



*The Internal Revenue Service Needs to Do
More to Stop the Millions of Dollars
in Fraudulent Refunds Paid to Prisoners*

September 2005

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 28, 2005

MEMORANDUM FOR CHIEF, CRIMINAL INVESTIGATION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Needs to Do More
to Stop the Millions of Dollars in Fraudulent Refunds Paid to Prisoners
(Audit # 200510019)

This report presents the results of our limited-scope review to determine the effectiveness of the Internal Revenue Service's (IRS) procedures for detecting fraudulent and potentially fraudulent prisoner refund returns. This review was performed at the request of the House Ways and Means Subcommittee on Oversight. The report provides information relating to 10 questions posed by the Subcommittee to the Treasury Inspector General for Tax Administration.

Synopsis

Refund fraud committed by prisoners is increasing at an alarming rate. The number of fraudulent prisoner returns identified by the Criminal Investigation (CI) function has grown 318 percent, from about 4,300 during Processing Year¹ (PY) 2002 to over 18,000 during PY 2004. During this same period, the universe of all fraudulent returns increased by 45 percent, from about 81,000 to about 118,000.

In addition, there may be other fraudulent prisoner returns the IRS is not aware of, for two primary reasons: resources and incomplete and inaccurate prisoner data. The number of returns screened by the CI function for fraud is based on two factors: the likelihood that fraud is present and the availability of resources to work the cases. During PY 2004, the Fraud Detection

¹ Processing year refers to the year in which taxpayers file their tax returns at the Submission Processing sites. Generally, returns for 2003 were processed during 2004, although returns for older years were also processed.



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Centers (FDC)² physically screened about 36,000 of the approximately 455,000 refund returns identified as filed by prisoners. The FDCs did not screen the remaining 419,000 prisoner returns. We performed additional analysis of data maintained in the CI function's Electronic Fraud Detection System³ and the prisoner data file and determined that over 18,000 prisoners incarcerated during the entire Calendar Year 2003 filed returns with a filing status of either "Single" or "Head of Household" and claimed over \$19 million in Earned Income Tax Credits.⁴ This problem was reported in 1995 by the prior Inspection Service.⁵ The IRS implemented most of the corrective actions for that report; however, the IRS has still not developed and implemented procedures to effectively identify prisoner returns during initial returns processing.

In addition, our analysis of the approximately 2.8 million prisoner records on the 2004 prisoner data file identified about 550,000 records that were either missing or inaccurate. More specifically, there were about 118,000 duplicate Social Security Numbers (SSN), 298,000 records with invalid SSNs, and 134,000 records that were missing from the prisoner data file because an early deadline excluded individuals incarcerated between September 1 and December 31, 2003. These inaccuracies prevented the IRS from detecting all fraudulent refund returns filed by prisoners.

Further, prison authorities expressed frustration with the IRS' inability to share information on prisoner refund fraud. Internal Revenue Code (I.R.C.) Section (§) 6103⁶ generally prohibits the IRS from sharing Federal tax information with other agencies such as State prison authorities, except under limited circumstances. Federal tax information is shared primarily with State tax agencies, under the provisions of Federal-State Agreements executed between the IRS and each State. We reviewed 21 Federal-State Agreements and determined that none had any specific provision authorizing the IRS to share Federal tax information with State prisons.

We analyzed prisoner refund scheme data and the prisoner data file to determine which prisons had the highest incidence of fraudulent returns. Prison facilities located in South Carolina and Florida were among the top prisons listed with 200 or more instances of fraudulent refund returns. Although providing specific information about individuals filing fraudulent returns would violate I.R.C. § 6103, it would not be a violation if the CI function provided summary

² The FDCs operate closely with Submission Processing sites where individual tax returns are filed. The FDCs use manual and computerized techniques to detect potentially fraudulent refund returns, prevent the issuance of those refunds, and refer cases to the CI function field offices for investigation.

³ The Electronic Fraud Detection System is an automated system used by personnel in the FDCs to review potentially fraudulent tax returns.

⁴ The Earned Income Tax Credit is a refundable credit established by Congress to aid low-income workers. Refundable means the taxpayer will receive the credit even if he or she does not owe taxes.

⁵ *Review of the Tax Implications of the New Earned Income Tax Credit Laws* (Reference Number 055503, dated July 7, 1995). The Inspection Service was the predecessor organization to the current Treasury Inspector General for Tax Administration, created in 1999.

⁶ I.R.C. § 6103 (2004).



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information to the various prisons. This could alert prison authorities and allow them to take appropriate actions.

We presented our interim results to and participated in a hearing with the House Ways and Means Subcommittee on Oversight on June 29, 2005. Prior to the hearing, we shared our results with CI function management and learned of their initiatives to enhance the detection of fraudulent refund returns, including prisoner returns. These initiatives, which were described during the Chief, CI's, testimony, included continuing coordination to acquire accurate prisoner information to maximize the effectiveness of the CI function's automated systems for timely identification of questionable prisoner returns, conducting training sessions with all Questionable Refund Program field coordinators and management to discuss expectations of the fraud program and emerging trends in prisoner refund schemes and to share best practices for coordinating efforts with prisons, increasing efforts in working with the prisons to identify emerging activities involving refund fraud, and assuring all FDCs have procedures in place to coordinate fraud prevention efforts with the prisons.

We are encouraged by CI function management's efforts to enhance the detection of fraudulent refund returns. As described throughout this report, we will conduct follow-on reviews to determine the effectiveness of the IRS' processes for detecting and preventing fraudulent refund returns and will make recommendations at that time.

Response

We discussed the results of our review with CI management officials during our fieldwork, and management advised us of their ongoing efforts to combat prisoner-related refund fraud. Accordingly, we made no further recommendations in this report; however, we plan to continue assessing the IRS' efforts on this important tax administration issue. The Chief, CI, provided a written response outlining the CI function's commitment to improving its ability to identify and stop fraudulent refund returns. The complete response to the discussion draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers affected by the report findings. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.



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Background

This review was performed at the request of the House Ways and Means Subcommittee on Oversight. The Subcommittee expressed concerns about the increase in refund fraud committed by individuals who are incarcerated in Federal and State prisons.

The Oversight Subcommittee members asked the Treasury Inspector General for Tax Administration (TIGTA) to assess the Internal Revenue Service's (IRS) procedures to detect fraudulent and potentially fraudulent prisoner refund returns and to provide information concerning the following:

- 1) *How many fraudulent refunds are issued? How many are stopped? What is the estimated cost to the taxpayer? Could there be other fraudulent prisoner returns that the IRS is unaware of?*
- 2) *The IRS reported to the Committee that in Processing Year 2004, of the 18,159 returns determined to be fraudulent, only 14,033 refunds were stopped. Why wasn't the IRS able to stop the refunds in the additional 4,000 cases?*
- 3) *It is our [the Committee's] understanding the IRS' efforts are focused on flagging returns filed by inmates whose names are in the prisoner file. Does the IRS have any way to detect fraud committed by prison inmates who are using the names of other individuals to commit fraud? Is there any estimate of the scope of such fraud?*
- 4) *How frequently do inmate fraud schemes use EITC [the Earned Income Tax Credit],¹ Form 4852,² Form W-2, or false Schedule Cs³ to facilitate the fraud? What measures has the IRS taken?*
- 5) *What does the IRS do to deter tax fraud by inmates and those on the outside assisting inmates? Stopping refunds? Referring cases for prosecution? Does the IRS inform [S]tate prison authorities when they detect inmate fraud so that they can take*

¹ The Earned Income Tax Credit (EITC) is a refundable credit established by Congress to aid low-income workers. Refundable means the taxpayer will receive the credit even if he or she does not owe taxes.

