



*Expanded Access to Wage and Withholding
Information Can Improve Identification of
Fraudulent Tax Returns*

September 30, 2010

Reference Number: 2010-40-129

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

2(f) = Risk Circumvention of Agency Regulation or Statute

Phone Number | 202-622-6500

Email Address | inquiries@tigta.treas.gov

Web Site | <http://www.tigta.gov>



HIGHLIGHTS

EXPANDED ACCESS TO WAGE AND WITHHOLDING INFORMATION CAN IMPROVE IDENTIFICATION OF FRAUDULENT TAX RETURNS

Highlights

Final Report issued on September 30, 2010

Highlights of Reference Number: 2010-40-129 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

As of April 17, 2010, the Internal Revenue Service (IRS) identified 249,185 tax returns with \$1.51 billion being claimed in fraudulent refunds. While the IRS has shown a significant increase in the number of fraudulent tax returns identified and refunds stopped, it needs expanded and expedited access to wage and withholding information to assist in its efforts.

WHY TIGTA DID THE AUDIT

This audit was initiated because unscrupulous individuals continue to submit tax returns with false income documents to the IRS for the sole purpose of receiving a fraudulent refund. In October 2009, the IRS transferred responsibility for its pre-refund fraudulent tax return detection activities to its Accounts Management function. Management noted that transferring these activities will capitalize on opportunities to complete this work more efficiently. Our overall objective was to assess the IRS' Taxpayer Assurance Program processes to identify potentially fraudulent tax returns for screening.

WHAT TIGTA FOUND

Expanded and expedited access to wage and withholding information would significantly increase the IRS' ability to more efficiently and effectively verify wage and withholding information reported on a tax return when processed. Our analysis of the 151,776 Tax Year 2008 tax returns sent to an examiner for screening and then released for processing identified that 96,178 (63 percent) of these tax returns had valid wages reported. TIGTA

estimates that the IRS needlessly expended 22,110 hours screening these tax returns. Currently, the law limits IRS access to the United States Department of Health and Human Services wage information. In addition, processes have not been developed to expedite the use of wage and withholding data received from the Social Security Administration.

In addition, TIGTA found that the majority of tax returns the IRS identifies as being filed by prisoners are not being sent to screening to assess fraud potential. Our review identified 253,929 (88 percent) of the 287,918 tax returns filed by a prisoner as of March 24, 2010, were not selected for screening. Of those tax returns not screened, 48,887 individuals had no wage information reported to the IRS by employers. These 48,887 prisoners claimed refunds totaling more than \$130 million including Earned Income Tax Credit (EITC) claims of \$78.5 million. Some of these refunds may have been stopped by other compliance activities. For example, TIGTA determined that the IRS prevented the issuance of nearly \$18.1 million in EITC claims for 4,532 of the 48,887 prisoner tax returns.

WHAT TIGTA RECOMMENDED

Legislation is needed to expand IRS access to the United States Department of Health and Human Services wage information. TIGTA recommended that the Commissioner, Wage and Investment Division, obtain wage information for **2(f)** returns with EITC claims and develop a process to expedite the availability of wage and withholding information received from the Social Security Administration. The Commissioner should also verify whether the 48,887 tax returns with tax refunds that were filed by prisoners with no reported wages were fraudulent and identify revisions that could be made to data mining criteria to better identify fraudulent tax returns filed by prisoners.

In their response to the report, IRS officials fully agreed with three recommendations and partially agreed with the other. The IRS plans to first examine the benefits of obtaining wage information for **2(f)** returns with EITC claims prior to implementing any process modifications.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 30, 2010

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Expanded Access to Wage and Withholding
Information Can Improve Identification of Fraudulent Tax Returns
(Audit # 201040003)

This report presents the results of our review of the Internal Revenue Service's (IRS) Taxpayer Assurance Program processes to identify potentially fraudulent tax returns for screening. This audit is included in our Fiscal Year 2010 Annual Audit Plan and addresses the major management challenge of Erroneous and Improper Payments and Credits.

IRS management disagreed with our computation of potential savings from expanded and expedited access to Social Security Administration (SSA) data. The IRS raises concerns regarding the completeness of SSA data received early in the filing season. We agree that the volume of SSA data received increases as the filing season progresses. However, as detailed in our report, the IRS begins receiving SSA wage and withholding information on a daily basis in late January *****2(f)*****

In addition, management disagreed with our potential savings related to our recommendation on improving verification of prisoner tax returns. Management indicated that verification of prisoner tax returns must be weighed against available IRS resources. We agree that post-refund compliance efforts are costly and the IRS has limited resources. This is precisely the reason we recommended the IRS identify revisions that could be made to its screening process to stop fraudulent refunds from being sent to prisoners at the time tax returns are processed. Our outcome measure reflects the potential revenue that could be protected at the time tax returns are processed.

Finally, the IRS disagreed with our revenue protection outcome measure related to the 2,716 tax returns that resulted in \$6.7 million in erroneous refunds being issued for tax returns in which examiners confirmed fraud potential. The IRS provided no explanation to support its



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disagreement. In our opinion, there is no basis for IRS' disagreement as the IRS has initiated or plans to initiate programming changes that once in place will prevent the release of the types of erroneous refunds we identified. Our outcome measure reflects the amount of revenue that will be protected once this programming has been completed.

Management's complete response to the draft report is included in Appendix V.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.



