There Are Significant Weaknesses in the Internal Revenue Service's Efforts to Measure Earned Income Credit Compliance

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INSPECTOR GENERAL
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MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISON
COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - There Are Significant Weaknesses in the Internal Revenue Service's Efforts to Measure Earned Income Credit Compliance (Audit # 200140009)

The report presents the results of our review to determine if the Internal Revenue Service (IRS) has developed an effective methodology for timely measuring and monitoring Earned Income Tax Credit (EIC)[1] compliance.

In summary, we found that from Tax Year (TY) 1997 to TY 1999, the IRS made some improvements in its methodology to measure EIC compliance. However, the IRS' methodology to measure EIC compliance still has some significant weaknesses. Specifically:

- Some of the audits in the TYs 1997 and 1999 EIC compliance studies lacked the necessary information to support the IRS' results.
- The IRS was inconsistent in its study methodology.
- The IRS' emphasis on EIC taxpayers with business income during the TY 1999 EIC compliance study increased the time spent on the audits but has not produced any apparent benefits.
- Poor planning by the IRS has caused taxpayers to be needlessly audited as part of the TY 1998 EIC compliance study.

[1] The Earned Income Tax Credit will be referred to as the Earned Income Credit (EIC) in future references in this memorandum.

Management's Response: The IRS disagreed with our assessment that there are significant weaknesses in its methodology for measuring EIC compliance and questioned the relevance of our recommendations. The IRS pointed out that improvements have been made to the EIC program due to the results of its current measurement methodology and compliance efforts. The IRS stated, "We believe our current measurement methodology is robust and therefore disagree with your assessment. In fact, we use the results of our compliance efforts to guide our EITC [EIC] activities."

The IRS also stated that the Treasury Inspector General for Tax Administration's (TIGTA) report was based on incomplete research and that "TIGTA's conclusion that the study has 'significant weaknesses' will create the false impression that they [TIGTA] have actually reviewed the final report."

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

Office of Audit Comments: The IRS' response does not adequately support its disagreement with our assessment of the IRS' EIC compliance measurement methodology. We recognize that several initiatives have been made over the past few years to improve the administration of the EIC program. However, the majority of the improvements listed by IRS management in its response were the result of other EIC initiatives and not due to the IRS' current efforts at measuring EIC compliance. To date, the IRS has issued only one report as a result of its last three EIC compliance studies. The report, *Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns*, was issued more than two years after most of the audits in the study were completed. If the IRS improvement decisions were based on data from this one report, this raises questions as to the effectiveness of the IRS using dated information to guide its EIC program.

In addition, TIGTA's conclusion that there are significant weaknesses in the methodology the IRS used to conduct its study does not imply that TIGTA has reviewed the final report for the TY 1999 EIC compliance study. We clearly stated on page 2 of our report that the IRS' TY 1999 study was not completed at the time of our review. Our review and subsequent report were focused specifically on the IRS' methodology for measuring EIC compliance during the TYs 1997, 1998, and 1999 studies. As a result, our analysis of the TY 1999 study focuses on the data collection methods used by the IRS to obtain information through taxpayer audits.

We address the specific issues raised by IRS management in the appropriate sections of our report.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Acting Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-7085.

Table of Contents

Background

The Earned Income Tax Credit[1] (EIC) is a refundable credit created by the Congress in 1975 to offset the impact of Social Security taxes on low-income families and encourage them to seek employment rather than welfare. This credit, which mainly affects Wage and Investment taxpayers,[2] provided a major source of assistance to over 20 million low-income families in Tax Year (TY) 1999.

Since the inception of the EIC, the law and administration of the credit have grown increasingly complex. In addition, the amount of allowable credit has increased from a maximum amount of $400 in 1975 to $3,888 in 2000. As the EIC has evolved, more taxpayers have become eligible for the credit. With the increase in eligibility, unintentional and fraudulent EIC noncompliance has increased. The Internal Revenue Service (IRS) reported that taxpayers overclaimed EIC by an estimated $9.3 billion in 1997. In addition, the IRS reported that this was 30.6 percent of all EIC claims.

The General Accounting Office reported in 1999 that EIC fraud is a high-risk area. Subsequently, the IRS has reported EIC filing fraud as a Federal Managers' Financial Integrity Act[3] material weakness. In addition, the Congress has been concerned with the IRS' ineffectiveness in reducing EIC noncompliance. In 1997, the Congress authorized the IRS to spend $716 million over a 5-year period to improve the administration of the EIC.

The IRS planned to periodically measure EIC compliance levels starting with TY 1997. The basis for the compliance levels would come from audits of tax returns claiming the EIC each year. The audit results for TY 1997 would

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[1] The Earned Income Tax Credit will be referred to as the Earned Income Credit (EIC) in future references in this report.

[2] Wage and Investment taxpayers file returns containing simpler tax issues, with most of their taxes being withheld by their employers. Generally, these returns do not contain business issues.

[3] Federal Managers' Financial Integrity Act of 1982, 31 U.S.C. §§ 1105, 1113, and 3512 (1994 & Supp. IV 1998), requires federal agencies to annually assess their management controls and report on their statuses.

provide a baseline for comparing subsequent years' measurements.

The following table shows each EIC compliance study initiated since TY 1997 and its status:

Recent EIC Compliance Studies

Tax Year Studied	Current Status
1997	Study report issued in September 2000.
1998	Audits were conducted, but the study was never completed.
1999	The study is currently ongoing.

Source: The information for this table was obtained through discussions with IRS management and through reviews of paper documentation provided by the IRS.

