

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



Actions Were Taken to Improve the Identification of Prisoner Tax Returns

April 15, 2021

Report Number: 2021-40-027

Why TIGTA Did This Audit

This audit was initiated to follow up on prior TIGTA reports that identified concerns with the IRS's ability to identify and prevent tax refund fraud associated with prisoner Social Security Numbers.

The overall objective of the audit was to evaluate the effectiveness of the IRS's corrective actions to identify and reduce prisoner fraud.

Impact on Taxpayers

Preventing refund fraud associated with prisoners' Social Security Numbers is a challenge for tax administration. For example, the IRS identified more than 4,500 fraudulent tax returns using a prisoner Social Security Number in Calendar Year 2019. The refunds claimed on these tax returns totaled more than \$14 million.

The IRS must protect tax revenue by implementing processes to avoid issuing refunds to prisoners and individuals who use prisoners' Social Security Numbers to file fraudulent tax returns.

What TIGTA Found

The IRS implemented corrective actions in response to concerns raised in TIGTA's prior report, issued in July 2017. For example, the IRS implemented processes to ensure that the Federal Bureau of Prisons and State Departments of Corrections comply with the requirement to provide the IRS with an annual list of all prisoners incarcerated within their prison system. Our review did not identify any prison institutions that did not report their prisoners to the IRS. Other corrective actions included:

- The IRS improved its processes to ensure that it identifies all paper-filed prisoner tax returns for screening and verification. Our analysis found that no paper-filed tax returns were processed in January 2020 during the brief time frame when the Return Review Program was shut down.
- The IRS improved its verification of prisoner records received from Federal prisons and State correctional facilities to ensure that all valid records are added to the IRS Prisoner File.

The IRS can take additional actions to expand participation in the IRS's Blue Bag Program, which is the program in which the IRS partners with the Federal Bureau of Prisons and State Departments of Corrections to identify potentially fraudulent tax returns and refunds. The IRS has not established processes to track Federal Bureau of Prisons' and State Departments of Corrections' participation in the Blue Bag Program.

In addition, the IRS Prisoner File used in Processing Year 2019 resulted in 906 prisoner returns bypassing the systemic selection for fraud analysis. Our further analysis found that eight of these returns reported income and withholding amounts that were not supported by third-party income documents. These filers received potentially fraudulent refunds totaling more than \$24,000.

Finally, 3,984 Tax Year 2018 refund tax returns, filed using prisoners' Social Security Numbers and claiming refundable tax credits totaling \$4.8 million, erroneously bypassed the Automated Questionable Credit Program for review.

What TIGTA Recommended

TIGTA made three recommendations to the Commissioner, Wage and Investment Division, that included ensuring that responses to the Blue Bag Program letter received from prison institutions are tracked to enable the IRS to identify and work with those prison institutions that do not respond or agree to participate in the program.

IRS management agreed with all three recommendations and has already implemented corrective actions to properly track responses received to the Blue Bag Program letter, validate data quality, ensure quality checks, and update its internal procedures.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

April 15, 2021

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

A handwritten signature in blue ink that reads "Michael E. McKenney".

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Actions Were Taken to Improve the Identification of
Prisoner Tax Returns (Audit # 202040005)

This report presents the results of our review to evaluate the effectiveness of the Internal Revenue Service's (IRS) corrective actions to identify and reduce prisoner fraud. This review is part of our Fiscal Year 2021 Annual Audit Plan and addresses the major management and performance challenge of *Reducing Fraudulent Claims and Improper Payments*.

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

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

Table of Contents

<u>Background</u>	Page 1
<u>Results of Review</u>	Page 5
<u>Additional Actions Can Be Taken to Expand Participation in the Blue Bag Program</u>	Page 6
<u>Recommendation 1:</u>	Page 7
<u>Corrupted Prisoner File Data Resulted in Some Full-Year Prisoner Tax Returns Bypassing Systemic Selection for Fraud Analysis</u>	Page 7
<u>Recommendation 2:</u>	Page 8
<u>Prisoner Returns With Refundable Credits Are Not Always Reviewed for Fraud</u>	Page 8
<u>Recommendation 3:</u>	Page 9
Appendices	
<u>Appendix I – Detailed Objective, Scope, and Methodology</u>	Page 10
<u>Appendix II – Outcome Measures</u>	Page 12
<u>Appendix III – Management’s Response to the Draft Report</u>	Page 14
<u>Appendix IV – Abbreviations</u>	Page.18

Background

In an effort to prevent the issuance of false or fraudulent refund claims, Internal Revenue Service (IRS) systems include detection filters that identify returns filed using a prisoner’s Social Security Number (SSN). The IRS’s Prisoner File is the cornerstone of its efforts to identify and prevent the issuance of fraudulent refunds to individuals filing false tax returns using a prisoner SSN, hereafter referred to as a prisoner tax return. This file is compiled each year from information the IRS receives from the Federal Bureau of Prisons and State Departments of Corrections. In addition, the IRS uses Prisoner Update Processing System (PUPS) data from the Social Security Administration (SSA)¹ to identify for additional screening tax returns filed using a prisoner SSN. Figure 1 provides the number of tax returns filed using a prisoner SSN that the IRS identified and confirmed as fraudulent in Processing Years² 2017 through 2019.