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Abbreviations

CADE	Customer Account Data Engine
EFDS	Electronic Fraud Detection System
EITC	Earned Income Tax Credit
HHS	Health and Human Services
IRS	Internal Revenue Service
NDNH	National Directory of New Hires
OMM	Operation Mass Mail
SSA	Social Security Administration
TAP	Taxpayer Assurance Program



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Background

In January 1977, the Internal Revenue Service (IRS) established a nationwide, multifunctional detection program designed to identify fraudulent tax returns and prevent the payment of fraudulent refunds. However, unscrupulous individuals continue to submit tax returns with false income documents to the IRS for the sole purpose of receiving a fraudulent refund. On October 11, 2009, the IRS transferred responsibility for its pre-refund fraudulent tax return detection activities from its Criminal Investigation Division to its Accounts Management function. Subsequent to the transfer, the IRS renamed its fraud detection program to the Taxpayer Assurance Program (TAP).

The IRS Taxpayer Assurance Program is responsible for identifying fraudulent tax returns and stopping the release of fraudulent tax refunds.

The TAP is responsible for identifying fraudulent tax returns and stopping the release of the related refunds. IRS management noted that transferring detection, verification activities, and resources to the Accounts Management function will capitalize on opportunities to complete this work more efficiently and allow the Criminal Investigation Division to use resources on the development of fraudulent refund schemes.¹

The Electronic Fraud Detection System (EFDS) is used to identify potentially fraudulent tax returns

The EFDS is the primary tool used by the IRS to identify potentially fraudulent tax returns. The EFDS includes a process called “data mining,” which uses various formulas to identify potentially fraudulent paper and electronically filed tax returns. Suspicious paper and electronically filed tax returns are identified based on specific characteristics of the tax return. An associated data mining score (risk that tax return is fraudulent) is computed for the tax return. The higher the data mining score given to a tax return, the greater the likelihood that the tax return is fraudulent. Those potentially fraudulent tax returns that meet the IRS criteria (data mining score and refund amount) are then forwarded to TAP examiners for screening.

¹ Schemes involve people who engage in, facilitate, or promote tax fraud (e.g., claiming fictitious deductions on tax returns).



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The TAP screening process is designed to identify potentially fraudulent tax returns for verification

Screening individual tax returns to identify potentially fraudulent tax returns is the first step in the IRS' pre-refund fraud detection process. Once a questionable tax return is identified, the following takes place:

- A hold is placed on the individual's tax account for 2 weeks to prevent the issuance of any refund. This delay allows TAP examiners to evaluate the tax return for fraud potential.
- The tax return is assigned to a TAP examiner for screening. The examiner reviews the income and withholding information reported on the tax return including comparing the information reported on the current tax year² return to previous tax year returns to identify inconsistencies. If the TAP examiner concludes that the tax return is potentially fraudulent, the tax return is sent for verification. Verification is the process in which TAP examiners attempt to contact the employer to confirm wages and withholding detailed on the Wage and Tax Statement (Form W-2) and/or Miscellaneous Income (Form 1099-MISC) associated with the potentially fraudulent tax return. For those tax returns determined as having no fraud potential, the tax return is released for processing and issuance of any associated tax refund.

Figure 1 provides statistical information on tax returns screened and/or verified for Processing Years 2008 through 2010.

Figure 1: Comparison of Screening and Verification Results for the Filing Season³ in Processing Years 2008 Through 2010

Filing Season	Tax Returns Sent to Screening	Tax Returns Sent to Verification	Tax Returns Verified as Fraudulent
2008	287,318	255,688	154,648
2009	243,907	200,477	113,740
2010	326,398	232,634	127,868

Source: Questionable Refund Program Workload Comparison Summary Report for Processing Years 2008 through 2010.

This review was performed at the Wage and Investment Division Office of Customer Account Services in Atlanta, Georgia, and the TAP office in Austin, Texas, during the period January

² The tax year for most individual tax returns covers a calendar year, which is the 12 months from January 1 through December 31.

³ The filing season is the period from January through mid-April when most individual income tax returns are filed.



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through July 2010. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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Results of Review

***Expanded Access to Wage and Withholding Information Would
Improve Identification of Fraudulent Tax Returns***

As of April 17, 2010, the IRS had identified 249,185 tax returns with \$1.51 billion being claimed in fraudulent refunds and was able to prevent the issuance of \$1.48 billion (98 percent) of the fraudulent refunds being claimed. This represents a 50 percent increase in the number of

***As of April 17, 2010, the IRS
prevented the issuance of
\$1.48 billion in fraudulent
tax refunds.***

fraudulent tax returns identified as of this same period last processing year. This increase is in part the result of the Accounts Management function effectively monitoring workload and adjusting data mining tolerances during the filing season to increase the identification of potentially fraudulent tax returns for screening. For example, the

Accounts Management function lowered the data mining tolerances for 17 of the 25 EFDS data mining models through March 5, 2010, to increase the number of potentially fraudulent tax returns for screening. As of April 17, 2010, a total of 326,398 tax returns were identified for screening which represented a 34 percent increase of tax returns identified for screening when compared to the same period last processing year.

While the IRS has shown a significant increase in the number of fraudulent tax returns identified and refunds stopped, it needs expanded and expedited access to wage and withholding information during the filing season. This information would significantly increase the IRS' ability to more efficiently and effectively verify wage and withholding information reported on a tax return at the time a tax return is processed.

The law limits IRS access to the United States Department of Health and Human Services wage information

The United States Department of Health and Human Services (HHS) maintains the National Directory of New Hires (NDNH). The NDNH is a national repository of wage and employment information. NDNH data contain quarterly wage information submitted by Federal agencies and State workforce agencies to the HHS. The Social Security Act⁴ and Federal regulations⁵ require wage information on individual employees be provided to the HHS within 4 months of the end of a calendar quarter. The following information for each individual is required:

⁴ 42 United States Code Section 653.