In addition to reducing EIC taxpayer noncompliance, there has been a recent increased interest in reducing the burden EIC audits cause taxpayers. During testimony[4] to the Congress, the National Taxpayer Advocate stated:

> *It is my firm belief that if we subjected middle class and more affluent taxpayers to the kind of intrusive inquiries we routinely subject a taxpayer to in an EIC audit, the entire EIC audit program would be shut down in response to taxpayer complaints.*

Current EIC eligibility requirements are based considerably on the living arrangements and familial relationships of taxpayers. As a result, IRS auditors need to inquire about a taxpayer's personal life in order to determine if the taxpayer meets the EIC eligibility requirements.

This audit was performed in Washington, D.C.; Covington, Kentucky; and Oakland, California, between October 2000 and July 2001. Our review focused on the Department of the Treasury Office of Tax Policy; and the IRS' EIC

[4] Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means regarding the 2001 Tax Return Filing Season, on April 3, 2001.

Program Office, Examination, and Research functions. The audit was conducted in accordance with *Government Auditing Standards.* Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The Accuracy of the Earned Income Credit Compliance Rate Is Questionable Due to Poor Quality Audits

The IRS has implemented various initiatives to improve the quality of its EIC compliance measurement studies. For example, the IRS began using proforma workpapers to help ensure audit consistency. In addition, the IRS implemented a centralized quality review process to validate the results of the EIC audits. The EIC quality reviewers effectively identified numerous errors committed by the IRS auditors. In some instances, local IRS offices also conducted quality reviews of the EIC study cases assigned to them.

We analyzed a statistically valid random sample of 281 EIC returns audited for the TY 1997 EIC compliance study to evaluate the quality of the audits.[5] Based on IRS quality reviewer comments found in the case files, 40 percent of the audits initially contained incorrect or incomplete information.

Specifically, the IRS quality reviewers identified that:

- One hundred sixty-nine cases (60 percent) were worked correctly.
- Thirty-one cases (11 percent) had technical errors that affected the accuracy of the audit.
- Eighty-one cases (29 percent) did not have enough information to support the audit results.

For the 81 cases with inadequate supporting documentation, the IRS quality reviewers had to reconstruct evidence and make assumptions on issues to determine the amount of tax and EIC to allow for the study. In many instances, the IRS quality reviewers were able to locate information in the case files or on IRS computer files to reconstruct the correct

[5] Our random samples for each of the IRS' studies were based on a 5 percent error rate, a 90 percent confidence level, and a desired precision of +/- 2 percent.

amount of EIC. However, the quality reviewers had to accept inadequately supported audit results in 29 out of the 281 cases in our sample. The amount of the EIC was directly affected in 9 of these cases (3 percent of the population).

Current IRS policy prohibits the reopening of audits except in special circumstances, such as fraud. Based on information obtained from the IRS sampled cases, the quality reviews for the TY 1997 EIC compliance study were conducted on average 119 days after the audits were closed. As a result, the IRS did not re-contact the majority of these taxpayers to obtain the additional information needed to accurately determine EIC eligibility.

Applying the 3 percent error rate shown above to the IRS' study population of 2,221 cases from TY 1997, the results of approximately 67 audits reported in the IRS' *Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns* are questionable.

To determine the correct amount of allowable EIC, several issues must be addressed during the course of each audit. These issues focus on determining the taxpayer relationships, residency, age, income, etc., that are needed in order to calculate the correct amount of EIC.

The following are some examples of IRS quality reviewer comments on questionable documentation from the TY 1997 audit results:

> *The contact sheet indicated that the taxpayer had lived with the grandmother……It is possible from the comments that the taxpayer's father also lived there. These two would have the same qualifying child if the residency requirement had been made. It is not clear that an income probe was done. …examiner indicated that an income probe was not necessary.*

> It appears in this case that the IRS knows no more about the taxpayer's eligibility for EIC after the audit than it did before.

Sch. C [Schedule C] Expenses were accepted based on the TP's [taxpayer's] oral testimony and credibility…. They should have been examined.

The amount of income earned is one of the key factors in determining a taxpayer's eligibility for the EIC. The taxpayer's expenses need to be established in order to validate the amount of income, which is then used to determine the allowable amount of EIC.

No workpapers for dependents or filing status. Workpapers say TA [tax auditor] did not feel issues were worthy of examination. However, check sheet says the TP meets all requirements for filing status and dependents… test for dependents likely met.

It appears that the auditor did not adequately address issues that affect EIC amounts.

To determine whether the quality of the audits had improved since the TY 1997 study, we reviewed a sample of 290 cases[6] from the ongoing TY 1999 EIC compliance study. In these cases, the IRS quality reviewers identified that:

- One hundred fifty-six cases (54 percent) were worked correctly.
- Sixty-seven cases (23 percent) had technical errors that affected the accuracy of the audit.
- Sixty-seven cases (23 percent) did not have enough information to support the audit results.

The IRS quality reviewers had to accept questionable audit results with no supporting documentation in 50 audits from our sample of 290 cases. EIC amounts were directly affected for 19 (7 percent) of these cases. Applying this error rate to the IRS' study population of 3,448 cases for TY 1999, the EIC amounts for approximately 241 audits may be wrong. Therefore, the EIC compliance rate

[6] Our total sample was 294 cases for the TY 1999 EIC compliance study. However, we were unable to obtain four cases for this portion of our review.

calculated by the IRS as a result of the TY 1999 study would be questionable.

Based on information obtained from the IRS sampled cases, these quality reviews were conducted on average 71 days after the audits were completed. The following are some examples of IRS quality reviewer comments on questionable documentation from the TY 1999 audit results:

> *Although this case was apparently returned to the agent for further development, the workpapers remain among the poorest in quality seen in the EITC study. Because of time constraints imposed by National Office, the case will not be formally charged back to the district for further development. Among the deficiencies… The agent allowed dependent exemption for [taxpayer's son]… although it appears he provided more than 1/2 of his own support…. The agent states the TP is on the accrual accounting method, however the Sch. C shows the TP uses the cash method and the agent allowed a bad debt deduction….*
>
> *Examiner did not audit Schedule C gross receipts or expenses. Examiner mentions on the Form 4318 that oral testimony was accepted as substantiation for the cost of goods sold, but the gross receipts and the other Schedule C expenses were not audited.*

We were unable to determine the specific cause of these poor quality EIC audits. However, IRS program analysts informed us of the following potential causes.

