



*Reduction Targets and Strategies Have Not  
Been Established to Reduce the Billions of  
Dollars in Improper Earned Income Tax  
Credit Payments Each Year*

**February 7, 2011**

**Reference Number: 2011-40-023**

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 Regulations or Statutes



## HIGHLIGHTS

### **REDUCTION TARGETS AND STRATEGIES HAVE NOT BEEN ESTABLISHED TO REDUCE THE BILLIONS OF DOLLARS IN IMPROPER EARNED INCOME TAX CREDIT PAYMENTS EACH YEAR**

## Highlights

**Final Report issued on February 7, 2011**

Highlights of Reference Number: 2011-40-023 to the Internal Revenue Service Deputy Commissioner for Operations Support.

### **IMPACT ON TAXPAYERS**

The Government Accountability Office has listed the Earned Income Tax Credit (EITC) Program as having the second highest dollar amount of improper payments of all Federal programs. The Internal Revenue Service (IRS) has made little improvement in reducing EITC improper payments since 2002 when it was first required to report estimates of these payments to Congress. The IRS continues to report that 23 percent to 28 percent of EITC payments are issued improperly each year. In Fiscal Year 2009, this equated to \$11 billion to \$13 billion in EITC improper payments.

### **WHY TIGTA DID THE AUDIT**

This audit was initiated because Executive Order 13520 requires the Secretary of the Treasury to provide specific information regarding EITC improper payments to TIGTA. The objective of this review was to assess the IRS's efforts to implement Executive Order 13520.

### **WHAT TIGTA FOUND**

Executive Order 13520 requires the IRS to intensify its efforts and set targets to reduce EITC improper payments. The IRS's report to TIGTA did not include any quantifiable targets to reduce EITC improper payments. IRS management noted that reduction targets were not set because the IRS has to balance enforcement efforts among different taxpayer income levels. The IRS stated that its new

efforts to regulate tax return preparers will reduce the improper payment rate. However, it is unknown whether the regulation of tax return preparers will result in a significant reduction in EITC improper payments.

TIGTA has conducted a number of audits that have provided the IRS with specific actions that could be taken to reduce improper payments. While the IRS has implemented some of our recommendations, it has not taken actions to address key recommendations aimed at preventing/reducing EITC improper payments.

TIGTA also found that the methodology used to compute the Fiscal Year 2009 EITC improper payment rate provides a valid estimate of EITC overpayments. The IRS used results from its National Research Program to estimate the 2009 EITC improper payment rate. While one goal of the National Research Program may be to identify noncompliance, the statistical nature of the study provides the IRS the opportunity to estimate EITC underpayments.

### **WHAT TIGTA RECOMMENDED**

TIGTA recommended that the IRS establish quantifiable reduction targets and strategies to meet those targets and use the National Research Program sample to estimate instances in which the IRS incorrectly pays less in the EITC than the taxpayer claims (underpayments).

In their response, IRS officials agreed with our first recommendation and agreed in concept with our second. Specifically, the tax return preparer initiative will enable the IRS to have a baseline against which it can set meaningful reduction targets. The IRS will explore whether the recommendation on estimating underpayments is possible and practical.

TIGTA does not believe the IRS response is adequate. The loss of billions of dollars in improper EITC payments annually calls for more aggressive and immediate actions to reduce improper payments. Executive Order 13520 requires the IRS to intensify its efforts and set targets to reduce EITC improper payments. The IRS has not met this requirement and, as a result, the risk remains high that no significant improvement will be made in reducing improper EITC payments.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

February 7, 2011

**MEMORANDUM FOR** DEPUTY COMMISSIONER FOR OPERATIONS SUPPORT

*Michael R. Phillips*

**FROM:**

Michael R. Phillips

Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year (Audit # 201040044)

This report presents the results of our review to assess the Internal Revenue Service's (IRS) efforts to implement Executive Order 13520. Under the Executive Order, the Treasury Inspector General for Tax Administration is to review the IRS's report on Earned Income Tax Credit improper payment information and provide the IRS Commissioner with recommendations for modifying its plan to address such payments. This review addresses the major management challenge of Erroneous and Improper Payments and Credits.

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*

EITC	Earned Income Tax Credit
FY	Fiscal Year
IRS	Internal Revenue Service
NRP	National Research Program
OMB	Office of Management and Budget
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year



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## *Background*

The Earned Income Tax Credit (EITC) is a refundable Federal income tax credit for low- to moderate-income working individuals and families. Congress originally approved the tax credit legislation in 1975 in part to offset the burden of Social Security taxes and to provide an incentive to work. When the EITC exceeds the amount of taxes owed, it results in a tax refund to those who claim and qualify for the credit. The Internal Revenue Service (IRS) reported that 24 million taxpayers received \$55 billion in the EITC for Tax Year (TY) 2009.

The IRS is responsible for administering the EITC. IRS efforts include education and outreach so taxpayers are aware of potential eligibility requirements for the credit and programs to reduce improper payments. The Office of Management and Budget (OMB) defines an improper payment as any payment that should not have been made or that was made in an incorrect amount. Incorrect payments include overpayments as well as underpayments. The IRS has estimated the EITC improper payment rate since Fiscal Year (FY) 2005. The FY 2009 EITC improper payment rate is estimated to be between 23 percent to 28 percent or \$11 billion to \$13 billion in EITC improper payments each year.

***The Government  
Accountability Office has  
listed the EITC Program as  
having the second highest  
dollar amount of improper  
payments of all Federal  
programs.***

In October 2001, the Government Accountability Office issued an Executive Guide – Strategies to Manage Improper Payments. This Guide provided best practice recommendations for Federal agencies to consider when developing strategies and planning and implementing actions to manage improper payments in their programs. The Improper Payment Information Act of 2002<sup>1</sup> requires agencies to annually estimate the amount of improper payments and report to Congress on the steps the agency is taking to reduce improper payments. The Act also requires agencies to address whether they have the information systems and other infrastructure needed to reduce improper payments. The report must also describe steps the agency has taken to ensure agency managers are held accountable for reducing improper payments.

Executive Order 13520, signed by the President on November 20, 2009, further increases Federal agencies' accountability for reducing improper payments while continuing to ensure Federal programs serve and provide access to their intended beneficiaries. The Order requires Federal agencies to provide their agency Inspector General detailed information on efforts to identify and reduce the number of improper payments in Federal programs with the highest dollar value of improper payments. The Secretary of the Treasury is required to provide specific information

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<sup>1</sup> Pub. L. No. 107-300, 116 Stat. 2350.



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regarding EITC improper payments to the OMB and the Treasury Inspector General for Tax Administration (TIGTA). The Executive Order requires the TIGTA, following receipt and review of the reported information, to assess the level of risk associated with the EITC Program, determine the extent of oversight warranted, and provide the IRS Commissioner with recommendations for modifying the IRS's plan to reduce EITC improper payments.

This review was performed at the IRS National Headquarters in Washington, D.C., in the Office of Research, Analysis, and Statistics and in the Office of the Deputy Commissioner for Operations Support during the period of June through September 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*

***The Risk Remains High That No Significant Improvement Will Be  
Made in Reducing Improper Earned Income Tax Credit Payments***

The IRS has made little improvement in reducing EITC improper payments since being required to report estimates of these payments to Congress in 2002. Based on our review of the IRS report provided in response to Executive Order 13520, we believe there is a high risk the IRS will continue to pay billions of dollars in EITC improper payments annually. The IRS continues to report that 23 percent to 28 percent of EITC payments are issued improperly each year. In FY 2009, this equated to \$11 billion to \$13 billion in EITC improper payments. Figure 1 provides a summary of the percentage of IRS estimated EITC improper payments and the associated dollar amounts.