Figure 1: Fraudulent Tax Returns Filed Using a Prisoner SSN in Processing Years 2017 Through 2019³

Processing Year	Fraudulent Tax Returns	Refunds Claimed	Refunds Prevented	Refunds Issued
2017	8,486	\$370,610,544	\$370,098,071	\$512,473
2018	6,799	\$118,600,328	\$118,584,639	\$15,689
2019	4,547	\$14,080,784	\$13,648,020	\$432,763 ⁴

Source: Wage and Investment Division, Return Integrity and Compliance Services function.

IRS management attributes the decrease in returns filed using a prisoner SSN to several efforts. Examples include providing posters to prison officials to advise prisoners of the consequences of convictions for tax-related offenses and limiting prisoner access to tax forms, instructions, and publications.

Key legislation enacted in an effort to address fraud perpetrated by prisoners

- ***The Inmate Tax Fraud Prevention Act of 2008⁵*** - signed October 15, 2008, requires the Secretary of the Treasury to provide an annual report to Congress on the filing of false or fraudulent tax returns by prisoners at Federal and State prison institutions. The most recent report issued to Congress on the filing of false and fraudulent tax returns associated with individuals incarcerated in Federal prisons and State correctional facilities was for Calendar Year 2019.

¹ The SSA has the authority to provide incentives to institutions that provide prisoner information. The SSA pays institutions for each individual identified whose Social Security or Supplemental Social Security Income is suspended because the individual is incarcerated.

² The calendar year in which the tax return or document is processed by the IRS.

³ The IRS reported in its annual report to Congress on prisoner fraud that the tax returns included those filed both by prisoners and unknown individuals using prisoners’ SSNs.

⁴ The refunds issued amount does not equal refunds claimed minus refunds prevented due to rounding.

⁵ Pub. L. No. 110-428, 122 Stat. 4839.

- ***The United States–Korea Free Trade Agreement Implementation Act*⁶** - signed October 21, 2011, requires the Federal Bureau of Prisons and State Departments of Corrections to provide the IRS with an electronic list of all the prisoners incarcerated within their prison system for any part of the prior two calendar years or the current calendar year through August 31. The Federal Bureau of Prisons and State Departments of Corrections are required to provide the list of prisoners to the IRS no later than September 15 each year.

The IRS compiles a list of prisoners (the Prisoner File) received from the Federal Bureau of Prisons and State Departments of Corrections. The Prisoner File is the cornerstone of IRS efforts to identify and prevent the issuance of fraudulent refunds to individuals filing false tax returns using a prisoner SSN. The IRS also creates the Institution File, which contains the contact information for each of the prison institutions reporting prisoner records to the IRS.

- ***The American Taxpayer Relief Act of 2012*⁷** - enacted in January 2013, expanded the Secretary of the Treasury's authority to share false prisoner tax return information with Federal prisons and State correctional facilities and gave the IRS permanent authority to share such information.
- ***The Bipartisan Budget Act of 2013*⁸** - enacted in December 2013, amended the Improper Payments Elimination and Recovery and Improvement Act⁹ to give the Secretary of the Treasury the legal authority to obtain PUPS data from the SSA and make it available for those programs in which prisoners are ineligible for benefits. The Act authorizes the IRS to compare SSA prisoner information with any other Personally Identifiable Information derived from a Federal system of records. The Act further provides the IRS with the authority to provide information to the head of the Federal Bureau of Prisons and State Departments of Corrections regarding inmates whom the IRS has determined either may have been issued an improper payment or somehow facilitated the payment.

The Return Review Program (RRP) detects potentially fraudulent tax returns filed using prisoner SSNs

The IRS uses the RRP¹⁰ to detect potentially fraudulent tax returns filed using prisoners' SSNs. The RRP includes the capability to review multiple prior years to see if an SSN listed on a tax return is associated with an individual incarcerated in the prior tax year or at some point in prior years.

When tax returns are processed, the SSNs on the returns are matched against the IRS's Prisoner File filters. The RRP selects all refund tax returns filed using the SSN of a full-year prisoner, *i.e.*, incarcerated for 335 or more consecutive days in the calendar year, for further screening and/or verification. This evaluation includes an IRS tax examiner in the Return Integrity and

⁶ Pub. L. No. 112-41, § 502, 125 Stat 428.

⁷ Pub. L. No. 112-240, 126 Stat. 2313.

⁸ Pub. L. No. 113-67, § 204, 127 Stat 1165.

⁹ Pub. L. No. 112-248, 126 Stat. 2390.

¹⁰ An automated system used to enhance the IRS's capabilities to detect, resolve, and prevent criminal and civil noncompliance and identity theft, thereby reducing issuance of fraudulent tax refunds.