- Some IRS auditors may not have treated the audits with the importance needed for the EIC study because of low revenue potential.
- Many of the auditors were revenue agents, who do not traditionally work EIC cases.
- There was a lack of lead-time to prepare training for the studies.

Poor quality audits resulted in some taxpayers receiving more EIC than they should have

The poor quality of the audits also affected the accuracy of taxpayers' accounts. The study plan for the TY 1997 EIC compliance study stated that establishing individual return accuracy was one of the three primary objectives. Although the EIC and tax applied to the taxpayers' accounts does not directly affect the EIC noncompliance rates computed in the studies, these accounts were significantly affected and continue to contain erroneous information.

Due to errors by IRS auditors, some taxpayers received more EIC than they should have. All of these errors were corrected in the IRS study data; however, some of these errors were not corrected on the taxpayers' accounts. Similarly, taxes for many of these taxpayers were under-assessed. As a result, this allowed refunds to generate to some taxpayers that should not have received them. The following is an example of one such case from our sample of TY 1997 study cases.

A husband and wife claimed the maximum amount of EIC. After auditing the tax return, the IRS auditor found nothing wrong and allowed the entire EIC claim as filed. However, the IRS quality reviewer determined that the EIC was not allowable and made the following comments concerning mistakes made by the auditor:

> *Per workpapers, tph (taxpayer husband) worked in a friend's grocery store and doing construction. Tph was paid cash, received no Forms 1099…. RA [revenue agent] did not adequately examine income. The income tph reported allows him to claim the maximum amount of EITC. This issue should have been pursued further as there is a question as to whether income was created in order to claim EITC.*
>
> *Tps [taxpayers] are claiming their four children. One child… has an incorrect SSN [Social Security Number] listed on the tax return… the SSN listed per return is for a different person. There is no information in the workpapers listing her correct SSN. Since there is no valid SSN or ITIN [Individual*

Tax Identification Number] provided, the dependency exemption for this child is disallowed.

… case file show that both tph and tpw [taxpayer wife] are legal aliens not authorized to work…. For EITC purposes, these numbers are not considered valid SSNs…. You cannot get the earned income credit if the SSN was issued solely for use in applying for or receiving federally funded benefits. Therefore, tps do not qualify for EITC.

Had the quality review occurred immediately following the audit, these taxpayers most likely would not have received a refund. However, as a result of the IRS auditor's mistakes, the taxpayers were issued a $1,900 refund. The IRS also paid almost $50 in interest due to delays in sending out the refund.

After successfully passing the IRS' audit of their TY 1997 tax return, the taxpayers again claimed the EIC in TY 1998. However, the IRS denied their claim this time, and the taxpayers have not filed any subsequent tax returns.

Since most of the quality reviews took place after the cases were closed, these types of errors could not be corrected without re-opening the audits. Based on our sample of 281 audits from the TY 1997 EIC compliance study, 42 taxpayers (15 percent) received improper tax benefits totaling $27,267. In addition, 42 taxpayers (14 percent) from our sample of 290 cases from the TY 1999 EIC compliance study received improper tax benefits totaling $28,726. Applying these results to the total sample populations of both IRS studies, we estimate that the IRS lost over $500,000 in incorrect EIC claims and under-assessed tax because of poor quality IRS audits.

Recommendations

1. The EIC Program Office should coordinate with the appropriate IRS Examination function to ensure the quality review process occurs immediately after the audits are completed (before the audits are closed).
2. The EIC Program Office should coordinate with the appropriate IRS Examination function to ensure that IRS auditors are effectively trained on EIC issues and reminded of the importance of the studies.
3. The EIC Program Office should coordinate with the appropriate IRS Examination function to ensure that the audit results from the EIC compliance studies are accurately credited or charged to taxpayer accounts.

Management's Response: IRS management disagreed with our findings and recommendations in this area. The IRS stated that using mandatory audit workpapers for the TY 1999 audits should have provided better documentation to substantiate the auditors' conclusions. The IRS also stated that the Treasury Inspector General for Tax Administration's (TIGTA) report did not provide compelling evidence that items identified as errors or omissions from the audits had any effect on the amount of the EIC determined by the IRS auditors. In addition, the findings in TIGTA's report are based on a random sample of the IRS' study sample. Because the IRS study used a stratified random sample, the random sample used by TIGTA cannot be used to generate estimates for the entire population.

Office of Audit Comment: As shown on pages 3 through 5 of this report, our audit results show that the IRS did improve its documentation of evidence during the TY 1999 EIC audits. The total number of cases that did not have enough information to support the audit results decreased from the TY 1997 study to the TY 1999 study. However, the number of these cases that did not have enough information to support EIC issues increased significantly.

The results of our review provided sufficient evidence to show that the EIC amounts determined by the IRS may not be accurate. For instance, examples on pages 5 and 6 of our report show that IRS auditors did not always verify the taxpayers' business income when determining the allowable EIC amount. Income is a key factor in determining the proper amount of EIC a taxpayer can claim. As a result, by not validating the taxpayers' income in these cases, the IRS cannot accurately determine the correct amount of the EIC.

In addition, our statistically valid random samples were taken from cases sampled by the IRS for its EIC compliance studies. Our analyses looked mainly at the quality of the audits conducted by IRS auditors during these studies. The results of our analyses were only applied to the population of IRS' sampled cases. We did not generate estimates concerning the entire population of EIC filers. Therefore, we were correct in using simple random samples.