***Figure 1: Payments for FYs 2003 to 2009***

<b>FY</b>	<b>Minimum Improper Payments<sup>2</sup> Percentage</b>	<b>Maximum Improper Payments Percentage</b>	<b>Minimum Improper Payments Dollars (Billions)</b>	<b>Maximum Improper Payments Dollars (Billions)</b>
2003	25%	30%	\$9.5	\$11.5
2004	22%	27%	\$8.6	\$10.7
2005	23%	28%	\$9.6	\$11.4
2006	23%	28%	\$9.8	\$11.6
2007	23%	28%	\$10.4	\$12.3
2008	23%	28%	\$11.1	\$13.1
2009	23%	28%	\$11.2	\$13.3

*Source: Various Department of the Treasury Performance and Accountability Reports and the 2009 Agency Financial Report.*

The IRS has established adequate oversight of the administration of the EITC Program. It has designated an office dedicated to improving EITC participation and compliance. As we reported

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<sup>2</sup> The IRS computes the minimum and maximum improper payment rates (referred to as the upper and lower bounds) using different sets of assumptions concerning the compliance of EITC claimants who fail to show up for the National Research Project audit.





## *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year*

in December 2008, the IRS has developed processes to successfully identify billions of dollars in erroneous EITC payments.<sup>3</sup> However, Compliance function resources are limited and alternatives to traditional compliance methods have not been developed, resulting in the majority of the potentially erroneous EITC claims identified being paid in error. Beginning in TY 2005, the IRS reallocated its examination resources across all areas of the tax code to address a greater number of higher income taxpayers. This decision limited the number of EITC audits that the IRS performs each year, \*\*\*\*\*2(f)\*\*\*\*\*.

Although the IRS has developed better ways to identify potentially erroneous EITC payments, it has not developed alternatives to address the erroneous claims it identifies. For example, the IRS has spent millions of dollars developing probability filters<sup>4</sup> to improve its selection of cases for audit using information contained in the Dependent Database.<sup>5</sup> By combining the use of probability filters with external data included in the Dependent Database, the IRS increased its EITC audit change rate (percentage of audits that result in a change to the EITC) from

\*\*\*\*\*2(f)\*\*\*\*\*  
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89.7 percent on TY 2004 tax returns to 93.9 percent on TY 2005 tax returns. The IRS's audit selection process identified 594,312 TY 2005 EITC claims, totaling \$1.3 billion, for which information contained in the Dependent Database identified that the residency requirement did not appear to have been met. \*\*\*\*\*2(f)\*\*\*\*\*  
\*\*\*\*\*  
\*\*\*\*\*.

If the IRS does not move beyond traditional compliance methods, it will be unable to significantly reduce the estimated \$11 billion to \$13 billion in EITC improper payments made annually. IRS management acknowledges the limitations faced in significantly reducing noncompliance using the traditional process of auditing tax returns. The IRS noted in its June 2010 report to the TIGTA that it cannot fully address EITC noncompliance by simply auditing returns and must pursue alternatives to traditional compliance efforts. However, the IRS has not made significant progress to date in its pursuit of alternative compliance methods.

<sup>3</sup> *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* (Reference Number 2009-40-024, dated December 31, 2008).

<sup>4</sup> Probability filters are characteristics of noncompliance the IRS has developed using historical data and are used to determine the likelihood that an EITC claim is erroneous.

<sup>5</sup> The Dependent Database is a risk-based audit selection tool used by the IRS to identify EITC tax returns for audit.



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***Information Required by Executive Order 13520 Was Not Included in  
the Report to the Treasury Inspector General for Tax Administration***

The purpose of Executive Order 13520 is to reduce improper payments by intensifying efforts to eliminate payment error, waste, fraud, and abuse while continuing to ensure that Federal programs serve and provide access to their intended beneficiaries. The Executive Order required the IRS to provide the TIGTA with a report that includes the methodology for computing the error rate, plans for meeting improper payment reduction targets, and plans to ensure program access and participation by eligible beneficiaries. In addition, the Executive Order also established a quarterly reporting requirement.

The IRS provided the required report to the TIGTA on June 14, 2010. However, this report did not include all of the information required by the Executive Order. Appendix IV provides a copy of this report. Figure 2 details the IRS's compliance with the Executive Order requirements to provide specific improper payment information to the TIGTA.



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**Figure 2: Compliance With Improper Payment Reporting Requirements**

Reporting Frequency	Requirement	Requirement Met?
One Time	Provide the TIGTA with a report containing: <ul style="list-style-type: none"> <li>• Methodology for identifying and measuring EITC improper payments.</li> <li>• Plans and supporting analysis for meeting the reduction targets for EITC improper payments.</li> <li>• Plans and supporting analysis for ensuring the initiatives undertaken do not unduly burden program access and participation by eligible beneficiaries.</li> </ul>	Yes  No  No
Quarterly	Submit a report to the TIGTA and Council of the Inspectors General on Integrity and Efficiency on EITC improper payments identified by the agency and make it available to the public. The report shall describe: <ul style="list-style-type: none"> <li>• Number of high-dollar improper payments made during the quarter.<sup>6</sup></li> <li>• Individuals or entities who received the high-dollar payments.</li> <li>• Actions taken or planned to recover the improper payments.</li> <li>• Actions the IRS intends to take to prevent improper payments from occurring in the future.</li> </ul>	Disclosure laws limit the IRS's ability to comply with this requirement.

Source: Executive Order 13520 and TIGTA analysis of IRS report entitled "Initial Report on Earned Income Tax Credit (EITC) Improper Payments Executive Order 13520: Reducing Improper Payments" issued on June 14, 2010.

**Reduction targets were not included in the IRS report to the TIGTA**

Executive Order 13520 requires the IRS to intensify its efforts and set targets to reduce EITC improper payments. The Order requires the IRS to provide the TIGTA with its plans and supporting analysis for meeting those targets. The IRS's report to the TIGTA did not include any quantifiable targets to reduce EITC improper payments. IRS management noted that reduction targets were not set because it has to balance its enforcement efforts among different taxpayer income levels. Increasing the number of EITC examinations it performs to further

<sup>6</sup> High-dollar improper payments are payments totaling more than \$750 million that should not have been made or that were made in an incorrect amount.



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reduce improper payments would disrupt this balance. Management indicated that the IRS allocates more resources to conduct EITC compliance audits involving lower income taxpayers when compared to other segments of the taxpayer population.

As detailed earlier in the report, the IRS has made no significant improvements in reducing EITC improper payments. Without targets to reduce EITC improper payments as required by the Executive Order, there is a lack of accountability for eliminating payment error, waste, fraud, and abuse.

**No basis was provided for the IRS's assertion that new regulation of tax return preparers will significantly reduce EITC improper payments**

The IRS report notes that it has made a number of improvements to stop erroneous EITC payments. These include improvements to the examination selection process and data matching using third-party data. The IRS notes that its new efforts to regulate tax return preparers will drive increased EITC compliance, decrease fraud, and reduce the improper payment rate. We agree the regulation of tax return preparers will have some impact on reducing EITC improper payments. Nonetheless, the IRS report does not provide details on when or how the IRS plans to measure the impact of the tax return preparer strategy on EITC improper payments. It is unknown whether regulation of tax return preparers will result in a significant reduction in the EITC improper payment rate. Further, the IRS has just begun implementing the tax return preparer strategy and does not anticipate the strategy will be fully implemented until 2014.

In addition, we recently completed a review of the IRS's EITC Paid Preparer Strategy.<sup>7</sup> Beginning in 1999, the IRS developed a strategy specifically focused on increasing tax return preparer compliance with the EITC due diligence requirements.<sup>8</sup> The IRS refers to this strategy as the EITC Paid Preparer Strategy. Representatives from the IRS indicated that the EITC Paid Preparer Strategy serves as a model for enforcement of tax preparer compliance within the new IRS Paid Preparer Strategy. The results of our review show that Due Diligence visits<sup>9</sup> to tax return preparers as part of this strategy resulted in some reduction in erroneous EITC payments. Specifically, we found of the 541 tax return preparers who received a Due Diligence visit in FY 2009:

- 414 (77 percent) tax return preparers appear to have changed their behavior. Of the 414, 295 tax return preparers were still filing EITC claims but were no longer identified as potentially noncompliant in the IRS's FY 2010 analysis. The remaining 119 tax return preparers appear to no longer be filing EITC claims. Although it appears these tax return

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<sup>7</sup> *Actions Can Be Taken to Improve the Identification of Tax Return Preparers Who Submit Improper Earned Income Tax Credit Claims* (Reference Number 2010-40-116, dated September 14, 2010).