Verification Operation (RIVO) reviewing the income and withholding amounts reported on the tax return to determine if those amounts are supported by third-party wage and withholding information, *e.g.*, Form W-2, *Wage and Tax Statement*, reported to the IRS. If the tax examiner concludes that the return is potentially fraudulent, the return is then sent for verification. Verification is when a RIVO tax examiner attempts to confirm the income and withholding amounts on the return. For example, tax examiners compare the third-party income and withholding information on the Information Returns Master File¹¹ to the income and withholding information on the tax return. If the tax examiner is unable to verify the income and withholding, the return remains in a “frozen” status to prevent issuance of the refund.

Beginning in Processing Year 2019, the IRS implemented a systemic process to suspend the processing of all tax returns with unsupported income and withholding amounts to provide the IRS with additional time to receive third-party income documents, *e.g.*, Forms W-2. The IRS suspends these tax returns until either the third-party income documents are received or June 15. For those tax returns for which a third-party income document is received, the IRS will determine if the income and withholding amounts reported on the return are supported or will send the return for further review if the income and withholding do not match. Tax returns for which the IRS receives no third-party income document by June 15 are selected for a fraud review.

The Automated Questionable Credit (AQC) Program reviews prisoner returns claiming refundable credits¹²

Prisoner returns that are screened and verified by RIVO tax examiners are routed to the AQC Program for further review if the income and withholding amounts are supported by third-party income documents, but there is a claim on the return for either the Earned Income Tax Credit (EITC) or the Additional Child Tax Credit (ACTC). These returns are sent to the AQC Program to determine if the income reported on the return was received for work performed while a prison inmate, in a work release program, or while living in a halfway house. This type of income does not qualify as earned income to claim these refundable credits.¹³ To qualify for the EITC in Tax Year 2020, an individual must have earnings of \$56,844 or less. The EITC may be worth as much as \$6,660 for a family with three or more children or up to \$538 for taxpayers who do not have a qualifying child. To qualify for the ACTC, the modified adjusted gross income amount on the tax return must be \$400,000 or less for couples and \$200,000 or less for individuals. The ACTC is available for certain individuals who get less than the full amount of the Child Tax Credit of \$2,000 per qualifying child.

Once these claims are received, tax examiners in the AQC Program issue the taxpayer a Letter 4800C, *Questionable Credit 30 Day Contact Letter*, informing them that income received for work performed while a prison inmate, in a work release program, or while living in a halfway

¹¹ An IRS database containing data from Information Returns, also called “payer documents” or “third-party returns.”

¹² Refundable credits are designed to help low-income individuals reduce their tax burden or to provide incentives for other activities. The Earned Income Tax Credit is used to offset the impact of Social Security taxes on low-income families and to encourage them to seek employment. The Additional Child Tax Credit is used to adjust the individual income tax structure to reflect a family’s reduced ability to pay taxes as family size increases.

¹³ The Uruguay Round Agreements Act, enacted on December 8, 1994, states that no amount received for services by an individual while an inmate at a penal institution shall be considered as earned income for the purposes of determining the EITC. Pub. L. No. 103-465, 108 Stat. 4809.

house does not qualify as earned income for the refundable credit. The letter asks the taxpayer to provide documentation that shows the earnings were not for work performed while incarcerated, in a work release program, or living in a halfway house. If the taxpayer does not provide this support or respond to Letter 4800C, the taxpayer is issued a Letter 3219C, *Statutory Notice of Deficiency*, allowing the taxpayer 90 calendar days to file a petition with the U.S. Tax Court. If the taxpayer does not respond to either letter, the IRS disallows the refundable tax credit, in most cases. Figure 2 provides the number of cases closed and revenue protected by the AQC Program for prisoner returns claiming the EITC or the ACTC in Calendar Years 2017 through 2019.

Figure 2: AQC Program Accomplishments for Prisoner Returns Claiming the EITC or the ACTC

Calendar Year	Cases Closed	Revenue Protected
2017	9,643	\$7,127,260
2018	4,837	\$3,436,017
2019	11,968	\$4,994,234

Source: Wage and Investment Division, Return Integrity and Compliance Services function.

The Blue Bag Program is a partnership with prison institutions

In addition to the previously mentioned information, the IRS also uses its Blue Bag Program to identify potential tax-related fraud involving prisoners. The Blue Bag Program is intended to identify potential tax-related fraud through Federal and State prison officials' monitoring of prisoner communications, *e.g.*, tax returns and tax-related correspondence. As part of the IRS's partnership with prison institutions, the IRS sends a letter each year to officials at the Federal Bureau of Prisons and State Departments of Corrections. This letter stresses the importance of their efforts to reduce inmate tax fraud through the Blue Bag Program and explains that their continued participation in the program is critical to prevent the spread of tax fraud when inmates move between facilities. The annual letter explains that the program not only benefits tax administration by preventing fraudulent refunds, but also benefits the institutional system by reducing gang activity, drug sales, and other criminal activities in prisons that fraudulent refunds often support.