An Inconsistent Audit Methodology Was Used During the Earned Income Credit Compliance Studies

Traditionally, the IRS conducts its EIC audits each year through the mail. The IRS correspondence examination function sends out letters to thousands of taxpayers requesting detailed information to support their EIC claims. In most cases, these are fairly basic audits, and the IRS interacts with the taxpayers remotely through written correspondence. In addition, IRS revenue agents and tax auditors do conduct some EIC audits. During these audits, the taxpayer may be asked to visit an IRS office or an IRS employee may conduct a face-to-face interview. However, in general, most EIC audits are not conducted at taxpayers' residences.

For the EIC compliance studies, IRS management wanted to conduct face-to-face audits in taxpayers' residences. A memo from the Assistant Commissioner (Examination) directed that no phone or correspondence interviews were acceptable.

The IRS' report, *Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns*, stated that, "if practical, all examinations were to be conducted at the taxpayers' residences." Based on our sample of 281 audits from the TY 1997 EIC compliance study, only 211 cases had enough information available to determine where the audits were conducted. The following table provides the details by audit location:

Location of Audits for the TY 1997 EIC Compliance Study

Audit Location	Number of Audits	Percentage[7]
Taxpayer Residence	68	32%
IRS Office	93	44%
Other Location	11	5%
Via Telephone	22	10%
Taxpayer Did Not Show for Audit	17	8%

Source: The information for this table was obtained through our review of 281 sampled cases from the TY 1997 EIC compliance study.

Based on our sample from the TY 1997 EIC compliance study, only 32 percent of the audits were conducted at taxpayer residences, and 10 percent were done remotely over the telephone.

The inconsistent methodology used to conduct the audits may have affected the accuracy of the study results. IRS management originally accepted that visits to taxpayer residences provided results that were more accurate for these types of audits. IRS auditors would be better able to determine taxpayer EIC eligibility and indicators of fraud by observing living arrangements in person. Because IRS auditors did not consistently visit taxpayer residences, the reliability and accuracy of the information obtained by the auditors will vary from taxpayer to taxpayer. This issue may also impact the TY 1999 EIC compliance study.

For the TY 1999 study, a memorandum from senior IRS management stated, "to maximize taxpayer cooperation and involvement it is important to have a face-to-face interview…." The following table provides the details by audit location:

[7] Numbers do not add up to 100 percent due to rounding.

Location of Audits for the TY 1999 EIC Compliance Study

Audit Location	Number of Audits	Percentage[8]
Taxpayer Residence	122	42%
IRS Office	102	35%
Other Location	45	16%
Via Telephone	5	2%
Taxpayer Did Not Show for Audit	16	6%

Source: The information for this table was obtained through our review of 290 sampled cases from the TY 1999 EIC compliance study.

Based on our sample from the TY 1999 EIC compliance study, 93 percent of the audits were conducted face-to-face, with 42 percent of the audits taking place at taxpayers' residences. In addition, only 2 percent were conducted remotely over the telephone.

IRS management stated that the purpose for not requiring all audits to be conducted at the taxpayers' residences for the TY 1999 EIC compliance study was because they wanted to limit taxpayer burden while still being able to obtain adequate evidence to accurately determine EIC eligibility. Employee safety and taxpayer cooperation were other factors that impacted the location of where the audits were held. In addition, IRS management stated that they did not have enough resources to do all the audits at taxpayer residences even though 2,490 out of the 3,448 audits (72 percent) in the TY 1999 study were conducted by revenue agents who do not traditionally work in an IRS office. For the TY 1997 EIC compliance study, revenue agents conducted 1,302 out of the 2,221 audits (59 percent).

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[8] Numbers do not add up to 100 percent due to rounding.

Recommendation

4. The EIC Program Office should coordinate with the appropriate IRS Examination function to develop an acceptable methodology concerning where and how audits are to be conducted on all future EIC compliance studies. Regardless of the preferred method, the IRS needs to ensure that taxpayers selected for these studies are treated fairly and consistently.

Management's Response: IRS management disagreed with our finding and recommendation in this area. IRS management stated there were specific circumstances that did not warrant face-to-face interviews with taxpayers. The reasons they noted were that taxpayers lived in high crime areas considered unsafe to visit; taxpayers would not, or could not, come to an IRS office; or a family illness prevented a face-to-face interview.

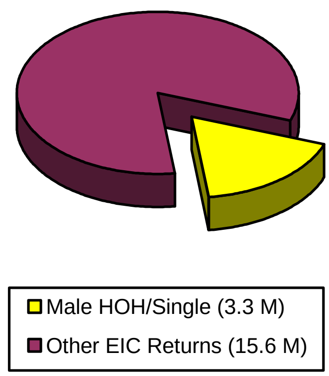
Office of Audit Comment: We agree that there are valid reasons for not conducting some face-to-face audits with the taxpayers. However, as we reported on page 11 of this report, IRS management accepted that IRS auditors would be better able to determine taxpayer EIC eligibility and indicators of fraud by observing living arrangements in person. Because IRS auditors did not consistently visit taxpayer residences, the inconsistent methodology used to conduct the audits may impact the accuracy of the study results.

In addition, it is important to note that the IRS stated in its report, *Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns*, that its intent was to conduct all audits at taxpayers' residences. However, its report did not disclose the fact that most of these audits were done at other locations. If the IRS decides to issue a report on its TY 1999 study of EIC compliance, a statement concerning audit locations should be included in its report to ensure that the reader is not misled.

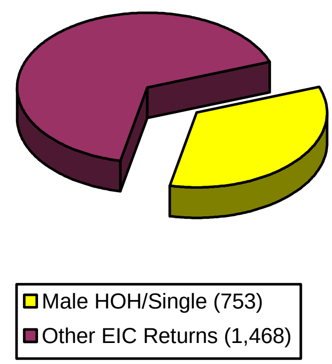
Emphasis on Specific Segments of the Population Increased the Cost and Time of the Earned Income Credit Compliance Studies With No Apparent Benefits

As part of its EIC compliance studies, the IRS placed additional emphasis on auditing specific segments of the EIC taxpayer population. For the TY 1997 EIC compliance study, the IRS audited a larger than normal proportion of male taxpayers claiming the Head of Household (HOH) or Single filing status on their returns.