<sup>8</sup> Due diligence requirements provide guidance to tax return preparers for ensuring that information used to claim the EITC is correct.

<sup>9</sup> A Due Diligence visit is an examination to determine whether a paid preparer is in compliance with all four Due Diligence requirements of Internal Revenue Code Section 6695(g).



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preparers have changed their behavior, it is possible they are filing claims under a different Social Security Number or Preparer Tax Identification Number than the one used in the prior year.<sup>10</sup>

- 127 (23 percent) tax return preparers were still identified as being potentially noncompliant in the FY 2010 analysis or were identified for a streamlined injunction.<sup>11</sup>

The IRS projects these efforts will reduce EITC improper payments by \$45 million in FY 2010. Although visits to egregious EITC tax return preparers are successful in changing the behavior of those preparers, the amount of EITC improper payments protected is insignificant (approximately \$35 million in FY 2007 or 0.32 percent) when compared to the \$11 billion to \$13 billion in improper payments reported by the IRS annually. The IRS must identify ways to reduce EITC improper payments by billions of dollars a year to show any substantial improvement in the improper payment rate.

**The TIGTA has identified opportunities for the IRS to reduce EITC improper payments, but little action has been taken**

The IRS has a number of programs in place to identify and address improper EITC payments. These programs include education and outreach programs, document matching to identify income discrepancies, examinations to validate EITC claims prior to issuing the refund, and math error processing to identify math or other statistical irregularities and adjust the tax return before refund issuance. According to the IRS, its efforts protect more than \$3.6 billion in improper EITC payments annually.

The TIGTA has conducted a number of audits that have identified opportunities to reduce the number of EITC improper payments. We have provided the IRS with specific actions that could be taken to reduce improper payments and allow the IRS to establish measurable reduction targets. While the IRS has implemented some of our recommendations, it has not taken actions to address key recommendations aimed at preventing/reducing EITC improper payments. Figure 3 summarizes our reported findings between June 2003 and September 2010 for actions that the IRS either disagreed with or has not yet implemented along with estimates of erroneous payments that could potentially be prevented/reduced.

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<sup>10</sup> We believe the IRS will be unable to determine if a tax return preparer continues to file EITC claims under a different Social Security Number or Preparer Tax Identification Number until it fully implements its tax return preparer registration process.

<sup>11</sup> A streamlined injunction is a process used to expedite the investigation and prosecution, when warranted, of individual tax return preparers who have repeatedly demonstrated egregious behavior with regard to filing improper EITC claims. The result of a successful injunction is a court order prohibiting the tax return preparer from preparing tax returns.



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**Figure 3: TIGTA Recommended Actions That Have Not Been Taken<sup>12</sup>**

<b>Actions the IRS Could Take to Prevent/Reduce Improper EITC Payments</b>	<b>Number of Recommendations Made</b>	<b>Potential Dollars Protected (Over 5 years)</b>
Comply with regulations requiring some taxpayers who previously filed a fraudulent EITC claim to recertify their eligibility before receiving the EITC in a subsequent tax year. <sup>13</sup>	1	\$330 Million
Ensure taxpayers comply with the law governing EITC qualifying-child eligibility before allowing EITC claims. <sup>14</sup>	2	\$5.6 Billion
Use available third-party data to ensure taxpayers comply with the law requiring individuals to have a Social Security Number that is valid for work when claiming the EITC. <sup>15</sup>	1	\$1.1 Billion
Ensure taxpayers comply with the law that limits the use of a Taxpayer Identification Number to claim the EITC on only one tax return. <sup>16</sup>	1	\$1.1 Billion
Ensure it is effectively addressing tax return preparer compliance with the EITC Due Diligence regulations. <sup>17</sup>	2	\$126 Million

Source: TIGTA final audit reports issued between June 2003 and September 2010.

<sup>12</sup> The IRS disagreed with three of the seven recommendations referenced in this table. It agreed or partially agreed with four recommendations. The IRS indicated that corrective actions for three of the four recommendations would not be implemented until Calendar Year 2011 or later.

<sup>13</sup> *While Progress Has Been Made, Limits on the Number of Examinations Reduce the Effectiveness of the Earned Income Tax Credit Recertification Program* (Reference Number 2008-40-131, dated July 3, 2008).

<sup>14</sup> *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* (Reference Number 2009-40-024, dated December 31, 2008).

<sup>15</sup> *Better Use of Available Third-Party Data Could Identify and Prevent More Than One Billion Dollars in Potentially Erroneous Refunds* (Reference Number 2010-40-062, dated July 13, 2010).

<sup>16</sup> *Multiple Use of Taxpayer Identification Numbers Continues to Result in Significant Erroneous Exemptions and Credits* (Reference Number 2010-40-117, dated September 14, 2010).

<sup>17</sup> *Actions Can Be Taken to Improve the Identification of Tax Return Preparers Who Submit Improper Earned Income Tax Credit Claims* (Reference Number 2010-40-116, dated September 14, 2010).





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## **Recommendation**

**Recommendation 1:** The Deputy Commissioner for Operations Support should establish quantifiable reduction targets and strategies to meet those targets as required by Executive Order 13520.

**Management's Response:** The IRS agreed with this recommendation, stating that its return preparer initiative is its most promising avenue to substantially reduce erroneous EITC payments. Sixty-six percent of all EITC tax returns and most EITC tax returns with errors are prepared by tax return preparers. The IRS is in the first year of a 3-year ramp-up of this initiative. After the program is fully established, the IRS will have a baseline against which it can set meaningful reduction targets.

**Office of Audit Comment:** Although the IRS cited a number of actions taken to reduce improper EITC payments, by its own measurement, no significant improvement has resulted. As our report indicated, the IRS continues to report billions of dollars in improper EITC payments each year with FY 2009 estimates totaling \$11 billion to \$13 billion. The IRS also stated that it is moving beyond traditional compliance methods (audits) to address EITC improper payments. We disagree. As detailed in our report, the IRS has developed processes to successfully identify billions of dollars in erroneous EITC payments. However, despite our December 2008 recommendation to develop alternatives to traditional compliance, the IRS has not developed or proposed alternatives. As such, the majority of the potentially erroneous EITC claims identified continue to be paid in error.

In addition, the IRS noted that its focus on tax return preparers will serve to improve EITC tax returns and further reduce EITC errors. We agree the regulation of tax return preparers will have some impact on reducing EITC improper payments. Nonetheless, the IRS report does not provide details on when or how the IRS plans to measure the impact of the tax return preparer strategy on EITC improper payments. As we noted in our report, the IRS has just begun implementing the tax return preparer strategy and does not anticipate the strategy will be fully implemented until 2014. Using IRS estimates for FY 2009, it is likely that the IRS will have issued anywhere from \$55 billion to \$65 billion in improper payments by FY 2014.

IRS management also noted that they partially agree with four of the previous recommendations we cited in our report. However, the majority of the recommendations will not be implemented until 2013. The loss of billions of dollars in improper EITC payments annually calls for more aggressive and immediate actions to reduce improper payments by intensifying efforts to eliminate payment error, waste, fraud, and abuse. Executive Order 13520 requires the IRS to intensify its efforts and set targets to reduce EITC improper payments. The IRS has not met this requirement and, as a result, the risk



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remains high that no significant improvement will be made in reducing improper EITC payments.