When prison officials identify potential fraud, they forward the questionable tax return and refund check image to the IRS's RIVO Prisoner Lead Program, which identifies and prevents improper refunds. If the IRS determines that the check is authorized, the IRS notifies the prison to release the check to the inmate. Figure 3 shows the program's accomplishments for Calendar Years 2017 through 2019.

Figure 3: Blue Bag Program Results for Calendar Years 2017 Through 2019

Calendar Year	Tax Returns	Refund Checks	Revenue Protected
2017	1,391	2,582	Not Available ¹⁴
2018	1,220	2,384	\$693,266
2019	924	1,991	\$239,840

Source: Wage and Investment Division, Return Integrity and Compliance Services function.

A prior Treasury Inspector General for Tax Administration (TIGTA) report identified that processes did not ensure that Federal and State prisons comply with prisoner reporting requirements

TIGTA has issued a number of reports on this issue, and the IRS has taken steps to improve its processes. In our most recent report,¹⁵ issued in July 2017, we identified the following conditions and made recommendations to the IRS to address the concerns raised.

- IRS processes did not ensure that the Federal Bureau of Prisons and State Departments of Corrections complied with prisoner reporting requirements. For example, our comparison of the PUPS file to the IRS’s Prisoner File identified 861 prisons that reported prisoner data to the SSA but not to the IRS as required.
- Paper-filed prisoner tax returns were not identified during the IRS’s annual fraud detection system maintenance period. As a result, 52,687 paper tax returns with refunds totaling more than \$151 million were not screened through IRS fraud detection filters during processing.
- The IRS’s validation process incorrectly determined that prisoner records received from Federal prisons and State correctional facilities did not have a valid SSN, name, or date of birth. Therefore, any return filed using the mismatched prisoner information was not evaluated for prisoner fraud. As a result, we identified 1,113 prisoner tax returns with refunds totaling more than \$1.7 million that the IRS did not identify as prisoner tax returns.

Results of Review

In response to the concerns we raised in our July 2017 report, the IRS completed a number of actions to reduce refund fraud associated with prisoner tax returns. Below are actions that the IRS completed:

- The IRS implemented processes to ensure that the Federal Bureau of Prisons and State Departments of Corrections comply with the requirement to provide the IRS with an

¹⁴ This amount was unavailable because the IRS did not track the amount of protected revenue until Calendar Year 2018.

¹⁵ TIGTA, Ref. No. 2017-40-041, *Actions Need to Be Taken to Ensure Compliance With Prisoner Reporting Requirements and Improve Identification of Prisoner Returns* (July 2017).

Actions Were Taken to Improve the Identification of Prisoner Tax Returns

annual list of all prisoners incarcerated within their prison system. Our comparison of the SSA's PUPS file to the IRS Prisoner File for Processing Year 2020 did not identify any prison institutions that did not report their prisoners to the IRS. We attribute this improvement to the IRS compiling a master list of all Federal and State prisons to evaluate compliance with legislated reporting requirements. As of May 15, 2020, the master list included 321 Federal and 1,148 State institutions that are required to report the prisoners incarcerated within their prison system.

- The IRS improved its processes to ensure that it identifies all paper-filed prisoner tax returns for screening and verification. Our analysis found that no paper-filed tax returns were processed in January 2020 during the brief time frame when the RRP was shut down. Figure 4 shows that the IRS now operates the RRP through the last cycle of the calendar year to prevent paper-filed tax returns from bypassing RRP fraud detection filters.

Figure 4: End of Year RRP and Return Processing Activities

Date	Activity
12/26/2019	Last day of individual tax return processing
12/30/2019	Last day of RRP processing
1/13/2020	Testing start day for new filing season

Source: Wage and Investment Division, Return Integrity and Compliance Services function.

- The IRS improved its verification of prisoner records received from Federal prisons and State correctional facilities to ensure that all valid records are added to the IRS Prisoner File. Specifically, before adding records to its Prisoner File, the IRS assesses the validity of the prisoner's SSN, name, and date of birth provided by the reporting institution. In addition, the IRS improved its processes to prevent mismatches based on the presence of special characters and spaces in prisoner records received from the Federal prisons and State correctional facilities.

Although the IRS's corrective actions improved detection of potentially fraudulent prisoner tax returns, addressing the below concerns will further reduce refund fraud.

Additional Actions Can Be Taken to Expand Participation in the Blue Bag Program

Our review identified that the IRS can take steps to improve its efforts to ensure that all Federal Bureau of Prisons and State Departments of Corrections participate in the Blue Bag Program. As previously explained, the IRS sends letters to the heads of the Federal Bureau of Prisons and State Departments of Corrections to thank them for their participation in the Blue Bag Program, remind them to promote the program to all institutions in their jurisdiction, and request their participation in the upcoming year. The annual letter asks each organization to respond by providing a point-of-contact and the contact's location, telephone number, and e-mail address. However, the IRS did not establish a process to track Federal Bureau of Prisons' and State Departments of Corrections' participation in the Blue Bag Program.

