 refund hold. As we reported, a documented evaluation plan that includes key data to assess the success of preventing fraud and noncompliance before issuing refunds will help IRS make better-informed decisions on potential changes to the refund hold date and those subjected to it. This includes, for example, assessing taxpayer burden to understand how taxpayers are affected by the current hold date and whether extending the hold or expanding it to all taxpayers would increase taxpayer burden.

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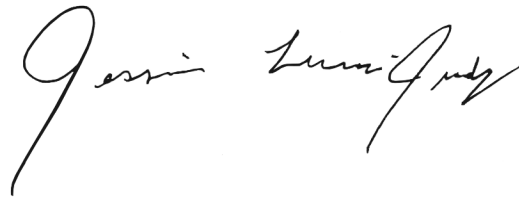
Regarding the second recommendation in our draft report to assess options for improving enforcement of late W-2 filing penalties by mailing notices before the next filing deadline, IRS stated that the timing of the receipt of a W-2 account file from SSA and the overall complexity of the process precludes notices from being issued prior to the start of the next filing season. Specifically, IRS noted that it assesses penalties on approximately 40 different types of information returns—in addition to W-2s—and that the penalty calculation is complex. For W-2s, IRS explained that it receives a reconciled file from SSA in December that identifies those employers that should not be penalized. Finally, IRS noted that issuing penalty notices on a piecemeal basis would burden the taxpayer and potentially lead to erroneous notices. We recognize that there are challenges to issuing penalty notices, or other communications, before the next filing season. However, there are also benefits. As we reported, earlier communication with the employer, whether it includes a penalty assessment or not, increases the potential for compliance, helps taxpayers avoid filing late in the subsequent year, and increases the availability of W-2 data for systemic verification to detect and prevent fraud and noncompliance. However, we continue to believe that assessing the options for improving enforcement of late W-2 filing penalties, such as through earlier communication, would help IRS identify potential opportunities to encourage compliance with the W-2 filing deadline and verify more wage information before releasing refunds. We intended the recommendation to be inclusive of other options beyond mailing notices earlier. As a result, we clarified the recommendation to make mailing notices before the next filing deadline an example.

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We are sending copies of this report to the appropriate congressional committees, the Acting Commissioner of Internal Revenue, the Acting Commissioner of Social Security, the Secretary of the Treasury, and other interested parties. In addition, the report is available at no charge on the GAO website at <http://www.gao.gov>.

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If you or your staff have any questions about this report, please contact me at (202) 512-9110 or [lucasjudyj@gao.gov](mailto:lucasjudyj@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix IV.

A handwritten signature in black ink that reads "Jessica Lucas-Judy". The signature is written in a cursive style with a large initial "J" and a long, sweeping underline.

Jessica Lucas-Judy  
Director, Tax Issues  
Strategic Issues

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*List of Requesters*

The Honorable Orrin Hatch  
Chairman

The Honorable Ron Wyden  
Ranking Member  
Committee on Finance  
United States Senate

The Honorable Kevin Brady  
Chairman  
Committee on Ways and Means  
House of Representatives

The Honorable Lynn Jenkins  
Chairman  
The Honorable John Lewis  
Ranking Member  
Subcommittee on Oversight  
Committee on Ways and Means  
House of Representatives

The Honorable Vern Buchanan  
Chairman  
Subcommittee on Tax Policy  
Committee on Ways and Means  
House of Representatives

The Honorable Sander Levin  
House of Representatives

The Honorable Peter Roskam  
House of Representatives

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# Appendix I: Objectives, Scope, and Methodology

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Our objectives in this report were to assess

- the Internal Revenue Service's (IRS) performance in detecting fraud and noncompliance using systemic verification, and the Social Security Administration's (SSA) performance providing timely Form W-2, Wage and Tax Statement (W-2) data to IRS; and
- the extent to which IRS analyzed the effectiveness of the refund hold on systemic verification as well as opportunities for IRS to apply systemic verification to other efforts to detect fraud and noncompliance.