⁵ 45 CFR Section 303.108(c).



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Legislation has been repeatedly proposed to expand IRS access to NDNH wage data. Most recently, the IRS Fiscal Year 2010 budget request again included a legislative proposal to strengthen tax administration by expanding IRS access to NDNH information. The proposal would revise 42 United States Code Section 653(i)(3) by deleting the phrase “Section 32 of” and deleting all verbiage after “1986.” The amended section would read as follows:

The Secretary of the Treasury shall have access to the information in the National Directory of New Hires for purposes of administering the Internal Revenue Code of 1986.

If enacted, the legislation would expand IRS access to much needed wage information. In addition, granting the IRS expanded access is in line with Executive Order 13520 on Reducing Improper Payments. This Executive Order outlines the President’s directive to improve information sharing among agencies with the goal of reducing improper payments. Expanding IRS access to NDNH wage information would enable the IRS to improve its identification of fraudulent tax returns and stop associated fraudulent refunds while reducing resources expended on verifying tax returns with no fraud potential.

*****2(f)*****

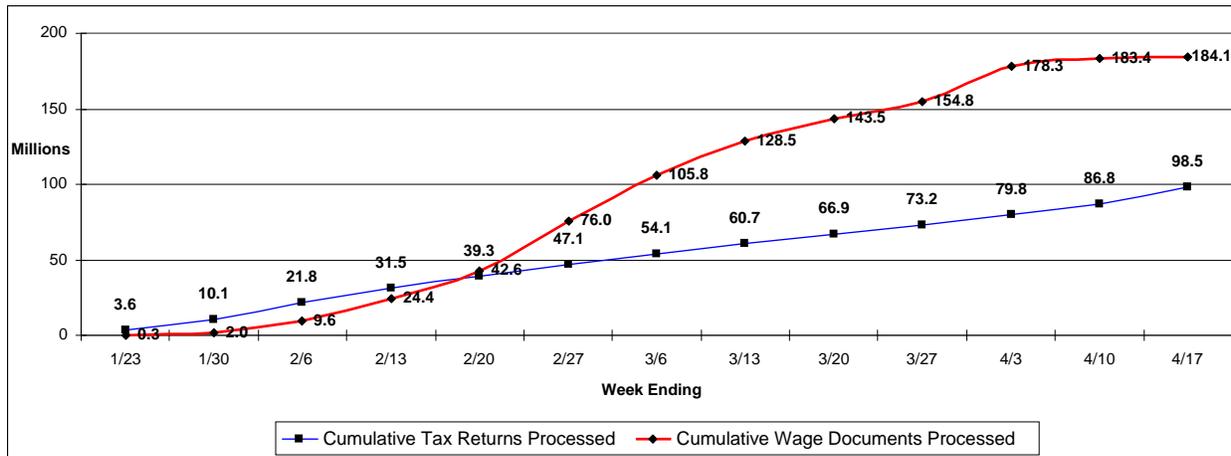
The IRS begins receiving wage and withholding information in late January each year from the SSA. *****2(f)*****
*****2(f)*****. Our discussions with representatives from the SSA identified that during the 2010 Filing Season, the IRS began receiving Form W-2 wage and withholding information on a daily basis on January 23, 2010. *****2(f)*****
*****2(f)*****.

As shown in Figure 2, the IRS could benefit from expediting the availability of SSA wage and withholding information on the EFDS because this information could be used to ensure tax returns with valid wages are not being screened needlessly. TAP examiners could use this information as it is being received from the SSA to improve the efficiency and effectiveness of the IRS process to identify potentially fraudulent tax returns.



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Figure 2: Cumulative Tax Year 2009 Wage Documents Processed by the SSA and Tax Returns Processed by the IRS During the 2010 Filing Season



Source: SSA Progress Report on Posting Wage Items for 2009 and IRS Returns Transaction File.

Expanded access to wage and withholding information could enable the IRS to transfer resources used for screening to other compliance efforts

Expanded and expedited access to wage and withholding information would allow the IRS to eliminate its screening process and send potentially fraudulent tax returns directly to verification. Our analysis of the 151,776 Tax Year 2008 tax returns sent to a TAP examiner for screening and then released for processing (TAP examiner concluded no fraud potential) identified that 96,178 (63 percent) of the screened tax returns had valid wages reported. We estimate that the IRS needlessly expended 22,110 hours screening these tax returns only to conclude that the tax returns were not fraudulent. As shown in Figure 3, transferring these 22,110 hours would allow the IRS to transfer resources totaling \$329,439⁷ to other compliance activities.

⁷ The \$329,439 in available funding for staffing was calculated by multiplying the 22,110 hours by \$14.90 per hour (the hourly wage for a General Schedule-5 tax examiner).



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Figure 3: Transferring Resources for Additional Compliance Efforts

Description	Results
Tax Returns Screened	326,398
Average Tax Returns Screened per Hour	9
Percent We Determined to Have Valid Wages on Tax Return – No Fraud Potential	63%
Hours That Could Be Transferred to Other Compliance Activities ⁸	22,110

Source: Treasury Inspector General for Tax Administration analysis of Tax Year 2008 tax return data and IRS Calendar Year 2010 reports through the end of the 2010 Filing Season.

Legislative Recommendation

Recommendation 1: As put forth in the IRS Fiscal Year 2010 budget proposal, legislation is needed to expand IRS access to NDNH wage information for tax administration purposes not limiting use of this information to just those tax returns with a claim for the EITC.