² Substitute for Form W-2, Wage and Tax Statement, or Form 1099-R, Distributions From Pensions, Annuities, Retirement, or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc. (Form 4852). This is a substitute for a Wage and Tax Statement (Form W-2) that taxpayers use to report wages and withholding when they do not receive a Form W-2 from their employer. IRAs are Individual Retirement Arrangements.

³ Profit or Loss From Business (Schedule C). This Schedule is used by taxpayers to report income and expenses from self-employment on a U.S. Individual Income Tax Return (Form 1040).



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administrative disciplinary action against the inmate? If not, is such action prohibited by [Internal Revenue Code] [S]ection 6103?⁴

- 6) *Does the IRS have a uniform system for informing and coordinating efforts with prison authorities in Federal and State prisons? Does the IRS have a system for coordinating its efforts in this area with State revenue authorities?*
- 7) *Does the IRS notify parole authorities if a paroled prisoner commits refund fraud? Is such action prohibited by IRC [I.R.C.] [S]ection 6103?*
- 8) *How frequently are prison files updated?*
- 9) *What is the largest number of returns prepared by a single prisoner?*
- 10) *What prison has the most number of inmates accused of refund fraud, and how many incidents occurred in that prison?*

Our review was performed at the Criminal Investigation (CI) function National Headquarters in Washington, D.C.; the Atlanta Fraud Detection Center (FDC);⁵ and the Fresno Submission Processing Site⁶ during the period May through July 2005. The audit was conducted in accordance with the President's Council on Integrity and Efficiency *Quality Standards for Inspections*. Detailed information on our objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The Oversight Subcommittee held a hearing on this subject on June 29, 2005, at which the Inspector General for Tax Administration testified. This report presents the results of the work we performed for and presented at that hearing, as well as some additional analyses.

We are presenting the results of our review by separately addressing each of the questions posed by the Subcommittee members. The information and data we obtained were provided to us by the CI function. Although we did not independently verify these data and do not express an overall opinion on their accuracy and completeness, we did identify some inaccuracies that we do comment on.

⁴ Internal Revenue Code (I.R.C.) Section (§) 6103 (2004).

⁵ The FDCs use manual and computerized techniques to detect potentially fraudulent refund returns, prevent the issuance of those refunds, and refer cases to the CI function field offices for investigation.

⁶ The Submission Processing site is the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.



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Results of Review

1) The Number of Fraudulent Refunds Issued and the Estimated Cost to the Taxpayer

Table 1 presents data reported by the IRS CI function on the total number of returns filed and refund amounts claimed by all individuals and by prisoners during Processing Year (PY) 2004.⁷

Table 1: Refund Returns Filed and Refunds Claimed

Number of Returns	Total	Prisoner	Percentage
Total Returns Filed	130,459,600	Not Available ⁸	
Refund Returns Filed	106,420,200	455,097	0.43%
Returns Reviewed for Potential Fraud	463,222	36,126	7.80%
Fraudulent Refund Returns ⁹	118,075	18,159	15.38%
Fraudulent Refunds Stopped	<u>81,922</u>	<u>14,033</u>	17.13%
Fraudulent Refunds Issued	<u>36,153</u>	<u>4,126</u>	11.41%
Amount of Refunds			
Refunds Requested	\$227,573,835,000	\$758,951,862	0.33%
Fraudulent Refunds	\$440,773,403*	\$68,179,070	15.47%
Fraudulent Refunds Stopped	<u>\$309,961,554*</u>	<u>\$53,456,963</u>	17.25%
Fraudulent Refunds Issued	<u>\$130,811,849</u>	<u>\$14,722,107</u>	11.25%
Average Fraudulent Refund	\$3,733	\$3,755	
Average Fraudulent Refund Stopped	\$3,784	\$3,809	
Average Fraudulent Refund Issued	\$3,618	\$3,568	
* Does not include 1 scheme with 2 returns claiming \$1.8 billion.			

Source: The CI function's data dated April 1, 2005.

As shown in Table 1, a disproportionately higher percentage of fraudulent returns are filed by incarcerated individuals. Although prisoner returns account for only .43 percent of all refund

⁷ Processing year refers to the year in which taxpayers file their tax returns at the Submission Processing sites. Generally, returns for 2003 were processed during 2004, although returns for older years were also processed.

⁸ The IRS cannot identify all prisoner returns because the prisoner data file is matched only against refund returns.

⁹ This could include fraudulent returns identified during IRS returns processing or by the Electronic Fraud Detection System, which is an automated system used by personnel in the FDCs to review potentially fraudulent tax returns. Fraudulent returns are also identified with the assistance of prison authorities, informants, or other sources.



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returns, they account for over 15 percent of the fraudulent returns identified by the IRS. Refund fraud committed by prisoners is growing at an alarming rate. The number of fraudulent prisoner returns identified by the CI function grew from about 4,300 during PY 2002 to over 18,000 during PY 2004 (a 318 percent increase). During the same period, all fraudulent returns identified grew by 45 percent, from about 81,000 to about 118,000. The percentage of fraudulent returns identified as prisoners grew from 5 percent to 15 percent.

The IRS may be unaware of other fraudulent prisoner returns

The IRS may be unaware of other fraudulent prisoner returns for two primary reasons: resources and incomplete prisoner data.

Resources: The total number of returns screened by the FDCs is based on two factors: the likelihood that fraud is present and the availability of resources to work the cases. Each refund return is given a “data mining score” based on certain criteria. The higher the score, the greater the chance the refund could be fraudulent. The CI function also uses other criteria to screen returns. The number of returns screened is based on these criteria and the resources available.

During PY 2004, the FDCs physically screened about 36,000 of the approximately 455,000 refund returns identified as filed by prisoners. However, the FDCs did not physically screen the remaining 419,000 prisoner returns that claimed \$640.4 million in refunds and \$315.8¹⁰ million in EITC. We performed additional analysis of the Electronic Fraud Detection System and the prisoner data file and determined that over 18,000 prisoners incarcerated during the entire Calendar Year 2003 filed returns with a filing status as “Single” or “Head of Household” and claimed over \$19 million in EITC. Since these prisoners were incarcerated for the entire year, they would have had neither eligible earned income to qualify for the EITC nor a qualified child who lived with them for more than 6 months.

Although the FDCs do not have the resources to physically screen all prisoner returns, we believe the IRS has the opportunity during regular returns processing to identify and stop most of the \$19 million of EITC claimed.¹¹

The problem of prisoners incorrectly claiming the EITC is not a new one. This issue was reported in 1995 by the prior Inspection Service,¹² which concluded the IRS did not have a plan

¹⁰ This number differs from that reported by the CI function due to data anomalies.

¹¹ The IRS disallowed some of these EITC claims through its “math error” process (e.g., when the EITC claimed was above the statutory maximum or the taxpayer did not meet the age requirements). However, we were unable to quantify the amount during this review. We plan to consider this area as part of a follow-on review.