To answer the first objective, we

- obtained and analyzed IRS documents and data, including documents describing the implementation of IRS's systemic verification of W-2 data and preliminary systemic verification data on the 2017 filing season, and used this information to determine how IRS used early W-2 data;
- reviewed the Protecting Americans from Tax Hikes Act of 2015 (the Act) and related tax laws and regulations to understand IRS's systemic verification matching W-2 data against individual income tax returns affected by the Act (taxpayers claiming the Earned Income Tax Credit (EITC) or the Additional Child Tax Credit (ACTC)), as well as other returns not affected by the Act (those not claiming EITC or ACTC), and statutory requirements for penalties, electronic filing, and authority to hold refunds;
- reviewed IRS laws, regulations, and policies on penalty assessments for filing W-2s late, IRS data on late W-2s for 2017, and interviewed IRS officials to understand the process for assessing penalties;
- interviewed officials from IRS's Wage and Investment division (which is responsible for managing filing season operations) on the challenges in implementing systemic verification, as well as planned improvements;
- interviewed officials from IRS's Information Technology Applications Development unit to understand the technological capabilities of IRS's Information Return Master File and related systems and identify system limitations and improvements. We compared IRS's actions to IRS's Strategic Plan, which includes objectives to strengthen refund fraud prevention by using third-party data and analytics for timely, informed decision making, and to innovate technology systems to support IRS's business needs. We also compared IRS's actions to the *Standards for Internal Control in the Federal Government*, which call

for management to design and implement internal controls within programs based on the related benefits and costs;<sup>1</sup>

- observed and interviewed SSA employees processing and transcribing paper W-2s at the SSA's Wilkes-Barre Direct Operations Center in Wilkes-Barre, Pennsylvania to understand how this work is performed and the time required for completing it;
- reviewed our prior reports, including reports on the filing season, tax credits, and identity theft, and evaluated IRS's actions to implement selected prior recommendations; and
- interviewed SSA managers and staff who oversee and process paper Form W-2 data and transmit the data to IRS, and obtained and analyzed SSA goals, documents, and data, including data on costs for processing paper W-2s.

To answer the second objective, we

- reviewed IRS documents that included internal working group meeting minutes, planning documents, and management reports;
- assessed IRS's data for 2017 and its preliminary and final analyses on the systemic verification results and outcomes under different scenarios for the 2017 filing season;
- compared IRS's efforts to detect and prevent fraudulent and noncompliant refund payments with leading practices in our A

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<sup>1</sup>GAO, *Standards for Internal Control in the Federal Government*, [GAO-14-704G](#) (Washington, D.C.: September 2014).



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*Framework for Managing Fraud Risks in Federal Programs* (Fraud Risk Framework) and program evaluation;<sup>2</sup>

- interviewed officials from IRS's Wage and Investment division on the benefits and costs of systemic verification and to determine whether IRS conducted an economic analysis of the effects on taxpayers burden as a result of holding all taxpayer's refunds until February 15;
- interviewed three economic experts to identify factors that IRS should consider or study following implementation of the Act. We selected economists based on their expertise in the field of tax policy and refundable tax credits, and to ensure variation in perspectives on tax issues. We asked similar questions of each economist and analyzed their comments to identify commonalities. We used these interviews to identify factors that IRS should consider in evaluating the refund hold date and any potential changes to it. The views of the economic experts are not generalizable; and
- interviewed officials from the Department of the Treasury's (Treasury) Bureau of the Fiscal Service and Office of Tax Policy about their actions to prepare for releasing a large volume of refunds on February 15 and to determine what analyses, if any, Treasury had conducted on taxpayer burden related to the holding all taxpayer's refunds until February 15.