When we raised this issue with IRS management, they stated that they updated their process to track responses from Federal prisons and State correctional facilities in a master list.

Management also stated they will follow up if a response is not received and include the reason provided by those institutions that do not participate.

An assessment of a sample of tax returns and checks received via the Blue Bag Program found that the IRS was working these referrals appropriately

Our review of a statistically valid sample¹⁶ of 137 closed Blue Bag Program cases, received from prison institutions in Calendar Year 2019, found that the IRS properly evaluated the tax returns and refund checks for fraud and took the appropriate case closure action. For example:

- Our review of 64 cases, in which the program received a tax return, identified that RIVO tax examiners reviewed the tax returns to ensure that wages and withholding were supported by third-party income documents. Additionally, the returns were reviewed to identify improper deductions and erroneous claims for refundable credits. For the 24 returns deemed fraudulent, the tax examiner took steps to ensure that any refund claimed on the return was not issued. For the 40 returns with no concerns identified, tax examiners accepted the return for processing.
- Our review of 73 cases, in which the prison intercepted a tax refund check, identified that RIVO tax examiners reviewed the underlying tax return, and for seven checks totaling \$5,594, they requested that the tax refund check be returned to the IRS for cancellation. For the 66 checks deemed legitimate, tax examiners notified the prison that the check could be released to the prisoner.

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Ensure that responses to the Blue Bag Program letter, received from the heads of the Federal Bureau of Prisons and State Departments of Corrections, are properly tracked to enable the IRS to identify and work with those prison institutions that do not respond or agree to participate in the program.

Management's Response: The IRS agreed with this recommendation and took action in its most recent mailing of the Blue Bag Program letters. By December 3, 2020, IRS management included in the master listing the date that each State responded and identified whether or not it would be participating in the program.

Corrupted Prisoner File Data Resulted in Some Full-Year Prisoner Tax Returns Bypassing Systemic Selection for Fraud Analysis

Our review of 67,873 Tax Year 2018 refund tax returns, filed using a full-year prisoner's SSN, found that 906 were not identified by the RRP as a prisoner tax return and thus, not sent to a RIVO tax examiner for review. Our further analysis found that eight of the 906 tax returns

¹⁶ We selected a statistical sample using a confidence level of 90 percent, an expected error rate of 5 percent, and a precision factor of \pm 5 percent.

reported income and withholding that were not supported by third-party income documents. These filers received potentially fraudulent refunds totaling more than \$24,000.

The 906 returns were not correctly identified as a result of corrupted data in the IRS Prisoner File that the IRS used in Processing Year 2019 to identify Tax Year 2018 prisoner tax returns. Specifically, the data were corrupted by employees in the Return Integrity and Compliance Services function who incorrectly formatted prisoner incarceration and release dates in the Prisoner File. As a result, the Prisoner File listed some full-year prisoners as partial-year prisoners or not incarcerated at all in Calendar Year 2018.

To prevent future errors, IRS management stated that they implemented quality checks and now compare the IRS Prisoner File to previous years to prevent employee errors. IRS analysts also compare the formatted data in the IRS Prisoner File to the original data in the files received from the prison institutions.

The Commissioner, Wage and Investment Division, should:

Recommendation 2: Ensure that the quality checks and data validation procedures are implemented when compiling the list of prisoners received from Federal and State prisons to prevent future corruption of the IRS Prisoner File.

Management's Response: The IRS agreed with this recommendation. In August 2019, IRS management created programming codes to validate the data quality and added additional error checking procedures to prevent future corruption of the Prisoner File.

Prisoner Returns With Refundable Credits Are Not Always Reviewed for Fraud

Our review of Tax Year 2018 refund tax returns¹⁷ identified 4,533 returns filed using a full-year prisoner SSN with refundable credits totaling \$6.6 million that were not routed to the AQC Program for review. Our review of a statistically valid sample¹⁸ of 66 returns identified:

- 44 returns (66.7 percent) bypassed the AQC Program as a result of an error by analysts in the Return Integrity and Compliance Services function not properly identifying these returns to place them on the list of returns that the IRS uses to update taxpayers' accounts with the refund freeze marker. This marker prevents the issuance of the refund while a tax examiner verifies the income and withholding amounts on the return are supported by third-party income documents. Once these amounts are verified, the return should be routed to the AQC Program for further review. The AQC Program reviews the return to determine if the income was earned for work performed while the taxpayer was a prison inmate, in a work release program, or living in a halfway house. This type of income does not qualify as earned income to claim the EITC and the ACTC. In addition, the refund freeze marker list was completed on a weekly, instead of daily, basis which delayed the marker updates to taxpayers' accounts. When this marker is not placed on a taxpayer's account, the refund will be released and the tax return will not be

¹⁷ The filing status on these returns is Single or Head of Household.