Management's Response: IRS management agreed with this recommendation. Legislation which will expand the use of data in the NDNH to returns without the EITC was included in the President's Fiscal Year 2011 budget. On April 9, 2010, the IRS met with HHS officials to brief them on the proposal. The IRS will continue to follow the progress of the proposed legislation. The IRS is analyzing the benefits the NDNH data will have on the TAP and the potential for other compliance efforts.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 2: Obtain NDNH wage information for individuals claiming the EITC on ***2(f)*** tax returns.

Management's Response: IRS management partially agreed with this recommendation. They will examine the benefits of obtaining NDNH information for individuals claiming the EITC on ***2(f)*** tax returns, including the effect on cycle time and improved accuracy of verification. If NDNH information expedites the

⁸ Because of rounding, the 22,110 hours that could be transferred to other compliance activities will not equal the 326,398 tax returns screened multiplied by 63 percent and divided by 9 tax returns screened per hour.



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scanning process and increases the accuracy of determinations, the IRS will consider a plan to request the data for ***2(f)***and the associated process modifications.

Recommendation 3: Develop a process to expedite the availability of wage and withholding information received from the SSA for use by the EFDS and TAP examiners in the identification of potentially fraudulent tax returns.

Management's Response: IRS management agreed with this recommendation. They continue to take strategic steps to accelerate access to information return data toward goals of refund verification at time of filing and upfront issue detection. The IRS has already initiated a pilot project to accelerate its access to SSA wage data. The IRS is working with the SSA to analyze the costs and benefits of accelerated transfer, perfection, and integration of SSA data into IRS systems.

Office of Audit Comment: The IRS disagreed with the potential savings associated with expanding and expediting access to SSA data, and raised concerns regarding the completeness of SSA data received early in the filing season. We agree that the volume of SSA data received from the SSA increases as the filing season progresses. However, the IRS begins receiving SSA data on a daily basis in late January ***2(f)*****
*****2(f)*****

Improvements Are Needed to More Effectively Identify and Stop Fraudulent Refunds

Improvements can be made to more effectively identify potentially fraudulent tax returns filed by prisoners. We found that the majority of tax returns identified as being filed by prisoners are not sent to a TAP examiner for screening to assess the potential that the tax return is fraudulent. Our review identified that 253,929 (88 percent) of the 287,918 tax returns identified by the IRS through March 24, 2010,⁹ as having been filed by a prisoner were not selected for screening. Using prisoner Social Security Numbers, we matched the file the IRS obtained from the SSA with wage and withholding information and identified that 48,887 of the prisoners filing these tax returns had no wage information reported by employers. These 48,887 individuals claimed refunds totaling more than \$130 million, including EITC claims of \$78.5 million. Some of these refunds may have been stopped by other compliance activities. For example, we determined that the IRS prevented the issuance of EITC claims of nearly \$18.1 million for 4,532 of the 48,887 prisoner tax returns.¹⁰ However, it should be noted that the identification of erroneous

⁹ We were only able to obtain the data extract for tax returns processed on the EFDS through March 24, 2010.

¹⁰ To determine whether the prisoners had actually earned wages in Tax Year 2009, we excluded 26,805 prisoners filing as married filing jointly because the income could have resulted from the individual who was not incarcerated. We matched the Social Security Numbers for the remaining 225,851 tax returns not sent to screening to the Form W-2 information the IRS received from the SSA.



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EITC claims for these 4,532 individuals was caught via IRS compliance efforts and not its TAP process that is supposed to identify fraudulent refunds when the tax returns are received.

In Fiscal Year 2005, the Treasury Inspector General for Tax Administration conducted an audit to determine the effectiveness of IRS procedures for detecting potentially fraudulent prisoner refund tax returns.¹¹ Our review concluded that there may be other fraudulent prisoner tax returns of which the IRS is not aware. The total number of tax returns screened is based on two factors: 1) the likelihood that fraud is present and 2) the availability of resources to work the cases. Each refund tax 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 Criminal Investigation Division also used other criteria to screen tax returns. The number of tax returns screened is based on these criteria and the resources available. If a tax return filed by a prisoner does not meet these criteria, it will not be reviewed to determine if it is fraudulent.

The IRS continues to identify tax returns filed by prisoners during tax return processing. However, the IRS has established selection criteria that result in the majority of these tax returns never being sent to screening to assess fraud potential. Following a Treasury Inspector General for Tax Administration report on First-Time Homebuyer Credit fraud,¹² the IRS in a June 23, 2010, release urged Congress to pass legislation giving the agency up-to-date prisoner information and pledged to take other steps to reduce improper claims of the credit by prisoners. We agree that up-to-date prisoner information would enable the IRS to better identify tax returns filed by prisoners. However, we have concerns about whether the IRS is effectively using the prisoner information it currently receives. We have initiated an audit to further analyze and evaluate IRS efforts to identify tax returns filed by prisoners and its attempts to reduce prisoner fraud.

Controls are not preventing issuance of tax refunds when tax returns are screened and identified as being potentially fraudulent

Our review identified 2,716 tax returns that resulted in \$6.7 million¹³ in erroneous refunds being issued for tax returns in which TAP examiners confirmed fraud potential requiring verification of wage and withholding information. Specifically, we found:

- **Tax refunds in excess of the amount of the EITC claimed being erroneously refunded** - We identified 2,451 screened tax returns sent to verification through April 17, 2010, that were also sent to pre-refund examination as a result of filters

¹¹ *The Internal Revenue Service Needs to Do More to Stop the Millions of Dollars in Fraudulent Refunds Paid to Prisoners* (Reference Number 2005-10-164, dated September 28, 2005).