1997 Estimated Total EIC Return Population (Millions)



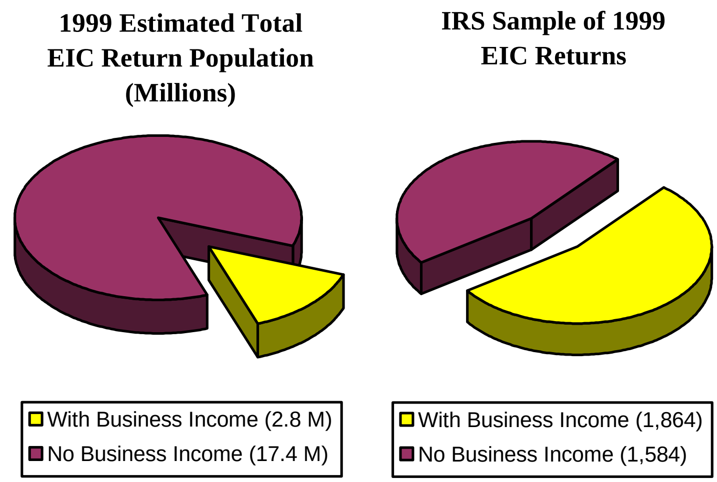
IRS Sample of 1997 EIC Returns



Source: The information for these tables was provided by the IRS in the Processing Year 1998 Earned Income Tax Credit Baseline Study Sample Design[9] and the TY 1997 EIC compliance study database.

[9] The processing year is the year in which tax returns from prior tax years are processed. For example, when the IRS receives a 1997 tax return in 1998, the tax return's processing year would be 1998 even though it is a 1997 tax return.

For the TY 1999 EIC compliance study, taxpayers with business income claiming the EIC were selected in substantially higher numbers.



Source: The information for these tables was provided by the IRS in the Request for Information Services (#RES-9-0003) Processing Year 2000 Earned Income Tax Credit Compliance Study and the TY 1999 EIC compliance study database.

In the TY 1999 EIC compliance study, the IRS expended more resources auditing taxpayers with business income than were needed to compute the overall EIC compliance rate. The audits of the TY 1999 business returns in the study took 10 hours longer per case than the non-business returns for the same year.

Tax returns with business income required a significant amount of additional audit work to determine the correct amount of EIC. Since EIC amounts were based on taxpayers' earned income, IRS auditors had to verify the accuracy of business income and expenses claimed on the returns.

Auditor time per case, as reported on the IRS' compliance study databases, increased from an average of 10 hours for TY 1997 to 28 hours for TY 1999. The overall direct audit time increased from 22,868 to 96,550 staff hours. Part of the staff hour increase was due to the number of audited returns increasing from 2,221 in TY 1997 to 3,448 in

TY 1999. In addition, some IRS auditors had problems with the audit report writing software used during the study.

Although special emphasis was placed on taxpayers with business income for the TY 1999 EIC compliance study, many of the IRS auditors did not address the taxpayers' business income or expenses during the audits. Based on comments from the IRS quality reviewers for our TY 1999 sample, auditors did not verify this information on 33 out of 161 (20 percent) returns filed with business income. Applying our results to the IRS' TY 1999 study population, approximately 373 out of the 1,864 (20 percent) audits conducted on taxpayers with business income were incomplete. As a result, any compliance rate that the IRS decides to report from the TY 1999 EIC compliance study will be questionable.

Although the methodology used by the IRS for stratifying the population was statistically valid, IRS management could not provide an explanation why these specific segments of the taxpayer population were targeted when the purpose of their study was to calculate an overall EIC compliance rate. In addition, the IRS did not maintain any accurate costing information on the EIC compliance studies. As a result, we were unable to calculate the monetary impact of the IRS' decision to select these taxpayers.

Personnel from the IRS' Research function did explain that if someone were looking at larger samples of these groups, it would provide a better estimate of that segment's compliance rate and would provide more information on their compliance characteristics. However, at the time of our review, the IRS Research function did not have any current or planned research projects specifically concerning taxpayers with business income claiming the EIC or male taxpayers claiming the EIC using the HOH or Single filing status.

Excessive weighting of any population segment is not necessary to obtain a reasonably accurate estimate of overall EIC compliance levels. The emphasis placed on the different taxpayer groups during sample selection made the study process more complex and increased study costs.

Recommendations

5. The EIC Program Office should coordinate with the IRS Research function to develop a standardized sampling methodology that will measure EIC compliance rates at the lowest cost with the least amount of burden to the taxpayers. The EIC Program Office should approve any deviation from this sampling plan.
6. The EIC Program Office should coordinate with the IRS Research function and the appropriate Examination function to capture and maintain detailed costing figures to monitor each study's return on investment.

Management's Response: IRS management disagreed with our findings and recommendations in this area. The IRS stated that the small investment of additional time to do the business returns provided much needed and valuable information about this segment of EIC taxpayers. In addition, the IRS stated that the information could be used in planning future education/outreach campaigns and compliance activities.

Office of Audit Comment: We agree that some of the information gathered in the study beyond what was needed for computing EIC compliance rates may be valuable and might be used to develop future EIC initiatives. However, we would like to emphasize that the expansion of the scope of a study beyond its original intent changes the objective of the study. This implies the initiation of a separate "research project" which should be discussed, properly documented, and approved by the appropriate level of management before being implemented. As we reported on page 16 of this report, IRS management could not provide an explanation or any documentation why these specific segments of the EIC taxpayer population were targeted. In the past, the IRS has been criticized for allegedly targeting certain taxpayers without justification. Without an adequate process to document deviations to their planned studies, the IRS runs the risk of raising the suspicions of the Congress and other stakeholders that taxpayers are being unjustly targeted.