¹⁸ We selected a statistical sample using a confidence level of 90 percent, an expected error rate of 5 percent, and a precision factor of \pm 5 percent.

Actions Were Taken to Improve the Identification of Prisoner Tax Returns

sent to the AQC Program for review. Based on our results, we project that 3,022¹⁹ prisoner tax returns erroneously bypassed AQC Program selection resulting in the issuance of potentially unallowable EITC and ACTC refundable credits totaling \$3.9 million.

When we brought the previously mentioned concern to management's attention, officials in the Return Integrity and Compliance Services function changed the weekly process for marking the tax accounts to a daily process and are documenting the return identification process in its internal guidelines. The updated guidelines will also address the timing of when the refund freeze markers must be placed on taxpayers' accounts.

- 14 returns (21.2 percent) bypassed AQC Program selection due to the corrupted Prisoner File data that we previously explained in this report. These returns were not identified as prisoner returns. Based on our results, we estimate that 962²⁰ tax returns erroneously bypassed the AQC Program due to the corrupted Prisoner File resulting in the issuance of EITC and ACTC credits totaling approximately \$907,000.
- 8 returns (12.1 percent) were not required to be routed to the AQC Program because they were reviewed by the IRS's Examination function or the refund was properly released by a Return Integrity and Compliance Services function tax examiner while resolving an inquiry from the taxpayer.

The Commissioner, Wage and Investment Division, should:

Recommendation 3: Develop processes and procedures to ensure that tax returns meeting AQC Program criteria are timely identified and refund freeze markers are timely placed on the appropriate taxpayers' accounts.

Management's Response: The IRS agreed with this recommendation and updated its procedures in the Internal Revenue Manual on March 2, 2021, to ensure that questionable tax returns are identified, refunds are appropriately frozen, and the returns are referred for treatment.

¹⁹ The point estimate projection is based on a two-sided 90 percent confidence interval. We are 90 percent confident that the point estimate is between 2,539 and 3,453 tax returns.

²⁰ The point estimate projection is based on a two-sided 90 percent confidence interval. We are 90 percent confident that the point estimate is between 606 and 1,409 tax returns.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to evaluate the effectiveness of the IRS's corrective actions to identify and reduce prisoner fraud. To accomplish our objective, we:

- Determined the adequacy of actions taken to improve the completeness and reliability of the IRS Prisoner File.
 - Evaluated IRS efforts to ensure that all Federal prisons and State correctional facilities provide information for incarcerated individuals.
 - Evaluated IRS actions to supplement the accuracy and completeness of its Prisoner File using SSA PUPS data.
- Evaluated IRS procedures for screening paper-filed prisoner tax returns for potential fraud when the RRP is taken down for maintenance and/or filing season updates.
- Determined the effectiveness of IRS actions to prevent prisoner record mismatches based on the presence of special characters and spaces in the prisoner records received from Federal prisons and State correctional facilities.
- Assessed the effectiveness of the IRS's strategy to promote the Blue Bag Program to increase institution participation.
- Evaluated IRS procedures for processing tax returns and refund checks received through the Blue Bag Program. To determine if closed Blue Bag Program cases were properly resolved in accordance with IRS guidelines, we reviewed:
 - A statistically valid sample of 64 closed Blue Bag Program tax return cases from a total population of 924 cases received in Calendar Year 2019.
 - A statistically valid sample of 73 closed Blue Bag Program prisoner check cases from a total population of 1,991 cases received in Calendar Year 2019.
- Determined the adequacy of the IRS's processes for using prisoner information to identify fraudulent Tax Year 2018 tax returns filed with an SSN issued to individuals who are incarcerated.
- Determined if Tax Year 2018 tax returns filed with prisoner SSNs for which a refundable credit was processed, *i.e.*, the ETIC and the ACTC, were routed to the AQC Program for review as required. To determine why full-year prisoner tax returns were not routed to the AQC Program for review, we reviewed a statistically valid sample of 66 returns from a total population of 4,533 Tax Year 2018 full-year prisoner tax returns.

All statistical samples were based on a confidence level of 90 percent, an expected error rate of 5 percent, and a precision factor of ± 5 percent. Our contracted statistician assisted with developing sampling plans and projections.

Performance of This Review

This review was performed with information obtained from the IRS Wage and Investment Division's Return Integrity and Compliance Services function in Atlanta, Georgia, during the period of April 2020 through February 2021. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Major contributors to the report were Russell Martin, Assistant Inspector General for Audit (Returns Processing and Account Services); Allen Gray, Director; Van Warmke, Audit Manager; Alexis Gomez, Lead Auditor; Ann Ring, Lead Auditor; Jennifer Bailey, Senior Auditor; Erica Law, Senior Auditor; and Mark Willoughby, Senior Auditor.