¹² *Additional Steps Are Needed to Prevent and Recover Erroneous Claims for the First-Time Homebuyer Credit* (Reference Number 2010-41-069, dated June 17, 2010).

¹³ Because of rounding, the total amount of \$6.7 million does not equal the two separately rounded amounts of \$5.4 million and \$1.4 million when added together.



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identifying the EITC as a probable erroneous claim. However, the amount of the refund in excess of the EITC claimed (\$5.4 million) did not remain frozen until a TAP examiner verified the wages and withholding. We brought this concern to management's attention on March 2, 2010. On March 11, 2010, management stated that a computer programming change request had been submitted to prevent the release of the tax refunds in excess of the EITC for those cases sent to both verification and pre-refund examination beginning in Processing Year 2011.

- **Tax refunds for tax returns processed through the Customer Account Data Engine (CADE)¹⁴ being erroneously issued** – We identified 265 tax returns processed through the CADE that were screened and sent to verification through April 17, 2010, in which the refunds were issued prior to a TAP examiner verifying wages and withholding. These tax refunds totaled approximately \$1.4 million. We advised management of this issue on March 2, 2010. On April 15, 2010, management responded that a system programming change was implemented to prevent future tax refunds from releasing for CADE-processed tax returns.

Recommendation

The Commissioner, Wage and Investment Division, should:

Recommendation 4: Verify whether the 48,887 tax returns with tax refunds that were filed by prisoners with no reported wages were fraudulent. Based on actions taken on these cases, the Commissioner should identify revisions that could be made to data mining criteria to better identify fraudulent tax returns filed by prisoners.

Management's Response: IRS management agreed with this recommendation. They will work with the Small Business and Self-Employed Division to review these 48,887 returns for potential inclusion in IRS post-refund compliance efforts. These returns will be sampled and reviewed to identify improvement opportunities for their data mining models. In addition, the IRS is evaluating an improved process to acquire and manage prisoner information from Federal and State prison systems.

Office of Audit Comment: The IRS disagreed with our potential savings related to improving verification of prisoner tax returns. Management indicated that verification of prisoner tax returns must be weighed against available IRS resources. We agree that post-refund compliance efforts are costly and the IRS has limited resources. However, our outcome measure reflects the potential revenue that could be protected at the time tax

¹⁴ The CADE is a major component of the IRS Modernization program. It consists of current and planned databases and related applications that work with the IRS Master File. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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returns are processed if improvements are made to data mining criteria to better identify fraudulent tax returns filed by prisoners. Further, the IRS disagreed with our outcome measure related to erroneous refunds being issued for tax returns in which examiners confirmed fraud potential. The IRS provided no explanation to support its disagreement. In our opinion, there is no basis for the IRS' disagreement as the IRS has initiated or plans to initiate programming changes that once in place will prevent the release of the types of erroneous refunds we identified. Our outcome measure reflects the amount of revenue that will be protected once this programming has been completed.

Some Fraudulent Tax Returns Were Not Retained for Possible Use As Evidence

As of April 7, 2010, the IRS reported that it identified a total of 43,067 fraudulent Operation Mass Mail (OMM) tax returns and stopped \$296 million in associated fraudulent tax refunds. These fraudulent tax returns are part of an extensive tax refund fraud scheme. ***2(f)*****
*****2(f)*****
*****. These fraudulent tax returns were first identified in Processing Year 1999 by the IRS Fraud Detection Center at the Brookhaven Campus¹⁵ and involved fraudulent tax refunds in the Bronx, New York, area. Since then, OMM schemes have spread to other States. Generally, OMM tax returns are identified when received by the IRS and prior to tax return processing. As a result, most OMM tax returns are not processed by the IRS.

Procedures instruct IRS employees to destroy unprocessed OMM tax returns without any retention period after inputting limited information into a computerized database. On April 22, 2010, we issued an email alert to the Director, Customer Account Services, Wage and Investment Division, expressing our concerns with the destruction of OMM tax returns. We recommended that a decision be obtained from the Records and Information Management Services Program office as to the filing and retention of unprocessed OMM tax returns and recommended that OMM tax returns be retained for a period consistent with the statute of limitations on fraud against the Government because these tax returns could be used as potential evidence in a civil or criminal case. In addition, we requested management to provide us with a detailed explanation as to the process developed and used to verify the accuracy of tax return volumes and refund dollars being reported as part of their OMM accomplishments.

Management Actions

- May 13, 2010 – Management initially responded that the Accounts Management function is working in conjunction with the Chief Counsel's Office, Criminal Investigation Division, and the Servicewide Records Officer to consider the proper disposition of these

¹⁵ 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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tax returns and that pending a final determination, necessary actions have been taken to retain these OMM tax returns.

- June 17, 2010 – Management responded that, effective immediately, the Accounts Management function would retain paper OMM tax returns for disposition to the Federal Records Center for a period of 5 years to provide an audit trail to ensure credibility of the program results. In addition, the Accounts Management function will work with the records retention officer to ensure retention and purge time periods for OMM tax returns are established and documented appropriately. Management commented that they initially followed the required procedures to obtain a decision regarding the filing and retention of OMM tax returns and that IRS Chief Counsel concluded that unprocessed tax returns are not Federal records which must be retained. However, management explained that even when not required by law, the IRS retains documents submitted by taxpayers and filers as needed to support effective tax administration.