**The IRS has undertaken a number of initiatives to ensure access and participation by eligible individuals**

The Executive Order requires the IRS to include in its report to the TIGTA plans and supporting analysis for ensuring the initiatives undertaken do not unduly burden program access and participation by eligible beneficiaries. The IRS report noted the EITC participation rate for individuals eligible to receive the credit is between 75 percent and 80 percent. However, the report did not provide any details on the actions it is taking or plans to take to continue to ensure eligible individuals have access to the EITC Program. Based on our prior reviews of the administration and oversight of the EITC Program, we are aware of a number of initiatives the IRS has undertaken to educate and assist eligible individuals in claiming the credit. These include:

- Launching a targeted EITC marketing campaign to reach EITC eligible taxpayers using research as a basis on how this demographic receives information. The 2010 campaign included new innovative social media methods such as Twitter and YouTube.
- Partnering to conduct outreach with more than 300 coalitions, which represent hundreds of nonprofit organizations, financial institutions, and government agencies. These coalitions conduct their own local EITC outreach through direct mail and media efforts.
- Holding an annual National EITC Awareness Day to create national awareness of the EITC and educate the diverse EITC population. Actions include public appearances by members of Congress, State and local key government officials, and key IRS executives to discuss the benefits of the EITC and free tax help. In 2010, the White House issued a statement supporting the day.
- Improving information and tools available on the IRS web site (IRS.gov) to provide assistance to taxpayers, tax preparers, and the IRS EITC partners. For example, the IRS has updated the EITC Assistant, the EITC Electronic Toolkit for Tax Preparers, and the Electronic Toolkit for EITC Partners and has launched EITC Marketing Express.
- Launching a new electronic toolkit (EITC Central) for partners and practitioners containing information, best practices, tools, and customizable products to reach the underserved taxpayer and improve the quality of EITC returns. This year, the IRS added an EITC due diligence continuing education training course to help tax preparers meet their due diligence requirements.
- Working with State governments to support EITC awareness and participation through their communication channels. Encouraging partnerships with those States that have an





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EITC equivalent in sending out notices to taxpayers who appear to be eligible for the EITC on their Federal return but did not claim the Credit.

- Providing key EITC Program information during annual Nationwide Tax Forum Presentations.
- Sending computer-generated notices proactively to taxpayers who file tax returns and appear to be eligible for the EITC but did not claim the Credit. For example, the IRS sent more than 570,000 notices based on information reported on TY 2008 returns.

**Privacy laws limit the IRS's ability to comply with quarterly reporting requirements**

The Executive Order requires the IRS to report quarterly on the number of high-dollar improper payments made during the quarter, the individuals or entities who received the payments, and the actions taken or planned to recover the improper payments. A high-dollar overpayment is defined by the OMB as any overpayment that is in excess of 50 percent of the correct amount of the intended payment and when the total payment to an individual exceeds \$5,000. Agencies are required to provide this information for public release unless the information requested is protected by privacy rules or regulations. OMB guidance issued in March 2010 further clarified that agencies with no high-dollar activity in a given quarter were not required to report for that quarter.

The IRS is prohibited from publicly releasing individual tax information under Internal Revenue Code Section 6103(a). As a result, the IRS is not required to publish the names of the individuals who received a high-dollar improper EITC payment in any given quarter. The IRS issues EITC payments to taxpayers once a year. As a result, the IRS would be subject to a quarterly reporting requirement only for the quarter in which EITC payments are issued, generally the first and/or second quarter of the calendar year. The IRS would also be subject to a quarterly reporting requirement only if it had issued an improper payment exceeding \$5,000 in any given quarter.

***IRS management indicated that they cannot meet the quarterly reporting requirement because the IRS is prohibited from publicly releasing individual tax information.***

However, the IRS should be aware that it may be required to report such payments in the future. The maximum EITC available to taxpayers is historically below the \$5,000 high-dollar threshold established in the OMB guidance. However, recent law<sup>18</sup> added a level of the EITC for families with 3 or more children and raised the maximum available EITC to more than \$5,000 for TY 2009 and TY 2010 tax returns. While the privacy requirements in place prevent the IRS from providing individual taxpayer information, it does not prevent the IRS from

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<sup>18</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009).



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providing aggregate information for high-dollar improper payments or its efforts to recover and prevent such payments.

### ***The Internal Revenue Service Continues to Improve Its Estimation of Earned Income Tax Credit Improper Payments***

The methodology used to compute the FY 2009 EITC improper payment rate provides a valid estimate of the percentage and amount of EITC overpayments. However, the improper payment calculation does not include the amount of EITC underpayments. Underpayments include EITC payments made to individuals that are less than the individual was entitled to receive. The formula used by the IRS to compute the improper payment rate of EITC claims is shown in Figure 4.

***Figure 4: Improper EITC Payment Rate Formula***

<b><i><u>Total Overclaims – Total Claims Protected/Recovered</u></i></b> <b><i>Total EITC Claims</i></b>
<b>Total Overclaims</b> – the difference between the amount of the EITC claimed by the taxpayer on his or her tax return and the amount the taxpayer should have claimed.
<b>Total Claims Protected/Recovered</b> – the amount the IRS prevents (protects) in EITC overclaims through various activities including math error processing and pre-refund examinations. This data element also includes the amount the IRS recovers in overclaims that were erroneously paid. Recovery activities include Automated Underreporter examinations and post-refund examinations.
<b>Total EITC Claims</b> – the amount of EITC claimed on all tax returns.

Source: Initial Report on Earned Income Tax Credit Improper Payments Executive Order 13520: Reducing Improper Payments.

### **The IRS is improving the timeliness of data used to compute the improper payment estimate**

The IRS used results from its National Research Program (NRP) for TY 2001 tax returns to estimate the FY 2009 EITC improper payment rate. The NRP data are used to estimate total EITC overclaims, total EITC claims, and the math error portion of total claims recovered. IRS management indicated that the NRP is the sole source of data the IRS uses to estimate taxpayer EITC behavior for the purpose of estimating the EITC improper payment rate. The NRP provides the IRS with compliance information that is statistically representative of the taxpayer population. The TY 2001 NRP results are based on a random sample of 44,800 individual tax returns that were audited in order to determine taxpayer compliance. The sample is grouped into



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predefined categories that represent a specific area of compliance that the IRS and its stakeholders are interested in measuring. The sample included approximately 6,500 EITC tax returns.

Although the IRS has attempted to assess the level of EITC compliance since 2002, the methodologies used were not consistent. In 2005, the IRS developed the EITC improper payment rate. However, this rate is still not a current measure of EITC compliance because it is not based on current tax returns. Although the rate was established in 2005, it was based on the TY 2001 NRP tax returns. The IRS applies the TY 2001 rate to the total EITC payments in a given year to estimate the amount of improper payments for that year. According to IRS management, after the TY 2001 NRP, there was no funding to perform another NRP until 2006.

***Beginning with TY 2006,  
the IRS performs NRP audits  
each year allowing the IRS to  
update the EITC improper  
payment rate annually starting  
in Calendar Year 2010.***

In 2007, the IRS began the process of updating its NRP data by reviewing a stratified, randomly selected sample of TY 2006 individual tax returns. The TY 2006 NRP used a sample of approximately 14,000 individual tax returns. The sample included about 2,200 EITC tax returns. The IRS plans to select a new sample of the next tax year's tax returns annually. The IRS will use each year's NRP results to update the improper payment rate. According to IRS management, the FY 2010 improper payment rate will be based on the results of the TY 2006 NRP. Although the new NRP process will result in a more current estimate of the accuracy of EITC claims, the estimated improper payment rate for a given fiscal year will not be based on current year data. Because of the time it takes to complete the annual NRP, the IRS's annual estimate will be based on data that are approximately 3 years old.

In addition, IRS management stated that the IRS plans to update its comprehensive EITC compliance study in Calendar Year 2012 using the first 3 consecutive years of NRP data.<sup>19</sup> The EITC compliance study is an analysis of tax returns claiming the EITC with specific attention given to the source of EITC errors. The last EITC compliance study conducted that included this type of detailed EITC information was based on TY 1999 tax returns. The IRS believes the ability to update its EITC compliance study will enable it to measure its success in reducing erroneous EITC payments. Further, the IRS notes that after 2012, it should also be able to update its compliance study annually.

**Underpayments need to be included in EITC improper payment estimates**

The OMB defines an improper payment as any payment that should not have been made or that was made in an incorrect amount. Using this definition, any EITC payment made to an individual that was less than the individual should have received (underpayment) is also

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<sup>19</sup> Beginning with TY 2006, the IRS will update its EITC compliance study using NRP data. Every third year, data for the 3 most recent tax years will be blended together to achieve improved statistical precision.