¹² *Review of the Tax Implications of the New Earned Income Tax Credit Laws* (Reference Number 055503, dated July 7, 1995). The Inspection Service was the predecessor organization to the current TIGTA, created in 1999.



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to implement an amendment to the EITC¹³ that denied the credit to prisoners who use income earned while in prisons to qualify for the credit. The IRS implemented most of the corrective actions for that report; however, the IRS still has not developed and implemented procedures to effectively identify prisoner returns during initial returns processing.

We could not specifically determine why systemic procedures were not implemented, but one CI function management official believed the inaccuracy of the prisoner data file was a factor. The Submission Processing function currently uses only manual procedures to identify prisoner returns. We were also advised by Wage and Investment Division management that there have been no studies, nor are there current plans to conduct a study, to determine the feasibility of inputting a prisoner code to identify prisoner returns during initial returns processing. Further, management believed it would not be cost effective to match income reporting documents or prison identification numbers to identify fraudulent prisoner returns.

Incomplete Prisoner Data: During PY 2004, individuals identified on the prisoner data file filed 455,097 refund returns. There were about 2.8 million prisoner records in the 2004 prisoner data file. However, we estimate almost 19 percent (about 550,000 records) are missing or inaccurate for the following reasons:

- About 255,000 records did not have a Social Security Number (SSN) that is consistent with a valid number. For example, over 252,000 records had 000-00-0000 as the SSN.
- About 118,000 records had duplicate SSNs.
- Almost 43,000 records had invalid SSNs because they exceeded the highest SSN issued by the Social Security Administration.
- About 134,000 records were not in the 2004 prisoner data file because prisons had to submit such information to the IRS by the end of August 2003. The early deadline excluded individuals incarcerated between September 1 and December 31, 2003.

We were unable to determine the number of potentially fraudulent refunds prisoners claimed because prison authorities did not provide accurate SSNs to the IRS. However, we performed an analysis of the 134,000 prisoner records that were excluded from the 2004 prisoner data file because of the early deadline and determined 23,185 prisoners claimed \$39.4 million in refunds, including \$15.7 million in EITC. Since these individuals were incarcerated for only part of Calendar Year 2003, they could have had a legitimate need to file returns. However, due to the propensity of prisoners to file fraudulent returns, timely identification of prisoner returns could result in detection of additional fraud.

¹³ Uruguay Round Agreements Act, Pub. L. No. 103-465, § 723, 108 Stat. 4809, 5003 (1994) (codified as amended at 26 U.S.C. § 32 (c)(2)(B)(iv) (2005)).



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During the June 29, 2005, Congressional hearing on prisoner refund fraud, Representative Tom Feeney of Florida, stated,

It is unacceptable that [S]tate prisons receive [F]ederal funding, yet some are unwilling to cooperate with the IRS to prevent inmates from defrauding the [F]ederal [G]overnment. I encourage the [C]ommittee to explore ways to encourage or to provide incentives to [S]tates to share basic information about inmates with the [F]ederal [G]overnment.

The inaccuracies in the prisoner data file prevented the IRS from detecting all fraudulent refund returns filed by prisoners. We believe it is imperative for the IRS to have an accurate and timely prisoner data file, not only for the CI function but also for the Submission Processing function to stop fraudulent prisoner refunds that are below the tolerances established for possible criminal prosecution.

2) Why the Internal Revenue Service Did Not Stop Fraudulent Refunds

As previously noted, the IRS identified about 118,000 fraudulent refund returns during 2004 but was unable to stop the refunds on about 36,000 returns (31 percent), about 4,000 of which were prisoner returns. The IRS often issues refunds on tax returns it eventually identifies as fraudulent because of the short time constraints it sets for itself. Part of its customer service philosophy is to pay tax refunds promptly since the vast majority of tax refunds are legitimate. This attempt to pay refunds promptly generally gives the IRS about 3 weeks to prevent a fraudulent refund from being paid. During that time, the FDC evaluates the return for indicators of fraud, verifies any wage and withholding information with employers, and identifies other potentially fraudulent returns with similar characteristics. The IRS must work quickly within this time period to ensure legitimate refunds are paid promptly.

The CI function must physically review the return to collect return information that is not entered electronically. The CI function has even less time to review a paper return that requests an electronic direct deposit of the refund into a bank account. Over 75 percent of all fraudulent refund returns filed by prisoners in PY 2004 were filed by paper instead of electronically, and this presents the IRS with unique challenges.



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We obtained a computer extract from the CI function dated May 4, 2005, that contained 4,261 records of fraudulent refunds issued to individuals identified on the 2004 prisoner data file.¹⁴

Table 2 shows the five most common reasons why these fraudulent refunds were issued. These 5 reasons represented 91.3 percent of all fraudulent prisoner refunds issued.

Table 2: Top Five Reasons Why Refunds Were Issued

Reason Refund Issued	Total Refunds Issued	Electronic Return	Paper Return
Identified After Cycle Cutoff	2,196	600	1,596
Other	786	192	594
No Selection	462	79	383
Tax Examiner Error	320	108	212
Prior Year Return	<u>128</u>	<u>31</u>	<u>97</u>
Totals	<u>3,892</u>	<u>1,010</u>	<u>2,882</u>

Source: TIGTA analysis of the Scheme Tracking and Referral System (STARS).¹⁵

Cycle Cutoff: Tax returns entering the Submission Processing function go through various computer routines to perfect the data for processing. Various dates during the processing cycle have been established for certain routines to be completed so returns, and any resulting refunds, can be processed timely.

Other or No Selection: The CI function selected these two reasons why refunds were issued in over 29 percent of the cases. While these are legitimate reasons, we believe they should be used sparingly. Using generic reasons could make it more difficult to identify the real reason refunds are issued and to make improvements to better identify and stop the refunds. The CI function indicated time constraints during processing may have led to the high use of these categories.

Prior Year Return: These are returns that were processed in the prior year but were detected during the current processing year. For example, these returns could have been identified as a result of an informant or their association with a current-year scheme.

Table 2 is based on data as originally entered by the CI function into the STARS and may not be descriptive enough for CI function management to determine why refunds were issued. The

¹⁴ This is slightly higher than the 4,126 fraudulent refunds reported as of April 1, 2005, because fraudulent refunds are continuously being identified.

¹⁵ A database that contains information on fraudulent returns and schemes such as the amount of refunds claimed and stopped, the amount of EITC claimed and stopped, and information on the types of false documents used to perpetrate the scheme.



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CI function further analyzed the reasons tax refunds were not stopped and identified the following causes:¹⁶

Table 3: CI Function Analysis of Reasons Refunds Were Issued

Reason Refund Issued	Total Refunds Issued
Return Preparer Program Case	156
Prior Year Return	179
Did Not Meet Data Mining Tolerances	903
Untimely Receipt of, or Direct Deposit Refund on, Paper Returns	1,270
Volume of Electronic Return Scanning (resource issue)	428
Human Detection, Data, or Input Errors	<u>1,064</u>
Total Refunds Issued	<u>4,000</u>

Source: The CI function.

Return Preparer Program Case: According to CI function management, refunds are usually not stopped on these types of investigations because the focus of the investigation is on the return preparer, not individual taxpayers who, knowingly or unknowingly, are party to the fraud.

Did Not Meet Data Mining Tolerances: The return was processed in an earlier cycle and did not meet the tolerances. A later fraudulent return is detected (either by data mining or other sources) that contains data linking it to returns in an earlier cycle. The FDC analyst reviewing this later return determined the earlier return had similar characteristics and subsequently determined it to be fraudulent.