Validity and Reliability of Data From Computer-Based Systems

During this review, we relied on data obtained from the Individual Master File and Return Transaction File, which are stored on TIGTA's Data Center Warehouse.¹ We also obtained Forms W-2 wage and withholding information from the Information Returns Master File on the Data Center Warehouse. In addition, we relied on data from SSA PUPS files, RRP system files, and the Prisoner File that the IRS provided. Before relying on the data, we ensured that the files contained the specific data elements we requested and performed testing to ensure the reasonableness and validity of the data extracts. In addition, we selected random samples from the data extracts and verified that the data in the extracts were the same as the data captured in the IRS's Integrated Data Retrieval System. Based on the results of our testing, we determined that the data were valid and reliable for the purposes of this audit.

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: processes to improve the completeness and reliability of the IRS Prisoner File, procedures for screening potentially fraudulent prisoner tax returns when the RRP is down for maintenance, measures to minimize the number of prisoner mismatch records, strategy to promote the Blue Bag Program to increase institution participation, and processes for using prisoner information to identify fraudulent tax returns filed with the IRS. We evaluated these controls by reviewing the IRS Internal Revenue Manual containing the policies and procedures on reviewing prisoner tax returns, interviewing Return Integrity and Compliance Services function staff and management, and reviewing other key documentation related to the IRS's corrective actions to identify and reduce prisoner fraud.

¹ A TIGTA repository of IRS data.

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$24,423 in fraudulent tax refunds issued for eight tax returns that reported income and withholding that were not supported by third-party income tax documents (see Recommendation 2).

Methodology Used to Measure the Reported Benefit:

Our review of 67,873 Tax Year 2018 refund tax returns, filed using a full-year prisoner's SSN, found that 906 were not identified by the RRP as a prisoner tax return and thus, not sent to a RIVO tax examiner for review. The 906 returns were not correctly identified as a result of corrupted data in the IRS Prisoner File that the IRS used in Processing Year 2019 to identify Tax Year 2018 prisoner tax returns. Specifically, the data were corrupted by employees in the Return Integrity and Compliance Services function who incorrectly formatted prisoner incarceration and release dates in the Prisoner File. As a result, the Prisoner File listed some full-year prisoners as partial-year prisoners or not incarcerated at all in Calendar Year 2018. Our further analysis found that eight of the 906 tax returns reported income and withholding that were not supported by third-party income documents. These filers received potentially fraudulent refunds totaling \$24,423.

Type and Value of Outcome Measure:

- Cost Savings (Funds Put to Better Use) – Potential; \$4.8 million in unallowable EITC and ACTC refundable credits for 3,984 prisoner tax returns that erroneously bypassed AQC Program selection (see Recommendation 3).

Methodology Used to Measure the Reported Benefit:

Our review of Tax Year 2018 refund tax returns¹ identified 4,533 returns filed using a full-year prisoner SSN with refundable credits totaling \$6.6 million that were not routed to the AQC Program for review. We reviewed a statistically valid sample² of 66 returns and identified 44 returns (66.7 percent) bypassed the AQC Program because of an error by analysts in the Return Integrity and Compliance Services function. The error involved not properly identifying these returns to place them on the list of returns that the IRS uses to update taxpayers' accounts

¹ The filing status on these returns is Single or Head of Household.

² We selected a statistical sample using a confidence level of 90 percent, an expected error rate of 5 percent, and a precision factor of \pm 5 percent.

Actions Were Taken to Improve the Identification of Prisoner Tax Returns

with the refund freeze marker. Based on our results, we project that 3,022³ prisoner tax returns erroneously bypassed AQC Program selection resulting in the issuance of potentially unallowable EITC and ACTC refundable credits totaling \$3.9 million.

In addition, we identified 14 returns (21.2 percent) that bypassed AQC Program selection due to the corrupted Prisoner File data and were not identified as prisoner returns. Based on our results, we estimate that 962⁴ tax returns erroneously bypassed the AQC Program due to the corrupted Prisoner File, resulting in the issuance of EITC and ACTC credits totaling approximately \$907,000.

In total, we project that 3,984 tax returns (3,022 + 962) erroneously bypassed the AQC Program resulting in the issuance of potentially unallowable EITC and ACTC refundable credits totaling \$4,839,871 (\$3,932,584 + \$907,287).

³ The point estimate projection is based on a two-sided 90 percent confidence interval. We are 90 percent confident that the point estimate is between 2,539 and 3,453 tax returns.

⁴ The point estimate projection is based on a two-sided 90 percent confidence interval. We are 90 percent confident that the point estimate is between 606 and 1,409 tax returns.

Appendix III

Management's Response to the Draft Report

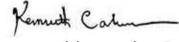


COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

March 23, 2021

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

Digitally signed by Kenneth C.
Corbin
Date: 2021.03.23 16:32:12 -04'00'

SUBJECT: Draft Audit Report – Audit #202040005 - *Actions Were Taken to Improve the Identification of Prisoner Tax Returns*

Thank you for the opportunity to review the subject draft report and provide comments. We appreciate the report's acknowledgement of the significant work we have done in improving both the completeness and accuracy of the prisoner files, as well as our efforts in preventing the issuance of improper refunds.