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considered an improper payment.<sup>20</sup> IRS management indicated that they are unable to determine when an individual is eligible for the EITC but does not claim it. However, these types of “no claims” are not underpayments by definition. An underpayment only occurs when the IRS incorrectly pays less in the EITC than the taxpayer claims. The IRS did not provide an explanation as to why it has not estimated the amount of EITC claims the IRS incorrectly reduced during tax return processing resulting in an EITC payment less than the individual was entitled to receive.<sup>21</sup>

One of the reasons the IRS has not estimated the amount of EITC payments incorrectly made for less than the amount claimed could be the tool the IRS uses to estimate the EITC improper payment rate. The focus of the NRP is to assess the level of voluntary taxpayer compliance and is aimed at closing the tax gap.<sup>22</sup> The study gathers strategic information about taxpayer compliance behavior that will allow the IRS to better allocate its resources to enforcement and service activities, which are intended to bring taxpayers into compliance. As a result, the IRS’s focus when reviewing tax returns selected for the NRP is on identifying overpayments, not underpayments. While one goal of the NRP may be to identify noncompliance, the statistical nature of the study provides the IRS the opportunity to estimate EITC underpayments based on the NRP sample as well as the overpayments.

By not including EITC underpayments in the estimate of EITC improper payments, the IRS is understating the rate and/or dollar value of improper payments being made. While we are unable to determine at this time the significance of underpayments on the overall EITC improper payment rate, it may be beneficial for the IRS to capture these data in the NRP results it evaluates when updating the improper payment rate for future fiscal years.

## ***Recommendation***

**Recommendation 2:** The Deputy Commissioner for Operations Support should use the NRP sample to estimate instances in which the IRS incorrectly pays less in the EITC than the taxpayer claims (underpayments).

**Management’s Response:** IRS management agreed in concept with this recommendation and will explore whether using the NRP sample is possible and practical. Underpayments happen so infrequently in the NRP sample that the IRS may be unable to use NRP audit results to construct a statistically valid estimate of a population total. Further, there is nothing in TIGTA’s report or otherwise to substantiate that the

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<sup>20</sup> An individual who is entitled to receive the EITC but does not claim it on his or her tax return does not constitute an EITC underpayment within the OMB definition of improper payments.

<sup>21</sup> The amount of underpayments would be limited to the difference between what the taxpayer correctly claimed on his or her tax return and the amount of EITC actually paid.

<sup>22</sup> The tax gap is the difference between the true tax liability required under the Internal Revenue Code and the amounts that are reported and paid on a timely basis.



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IRS underpays a significant number of properly computed EITC claims. Also, since approximately 70 percent of all returns are filed electronically, there is no opportunity for any such IRS errors on these returns. For the residual 30 percent of returns filed on paper, the refund error rate was 2 percent during FY 2009, which makes it highly unlikely IRS underpayment errors for EITC are significant.



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## **Appendix I**

### *Detailed Objective, Scope, and Methodology*

The overall objective of this review was to assess the IRS's efforts to implement Executive Order 13520. To accomplish this objective, we:

- I. Determined whether the IRS included required reporting deliverables in its report to the TIGTA by reviewing the IRS report on EITC improper payments to determine if the report included:
  - A. A methodology for identifying and measuring EITC improper payments.
  - B. Plans and supporting analysis for meeting the reduction targets for EITC improper payments.
  - C. Plans and supporting analysis for ensuring the initiatives undertaken to reduce improper payments do not unduly burden program access and participation by eligible beneficiaries.
- II. Assessed IRS compliance with reporting requirements contained in the Executive Order by discussing with the IRS its plans for publishing the name of the official accountable for EITC improper payments; current and historical rates and amount of EITC improper payments, including causes; current and historical rates and amount of recovery of EITC improper payments; targets for reducing as well as recovering EITC improper payments; and entities that have received the greatest amount of EITC improper payments. We also discussed with the IRS its plans for submitting a quarterly report to the TIGTA and Council of the Inspectors General on Integrity and Efficiency and making available to the public a quarterly report on EITC improper payments that includes actions the IRS has taken or plans to take to recover improper payments and actions the IRS intends to take to prevent improper payments from occurring in the future.
- III. Evaluated the IRS's methodology for identifying, measuring, and reducing EITC improper payments while ensuring eligible individuals continue to have access to the Program.
  - A. Reviewed the IRS report to the TIGTA on EITC improper payments to determine the accuracy and completeness of the information provided and met with the IRS Office of Research, Analysis, and Statistics to discuss the methodology and data used to compute the EITC improper payment rate. We also obtained and reviewed supporting documentation for the methodology and data used to compute the EITC improper payment rate and met with the IRS Office of Research, Analysis, and





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Statistics to discuss the NRP methodology for EITC claims as well as the planned schedule for completion and availability of data by tax year.

- B. Evaluated the IRS's plans for meeting the reduction targets for EITC improper payments by contacting the OMB to determine if the IRS is required to establish and meet reduction targets for EITC improper payments and contacted IRS personnel to determine plans for establishing and meeting the reduction targets.
  - C. Evaluated the IRS's plans to ensure eligible individuals continue to have access to the EITC by reviewing TIGTA reports relating to the EITC Program that were issued between Calendar Years 2003 and 2010 and identifying findings and recommendations made related to improving participation in the EITC Program. We identified IRS corrective actions taken in response to TIGTA recommendations. We also contacted the EITC Office to discuss any new initiatives it may be taking to ensure eligible individuals continue to have access to the EITC Program and determined whether the IRS's actions to increase EITC participation will reasonably ensure eligible individuals have access to the EITC Program.
  - D. Assessed level of risk and oversight warranted.
- IV. Determined whether EITC Program information captured and compiled by the IRS could be used to compute a more current estimate of EITC improper payments. To accomplish this, we gathered available IRS statistics for Processing Year 2009 including the number and value of EITC claims, the number and value of EITC claims paid, the number and value of potentially erroneous EITC claims identified by the IRS, and the number and value of erroneous EITC claims prevented or recovered through enforcement programs. We met with the TIGTA contract statistician to determine whether the methodology used by the IRS was a sound statistical methodology.

**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: controls in place to ensure the IRS met the reporting requirements established in Executive Order 13520.



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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

Deann L. Baiza, Audit Manager

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**Appendix III**

*Report Distribution List*

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Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division  
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## Appendix IV

### *Internal Revenue Service Report to the Treasury Inspector General for Tax Administration*



DEPUTY COMMISSIONER

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

June 14, 2010

The Honorable J. Russell George  
Treasury Inspector General for Tax Administration  
Department of the Treasury  
1125 15<sup>th</sup> Street, NW  
Washington, DC 20005

Dear Mr. George:

I am writing in response to the reporting requirements in Section 2(a)(i) of Executive Order 13520: Reducing Improper Payments - Executive Order, and Appendix C, Part III to the Office of Management and Budget (OMB) Circular A-123, Requirements for Effective Measurement and Remediation of Improper Payments. The Earned Income Tax Credit (EITC) has been designated a high-priority program by the OMB. To date, 24 million taxpayers received \$55 billion in EITC benefits for Tax Year 2009, making the credit one of the largest anti-poverty programs in the United States.

This initial report provides specific information on our current methodology for measuring the EITC improper payment rate, surmised root causes for improper claims and current and planned actions to mitigate improper payments.

The Internal Revenue Service (IRS) administers the EITC through a balanced program of education and outreach so that taxpayers are aware of potential eligibility for the credit coupled with strategic programs to reduce improper payments. The EITC has a 75 - 80% participation rate. The estimated improper payment rate, which has been calculated annually since Fiscal Year 2005, is 23 - 28% (\$11-13 billion).

The IRS has made a number of improvements to stop erroneous EITC payments. These include improvements to examination selection processes and data matching using third-party data. Most recently, in January 2010, the IRS announced a plan to register, license and create enforcement tools that impact the paid return preparer community more broadly. The IRS believes new regulation of tax return preparers will drive increased EITC compliance, decrease fraud and reduce the improper payment rate. Full registration and testing will be completed within three years, at which point the IRS will begin measuring the impact. In the interim, the IRS is aggressively pursuing improper payments through undercover shopping visits, additional preparer visits and by enjoining egregious return preparers.