In addition, the IRS' response does not address our recommendation to track detailed costing figures for each study. The Office of Management and Budget Circular A-123, which applies to all federal government agencies, states that managers are responsible for controlling cost.

Taxpayers Were Needlessly Burdened as a Result of Poor Planning for the Tax Year 1998 Earned Income Credit Compliance Study

The IRS had originally planned to study EIC compliance annually for 5 years beginning with TY 1997. As the audits for TY 1998 were being completed, the results for TY 1997 still had not been finalized. As a result, the IRS decided to abandon its original plan, halt the analysis of TY 1998 returns, and perform these studies every other year.

The IRS audited 3,349 taxpayers to study EIC compliance in TY 1998 but did little with the data it collected. Under normal EIC processing, the probability of the taxpayers in this study being selected for audit would have been very low. Based on IRS figures for that year, less than 2 percent of the taxpayers claiming the EIC on their returns were audited. However, if these taxpayers had been audited under the normal EIC process, most of the audits would have been conducted remotely through written correspondence and not through face-to-face interviews.

As part of the burden caused by these audits, a majority of the taxpayers had their refunds withheld until the audits were completed. In our TY 1998 sample, 157 (54 percent) of the 293 taxpayers filed correct tax returns. Of these taxpayers, 127 had approximately $2,000 withheld for an average of 74 days. With our sample being representative of the IRS' TY 1998 EIC compliance study population, the IRS withheld approximately $2.9 million from 1,450 compliant taxpayers for an average of 74 days.

At the time the IRS decided to measure the EIC compliance rates over 5 years, it did not accurately anticipate how long it would take to study 1 tax year. As a result, the IRS was still working on the data from the TY 1997 EIC compliance study when it began the TY 1998 study. By not properly planning the scope of its studies, the IRS needlessly burdened the taxpayers selected for the TY 1998 study.

In developing a methodology for periodically measuring and comparing data, the time needed for completing a study is a critical factor in determining when subsequent studies should be conducted. It appears that the main problem with the TY 1998 EIC compliance study was that the IRS did not effectively plan for the length of the study cycle.

Recommendation

7. The EIC Program Office should ensure that the scope of tasks needed to complete an entire study is taken into account when determining when subsequent studies should be started.

Management's Response: IRS management disagreed with our finding and recommendation in this area and stated that they did not needlessly audit these taxpayers. They also stated that they will use the data and have already done some analysis on a preliminary data file. In addition, they stated that officials from the Department of the Treasury and the Office of Management and Budget concurred with their decision not to issue a formal report for TY 1998.

Office of Audit Comment: The length of time that the IRS took to complete the TY 1997 study would suggest that an annual measurement of EIC compliance was not feasible. The results of the TY 1997 study were not reported by the IRS until September 2000. As stated on page 18 of our report, the IRS was still working on the TY 1997 EIC compliance study when the EIC audits for TY 1998 study began. At this point, the IRS would have had sufficient information to determine that a yearly study of this magnitude was not feasible.

Appendix I

Detailed Objective, Scope, and Methodology

The objective of our review was to determine whether the Internal Revenue Service (IRS) has developed an effective methodology for timely measuring and monitoring Earned Income Credit (EIC) compliance.

I. We determined whether the methodology developed for the Tax Years (TY) 1997, 1998, and 1999 EIC compliance studies will provide a consistent, timely, and effective measure of EIC compliance and fraud levels.

   A. We interviewed IRS and Department of the Treasury personnel.

      1. We discussed the development of the compliance study methodology and reviewed study and sampling plans for the TYs 1997 and 1998 EIC compliance studies. We identified there was no formal study plan for the TY 1999 study.

      2. We interviewed personnel in the IRS Research function and the EIC Program Office and reviewed project documentation to determine what the compliance study results were being used for and if the study met initial requirements.

      3. We discussed why the TY 1998 EIC compliance study was abandoned after the audits were completed and reviewed the study database to establish the effect on taxpayers and their refunds.

      4. We discussed plans and strategies for the EIC compliance studies beyond TY 1999.

      5. We discussed whether the reported results of the TY 1997 compliance study provide sufficient information for users to make sound business decisions.

      6. We discussed any decisions to improve taxpayer EIC compliance that have been made based on the results of the TY 1997 EIC compliance study.

   B. We interviewed personnel in the EIC Program Office, the IRS Research function, and the Department of the Treasury Office of Tax Policy regarding guidance provided by outside stakeholders to the IRS for the compliance studies.

   C. We evaluated the sampling methodology for selecting EIC returns for each compliance study to determine whether the samples fairly represent the population of all EIC filers.

      1. We determined whether sample selection procedures were unbiased and whether missing returns and no-show audits were appropriately handled.

      2. We reviewed documentation, and interviewed IRS Research personnel on the methodology used to determine the different strata sampled for the TYs 1997 and 1999 EIC compliance studies.

3. We reviewed the weighting and extrapolation techniques applied to different strata within the sample for the TY 1997 EIC compliance study to determine whether appropriate statistical procedures were used.

4. We evaluated the sampling strata used in the TYs 1997, 1998, and 1999 EIC compliance studies to determine whether the strata accurately reflected the characteristics of the overall population.

D. We interviewed IRS Examination function analysts and evaluated the guidance and instructions provided to the IRS auditors conducting the audits.

E. We evaluated the process for gathering audit results and related controls concerning the validity of the data to determine whether the methodology was consistent each year.

1. We interviewed personnel from the IRS Research and Examination functions concerning the EIC compliance study databases and checksheets.

2. We reviewed the consistency check program reports in actual case folders that are used to ensure data are valid.

F. We reviewed IRS computer files to determine whether there have been significant changes made to EIC amounts on taxpayer accounts since the completion of the TY 1997 EIC compliance study.