In addition, management responded that a number of actions were taken to ensure the accuracy of OMM data, including data matching and consistency checks between the OMM tax return information contained in the database and the Integrated Data Retrieval System.¹⁶ Our limited review of the database showed entries with incomplete or blank fields. Management acknowledged that mismatches were identified with a small number of records in the OMM database. However, the mismatches were addressed and the database was modified to improve the accuracy and completeness of the OMM tax return information. Because of management actions taken during our review, we are making no recommendations at this time.

¹⁶ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to assess the IRS' TAP processes to identify potentially fraudulent tax returns for screening. To accomplish this objective, we:

- I. Determined whether the EFDS is operating as intended.
 - A. Assessed whether all tax returns that should be sent through the EFDS were in fact processed through the EFDS.
 1. Reviewed the EFDS User Manual and other system documentation to identify the criteria for EFDS processing.
 2. Obtained an extract from the EFDS containing all tax returns scored by the System and matched the records against the Returns Transaction File¹ containing all tax returns posting to Master File² during Processing Year 2010. We conducted tests to assess the reliability of data, including comparing the volume of records on the extract to IRS tax return filing statistics for Processing Year 2010 and ensuring that the data extracted met the required criteria.
 3. Determined the volume and refund amounts for the tax returns that should have been processed through the EFDS but were not and measured the impact on tax administration.
 4. Identified the number of tax returns not processed through the EFDS as intended based on established EFDS selection by querying the Returns Transaction File for the 2010 Filing Season and measured the impact on tax administration.
 - B. Assessed whether all tax returns meeting the screening selection criteria are being included in the screening inventory as intended.
 1. Obtained EFDS tolerances (data mining and refund amount) established for screening selection during the 2010 Filing Season.³
 2. Analyzed the EFDS extract obtained in Step I.A.2. and determined whether tax returns meeting EFDS data mining scoring and refund tolerances were included in the screening workload.

¹ A file that contains data for individual tax returns and accompanying forms and schedules processed by the IRS.

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 filing season is the period from January through mid-April when most individual income tax returns are filed.



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- C. Assessed whether the EFDS is identifying all prisoner tax returns and sending them to screening if meeting the data mining tolerance.
 - 1. Obtained a copy of the prisoner data file for Processing Year 2010.
 - 2. Compared the data file to the EFDS extract obtained in Step I.A.2. and determined if all prisoner tax returns included a prisoner indicator.
- II. Determined if the screening process is effective and efficient.
 - A. Evaluated the use of HHS wage information by the TAP to prevent refund fraud for tax returns claiming the EITC.
 - 1. Reviewed the process by which States collect wage information from employers and forward it to the HHS.
 - 2. Identified the content of the wage information collected and determined if it includes withholding information and nonemployee compensation.
 - 3. Reviewed HHS Inspector General reports to determine whether any reports were issued assessing the accuracy and completeness of the wage information provided by the States.
 - 4. Determined the potential impact on tax administration where ***2(f)*****
*****2(f)*****.
 - B. Identified the volume of tax returns that could systemically bypass the screening process based upon more current reporting of wage and withholding information to the IRS.
 - 1. Obtained a Master File computer extract of all Tax Year 2008 tax returns that were screened and refiled and screened and verified “good.” We conducted tests to assess the reliability of data, including verifying the data against amounts reflected on the Integrated Data Retrieval System.⁴
 - 2. Matched the file obtained in Step II.B.1. against the Tax Year 2008 Wage and Tax Statement (Form W-2) file and compared the wage and withholding information for both the primary and secondary Social Security Numbers.
 - 3. Determined the volume of tax returns that could have bypassed the screening process for both categories (tax returns screened and refiled, and tax returns screened and verified “good”) based upon consistent wage information reported by the employer.

⁴ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer’s account records.



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- C. Identified the staffing resources that could be shifted to other compliance activities based upon the reduction in the screening workload determined in Step II.B.
- III. Determined whether the TAP will have sufficient resources to effectively identify and stop fraudulent refunds in Processing Year 2010.
 - A. Reviewed the staffing by activity for each TAP site and assessed the proficiency of staffing, availability of workstations, and effectiveness of management to ensure the quality of the screening process.
 - B. Reviewed program performance measures and quality review techniques and procedures established for the screening process.
 - C. Identified management information reports and reviewed managerial requirements for monitoring the caseload and evaluating the efficiency and effectiveness of the screening process.
 - D. Assessed any impact to the program resulting from the transition due to a decrease in the number of tax returns screened, the number of tax returns referred for verification, the number of tax returns verified false, and the amount of refunds stopped.
 - E. Assessed whether internal controls were effective to prevent the release of the refund after the tax returns were selected for screening during the 2010 Filing Season.

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 the following internal controls were relevant to our audit objective: Accounts Management function TAP policies, procedures, and practices for screening potentially fraudulent tax returns in campus⁵ operations. We evaluated these controls during the audit planning activity by reviewing the Internal Revenue Manual and lesson plans for screening procedures and reviewing a judgmental sample of screened tax returns. We also evaluated the controls that are incorporated directly into the EFDS to ensure that it was operating as intended during processing of tax returns for the 2010 Filing Season.

⁵ 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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Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)

Russell P. Martin, Director

Edward Gorman, Audit Manager

Van A. Warmke, Lead Auditor

Karen C. Fulte, Senior Auditor

Jeffrey R. Stieritz, Auditor

Arlene Feskanich, Information Technology Specialist



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Appendix III

Report Distribution List

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Appendix IV

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:

- Inefficient Use of Resources – Potential; \$1.6 million over 5 years. This estimate is based on transferring 22,110 hours that the IRS expended screening tax returns with valid wages to additional compliance efforts, which could result in \$329,439 in available funding from the transferred resources each year (see page 4).