Untimely Receipt of, or Direct Deposit Refund on, Paper Returns: As previously mentioned, paper returns present the IRS with unique challenges. An FDC analyst must obtain the actual return from the Submission Processing site. However, analysts may not receive the return in time to review it and stop the refund, whether electronic or paper.

Volume of Electronic Return Scanning: Electronic returns have most of the information, including employer, available electronically for review. The CI function is assuming the volume of returns was so large that the FDC analysts could not review them in time to determine if they were fraudulent and stop the refunds.

¹⁶ The CI function's analysis is based on 4,000 refunds. Therefore, it cannot be compared with the data we obtained on 4,261 refunds. Although the CI function's new analysis gives a general comparison and provides a better indication of the reason refunds are issued, the CI function made some assumptions based on data analysis and not on actual reviews of cases.



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Use of freeze codes to stop refunds

Operating procedures provide for the FDCs to input freeze codes on the Master File¹⁷ when a fraudulent refund return is identified. This will prevent the automatic issuance of a future refund.

We determined there were no freeze codes on the accounts of 2,972 of the 15,371 prisoners who filed 18,343 fraudulent returns during PY 2004. As a result, some of these prisoners filed 203 returns claiming \$587,645 in refunds during PY 2005. The IRS later reversed 29 refunds for \$115,338. We identified another 186 prisoner accounts on which the freeze codes were not input until 2005. Although only 8 refunds were issued on these 186 accounts, failure to timely input freeze codes could result in the issuance of improper refunds.

We did not determine why freeze codes were not entered for these accounts. The CI function has indicated it plans to automate the input of the freeze code during PY 2006. We plan to conduct a follow-on review, during which we will evaluate the effectiveness of this process.

3) The Internal Revenue Service's Ability to Detect Fraud by Prisoners Using the Names of Other Individuals

The CI function's management information system is currently not capable of providing the information needed to answer this question. This information could be obtained through a time-consuming process of manually reviewing each case file involving refund fraud. Our analysis of 18,343 fraudulent prisoner refund returns identified during PY 2004 showed:

- There were 1,193 schemes claiming \$68.7 million in refunds.¹⁸
- These schemes included almost 69,000 returns not identified as prisoners that claimed \$221.1 million in refunds.¹⁹

¹⁷ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

¹⁸ This includes 66 schemes designated as Return Preparer Program cases. A scheme could consist of only one fraudulent return or hundreds of fraudulent returns.

¹⁹ Returns not identified as prisoner-filed returns could actually have been filed by prisoners but not identified as such due to the incompleteness of the prisoner data file. These could also be situations involving prisoners using the SSNs of nonprisoners or nonprisoners using prisoner SSNs. Likewise, there could be only one or two prisoner-filed returns in a scheme that involves many nonprisoner returns. We excluded nonprisoner fraudulent returns that are part of a Return Preparer Program scheme or a nonprisoner dump scheme (defined later).



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4) Frequency of Fraud Committed Using the Earned Income Tax Credit and Other Forms

The CI function maintains information regarding refund fraud in the STARS. The STARS contains information on fraudulent returns and schemes, the amount of refunds claimed and stopped, the amount of EITC claimed and stopped, and the types of false documents used to perpetrate the scheme (e.g., Form 4852, Form W-2, or Schedule C).

Schemes claiming the EITC

According to the STARS, the number of fraudulent refund returns and schemes that claimed the EITC, regardless of the method or IRS forms used to commit the fraud, is:

Total Number of Different Schemes:	740
Number of Returns Claiming the EITC:	4,554
Amount of EITC Claimed:	\$9.4 million

Although the STARS contains information on the amount of EITC stopped, we are unable to determine the exact amount of EITC that was issued or stopped due to the number of variables involved in determining what makes up the refund amount. For example, there could be other credits claimed on the return such as the child credit. In addition, some of the EITC could be offset by self-employment tax.

Schemes using other IRS forms

We attempted to determine the number of schemes in which prisoners used Form 4852, Form W-2, or Schedule C. There could be more than one document per return. However, the STARS data are not complete and cannot be completely relied upon. Although the CI function identified 18,343 fraudulent refund returns, the STARS listed only 10,705 false documents. Based on these limited data, we determined the CI function identified the following:

Schemes With Form 4852: We were advised that many prisoner schemes involve Form 4852. In addition, during a visit to an FDC, we reviewed three different refund schemes. All involved Income Tax Returns for Single and Joint Filers With No Dependents (Form 1040EZ), with a handwritten Form 4852, and the Employer Identification Numbers were missing from the Forms 4852. However, we compared 1 of the schemes to the STARS and determined the STARS did not include 70 percent of the false Forms 4852 for that scheme. We were later



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advised the FDC did not include a Form 4852 on the STARS if the Employer Identification Number was missing.

Notwithstanding the incomplete data on Forms 4852, the STARS database showed the following information related to this Form:

Total Number of Different Schemes:	43
Number of Returns With Form 4852:	2,147
Amount of Refunds Claimed:	\$4.7 million
Amount of Refunds Stopped:	<u>\$4.0 million</u>
Amount of Refunds Issued:	<u>\$0.7 million</u>

Schemes With Form W-2:

Total Number of Different Schemes:	944
Number of Returns With False W-2:	7,662
Amount of Refunds Claimed:	\$34.2 million
Amount of Refunds Stopped:	<u>\$26.5 million</u>
Amount of Refunds Issued:	<u>\$ 7.7 million</u>

Schemes With Schedule C:

Total Number of Different Schemes:	184
Number of Returns With Schedule C:	1,314
Amount of Refunds Claimed:	\$5.0 million
Amount of Refunds Stopped:	<u>\$3.5 million</u>
Amount of Refunds Issued:	<u>\$1.5 million</u>

The schemes with Schedule C indicate there are only 1,314 fraudulent returns that had a Schedule C. However, the FDCs do not know if the Schedule C on each of these returns is fraudulent. That determination is made upon further investigation by either CI function field office or Compliance function personnel.

Since there can be more than one false document for each return, the same fraudulent return may be included more than once in the above analysis. The refund amounts listed relate to the returns in which the document appeared. We do not know if the entire amount of the refund claimed, stopped, or issued is entirely or partially related to any one document.



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5) Efforts to Deter Fraud, Refer Cases for Prosecution, and Inform Prison Authorities

Efforts to deter fraud

In the past, the CI function overall has not had a comprehensive approach with the State prisons to address tax fraud committed by prisoners, with the exception of obtaining prisoner data from the States for use in tax return processing. In some locations, prisoner refund fraud was not considered a prevalent issue. According to the CI function, some locations have established contacts and implemented procedures to address prisoner refund fraud issues. Further, some United States Attorney's offices are reluctant to pursue these investigations, believing it is not a prudent use of resources, particularly if the person is already incarcerated and an additional charge would likely not yield additional punitive sanctions. With the recent attention to this issue, as a deterrent, the CI function plans to initiate actions through its public affairs office to inform the State prisons of instances of prisoner refund fraud. In addition, the CI function has recognized steps that both the IRS and the States can take to deter and detect fraudulent tax return activity by prisoners. In the June 29, 2005, testimony before the House Ways and Means Subcommittee on Oversight, the Chief, CI, provided the following examples of current efforts to improve coordination:

- Continue coordination to acquire accurate prisoner information to maximize the effectiveness of the CI function's automated systems for timely identification of questionable prisoner returns.
- Conduct training sessions regarding prisoner schemes with all Questionable Refund Program field coordinators and management to discuss expectations of the fraud program and emerging trends in prisoner refund schemes and to share best practices for coordinating fraud prevention efforts with prisons.
- Increase coordination efforts between CI field offices and prisons, especially those with emerging or existing refund fraud issues.
- Enhance procedures for the FDCs to coordinate fraud prevention efforts with the prisons in the States the FDCs service. This may include the establishment of procedures for the FDCs to review IRS correspondence sent by prisoners.