II. We determined whether there were adequate controls in place to ensure that all reported results will be accurately represented in each year's EIC compliance study.

A. We reviewed the study plans for the TYs 1997 and 1998 EIC compliance studies to identify and evaluate controls that ensure the studies provided consistent, meaningful, and reliable data.

B. We discussed controls over the sample selection process with personnel from the IRS Research function.

C. We evaluated the quality assurance process used in the study.

1. We interviewed personnel from the IRS Examination function to identify all the quality review points and the process for correcting errors found in the study audits.

2. We evaluated the quality review documentation in TYs 1997 and 1999 case files.

D. We evaluated the controls over changes made to the TY 1997 EIC compliance study database. This involved reviewing documentation in the case files that supported changes made to any audit/checksheet results.

III. We determined whether the methodology developed for the TYs 1997, 1998, and 1999 EIC compliance studies would provide a timely measure of EIC compliance.

A. We reviewed the study plans and monthly status updates and constructed timelines to compare planned and actual critical project dates for the TY 1997 EIC compliance study.

B. We reviewed a sample of the audits conducted as part of the TY 1997 EIC compliance study to evaluate the timeliness and effectiveness of the audit process.

   1. We selected a statistically valid random sample of 281 cases from the 2,221 cases selected by the IRS for the TY 1997 EIC compliance study. We used a 90 percent confidence level, 5 percent error rate, and +/- 2 percent precision to determine the sample size.

   2. We matched data in 21 specific fields in the database to audit case file information to determine the accuracy of data input.

   3. We reviewed case documentation to determine whether the audits were done according to agreed upon methodology, effectively identified the correct EIC amount, and provided a method for identifying fraudulent activity.

   4. We compared the information in the TY 1997 compliance study database for each of our sample cases with audit adjustments made to the taxpayers' accounts to determine if there were errors made that may require additional abatements/refunds to the taxpayers.

   5. We evaluated the beginning and ending dates of the various tasks involved in the cases during the study to determine the timeliness of the different processes.

   6. We evaluated the process of matching income data available on IRS computer files to the EIC study cases. This process was necessary since the IRS computer data were not available while the audits were conducted.

C. We reviewed a sample of the audits conducted as part of the TY 1998 EIC compliance study to determine the impact on taxpayers from the IRS' decision to prematurely close the project.

   1. We selected a statistically valid random sample of 293 cases from the 3,349 cases selected by the IRS for the TY 1998 EIC compliance study. We used a 90 percent confidence level, 5 percent error rate, and +/- 2 percent precision to determine the sample size.

   2. We reviewed IRS computer files to determine the dollar amounts of compliant taxpayer refunds impacted by this study and determined how long the IRS withheld them.

D. We reviewed a sample of the audits conducted as part of the TY 1999 EIC compliance study to evaluate the effectiveness of the audit process.

1. We selected a statistically valid random sample of 294 cases from the 3,448 cases selected by the IRS for the TY 1999 EIC compliance study. We used a 90 percent confidence level, 5 percent error rate, and +/- 2 percent precision to determine the sample size. We reviewed 290 cases since we were unable to obtain 4 cases for our review.
2. We determined whether the audits were done according to agreed upon methodology and were consistent with TY 1997 EIC compliance study audits.
3. We evaluated the flow of the selected cases to identify if there were unresolved problems with the audit results.

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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EITC Program Manager W:EITC
Senior Operations Advisor W:S
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:F:M
Audit Liaisons:
    Commissioner, Small Business/Self-Employed Division S
    Commissioner, Wage and Investment Division W

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 the Congress.

Type and Value of Outcome Measure:

- Reliability of Information – Potential; results of 308 audits used for compliance measurement are questionable (see page 3).

Methodology Used to Measure the Reported Benefit:

The reliability of Earned Income Credit (EIC) amounts determined in 308 audits (67 in Tax Year (TY) 1997 and 241 in TY 1999) conducted in these studies is questionable due to the Internal Revenue Service (IRS) accepting incomplete audit information. The 67 audits were calculated by multiplying 2,221 (the population of the IRS' TY 1997 EIC compliance study audits) by 3 percent (the rate we calculated from our analysis of sample cases indicating that IRS quality reviewers accepted questionable audit results with no supporting documentation and the amount of EIC was directly affected). Our sample consisted of a statistically valid sample of 281 cases selected from the population of the IRS' TY 1997 EIC compliance study audits.

The 241 audits were calculated by multiplying 3,448 (the population of the IRS' TY 1999 EIC compliance study audits) by 7 percent (the rate we calculated from our analysis of sample cases indicating that IRS quality reviewers accepted questionable audit results with no supporting documentation and the amount of EIC was directly affected). Our sample consisted of a statistically valid sample of 290 cases selected from the population of the IRS' TY 1999 EIC compliance study audits.

Type and Value of Outcome Measure:

- Increased Revenue/Revenue Protection – Potential; 831 accounts totaling $557,058 in incorrect EIC claims and tax under-assessments ($215,516 from the TY 1997 EIC compliance study and $341,542 from the TY 1999 EIC compliance study) (see page 3).

Methodology Used to Measure the Reported Benefit:

The $215,516 was calculated by multiplying 7.903915 (the ratio of our sample size to the IRS' TY 1997 EIC compliance study population [2,221/281]) by $27,267 (the amount of improper tax benefits we calculated from our analysis of 281 sample cases from the IRS' TY 1997 EIC compliance study population). The $341,542 was calculated by multiplying 11.889655 (the ratio of our sample size to the IRS' TY 1999 EIC compliance study population [3,448/290]) by

$28,726 (the amount of improper tax benefits we calculated from our analysis of 290 sample cases from the IRS' TY 1999 EIC compliance study population).

Type and Value of Outcome Measure:

- Taxpayer Burden – Actual; 3,349 taxpayer accounts affected (see page 18).

