

#9 AUTHORIZE THE TREASURY DEPARTMENT TO RECOVER MISDIRECTED DEPOSITS OF TAX REFUNDS AND PAY THEM TO THE CORRECT TAXPAYERS

Present Law

The IRC does not currently authorize procedures through which the IRS may obtain information about an account holder who receives a misdirected direct deposit refund. The IRS has erroneous refund procedures to recover a direct deposit that has been applied to the wrong taxpayer's bank account due to IRS error.⁴⁹ An erroneous refund is defined as "the receipt of any money from the Service to which the recipient is not entitled."⁵⁰ However, the IRS may not use its erroneous refund procedures to recover a refund if it does not know the identity of the account owner.

Existing regulations provide that when federal payments (other than vendor payments) are deposited, the account at the financial institution shall be in the name of the recipient.⁵¹ However, financial institutions are not required to verify whether the name on the designated account matches the name of the depositor/taxpayer,⁵² and the IRS has no authority to take money out of the incorrect account or receive confidential information from the financial institution regarding the owner of the incorrect account.

The relevant guidelines provide, in part: "If the taxpayer or the taxpayer's agent gave incorrect account information, neither Fiscal Service nor IRS will assist the taxpayer with recovering the funds."⁵³

Reasons for Change

When a taxpayer or a preparer requests a tax refund via direct deposit, the taxpayer or preparer must enter the bank routing number and the taxpayer's account number on the return. Bank routing numbers are nine digits, and bank account numbers vary in length but generally are comparable. When entering roughly 18 digits, transcription errors sometimes happen. As a result, tax refunds are sometimes erroneously directed into the account of an unrelated third party. In a small number of cases, moreover, dishonest tax return preparers change the routing information on a return and the taxpayer's refund is deposited into the preparer's account.

There currently are no procedures that allow the IRS to recover a misdirected direct deposit and reissue it to the correct taxpayer. Thus, the IRS can do little more than contact the financial institution and ask that it attempt to persuade the incorrect account owner to return the misdirected funds. While the financial institution is required to take corrective action when the mistake is its own, it is generally not required to take action if the mistake is made by the taxpayer.⁵⁴ As a result, a taxpayer may lose his tax refund in entirety if he or his preparer inadvertently enters a wrong digit. This is an unacceptable and avoidable outcome.

49 See IRM 21.4.5.5.5, *Overview of Category D Erroneous Refunds* (Oct. 1, 2016).

50 See IRM 21.4.5.2, *Erroneous Refunds Overview* (Oct. 9, 2015).

51 31 C.F.R. § 210.5(a).

52 "It is important to note that [a financial institution] is not required to manually verify that the name on the [Automated Clearing House (ACH)] entry matches the name on the account at the time the payment is posted." Bureau of the Fiscal Service (BFS), *Green Book: A Guide to Federal Government ACH Payments* 2-6 (Rev. May 2013), <https://www.fiscal.treasury.gov/fsreports/ref/greenBook/pdf/greenbookchapter2.pdf>.

53 BFS, *Green Book: A Guide to Federal Government ACH Payments* 1-9 (Rev. May 2013), <https://fiscal.treasury.gov/fsreports/ref/greenBook/pdf/greenbookchapter1.pdf>.

54 See 31 C.F.R. § 210.8(d) (providing that if a financial institution becomes aware that an agency has originated an Automated Clearing House credit entry to an account that is not owned by the payee whose name appears in the ACH payment information, the financial institution shall promptly notify the agency).

By contrast, a taxpayer has substantially greater recourse if he requests that his refund be paid by paper check. If a taxpayer elects to receive his refund by check and the check does not arrive, the taxpayer may notify the IRS, and the Treasury Department's Bureau of the Fiscal Service (BFS, formerly Financial Management Service) will determine whether the check has been negotiated. If it has not been negotiated, BFS will issue a replacement check to the taxpayer. If BFS finds the paper check has been negotiated, it will conduct additional research and, if it determines the taxpayer was not involved in negotiation of the check, it will issue a replacement to the taxpayer and charge the Check Forgery Insurance Fund.⁵⁵

Current procedures providing recourse for taxpayers who elect to receive their tax refunds by check but not for taxpayers who elect to receive their tax refunds electronically make little sense. Direct deposit is a faster, more secure, and less expensive way of transmitting refunds than paper checks, and for those reasons, the IRS strongly encourages taxpayers to elect to receive their refunds in that way. The current procedures undermine the IRS's objective by providing a strong incentive for taxpayers to elect to receive their refunds by check.

One way to remedy a misdirected deposit is to grant the Treasury Department the authority to recover the mistakenly directed deposit from the bank and post the funds to the correct taxpayer's account. More specifically, when the BFS makes a direct deposit to a bank, the transmittal information would include both the taxpayer's name and account number. The bank would be required to verify that the account number into which the funds are deposited matches the taxpayer's name. If the bank does not do so, the BFS could require the bank to return the funds and the BFS could then issue the refund to the taxpayer.

Recommendation

Require financial institutions to verify that the name of the taxpayer matches the name on the account prior to processing a federal payment via the Automated Clearing House network.⁵⁶ If a financial institution fails to match the taxpayer's name with the name on the account, the Bureau of the Fiscal Service shall have the authority to demand that the financial institution return the funds, and shall use those funds to make the taxpayer whole for any loss sustained as a result of the institution's failure to conduct the name-matching.⁵⁷

55 See 31 U.S.C. § 3343. Once it is determined a refund check has been cashed and the BFS determines whether or not the payee endorsed the check, BFS may issue a replacement check or, when appropriate, may issue a denial letter. IRM 21.4.2.4.13 (Jan. 13, 2016).

56 There may be circumstances in which financial institutions cannot precisely match an account number with a taxpayer name. For example, if the guardian of an incapacitated taxpayer files a return and receives a refund, the refund may be directed to the taxpayer, but the account may be titled in the name of the guardian "for the benefit of" the taxpayer. Therefore, it may be necessary for Congress to provide the Secretary with flexibility to provide exceptions from the matching rule, where warranted.

57 This recommendation may fall within the jurisdiction of the banking committees (Senate Committee on Banking, Housing, and Urban Affairs; House Committee on Financial Services). For legislative language generally consistent with this recommendation but taking a different approach, see Protecting Taxpayers Act, S. 3278, 115th Cong. § 203 (2018).