Methodology Used to Measure the Reported Benefit:

Of the 151,776 Tax Year 2008 tax returns refiled (the reviewer of the tax return concluded it was not fraudulent), we identified 96,178 (63 percent) tax returns that were selected for screening that had valid wages reported. These included:

- 70,865 tax returns refiled after screening.
- 25,313 tax returns refiled after verification.

By reducing the volume of tax returns unnecessarily sent to screening, the IRS could transfer 22,110 hours expended screening tax returns with valid wages to other compliance activities.

To compute the inefficient use of resources, we:

- Matched Tax Year 2008 tax returns refiled either after screening or verification against the IRS Returns Transaction File to obtain the secondary Social Security Number, filing status, and reported wages on the tax return.
- Compared the wages reported on the 151,776 Tax Year 2008 tax returns refiled to the SSA W-2 file to identify the 96,178 (63 percent) tax returns that could have bypassed screening due to wages per the tax return being consistent with wages per the SSA W-2 file (wages per tax return within 90 percent of wages reported per the SSA W-2 file).



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- Calculated the hours that could be transferred to other compliance activities (22,110)¹ by multiplying the 326,398 tax returns screened in Calendar Year 2010 through April 17, 2010, by 63 percent and then dividing that amount by an average of 9 tax returns screened per hour.
- Computed the inefficient use of resources of \$329,439 by multiplying the 22,110 hours that could be transferred to other compliance activities by \$14.90 per hour (the hourly wage for a General Schedule-5 tax examiner).
- Calculated the inefficient use of resources total of \$1.6 million over 5 years by multiplying annual available funding from transferred resources of \$329,439 x 5 years.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$560.4 million over 5 years. This estimate is based on \$130.2 million in tax refunds associated with 48,887 prisoner Tax Year 2009 tax returns identified by the IRS in Calendar Year 2010 through March 24, 2010, less the \$18.1 million in EITC claims that were stopped on 4,532 of the 48,887 prisoner tax returns, which were sent to pre-refund examination as a result of filters identifying the EITC as a probable erroneous claim (see page 9).

Methodology Used to Measure the Reported Benefit:

From the data provided by the IRS, we determined that 253,929 Tax Year 2009 tax returns identified by the EFDS as prisoner tax returns through March 24, 2010, were not selected for screening.

To compute the revenue protection, we:

- Matched the 253,929 prisoner tax returns against the IRS Returns Transaction File to identify the 225,851 prisoner tax returns that had a filing status other than married filing jointly.
- Matched the 225,851 prisoner tax returns that had a filing status other than married filing jointly against the IRS W-2 file which resulted in the identification of 48,887 prisoner tax returns that had no wage information reported by employers.
- Computed the potential revenue loss of \$130.2 million by identifying the total refunds claimed for the 48,887 prisoner tax returns.

¹ Because of rounding, the 22,110 hours that could be transferred to verification will not equal the 326,398 tax returns screened multiplied by 63 percent and divided by 9 tax returns screened per hour.



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- Computed the reduction in potential revenue loss of \$18.1 million in EITC claims that were stopped by identifying the 4,532 prisoner tax returns that were sent to pre-refund examination as a result of filters identifying the EITC as a probable erroneous claim.
- Calculated the revenue loss total of \$560.4 million over 5 years by multiplying the annual loss (\$130,150,118 – \$18,065,269) x 5 years.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$6.7 million in tax refunds related to 2,716 tax returns processed in Calendar Year 2010 through April 17, 2010 (see page 9).

Methodology Used to Measure the Reported Benefit:

We identified 2,716 tax returns processed in Calendar Year 2010 through April 17, 2010, and sent to verification after screening that had refunds erroneously issued totaling \$6.7 million.² These included:

- 2,451 tax returns that were sent to pre-refund examination as a result of filters identifying the EITC as a probable erroneous claim. For these cases, the overpayment amount in excess of the EITC was systemically refunded. A system change request was submitted to prevent the release of the refunds beginning in Processing Year 2011.
- 265 tax returns processed on the CADE that had refunds erroneously issued. A system change was implemented to prevent future refunds from releasing.

To compute the revenue protection, we:

- Identified the issuance of potentially fraudulent refunds totaling \$5.4 million for the 2,451 screened tax returns that were sent to pre-refund examination.
- Identified the issuance of potentially fraudulent refunds totaling \$1.4 million for the 265 tax returns processed on the CADE.

² Because of rounding, the total amount of \$6.7 million does not equal the 2 separately rounded amounts of \$5.4 million and \$1.4 million when added together.



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Appendix V

Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

SEP 17 2010

BY: *DMS*

September 10, 2010

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard Byrd, Jr. *Richard Byrd*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Expanded Access to Wage and Withholding
Information Can Improve Identification of Fraudulent Tax
Returns (Audit # 201040003)

We have reviewed the subject draft report and appreciate your findings regarding the identification of returns reporting fraudulent wage and withholding information. The IRS continually strives to improve our abilities to identify these fraudulent returns and prevent the associated loss of revenue. Thank you for recognizing our efforts in this important area and for presenting additional opportunities for improvement.