If properly implemented, these efforts should improve the IRS' ability to detect and deter refund fraud and increase meaningful interaction between the IRS and prison authorities. We will continue to evaluate IRS activity on this important issue during our follow-on reviews and make recommendations as warranted.



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Fraudulent refunds referred for prosecution

As of March 31, 2005, individuals associated with only 3 of the 1,193 identified schemes involving prisoner returns had been referred for prosecution. This low number could be partially attributed to the length of time it takes the CI function to recommend a case for prosecution (about 13 months). Our comparison of the prisoner data file to the Criminal Investigation Management Information System²⁰ as of March 2005 illustrates that, although some of the prisoners with fraudulent refunds are criminally investigated, almost 91 percent are not referred for investigation or the investigations are closed without a prosecution recommendation. Because our review was limited in scope, we did not evaluate those returns that did not meet the criteria for criminal referral. We plan to consider this during our follow-on reviews.

Table 4 shows the investigative status (as of March 2005) of the 18,343 fraudulent returns the CI function identified during PY 2004.

²⁰ This is a database that tracks the status and progress of criminal investigations and the time expended by special agents. It is also used as a management tool that provides the basis for decisions of both local and national scope.



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Table 4: Status of Investigations on Fraudulent Prisoner Returns

	Number of Schemes	Number of Fraudulent Returns	Fraudulent Refund Amount
Not Referred for Investigation	881	15,274	\$59.96M
Primary Investigations (PI) Opened ²¹	<u>312</u>	<u>3,069</u>	<u>\$ 8.77M</u>
	<u>1,193</u>	<u>18,343</u>	<u>\$68.73M</u>
PI Closed Without a Resulting Subject Criminal Investigation (SCI) ²²	171	1,335	\$ 2.95M
PI Still Open	66	699	\$ 2.25M
SCI Opened	<u>75</u>	<u>1,035</u>	<u>\$ 3.56M</u>
	<u>312</u>	<u>3,069</u>	<u>\$ 8.76M</u>
SCI Closed With No Prosecution Recommendation	6	38	\$.11M
SCI Referred for Prosecution	3	62	\$.28M
SCI Still Open	<u>66</u>	<u>935</u>	<u>\$ 3.17M</u>
	<u>75</u>	<u>1,035</u>	<u>\$ 3.56M</u>
Total Discontinued Investigations	<u>1,058</u>	<u>16,647</u>	<u>\$63.02M</u>
Percentage of Discontinued Investigations	<u>88.7%</u>	<u>90.8%</u>	<u>91.7%</u>

Source: TIGTA analysis of the STARS and the Criminal Investigation Management Information System.

Informing prison authorities

Internal Revenue Code (I.R.C.) Section (§) 6103 generally prohibits the IRS from sharing Federal tax information with other agencies such as State prison authorities, except under limited circumstances. In general, Federal tax information is shared primarily with State tax agencies, under the provisions of Federal-State Agreements executed between the IRS and each State. CI function management advised that they had recognized the limitations of I.R.C. § 6103 and attempted to identify other avenues to share fraudulent return information with State prison authorities, but they were advised by the IRS Office of Disclosure that this was prohibited by

²¹ Primary investigations may evolve on individuals or entities from work completed in the evaluation process, when it appears that an identified individual or entity may have prosecution potential.

²² An SCI is opened when an individual or entity is alleged to be in noncompliance with the laws enforced by the IRS and has prosecution potential. The objective of an SCI is to gather pertinent evidence to prove or disprove the existence of a violation.



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I.R.C. § 6103. We reviewed 21 Federal-State Agreements and determined that none had any specific provision authorizing the IRS to share Federal tax information with State prisons. Further, except in limited circumstances, State tax agencies are also generally prohibited from sharing Federal tax information with other agencies in their States, including prisons.

During the June 29, 2005, Congressional hearing on prisoner refund fraud, two State prison authorities expressed frustration at the inability of the IRS to share prisoner tax data. One witness stated,

A vast amount of information is given to the IRS every tax year concerning inmate tax fraud. Virtually nothing is given to us in return. Once it is determined that the information has been used to file a tax return, the IRS then deems it to be, “confidential taxpayer information.” Once the information is turned over, our agency has no idea what happened to it or if it is in fact a fraudulent return.

The other witness stated,

. . . if the IRS identifies an inmate that is engaging in this criminal activity they are prohibited from informing my office. A cooperative effort is necessary to be successful in combating this problem.

In addition, two Congressmen called for more information sharing and better enforcement measures, such as allowing the IRS to share tax information with the States’ Departments of Corrections. The Chief, CI, also testified that, while the IRS may possess information related to ongoing criminal activities in prisons, it is unable to alert prison authorities of these activities.

At the conclusion of the hearing, Committee Chairman Ramstad asked the TIGTA to draft a legislative proposal to amend I.R.C. § 6103 to allow the IRS to share information with prison authorities.

6) Efforts to Coordinate With Prisons and State Revenue Authorities

The IRS does not have a uniform system for coordinating with Federal and State prisons. Each FDC and CI function field office is responsible for establishing its own contacts and procedures. While some FDCs may be more proactive, others are not. For example, we surveyed the 10 FDCs and determined 4 have not established any procedures to have prison mail addressed to the IRS sent directly to the FDC. Of the other six FDCs, one receives mail from all States in its area and the other five receive mail from only some of the prisons in the States they oversee.

I.R.C. § 6103 allows the IRS to share tax information with State tax agencies using Federal-State Agreements. However, the CI function has not coordinated efforts between the FDCs and the State tax agencies on refund fraud, including fraud committed by prisoners. Eight of the 10 FDCs indicated they do not share information on fraudulent refunds; 1 of these 8 advised that



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it previously provided information to 1 State tax agency but discontinued the practice. Of the remaining two FDCs, one responded that it shares data with three State tax agencies (two through the Questionable Refund Program coordinators and one directly with the Department of Revenue); the other FDC advised that it provides information to one State tax agency.

7) Notification of Parole Authorities

Generally, I.R.C. § 6103 prohibits the IRS from notifying parole authorities if a paroled prisoner commits tax fraud. However, the IRS can notify parole authorities if a former prisoner was on parole for a prior tax violation, the conditions of the parole required future compliance with tax laws, and the former prisoner violates the terms of parole by committing tax fraud.

The CI function uses a computer code to monitor the accounts of individuals on probation for prior tax violations. A survey of all the FDCs indicated that 6 of the 10 did not have procedures for checking the accounts of prisoners filing fraudulent refund returns to determine if they were on probation. Therefore, the vulnerability still exists that parole authorities would not be notified of a parolee committing refund fraud, even though our analysis identified only 4 of the 18,343 fraudulent returns with a computer code indicating the prisoner was on probation for a prior tax violation.