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If you have any questions, please contact me, or a member of you staff may contact my Assistant Deputy, Kathleen E. Walters, at (202) 622-5036.

Sincerely,

Mark A. Ernst  
Deputy Commissioner for  
Operations Support

Enclosure



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**Initial Report on Earned Income Tax Credit (EITC) Improper Payments  
Executive Order 13520: Reducing Improper Payments**

**BACKGROUND**

To date, 24 million taxpayers received \$55 billion in EITC benefits for Tax Year (TY) 2009, making the credit one of the largest anti-poverty programs in the United States. In Calendar Year 2009, 6.6 million individuals, half of them children, were lifted above the poverty level as a result of the EITC. For TY 2009, the maximum EITC available is more than \$5,600 for a married couple with three qualifying children. The maximum EITC available in TY 2008 was approximately \$4,800 for a married couple with two qualifying children.

The EITC estimated participation rate for Fiscal Year (FY) 2009 was 75-80%. The estimated error rate, which has been calculated annually since FY 2005, is 23-28% (\$11-13 billion). The estimated percentage range continues to be used each year and is based on taxpayer compliance behavior as measured by the TY 2001 National Research Program (NRP) study. Beginning with TY 2006, data from the annual NRP samples will be incorporated into the estimation methodology as it becomes available.

Addressing EITC improper payments has been an ongoing effort for the IRS primarily through an aggressive compliance program. Recent developments focus on paid return preparers, who are believed to impact the improper payment rate. The IRS believes the implementation of new registration and licensing requirements, as well as the use of compliance tools, for all paid return preparers will impact the improper payment rate, although data is not yet available to permit proper estimation of the effects of this effort.

**IMPROPER PAYMENTS INFORMATION ACT (IPIA) PROGRAM ERROR MEASUREMENT  
METHODOLOGY**

**I. Introduction**

The methodology used to determine the FY 2009 estimates for EITC improper payments consists of the erroneous amounts of EITC paid out to taxpayers that are not later recovered through IRS enforcement activities.<sup>1</sup> Because the "true" amount of improper payments for a given year cannot be known, it must be estimated. This is done using the same general framework as in recent years, the heart of which is to use data from the IRS's NRP individual income tax reporting compliance studies to estimate the "improper payments rate," defined as the percentage of total EITC claims that are improperly paid, net of revenue recovered through enforcement. After adjusting to account for the effects of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the improper payment rate is then applied to the Department of the Treasury's (Treasury) budget estimates for total EITC payments by year to arrive at the

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<sup>1</sup> These improper payments include both EITC amounts that are refunded to taxpayers and EITC amounts that offset or reduce tax liability.



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annual estimate of improper payments. The approach for FY 2009 is identical to that used for prior years, but for the standard revision to account for updated projections of total EITC payments in the most recent version of the FY 2010 federal budget.

#### **II. Improper Payment Rate Estimates for Tax Year 2001**

To expand on the general framework described above, the methodology for developing the FY 2009 set of EITC improper payments estimates involves the following steps: (1) estimating an improper payment rate for TY 2001, the most recent year for which individual income tax reporting compliance data from the NRP are available; (2) adjusting the TY 2001 rate to reflect the estimated impact of the EITC-related EGTRRA provisions; (3) projecting EITC claims for FY 2009 by using Treasury's budget estimates; and (4) multiplying the improper payment rate by the estimated claims to calculate estimated improper payments for each fiscal year. This section describes the first step of estimating the improper payment rate and includes a discussion of the relevant sources of data. The second step is described in Section III, and the latter two steps are described in Section IV.

Consistent with the methodology in recent years, the improper payment rate is defined as follows<sup>2</sup>:

$$\text{EITC Improper Payment Rate} = \frac{\text{Amount of EITC Overclaimed} - \text{Amount of EITC Overclaims Recovered}}{\text{Amount of EITC Claimed on All Returns}}$$

#### **Primary Data Source: The National Research Program**

Both *Amount of EITC Overclaimed* and *Amount of EITC Claimed on all Returns* are estimated using data from the NRP's reporting compliance study of individual income tax returns for TY 2001.<sup>3</sup> In this study, individual income tax returns filed during Calendar Year 2002 for TY 2001 were selected for examination using a stratified, random sample design.<sup>4</sup> This selection method allows conclusions drawn from the NRP sample to be projected to the full population of individual income tax return filers. There are approximately 44,800 individual income tax returns in the NRP sample for TY 2001, about 6,500 of which capture EITC claimants.

Because one of the objectives of the NRP is to provide data for compliance measurement, NRP classification, examination and data collection procedures are more

<sup>2</sup> The EITC improper payment rate is identical in concept to the Unrecovered Overclaim Percentage from the TY 1999 EITC Compliance Study

<sup>3</sup> The NRP is nearing completion of its individual, income tax reporting compliance study for TY 2006, but since those data are still preliminary, this report continues to make use of the TY 2001 study.

<sup>4</sup> In a stratified, random sample, returns are grouped into predefined categories, or "strata", and selected randomly within each stratum.





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comprehensive in scope and depth than those for standard examination programs. These expanded procedures are designed to provide a more thorough determination of true taxpayer liability, i.e., what taxpayers should have reported on their returns. For the NRP sample cases, true taxpayer liability can be compared with what taxpayers actually reported on their returns in order to estimate various measures of compliance. The NRP sample results can be projected to the full population of individual income tax returns using weights assigned to each return to reflect the sample design.<sup>5</sup>

#### ***Estimating Amount of EITC Overclaimed and Amount of EITC Claimed on All Returns***

For an individual taxpayer, the amount of EITC “overclaimed” is the difference between the amount of EITC claimed by the taxpayer on his or her return and the amount the taxpayer should have claimed, as determined by the NRP examination. For purposes of estimating the *EITC Improper Payment Rate*, the *Amount of EITC Overclaimed* is the weighted sum of the amounts of EITC overclaimed on NRP sample returns where the EITC was in fact overclaimed.<sup>6</sup> The *Amount of EITC Claimed on All Returns* is the weighted sum of the amount of EITC claimed by all EITC claimants in the NRP sample. The weights used are NRP study sample weights.

#### ***Estimating Amount of EITC Overclaims Recovered***

The IRS, through various administrative activities, prevents the payment of some EITC overclaims and recovers some overclaims that were paid. This occurs primarily through math error processing, information document matching in the Automated Underreporter Program (AUR), and the examination of returns. These amounts are reflected in the *EITC Improper Payment Rate* through the *Amount of EITC Overclaims Recovered* term.

Math error processing involves computerized checks for mathematical and clerical errors during standard tax return processing. This process generally involves checks for arithmetic mistakes and errors in reading tax and EITC tables but also includes checks for valid taxpayer identification numbers. IRS data files contain fields for both the EITC claimed by the taxpayer and the EITC calculated by computer. The difference in these two fields, when the amount claimed is greater than the computer amount, is the amount of overclaims that were not paid because of IRS math error activities. The math error EITC recovered amounts were estimated from the NRP EITC claimant sample returns on which EITC was overclaimed. These amounts were calculated as the weighted sum of the difference between the EITC claimed and computer amounts for NRP EITC sample returns that overclaimed EITC. Again, the weights used were the NRP sample weights.

Some EITC overclaims are identified and recovered through AUR activities. The AUR system allows the IRS to detect misreported and underreported income by comparing

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<sup>5</sup> Each weight reflects the number of returns in the population that the sample return represents.

<sup>6</sup> This is not offset by “underclaims,” nor does it include any EITC amounts that were properly claimed by the taxpayer.



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documents provided by third parties with corresponding income information reported by the taxpayer. AUR information is captured in IRS Enforcement Revenue Information System (ERIS) data, which tracks assessments and collections from IRS enforcement-related activities. The estimate of the amount of overclaims recovered through AUR reflects amounts IRS has collected or expects to collect on TY 2001 EITC overpayments that were identified by AUR. This estimate was based on actual AUR results shown in ERIS data through December 2004, increased slightly to account for estimated assessments and collections made after December 2004 on TY 2001 returns. These figures are based on IRS operations applied to all EITC claims, not just NRP sample returns, and therefore do not require sample weighting.