As reflected in your report, the Taxpayer Assurance Program (TAP) was transferred to the Wage and Investment Division Accounts Management function in October 2009. This allows the Criminal Investigation Division to pursue tax schemes and investigate criminal tax fraud while Accounts Management focuses on cases with questionable refunds. The realignment also provided multiple opportunities to reevaluate and improve our processes. For example, we made process and data mining tolerance changes that significantly increased the identification of potentially fraudulent tax returns in the TAP. We particularly appreciate your acknowledgement of our success in preventing \$1.48 billion of fraudulent refunds, which was 98 percent of all questionable refunds claimed. This represents a 50 percent increase in the number of fraudulent returns identified during the prior year.

Your report addresses IRS' efforts to identify fraudulent returns filed by prisoners and prevent the associated erroneous refunds. In this regard, it should be noted that our data mining models and Internal Revenue Manual procedures currently give special scrutiny to prisoner returns. We also appreciate your support for legislation giving IRS access to up-to-date prisoner information that will further enhance these efforts. We will continue to explore improvements to maximize the screening and verification of prisoner returns in the TAP. Additionally, any prisoner returns not identified for screening will continue to be subject to IRS post-refund compliance programs.



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We also welcome your observations regarding the limitations of the National Directory of New Hires with regard to wage verification and your support for legislation to expand our access to this data. With regard to your comments related to the timely availability of wage and withholding information from the Social Security Administration (SSA), the IRS actively, and continually explores strategies to improve our access to this data, and to better utilize the data that is available.

While your report focuses on the efforts of the TAP with regard to pre-refund identification of questionable returns, the IRS believes it is important to recognize that we also have extensive post-refund compliance programs that address potentially fraudulent returns. Despite these pre- and post-refund efforts, we recognize there are opportunities for improvement and we agree with most of your recommendations.

However, the IRS does not agree with the potential savings computation associated with the outcome measure for the inefficient use of resources. The methodology TIGTA utilized included SSA wage and withholding data for the 2008 Tax Year that was complete. In fact, during the early Filing Season processing of tax returns, SSA data is incomplete and results in a lower percentage of returns identified as having valid wages. This lower percentage will result in a lower figure for potential savings.

Further, the IRS does not agree with the outcome measures related to revenue protection. These outcome results are not achievable, since it is not practical for IRS to verify every return submitted by a prisoner. Verification of such returns must be weighed against available IRS resources and other, potentially more productive work. In addition, these outcome measures do not account for IRS post-refund compliance results.

Attached are our comments to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Peter Stipek, Director, Customer Account Services, Wage and Investment Division, at (404) 338-8910.

Attachment



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Attachment

Legislative Recommendation

RECOMMENDATION 1: As put forth in the IRS Fiscal Year 2010 budget proposal, legislation is needed to expand IRS access to NDNH wage information for tax administration purposes not limiting use of this information to just those tax returns with a claim for the EITC.

CORRECTIVE ACTION

We agree with this recommendation. Legislation which will expand the use of data in the National Directory of New Hires (NDNH) to returns without the Earned Income Tax Credit (EITC) was included in the President's Fiscal Year 2011 budget. On April 9, 2010, IRS met with Health & Human Services officials to brief them on the proposal. The IRS will continue to follow the progress of the proposed legislation. We are analyzing the benefits the NDNH data will have on the Taxpayer Assurance Program (TAP), and the potential for other compliance efforts.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 2: Obtain NDNH wage information for individuals claiming the EITC on ***2(f)*** tax returns.

CORRECTIVE ACTION

We partially agree with this recommendation. We will examine the benefits of obtaining the NDNH information for individuals claiming the EITC on ***2(f)*** tax returns, including the effect on cycle time and improved accuracy of verification. If NDNH information expedites the scanning process and increases the accuracy of determinations, IRS will consider a plan to request that data for ***2(f)***, and the associated process modifications.

IMPLEMENTATION DATE

January 15, 2012

RESPONSIBLE OFFICIAL

Director, Earned Income Tax Credit, Wage and Investment Division
Director, Accounts Management, Wage and Investment Division



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RECOMMENDATION 3: Develop a process to expedite the availability of wage and withholding information received from the SSA for use by the EFDS and TAP examiners in the identification of potentially fraudulent tax returns.

CORRECTIVE ACTION

We agree with this recommendation. We continue to take strategic steps to accelerate access to information return data toward goals of refund verification at time-of-filing and upfront issue detection. We have already initiated a pilot project to accelerate our access to Social Security Administration (SSA) wage data. The IRS is working with SSA to analyze the costs and benefits of accelerated transfer, perfection, and integration of SSA data into IRS systems.

IMPLEMENTATION DATE

June 15, 2012

RESPONSIBLE OFFICIAL

Director, Earned Income Tax Credit, Wage and Investment Division
Director, Accounts Management, Wage and Investment Division

RECOMMENDATION 4: Verify whether the 48,887 tax returns with tax refunds that were filed by prisoners with no reported wages were fraudulent. Based on actions taken on these cases, the Commissioner should identify revisions that could be made to data mining criteria to better identify fraudulent tax returns filed by prisoners.

CORRECTIVE ACTION

We agree with this recommendation. We will work with Small Business and Self Employed Division to review these 48,887 returns for potential inclusion in IRS post-refund compliance efforts. These returns also will be sampled and reviewed to identify improvement opportunities for our data mining models. In addition, we are evaluating an improved process to acquire and manage prisoner information from Federal and State prison systems.

IMPLEMENTATION DATE

January 15, 2012

RESPONSIBLE OFFICIAL

Director, Earned Income Tax Credit, Wage and Investment Division
Director, Accounts Management, Wage and Investment Division
Director, Reporting Compliance, Wage and Investment Division