To assess the reliability of the data we used for this report, we reviewed IRS and SSA reports on W-2 data and IRS reports on systemic verification and its results. We also reviewed IRS reports on the

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<sup>2</sup>See [GAO-14-704G](#) and GAO, *A Framework for Managing Fraud Risks in Federal Programs*, [GAO-15-593SP](#) (Washington, D.C.: July 2015). This framework is a comprehensive set of leading practices that serves as a guide for program managers to use when developing efforts to combat fraud in a strategic, risk-based manner. We identified these leading practices through focus groups with antifraud professionals; interviews with government, private sector, and nonprofit antifraud experts; and a review of literature. We used the leading practices in this framework to assess IRS efforts because, as the framework states, it encompasses control activities to prevent, detect, and respond to fraud, as well as structures and environmental factors that influence or help managers achieve their objective to mitigate fraud risks. Thus, this framework is applicable to IRS efforts to address fraud risks in systemic verification. Pursuant to the Fraud Reduction and Data Analytics Act of 2015, the Director of the Office of Management and Budget is to establish, in consultation with the Comptroller General, guidelines for agencies to establish financial and administrative controls to identify and assess fraud risks and design and implement control activities to prevent, detect, and respond to fraud, including improper payments, and which are to incorporate the leading practices identified in GAO's Fraud Risk Framework. Pub. L. No. 114-186, 130 Stat. 546 (June 30, 2016). See also GAO, *Designing Evaluations: 2012 Revision*, [GAO-12-208G](#) (Washington, D.C.: January 2012).

performance of its fraud filters. We examined systemic verification data to identify obvious errors or outliers and assessed potential data limitations that would affect use of the data for assessing performance. We also interviewed IRS officials about their data quality procedures and the reliability and limitations of these data. We determined that the data presented in this report are sufficiently reliable for the purposes of our reporting objectives.

We conducted this performance audit from March 2017 to January 2018 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

# Appendix II: Comments from the Internal Revenue Service



DEPUTY COMMISSIONER

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

January 11, 2018

Ms. Jessica Lucas-Judy  
Director, Tax Issues  
U.S. Government Accountability Office  
441 G Street, N.W.  
Washington, DC 20548

Dear Ms. Lucas-Judy:

I have reviewed the draft report entitled *Tax Fraud and Noncompliance: IRS Can Strengthen Pre-refund Verification and Explore More Uses* (GAO-18-224), and appreciate the opportunity to provide comments. The Protecting Americans from Tax Hikes (PATH) Act of 2015<sup>1</sup> introduced certain provisions, intended to reduce improper payments, that became effective for the 2016 tax year. One such provision, Section 201, changed the due date for filing Form W-2, *Wage and Tax Statement*, Form W-3, *Transmittal of Wage and Tax Statements*, and Form 1099-MISC, *Miscellaneous Income*, reporting non-employee compensation, to January 31. Prior to the passage of the PATH Act, the due date for these forms was the last day of February for paper filings, and March 31 for electronic filings. Section 201 also prevents the payment of refunds that include claims for the Earned Income Tax Credit (EITC) or the Additional Child Tax Credit (ACTC), prior to February 15 for calendar-year taxpayers.

For the 2016 filing season, the IRS began using the systemic verification process within our fraud detection system, the Return Review Program (RRP), to assess the fraud potential of all individual income tax returns claiming refunds. Systemic verification compares available wage and other income data provided by third-party reporters on information returns to the information reported on tax returns. With systemic verification, we leverage the data from information returns to make better-informed decisions on the risk level of potential identity theft refund fraud and non-compliance on each tax return. It is important to note that systemic verification of wage data is performed on all returns claiming refunds, not just those with refunds comprised of the EITC or ACTC. The systemic verification process works independently of the procedures we implemented to hold EITC and ACTC refunds until February 15.

<sup>1</sup> Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, 129 Stat. 2242 (2015).