EITC overclaims also are prevented and recovered through examination activities. Many examinations of EITC claims are conducted pre-refund. This means that the EITC claim is not paid but rather is held by the IRS pending the outcome of the examination. For these cases, the EITC amount is paid only if the examination is resolved in support of the taxpayer's claim. Other EITC examinations are conducted after the credit is paid, i.e., post-refund. For these cases, should the IRS reduce or deny the EITC claim, the IRS must recover the amount that was previously paid. The estimate of the amount of EITC overclaims that were not paid due to pre-refund examinations and the amount that was recovered through post-refund examinations was based on actual amounts either not paid or recovered as shown in ERIS data. The ERIS data through December 2004 were adjusted slightly to account for assessments and collections made after December 2004 on TY 2001 returns.

### ***Capturing the Uncertainty of Non-Response Audits Using Bounds***

The FY 2009 methodology continues to use the practice followed in previous years of using an upper and lower bound for EITC improper payments. Not to be confused with the bounds of a confidence interval, the upper and lower bounds reflect two specific assumptions about the true EITC eligibility of taxpayers who do not respond to the NRP's request for an audit or provide information related to the examination. At one end is the assumption that these "no-show" taxpayers are noncompliant and are not legally entitled to the EITC amount they claim; under this assumption, the majority of these EITC amounts are treated as overclaims.<sup>7</sup> This assumption of high noncompliance among no-show taxpayers yields the upper bound estimate for the improper payment rate. The lower bound estimate assumes that the compliance of "no-show" taxpayers is the same as that of other, similar taxpayers who do appear for an examination. Here, the EITC overclaim rate for "no-show" taxpayers is imputed from the average of other taxpayers in the same stratum. This provides the lower bound for the estimate of the improper payment rate.

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<sup>7</sup> This is consistent with existing operational audit practice, which is to disallow the EITC amount for a taxpayer who does not appear for an audit.



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**III. Adjustment of the TY 2001 Improper Payments Rate to Account for Estimated Effects of EGTRRA**

Enacted in 2001, EGTRRA contains several provisions related to EITC that became effective for TY 2002. These provisions are believed to influence taxpayer behavior in a number of ways, among them increased claims and improved compliance for EITC claimants.<sup>8</sup> Since the improper payment rate is derived from pre-EGTRRA taxpayer behavior (TY 2001), it must be adjusted to reflect the estimated impact of the EITC-related EGTRRA provisions. Treasury economists conducted an analysis of the EITC-related EGTRRA provisions, concluding that the provisions reduced EITC erroneous claims by about 13% and increased claims by about 5%.<sup>9</sup> To account for these effects, the NRP-based estimate of the improper payment rate for TY 2001 was adjusted by reducing the of the *Amount of EITC Overclaimed* by 13% and increasing the *Amount of EITC Claimed on all Returns* by 5%.

**IV. EITC Improper Payment Estimates for FY 2009**

The improper payments estimates for FY 2009 were developed by multiplying an improper payment rate for the fiscal year by total estimated EITC claims. It is assumed that the EGTRRA-adjusted, NRP-based TY 2001 improper payments rate is applicable for FY 2009 and in each year thereafter. Total EITC claims are from FY 2010 EITC budget estimates from Treasury's Office of Tax Analysis. Multiplying the improper payment rate for the fiscal year by the corresponding claims yields the EITC improper payment amount estimates for FY 2009. The estimate is shown in the table below.

**FY 2009 EITC IPIA Erroneous Payments Estimates  
(\$ billions)**

Fiscal Year	2009	
	Dollars	Rate
Total EITC Payments <sup>1/</sup>	\$48.1	
Total Erroneous Payments		
Upper Bound Estimate	\$13.3	28%
Lower Bound Estimate	\$11.2	23%

1/ The amounts shown are projections of total payments for the EITC, estimated by Treasury's Office of Tax Analysis.

<sup>8</sup> For example, EGTRRA implemented a uniform definition of a "qualifying child" and simplified the rule for determining which taxpayer was eligible to claim the qualifying child in potentially ambiguous cases (the AGI tiebreaker rule). The simpler rules were expected to enhance compliance by reducing the number of claims arising from misinterpretation of the tax law and to increase claims by those who were deterred by its complexity.

<sup>9</sup> The estimates were in 1999 dollars.





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#### **EXISTING IRS ACTIONS TO REDUCE IMPROPER PAYMENTS**

The EITC is a social benefit program administered through the Internal Revenue Code. EITC eligibility is determined through a complex set of determinations regarding income levels, residency and relationships of qualifying children to the taxpayer. Unlike other social benefit programs, EITC is claimed voluntarily through the filing of a tax return, without upfront eligibility determinations through a caseworker. Current administration costs are less than 1% of benefits delivered. This is quite different from other non-tax benefits programs in which administrative costs related to determining eligibility can range as high as 20% of program expenditures.

The IRS continues to explore the root causes of EITC improper payments. The surmised root causes outlined below are based on the most recent detailed compliance study from TY 1999 and updated FY 2008 estimates of improper payments computed using TY 2001 NRP compliance study data, which contained less detail. The tax law changes enacted by the EGTRRA were not in effect for 1999. These law changes will be in effect for the years included in the new three-year rolling NRP compliance study, which started with TY 2006. Information on the first year of the study will be available in 2010, however, information that matches that reviewed in the 1999 study will be available when the cumulative data from the three-year study is available in 2012. At that time, we will know more regarding our current hypothesis on root causes. The following discusses the currently surmised root causes of EITC improper payments.

#### **I. Issues with EITC Statutory Framework**

The root causes for improper payments are a combination of intentional and inadvertent errors by both taxpayers and practitioners and can be grouped as follows:

**Complicated Eligibility Criteria.** The EITC eligibility rules are complicated and cause taxpayers and practitioners to make errors while attempting to interpret and apply the tax laws to the taxpayer's individual situation. These errors include those associated with the difficulty of determining who is a qualifying child – principally with respect to relationship and residency requirements. Errors also include determining filing status, i.e., whether married couples file as single or head of household, and eligibility in nontraditional and complex living situations.

The eligibility criteria for the EITC and their application to specific fact patterns can be especially problematic in light of the population of eligible taxpayers. Low income taxpayers may not have experience in making legal determinations under the tax laws. The complexity of the EITC is likely a factor in the use of paid preparers. Taxpayers often must rely on return preparers to assist them in determining eligibility for the credit.

Other errors in EITC payments relate to improper income reporting, which allows claimants to fall within the EITC income limitations and qualify for the EITC. These



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errors include both underreporting and overreporting of income by both wage earners and taxpayers who report being self-employed.

**Shifting Population of Those Who Are Eligible.** It has been estimated that those eligible for the EITC change by a third each year. This changing population of taxpayers who claim the EITC increases the difficulty the IRS faces in improving EITC compliance.<sup>10</sup> The ever-changing EITC population reduces the effectiveness of the IRS's education, outreach and enforcement efforts.

**Nature of the Credit.** The EITC is a refundable credit which means it has value regardless of tax liability. The IRS has found that refundable credits of significant amounts attract fraud and fraudulent preparers.

### **II. Existing Program to Prevent Improper Payments**

The IRS has made a number of improvements to the EITC program. The IRS strategy with respect to EITC improper payments is to intervene early to ensure compliance with the rules. Thus, the IRS has expanded outreach and education to taxpayers and preparers so that they are aware of the legal requirements for EITC eligibility. Efforts also include improved examination selection processes and data matching using third-party data, reducing taxpayer burden while increasing revenue protected. Most recently the IRS has begun to concentrate more on regulating the preparer community.

IRS's EITC-focused enforcement programs currently protect over \$3.6 billion annually. The following programs contribute to the broader strategy of identifying errors as early in the process as possible:

**Math Error:** This refers to an automated process in which the IRS identifies math or other statistical irregularities and automatically prepares an adjusted return for a taxpayer. These upfront, systemic processing checks protect \$344 million in EITC refund claims annually.