8) Frequency of Updating Prison Files

The IRS updates the prisoner data file once a year, as described below.

- The CI function begins calling contacts at the prisons in February and March of each year to update the prison mailing list and to determine if there are any changes.
- The CI function's Office of Refund Crimes issues memoranda in June requesting the data from the prisons.
- The IRS receives most of the data between August 15 and September 1. Information from some States comes in piecemeal after that, some as late as November.
- The IRS consolidates the data and resolves any outstanding data issues in December/early January, in time to load the prisoner data into the Electronic Fraud Detection System for that year's tax return processing.

As previously mentioned, one reason the prisoner data file is incomplete is because of the early deadline. We obtained the prisoner data file for PY 2005 and determined about 134,000 prisoners incarcerated between September 1 and December 31, 2003, were not on the PY 2004 prisoner data file.



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The incompleteness of the prisoner data file prevented the IRS from detecting additional fraudulent refund returns filed by prisoners. We believe it is imperative for the IRS to have an accurate and complete prisoner data file, not only for the CI function but also for the IRS Submission Processing function to stop fraudulent prisoner refunds that are below the thresholds established for possible criminal prosecution. If Federal and State prisons were required to provide accurate SSNs and other prisoner information in a consistent format, the IRS could obtain the data much later in the year and include it in the prisoner data file for the upcoming processing year. This improvement would help prevent prisoners from defrauding the Federal Government of millions of dollars.

9) Largest Number of Returns Prepared by a Single Prisoner

As previously described, the CI function's management information system is currently not capable of providing the information needed to answer this question. This information could be obtained through a time-consuming process of manually reviewing each case file involving refund fraud to identify the preparer.

We analyzed data from the STARS and identified the 10 schemes involving the largest number of prisoner returns. Returns not identified as prisoner-filed returns could actually have been filed by prisoners but not identified as such due to the incompleteness of the prisoner data file. These could also be situations involving prisoners using the SSNs of nonprisoners or nonprisoners using prisoner SSNs.



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Table 5: Schemes With the Largest Number of Prisoner Returns

2004 Scheme Numbers	Number of Fraudulent Prisoner Returns	Refunds Claimed on Fraudulent Prisoner Returns	Number of Fraudulent Nonprisoner Returns	Refunds Claimed on Fraudulent Nonprisoner Returns	Number of Total Fraudulent Returns	Refunds Claimed on All Fraudulent Returns
0720040020*	4,259	\$18,494,308	1,689	\$7,601,259	5,948	\$26,095,567
0920040058	1,546	\$9,191,419	624	\$3,182,618	2,170	\$12,374,037
8920040022	1,103	\$1,858,806	71	\$80,966	1,174	\$1,939,772
0720040317*	1,041	\$5,671,747	209	\$1,156,713	1,250	\$6,828,460
0720040019*	774	\$2,185,222	84	\$202,829	858	\$2,388,051
1820040018*	651	\$1,849,262	730	\$2,637,717	1,381	\$4,486,979
0720040146	310	\$1,756,224	203	\$1,256,461	513	\$3,012,685
0920040434	240	\$104,017	78	\$32,929	318	\$136,946
8920040273	237	\$310,418	149	\$192,729	386	\$503,147
1820040238	200	\$113,174	21	\$12,119	221	\$125,293

Source: TIGTA analysis of the STARS.

- * This is a “dump” scheme. Each FDC places fraudulent returns into the category of a dump scheme if the FDC cannot associate the return with a larger, individual scheme. Some FDCs also had a dump scheme for prisoner returns.

10) Prisons With the Highest Incidence of Refund Fraud

As previously described, the CI function’s management information system is currently not capable of providing the information needed to respond to this question. This information could be obtained through a time-consuming process of manually reviewing each case file involving refund fraud to identify the preparer.

We analyzed the STARS and the prisoner data file information to determine which prisons had the highest incidence of fraudulent returns. Table 6 shows those prisons with 200 or more instances of fraudulent refund returns filed by individuals on the prisoner data file.

The first column shows the total number of fraudulent returns, while the second column shows the number of fraudulent returns filed while the individual was incarcerated.²³

²³ The prisoner data file includes all individuals that were incarcerated during the last 2 ½ years. We believe it is important to distinguish between those individuals filing fraudulent returns while they are incarcerated and those who have been released. Our analysis is based on the dates of incarceration as provided by the prisons. Although we did not validate the accuracy of these data, we eliminated 338 records for which the incarceration dates were missing or obviously invalid.



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Table 6: Incidence of Refund Fraud at Prisons

Number of Fraudulent Returns Filed	Fraudulent Returns Filed While Incarcerated	State or Federal	Prison Name
499	489	CA	CALIFORNIA SUBSTANCE ABUSE TREATMENT FACILITY
474	429	SC	EVANS CORRECTIONAL INSTITUTION (C.I.)
353	320	FL	DESOTO C.I. – ANNEX
303	268	FL	JACKSON C.I.
292	269	SC	MCCORMICK C.I.
240	228	FL	JEFFERSON C.I.
236	194	FEDERAL	FORT DIX FEDERAL C.I. (FCI)
203	166	FL	CENTURY C.I.
201	177	FL	HARDEE C.I.

Source: TIGTA analysis of the STARS and the 2004 prisoner data file.

Refund fraud committed in Federal prisons

On July 18, 2005, Senator Bill Nelson of Florida requested that our report include the scope of these crimes committed in Federal prisons.

Our analysis of a CI function file dated May 4, 2005 showed that Federal prisoners filed 2,835 (15.5 percent) of the 18,343 fraudulent returns. The 2004 prisoner data file contained about 2.8 million records, 3.3 percent of which were Federal prisoners. While some CI function managers did not believe refund fraud was a problem in Federal prisons, our analysis shows that the overall rate of fraud in Federal prisons is slightly higher than that in other prisons.

Table 7 shows the 10 Federal prisons with the highest incidence of refund fraud.



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Table 7: Incidence of Refund Fraud at Federal Prisons

Number of Fraudulent Returns Filed	Fraudulent Returns Filed While Incarcerated	State	Prison Name
236	194	NJ	FORT DIX FCI
149	133	TX	SEAGOVILLE FCI
133	18	NY	BROOKLYN METROPOLITAN DETENTION CENTER
118	113	CA	LOMPOC UNITED STATES PENITENTIARY
84	82	TX	BASTROP FCI
51	50	CA	ATWATER UNITED STATES PENITENTIARY
44	41	WI	OXFORD FCI
43	41	IL	PEKIN FCI
41	38	TX	TEXARKANA FCI
41	36	CA	TAFT FCI

Source: TIGTA analysis of the STARS and the 2004 prisoner data file.

The Federal Bureau of Prisons provided the CI function with a tape that contained 378,509 records for which we determined 124,663 (32.9 percent) of the SSNs were missing, incorrect, or invalid. The error rate ranged from 4.3 to 76.5 percent per prison. This compares with an error rate of 15.4 percent for all State prisoner records, with a range of 2.4 to 87.8 percent per prison.