2

To maximize the benefits obtained from systemic verification, on August 13, 2015, the IRS removed Treasury Regulation § 1.6081-8<sup>2</sup>, which provided for an automatic 30-day extension of time to file Form W-2, and replaced it with temporary Treasury Regulation § 1.6081-8T. The temporary regulation eliminated the automatic 30-day extension for submission of Form W-2. The intended result was to realize increased volumes of Forms W-2 received earlier in the year when the data has significant value during return processing. The passage of the PATH Act on December 18, 2015, which accelerated the filing deadline for all Form W-2 submissions, further assisted our efforts in increasing the volume of wage data available earlier in the filing season.

The January 31 due date became effective for the applicable information returns required to be filed for the 2016 tax year. We worked with the Social Security Administration to ascertain that Forms W-2 could be filed by employers as early as December 2016 and would be transmitted daily to the IRS. As the Form W-2 data was received, it was formatted and prepared for weekly uploading to the Information Returns Master File, which makes the data available to the RRP for use in systemic verification. Recognizing the significant impact the change of the filing due date and the elimination of automatic extensions could have on the payor community, the IRS also engaged stakeholders with educational outreach and communications to ensure employers were aware well ahead of the end of the tax year that their information returns would be due by January 31, 2017. These actions contributed to a two-fold increase in the number of Forms W-2 that had been filed and were available to the IRS on February 15, as compared to the same point in time the previous year.

Although systemic verification was first used in 2016, the accelerated due date for Form W-2, combined with the required hold placed on the population of refunds claiming EITC or ACTC, permitted us to perform baseline analyses on the ability to use it for authenticating the identities of taxpayers filing returns, as well as to use it as one of many tools in detecting potential refund fraud. We are leveraging the results of our systemic verification analyses of the 2017 filing season results to further refine fraud detection models and improve our ability to detect and stop more attempted identity-related refund fraud and noncompliance in 2018. Despite modifications to the filters, systemic verification does not overcome the complex eligibility requirements for EITC or ACTC such as residence and relationship. In addition, all identified cases with EITC or ACTC and income related issues require official notification through Statutory Notice of Deficiency procedures.

<sup>2</sup> 80 FR 48433, 48435, Aug. 13, 2015

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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 470-639-3250.

Sincerely,



Kirsten Wielobob  
Deputy Commissioner for  
Services and Enforcement

Enclosure

Enclosure

**Recommendations for Executive Action**

We are making the following six recommendations to IRS.

**RECOMMENDATION 1**

The Acting Commissioner of Internal Revenue should collect data to track late W-2 filing penalty notices and the extent to which they are associated with fraud and noncompliant returns.

**COMMENT**

We will review the source data from which the late filing penalty notices are created to assess its sufficiency for determining a correlation between late-filed Forms W-2, *Wage and Tax Statement*, and potentially fraudulent or noncompliant income tax returns. The late filing penalty notices are not an appropriate source for this analysis. Under the provisions of Internal Revenue Code § 6721, *Failure to file correct information returns*, the penalty notices cover all late-filed information returns, penalties other than late-filing penalties and are subject to statutory caps based on the penalty amounts, rather than the number and type of delinquent filings. Consequently, the notices do not contain the granularity of data needed to determine a correlation between late information return filings and potentially fraudulent of noncompliant income tax returns.

**RECOMMENDATION 2**

The Acting Commissioner of Internal Revenue should assess options for improving enforcement of late W-2 filing penalties by mailing notices before the next filing deadline.

**COMMENT**

Penalties for late-filed information returns are assessable on approximately 40 different types of returns, in addition to the Form W-2 series, with varying due dates and possible extensions of the time for filing that can impact penalty computations. Combined with the differing conditions that may be subject to assessment and the annual assessment limit, the analysis performed to calculate applicable penalties is complex. Consequently, it is imperative that when the computation is performed, all information pertinent to the tax year is available. With specific regard to Form W-2, the Social Security Administration provides a reconciled file to the IRS in December of each year that identifies accounts that should not be penalized for late-filed Forms W-2. That file is critical to the accuracy of the penalty notice generation process. After its receipt, additional manual and systemic analysis and programming are needed to complete the penalty notice process. Issuing penalty notices on a piecemeal basis, without all needed information, would cause substantial taxpayer burden due to multiple notices being issued, and would have a high potential for the issuance of erroneous notices. The timing of the receipt of the reconciled Form W-2 account file and the overall complexity of the process precludes notices from being issued prior to the start of the next filing season.