The IRS has improved its verification of prisoner records received from federal prisons and state correctional facilities to ensure that all valid records are added to the Prisoner File. To prevent the issuance of false or fraudulent refund claims, our processes use the Return Review Program (RRP) pre-refund filters to identify questionable returns filed using a prisoner's Social Security Number. After finding a formatting error had corrupted some records in the Prisoner File, we strengthened our review processes to improve data reliability in the future. While 906 prisoner returns were affected by the corrupted records, only eight returns were found to claim income tax withholding that was not supported by third-party documents.

We have also made several process improvements to mitigate the risk of prisoner refunds being issued prior to the completion of appropriate risk assessments. In August 2019, the number of quality checks and data validation procedures to identify incarceration data discrepancies in the Prisoner File was increased. A three-step error check process was also implemented to identify potentially corrupt data.

Prisoner returns claiming the Earned Income Tax Credit and/or the Additional Child Tax Credit are screened and verified by the Return Integrity and Verification Operation unit. Income earned while incarcerated does not qualify as earned income for these refundable credits; however, the IRS does not have the authority to simply correct the return for this error. Instead, the returns are referred to the Automated Questionable Credit (AQC) process for treatment. The AQC treatment stream follows deficiency

Actions Were Taken to Improve the Identification of Prisoner Tax Returns

2

procedures, which provide taxpayers their rights to an administrative appeal of the IRS's determination and to a review by the Tax Court prior to additional tax being assessed or a credit being denied. During this review, instances of accounts not being timely marked prior to AQC review were noted. We have since updated procedural guidance to ensure timely account identification occurs prior to referral to the AQC process so that refunds are not issued prematurely.

Annually, we send letters to the heads of the Federal Bureau of Prisons and the State Departments of Correction to educate them on the Blue Bag Program (BBP) and to encourage their participation. The annual letter asks each organization to respond by providing a point-of-contact and to confirm their participation in the upcoming year. The BBP provides a method for the institution to submit leads related to the preparation or receipt of questionable tax returns and/or refunds. Our tracking process has been updated to capture the responses of the Federal Bureau of Prisons and the State Departments of Correction responses to the BBP letter, and to perform follow-up actions if no response is received.

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.

Attachment

Actions Were Taken to Improve the Identification of Prisoner Tax Returns

Attachment

Recommendations

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 1

Ensure that responses to the Blue Bag Program letter, received from the heads of the Federal Bureau of Prisons and State Departments of Correction, are properly tracked to enable the IRS to identify and work with those prison institutions that do not respond or agree to participate in the program.

CORRECTIVE ACTION

Action was taken with the most recent mailing of the Blue Bag Program letters. By December 3, 2020, the master listing included the date that each state responded and identified whether they would be participating or not.

IMPLEMENTATION DATE

Implemented

RESPONSIBLE OFFICIAL

Director, Return Integrity Verification Program Management, Return Integrity and Compliance Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 2

Ensure that the quality checks and data validation procedures are implemented when compiling the list of prisoners received from Federal and State prisons to prevent future corruption of the IRS Prisoner File.

CORRECTIVE ACTION

In August 2019, we created programming codes to validate the data quality and added additional error checking procedures to prevent future corruption of the Prisoner File.

IMPLEMENTATION DATE

Implemented

RESPONSIBLE OFFICIAL

Director, Return Integrity Verification Program Management, Return Integrity and Compliance Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

N/A

Actions Were Taken to Improve the Identification of Prisoner Tax Returns

2

RECOMMENDATION 3

Develop processes and procedures to ensure that tax returns meeting AQC Program criteria are timely identified and refund freeze markers are timely placed on the appropriate taxpayers' accounts.

CORRECTIVE ACTION

The Internal Revenue Manual 25.25.12.14, *General Agreement on Tariffs and Trade (GATT) Procedures*, was updated on March 2, 2021. The update provides revised procedures to ensure the timely identification of questionable tax returns occurs, refunds are appropriately frozen, and the returns are referred for treatment.

IMPLEMENTATION DATE

Implemented

RESPONSIBLE OFFICIAL

Director, Return Integrity Verification Program Management, Return Integrity and Compliance Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

N/A

Appendix IV

Abbreviations

ACTC	Additional Child Tax Credit
AQC	Automated Questionable Credit
EITC	Earned Income Tax Credit
IRS	Internal Revenue Service
PUPS	Prisoner Update Processing System
RIVO	Return Integrity and Verification Operation
RRP	Return Review Program
SSA	Social Security Administration
SSN	Social Security Number
TIGTA	Treasury Inspector General for Tax Administration



**To report fraud, waste, or abuse,
call our toll-free hotline at:**

(800) 366-4484

By Web:

www.treasury.gov/tigta/

Or Write:

Treasury Inspector General for Tax Administration

P.O. Box 589

Ben Franklin Station

Washington, D.C. 20044-0589

Information you provide is confidential, and you may remain anonymous.