Table 7 shows the Fort Dix FCI had the highest incidence of refund fraud in the Federal prison system, and Table 6 shows it has the seventh highest rate of all prisons. However, the Newark CI function field office responded to a questionnaire that it was unaware of a particular prison having a larger problem with refund fraud or if there were higher instances of refund fraud in Federal prisons. The Newark CI function field office also replied it did not periodically coordinate efforts with prison authorities in Federal and State prisons.

We believe the CI function field offices could take a more proactive and coordinated approach with the FDCs by analyzing the bad data received, determining where it came from, contacting the appropriate prison authorities, and stressing the mutual benefits of accurate data. This could improve the accuracy of the data, resulting in the identification of more fraudulent returns.



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Impact on State prison systems

During the June 29, 2005, Congressional hearing, a Criminal Investigator from the South Carolina Department of Corrections testified on the costs associated with prisoner refund fraud and stated,

The vast majority of the money received by the inmates is used in the drug trade. . . . Connected with the drug rings are assaults and extortion over territory or unpaid debts. Unfortunately, some of the money is used to lure employees into illegal activity.

Although the total costs of inmate tax fraud to our agency will never be completely known, there have been measurable costs. . . . In late 2004, Evans Correctional Institution was placed on total lockdown due to rampant criminal behavior. The amount of contraband drugs, cash, and other contraband such as cell phones being confiscated was phenomenally high as were allegations of employee misconduct. For a period of approximately two [2] months, Evans CI [C.I.] staffing was at least doubled, and at times more, in an effort to bring the situation under control. The extra staff was provided by other institutions from throughout the [S]tate.

Coincidentally, as noted in Table 6, the Evans C.I. had the second largest number of fraudulent returns based on the 2004 prisoner data file information. The CI function does not provide this information to the States' Departments of Corrections, and the South Carolina Criminal Investigator did not know of the existence of this information until a few days before the hearing.

Although providing specific information about individuals filing fraudulent returns would violate I.R.C. § 6103, it would not be a violation if the CI function provided summary information to the various prisons. This could alert prison authorities to potential fraudulent activity and allow them to take appropriate action.

In our opinion, there is mutual benefit for the prisons to provide the IRS with timely and accurate prisoner data and for the IRS to provide the prisons with statistical information of fraudulent activity as well as specific instances of fraud. We recognize that there are legal issues to overcome, but we believe the IRS must become more proactive in reaching solutions. Based on prior testimony and our discussions, CI function management has committed to improving communications and interaction with prison authorities. During our follow-on reviews, we will continue to evaluate IRS efforts on this important tax administration issue and make recommendations as warranted.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this limited-scope review was to determine the effectiveness of the Internal Revenue Service's (IRS) procedures for detecting fraudulent and potentially fraudulent prisoner refund returns. We attempted to collect sufficient information to respond to questions from the House Ways and Means Subcommittee on Oversight. The scope of our review involved data on fraudulent refund returns and refund schemes identified during Processing Year (PY) 2004.¹ To accomplish our objective, we:

- I. Developed an understanding of the IRS' policies and procedures relating to the detection of fraudulent refund returns.
 - A. Interviewed IRS officials from the Criminal Investigation (CI) function and the Wage and Investment Division.
 - B. Discussed the processes and procedures the CI function uses to obtain prisoner data from prison authorities.
 - C. Identified enhancements the CI function is using to detect fraudulent prisoner refunds.
 - D. Determined if the CI function developed procedures for notifying parole authorities of prisoners committing refund fraud.
 - E. Analyzed procedures the Wage and Investment Division uses to identify potentially fraudulent returns.
 - F. Determined if the Wage and Investment Division performed any studies to determine the feasibility of inputting a prisoner code on the Master File² to assist in identifying potential fraudulent refunds.
- II. Evaluated the IRS' coordination efforts with Federal and State prison authorities, as well as State revenue authorities.
 - A. Performed a survey of the 10 Fraud Detection Centers (FDC)³ and 32 CI function field offices.

¹ Processing year refers to the year in which taxpayers file their tax returns at the Submission Processing sites. Generally, returns for 2003 were processed during 2004, although returns for older years were also processed.

² The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

³ The FDCs use manual and computerized techniques to detect potentially fraudulent refund returns, prevent the issuance of those refunds, and refer cases to the CI function field offices for investigation.



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- B. Identified which States send prisoner data to the IRS and the procedures the IRS uses to obtain and validate the data.
 - C. Obtained a listing from IRS personnel of 920 agreements related to information exchanges between the IRS and 21 judgmentally selected States and looked for provisions related to prisoner information.
 - D. Evaluated the effect disclosure provisions under Internal Revenue Code Section 6103⁴ had on the coordination with Federal and State prison authorities.
 - E. Obtained a Treasury Inspector General for Tax Administration Office of Chief Counsel opinion on the ability of the IRS to share prisoner tax data with prison authorities.
- III. Analyzed statistical information on fraudulent and potentially fraudulent refund returns filed by prisoners during PY 2004.
- A. Analyzed an extract of the prisoner data file for PYs 2004 and 2005.
 - 1. Used the 2004 prisoner data file, containing about 2.8 million records, and identified about 550,000 records that were missing or inaccurate (e.g., duplicate or erroneous Social Security Numbers such as 000-00-0000).
 - 2. Compared the 2.8 millions records from the 2004 prisoner data file to the Electronic Fraud Detection System⁵ to determine the number and amount of improper Earned Income Tax Credit (EITC)⁶ claims and other refunds issued on prisoner returns not selected by the FDCs for screening.
 - 3. Queried the 2005 prisoner data file, containing about 3.1 million records, and identified about 220,000 records of prisoners that were incarcerated on or after September 1, 2003. We compared this information to the 2.8 million records from the 2004 prisoner data file to identify the number of prisoners incarcerated during the last 4 months of Calendar Year 2003 that were not on the 2004 prisoner data file. This identified almost 134,000 prisoners.
 - 4. Used the results from Step III.A.3., researched the Individual Return Transaction File,⁷ and identified about 29,000 returns that were filed. We requested transcripts for almost 26,000 tax accounts that claimed refunds and identified the amount of the refund and EITC.

⁴ Internal Revenue Code Section 6103 (2004).

⁵ This is an automated system used by personnel in the FDCs to review potentially fraudulent tax returns.

⁶ The EITC is a refundable credit established by Congress to aid low-income workers. Refundable means that the taxpayer will receive the credit even if he or she does not owe taxes.

⁷ This File contains information as it was transcribed from an individual's tax return and its accompanying forms and schedules.



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- B. Analyzed extracts dated May 4, 2005, containing about 455,000 prisoner refund returns from the Electronic Fraud Detection System and 18,343 fraudulent refund returns from the Scheme Tracking and Referral System⁸ for PY 2004.
1. Identified the number of schemes involving prisoner returns and the number of fraudulent nonprisoner returns that involved the same scheme as a prisoner return.
 2. Identified the number of refund schemes and fraudulent returns claiming the EITC and using a Wage and Tax Statement (Form W-2);⁹ Substitute for Form W-2, Wage and Tax Statement, or Form 1099-R, Distributions From Pensions, Annuities, Retirement, or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc. (Form 4852);¹⁰ and/or Profit or Loss From Business (Schedule C).¹¹
 3. Compared the 1,193 schemes involving prisoner returns the FDCs identified during PY 2004 to the Criminal Investigation Management Information System¹² as of March 31, 2005, and determined if they had been referred for investigation and prosecution.
 4. Identified the prisons that had the most instances of refund fraud.
- C. Determined the reasons why refunds were issued for 4,261 prisoner-filed refund returns determined by the IRS to be fraudulent. We also obtained and analyzed the results of the CI function's additional analysis of why these refunds were issued.
- D. Matched the 18,343 fraudulent prisoner-filed refund refunds identified by the IRS in PY 2004 against the Master File to determine if Transaction Codes (TC) 910, 916, or 918 were present on the account.¹³ For accounts without a TC 916 or 918, we determined if a refund was issued during PY 2005.