**RECOMMENDATION 3**

The Acting Commissioner of Internal Revenue should develop an evaluation plan to fully assess the benefits and costs, including taxpayer burden, of modifying the February 15 refund hold, and determine how this effort informs IRS's overall compliance strategy for refundable tax credits and fraud risk management.

**COMMENT**

We will assess and evaluate options for improvements to our refundable tax credits and fraud risk management strategies.

**RECOMMENDATION 4**

Based on the benefits and costs assessment in Recommendation 3, the Acting Commissioner of Internal Revenue should use its existing authority to modify the refund hold such that it minimizes the risk of releasing fraudulent or noncompliant refunds.

**COMMENT**

We will continue to use existing authority to prevent the payment of fraudulent or noncompliant refunds, and consider what modifications are needed in light of our assessment in response to recommendation 3.

**RECOMMENDATION 5**

The Acting Commissioner of Internal Revenue should assess the benefits and costs of additional uses and applications of W-2 data for pre-refund compliance checks, such as addressing underreporting, employment fraud, and other fraud or noncompliance before issuing refunds.

**COMMENT**

We will identify and assess ways in which the earlier receipt of Form W-2, *Wage and Tax Statement*, data can be used to address noncompliance prior to refund issuance. The discussion will consider legal and operational actions that may be required for successful implementation.

**RECOMMENDATION 6**

Based on the assessment in Recommendation 5, the Acting Commissioner of Internal Revenue should implement any identified changes to improve pre-refund compliance checks.

**COMMENT**

After we complete our actions in response to recommendation 5, we will evaluate identified actions and implement those that support sound tax administration.

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# Appendix III: Comments from the Social Security Administration

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January 5, 2018

Ms. Jessica Lucas-Judy  
Director, Tax Issues, Strategic Issues  
United States Government Accountability Office  
441 G Street, NW  
Washington, DC 20548

Dear Ms. Lucas-Judy:

Thank you for the opportunity to review the draft report, "TAX FRAUD AND NONCOMPLIANCE: IRS Can Strengthen Pre-refund Verification and Explore More Uses" (GAO-18-224). We shared technical comments at the staff level and have no further comments.

If you have any questions, please contact me at (410) 965-9704. Your staff may contact Gary S. Hatcher, Senior Advisor for the Audit Liaison Staff, at (410) 965-0680.

Sincerely,

Stephanie Hall  
Acting Deputy Chief of Staff

SOCIAL SECURITY ADMINISTRATION BALTIMORE, MD 21235-0001



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# Appendix IV: GAO Contact and Staff Acknowledgments

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## GAO Contact

Jessica Lucas-Judy (202) 512-9110, [lucasjudyj@gao.gov](mailto:lucasjudyj@gao.gov)

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## Staff Acknowledgments

In addition to the contact named above, Joanna Stamatiades, Assistant Director; Erin Saunders Rath, Analyst-in-Charge; Jessica Ard; Mark Canter; Jacqueline Chapin; Jehan Chase; Felisa Garmon; Robert Gebhart; Tom Gilbert; Andrew Howard; Kirsten B. Lauber; Japheth McGee; Paul Middleton; Ed Nannenhorn; Sabine Paul; Bradley Roach; and Robert Robinson made key contributions to this report.

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Chuck Young, Managing Director, [youngc1@gao.gov](mailto:youngc1@gao.gov), (202) 512-4800 U.S. Government Accountability Office, 441 G Street NW, Room 7149 Washington, DC 20548

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## Strategic Planning and External Liaison

James-Christian Blockwood, Managing Director, [spel@gao.gov](mailto:spel@gao.gov), (202) 512-4707 U.S. Government Accountability Office, 441 G Street NW, Room 7814, Washington, DC 20548



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