Methodology Used to Measure the Reported Benefit:

This is the total number of taxpayers needlessly audited during the IRS' TY 1998 EIC compliance study.

Appendix V

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

COMMISSIONER
WAGE AND INVESTMENT DIVISION

November 20, 2001

RECEIVED
NOV 20 2001

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: John M. Dalrymple
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – There Are Significant Weaknesses in the Internal Revenue Service's Efforts to Measure Earned Income Credit Compliance (Audit No. 200140009)

In fiscal year 1998, the IRS established the Earned Income Tax Credit (EITC) Program Office to administer the five-year EITC appropriation and oversee the EITC-related activities of IRS functions involved in ensuring the efficient application of the law, increasing the participation of eligible taxpayers, and reducing EITC overclaims.

Over the past several years, the Program Office has also refined the way in which IRS measures EITC compliance. We believe our current measurement methodology is robust and therefore disagree with your assessment. In fact, we use the results of our compliance efforts to guide our EITC activities.

The EITC Program Office implemented a three-pronged strategy of enhanced education and outreach activities, additional compliance enforcement, and research into various aspects of the EITC. This strategy has improved the EITC program in many ways. We have:

- Revised all EITC taxpayer assistance products to emphasize determination of eligibility. We also revised the Form 1040 series instructions to enhance taxpayers' ability to determine EITC eligibility. Since we implemented these changes, our research shows the EITC math error rate has decreased significantly.
- Designated employees to perform EITC education and outreach activities in their communities.
- Implemented statutory authority (known as "math error authority") to correct returns with incorrect EITC claims when we can identify the error during our initial processing of returns. Our research shows taxpayers generally do not repeat these errors in subsequent year filings.
- Implemented a "pre-refund" examination process. For errors we can correct only through deficiency procedures, we select returns during the filing season and hold any refund until we complete the examination.

2

- Developed a database that uses third party information such as child custody records to determine which returns to select for examination of questionable EITC claims.
- Implemented a multi-year, integrated strategy to educate tax return preparers about common EITC errors and to examine preparer practices and propose appropriate penalties. This program will have significant impact because our research shows that paid preparers process more than 60 percent of all EITC returns.

Your report, "There Are Significant Weaknesses in the Internal Revenue Service's Efforts to Measure Earned Income Credit Compliance," acknowledges that we made improvements in our methodology to measure EIC compliance from tax year (TY) 1997 to 1999. We disagree, however, with your general finding that our methodology still contains significant weaknesses. The evidence presented in your report does not support your claim. Our comments on these purported weaknesses follow:

- *The accuracy of the Earned Income Tax Credit compliance rate is questionable due to poor quality audits* – Since we do not have access to TIGTA's analysis or their methodology, we have no way of determining the accuracy of their findings. However, we have several points to make in response:

    - For the TY 1999 study, we designed and instituted the use of mandatory audit workpapers. As a result, compared to TY 1997 cases, the TY 1999 EITC cases should contain better documentation to substantiate the IRS auditors' conclusions.
    - The report's excerpts of the quality reviewers' comments provide no compelling evidence that items they identified as errors or omissions from the audits had any effect on the amount of the EITC determined by the agent. Therefore, TIGTA failed to determine the potential impact on the estimated EITC overclaim percentage by not establishing a relationship between a perceived lack of documentation and audit outcomes.
    - In addition, TIGTA based their findings on a random sample of the IRS' study sample. While this might tell something about the TIGTA sample cases, one cannot use these results to generate estimates for the entire population. Because the IRS study used a stratified, random sample, the population weights differ for each observation. In contrast, all observations in the TIGTA sample have the same weight.

- *The IRS was inconsistent in its study methodology* – IRS designed the study methodology with a preference for face-to-face interviews in the taxpayers' homes. In actuality, IRS auditors had to conduct some interviews over the phone or via correspondence for numerous reasons, e.g., because the taxpayers lived in high crime areas considered unsafe to visit and the taxpayers would not, or could not come into the office for an interview. Other factors included personal or family illnesses that precluded face-to-face meetings between the taxpayers and auditors. TIGTA's raw numbers draw an incomplete picture in these types of cases.

- *The IRS' emphasis on EITC taxpayers with business income during the TY 1999 EITC compliance study increased the time spent on the audits but has not produced any apparent benefits* – The audits of the Schedule C returns in this study took only 10 hours longer per case than the non-business returns for the same year. This small investment of additional time provided much needed and valuable information about this particular segment of EITC taxpayers, which we can use in planning future education and outreach campaigns and compliance activities, as appropriate.

- *Poor planning by the IRS has caused taxpayers to be needlessly audited as part of the TY 1998 EITC compliance study* – We did not needlessly audit these taxpayers. We will use this data and have already done some analysis on a preliminary data file. Officials from the Department of the Treasury and the Office of Management and Budget concurred with our decision not to issue a formal report for TY 1998.

We disagree not only with the major findings but also with the recommendations and described benefits in this TIGTA report. TIGTA did not acknowledge the fact that the primary purpose of IRS' EITC compliance research is to determine the EITC claimants' true tax liabilities and EITC eligibility. Our research methodologies and analyses already do this. We question the relevance of TIGTA's recommendations.

We asked TIGTA to delay issuing their report until IRS and Treasury have the opportunity to complete our analysis of the TY 1999 data and issue a research report, anticipated by the end of this year. TIGTA refused to wait because their audit process does not allow for delays. We believe by prematurely issuing the report, which they based on incomplete research, TIGTA will create unnecessary confusion for two reasons. First, some of the TY 1999 data prematurely reported by TIGTA will differ from that available when the Treasury releases the study because TIGTA's numbers do not reflect population weights applied to the sample. Second, TIGTA's conclusion that the study has "significant weaknesses" will create the false impression that they have actually reviewed the final report.

If you have any questions or need additional information regarding this response, please contact me, or Candice Cromling, National EITC Program Manager, at (202) 622-5994.