⁸ A database that contains information on fraudulent returns and schemes such as the amount of refunds claimed and stopped, the amount of EITC claimed and stopped, and information on the types of false documents used to perpetrate the scheme.

⁹ Form W-2 is used by employers to report the amount of wages earned by and taxes withheld from employees.

¹⁰ Form 4852 is a substitute for a Form W-2 that taxpayers use to report wages and withholding when they do not receive a Form W-2 from their employer. IRAs are Individual Retirement Arrangements.

¹¹ Schedule C is used by taxpayers to report income and expenses from self-employment on a U.S Individual Income Tax Return (Form 1040).

¹² This is a database that tracks the status and progress of criminal investigations and the time expended by special agents. It is also used as a management tool that provides the basis for decisions of both local and national scope.

¹³ The CI function uses TC 910 to monitor accounts of taxpayers on probation (relating to the settlement of civil liabilities and fines). TCs 916 and 918 are input to the IRS' computers to prevent questionable refunds from being issued and to ensure subsequent activity in the accounts (e.g., the filing of an amended tax return or the applying of a payment to an account) is systemically identified and reviewed by FDC personnel.



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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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Appendix IV

Management's Response to the Draft Report



Criminal Investigation

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

RECEIVED
SEP 20 2005

September 19, 2005

MEMORANDUM FOR DANIEL R. DEVLIN
ASSISTANT INSPECTOR GENERAL FOR AUDIT
(HEADQUARTERS OPERATIONS AND EXEMPT
ORGANIZATIONS PROGRAM)

FROM: Nancy J. Jardini
Chief, Criminal Investigation CI

SUBJECT: Response To Draft Audit Report: The Internal Revenue
Service Needs to Do More to Stop the Millions of Dollars in
False Refunds Paid to Prisoners
(Audit #200510019)

Thank you for the opportunity to respond to the above-referenced draft report. Skilled Criminal Investigation (CI) employees at CI's fraud detection centers (FDCs) and field offices work diligently to address all refund fraud, including schemes perpetrated by prisoners. Criminal Investigation's experience with fraudulent filings is in direct correlation with the findings in the draft report, both of which confirm an exponential growth of prisoner filing fraud.

While the vast majority of the 106 million refund tax returns filed in 2004 were submitted by taxpayers who legitimately deserved those refunds, prisoner related fraud represented 15 percent of overall refund fraud. This percentage represents a substantial increase in prisoner related refund fraud activity from three years prior, when prisoner schemes represented only five percent of overall refund fraud. The characteristics of refund schemes are varied and the means by which prisoners commit such fraud are constantly evolving. In order to address the ever changing problem, the Internal Revenue Service (IRS) has deployed a variety of tools to identify and stop prisoner refund fraud. These tools include automation processes, manual review of questionable returns and return information, referral to CI FDCs of questionable returns identified by IRS processing functions, and ongoing coordination with correctional facilities, banks, and other government agencies.

As part of a comprehensive approach to increasing enforcement efforts and combating refund fraud, CI is committed to improving our ability to identify and stop false refunds before they are issued. In this regard, we increased the staffing of CI's 10 FDCs, which now employ nearly 600 skilled investigative analysts and special agents. We also enhanced outreach efforts to educate and partner with electronic return originators (EROs) and practitioners to alert them to the possibility that prisoners may attempt to engage them to file false returns. For the past 11 years, CI has participated in the IRS' nationwide tax forums, presenting refund fraud seminars



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Paid to Prisoners*

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to approximately 18,000 practitioners and enrolled agents in the last two years alone. Criminal Investigation representatives meet regularly with practitioner groups to discuss badges of fraud. A tip line was also established especially for practitioners to alert the IRS about potential fraudulent schemes.

Another area of outreach includes meetings with prison officials on the local and national level to enhance cooperation. These meetings resulted in a variety of coordinated efforts, such as the publication of deterrent messages in prison websites and various publications.

In our joint efforts with prison authorities, the quality and completeness of electronic data provided is a critical factor affecting CI's ability to address false refunds claimed by prisoners. Most states, the District of Columbia, and the Federal Bureau of Prisons strive to comply with IRS requests for a complete annual listing of all their inmates; however, as the draft report reflects gaps and irregularities in the data do exist. We agree the IRS must have an accurate and complete prisoner file to increase its effectiveness in stopping false prisoner refunds. In fact, this information is critical to CI's ability to timely identify false claims filed by prisoners. Therefore, CI will continue to work with prison officials to perfect both the process and the data provided to the IRS.

As the draft report points out, the restriction imposed by the non-disclosure provisions of the Internal Revenue Code (IRC), Section 6103 acts as a barrier to revenue protection and in some cases effective relationships with prison officials. If disclosures were permissible, CI could refer scheme information to prison authorities to impose administrative sanctions when appropriate. We appreciate the action TIGTA has taken to assist the House Ways and Means Oversight Committee in drafting legislation to amend IRC, Section 6103. Such a change, will allow for improved interchange of information and collaborative efforts with prison officials.

The draft report also emphasizes limited resources as a significant challenge to CI's ability to combat prisoner related refund fraud. While CI's resources were relatively flat over the last few years, we did increase staffing over 30 percent at the FDCs. In addition, CI's resources are also utilized to address other important enforcement activities and initiatives such as high income tax evaders, offshore abusive schemes, and abuse of charitable entities. The President's fiscal year 2006 Budget requests \$10.7 million to combat refund fraud. If approved, this funding will provide CI with access to the National Directory of New Hires (NDNH) database maintained by the Department of Health and Human Services. The NDNH contains compensation information that will allow a streamlined employment verification process; thereby stopping fraudulent prisoner refunds more effectively.



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The following items summarize CI's ongoing efforts to combat prisoner related refund fraud:

- In processing year 2006, those returns meeting certain criteria associated with prisoner schemes will be delayed to allow more time to identify and prevent the issuance of fraudulent refunds.
- We will continue to coordinate the acquisition of accurate prisoner information to maximize the effectiveness of our automated systems for timely identification of questionable prisoner returns.
- Criminal Investigation will conduct training sessions regarding prisoner schemes with all Questionable Refund Program (QRP) coordinators and field management officials. This training will focus on CI's expectations for the QRP program, emerging trends in prisoner refund schemes, and best practices for coordinating fraud prevention efforts with correctional facilities.
- We will assure all FDCs have procedures in place to coordinate fraud prevention efforts with the prisons in the states they service. This will include the establishment of procedures to review IRS correspondence sent by prisoners, for those FDCs not already engaged in such activity.

Once again, we appreciate this opportunity to respond to the draft report. We understand your review of this subject is continuing and value any recommendations that may enhance our ongoing efforts to detect and curtail prisoner refund fraud. If you have any questions, please contact me, or a member of your staff may contact Vicki Duane, Director of Refund Crimes (CI:RC), at 202-622-7140.