**Document Matching:** This process involves comparing income information provided by the taxpayer with matching information, e.g., Form W-2 and Form 1099, from employers to identify discrepancies. This post-refund process protects \$1.1 billion in EITC refund claims annually. In FY 2009, the IRS conducted 700,000 of these reviews, in addition to 500,000 audits.

**Examinations:** The IRS identifies tax returns and amended returns for examination and holds the EITC portion of the refund until an audit can be conducted. Of the approximate 500,000 audits conducted by the IRS annually, 60% are conducted before the EITC portion of the refund is released. These examinations are selected using an

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<sup>10</sup> Treasury Inspector General for Tax Administration, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* (Reference Number 2009-40-024, dated December 31, 2008).



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effective risk-based audit selection model that results in over a 90% change rate. Examinations protect over \$2.2 billion in EITC refund claims annually.

EITC taxpayers are disproportionately subjected to audit, and they are twice as likely to be audited as other individual taxpayers. For FY 2008, EITC audits were 36% of all individual audits. The IRS recognizes that it cannot fully address EITC noncompliance by simply auditing returns and must pursue alternatives to traditional compliance efforts. Significant expansion of EITC enforcement activities would come at the expense of other tax administration priorities and result in an unbalanced program focusing disproportionately on the working poor.

Other programs include the following:

- *Data Transcription:* The transcription of applicable income-related information and the Schedule EIC, *Earned Income Credit*, during the initial processing of the tax return provides data electronically to support automated income matching and various analysis and risk-based scoring processes.
- *Wage Verification:* The IRS uses complex rules and algorithms to identify potential false wages reported on EITC tax returns. Social Security Numbers on these returns are matched to wage information on the U.S. Department of Health and Human Services National Database of New Hires and other verification data to determine the legitimacy of the income.

**NEW APPROACH--RETURN PREPARER FOCUS FOR REDUCING IMPROPER PAYMENTS**

In January 2010, the IRS announced a plan that will register, license and create enforcement tools that impact the paid return preparer community more broadly. The IRS believes new regulation of tax return preparers will drive increased EITC compliance, decrease fraud and impact the improper payment rate. These activities will be implemented over the next three years. Paid return preparers assist in the preparation of approximately 66% of all EITC claims. Evidence suggests that unscrupulous preparers contribute to overall improper EITC claims.

The new IRS program establishes standards for the tax preparer community in order to enhance protections and services for taxpayers, increase confidence in the tax system and result in greater compliance with the tax laws. As part of the program, the IRS has recommended implementation of a number of activities in the next three years, including:

- Requiring all signing paid preparers to register with the IRS and obtain a unique preparer identification number;
- Applying compliance checks to some preparers;
- Requiring competency tests for all paid return preparers who are not attorneys or Certified Public Accountants in good standing;
- Requiring ongoing continuing professional education for all paid preparers; and





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- Extending the ethical rules in Treasury Department Circular 230 to all paid preparers, which will allow the IRS to suspend or otherwise discipline preparers who engage in unethical or disreputable conduct.

As part of the EITC-focused paid return preparer effort, the IRS developed a risk-based scoring and selection system to identify preparers for several enforcement treatment streams based on a preparer's level of egregiousness, including:

- *Due Diligence Visits:* Field examiners audit EITC preparers to verify they are meeting their due diligence requirements and assess penalties as warranted. The current penalty rate is over 90%.
- *Knock and Talk Visits:* This integrated approach consists of Criminal Investigation (CI) agents and examiners visiting EITC preparers to educate them on EITC laws and due diligence requirements.
- *Streamlined Injunctions:* This pilot utilizes the results of previous IRS compliance actions to enable an efficient injunction process to prevent egregious preparers from filing future returns. For example, in 2009 one preparer filing over 1,000 refund returns was stopped from filing any future returns.
- *Notices:* In this test, the IRS sends notices to segments of preparers, including first-time paid preparers and low and medium risk preparers, to educate them on their due diligence responsibilities and the consequences of noncompliance.
- *Undercover Shopping:* The IRS continues its efforts around EITC paid preparers, including undercover shopping by CI agents and preparer investigations.
- *Expanded Contact Approach:* The IRS sent more than 10,000 letters and made 2,000 visits to paid preparers in FY 2010 to discuss compliance issues.

Full registration and testing of return preparers will be completed within three years, at which point the IRS will begin measuring the impact of the initiative on EITC improper payments.

#### **Next Steps**

The IRS will continue to review root causes of EITC improper payments. As part of this work, the IRS will continue its aggressive enforcement program and will implement a more robust return preparer focus.



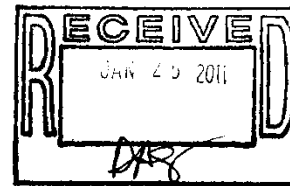
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**Appendix V**

*Management's Response to the Draft Report*



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
ATLANTA, GA 30303



JAN 25 2011

MEMORANDUM FOR MICHAEL R. PHILLIPS

DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

Richard Byrd, Jr.

Commissioner, Wage and Investment Division

SUBJECT:

Draft Audit Report - Reduction Targets and Strategies Have Not  
Been Established to Reduce the Billions of Dollars in Improper  
Earned Income Tax Credit Payments Each Year  
(Audit # 201040044)

We have reviewed your draft report resulting from the Treasury Inspector General for Tax Administration's requirement under Executive Order 13520 to review IRS' reported efforts to identify and reduce improper Earned Income Tax Credit (EITC) payments. Although we agree that the risk associated with improper EITC payments remains significant, we believe the actions we have taken and our evolving strategies reflect our substantial and ongoing commitment to addressing this complex issue. It is also important to understand that the root causes of EITC errors are many and arise from the highly complex nature of the tax law involved, the ever shifting EITC-eligible population, and the refundable nature of the credit, which makes it payable even if a claimant owes no tax. Moreover, any efforts at positive change with regard to error rate must be considered in light of adverse impact on the participation rate and on the need for the IRS to maintain a balanced enforcement and compliance program.

The IRS conducts approximately 500,000 EITC audits annually which represents 36 percent of all individual audits. The IRS is moving beyond traditional compliance methods, which is critically important since EITC taxpayers are already twice as likely to be subject to audit as other individuals.

The IRS is always looking for ways to reduce errors in EITC payments. Our most recent efforts include a focus on tax return preparers who prepare tax returns claiming EITC. The recent IRS effort to register, test, and require continuing education for return preparers will serve to improve EITC tax return quality and further reduce EITC errors. Sixty-six percent of all EITC tax returns, and most EITC tax returns with errors, are prepared by professional, paid tax return preparers. As part of this effort, the IRS is



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also conducting visits to preparers to discuss on-going compliance as well as sending targeted letters to heighten awareness of preparer responsibilities. While difficult to measure precisely, the IRS expects these return preparer initiatives to improve overall EITC accuracy.

The IRS has taken a number of actions over recent years to reduce EITC errors, while increasing the participation rate for eligible taxpayers. First, IRS has been refining and testing strategic options to address EITC errors, taking into account the fact that unlike other programs with upfront eligibility determinations, EITC claimants' qualifications are normally subject to scrutiny only after they file a claim on their annual income tax return.

The IRS created a new EITC Underreporter Program that compares third-party information to the taxpayer's return to identify discrepancies and propose adjustments. This new program has proven to be very effective and during Fiscal Year (FY) 2010, protecting over \$1.4 billion in improper payments.

In 2008 the IRS incorporated an EITC Tax Return Preparer component into its EITC strategy. IRS tested several compliance programs for EITC return preparers based on their level of noncompliance. The outgrowth of these efforts is a new EITC preparer risk-based scoring and selection tool that has significantly increased the effectiveness of audits of professionally-prepared EITC returns.

Finally, the IRS also conducted a 3-year test of an upfront qualifying child certification requirement as an additional way to reduce EITC errors. However, this test showed that there are limitations to a labor intense pre-qualification requirement which make it not a viable option at scale under the IRS' current resource constraints.

With regard to the seven prior recommendations referenced in this report, it is important to understand that the IRS has carefully considered and addressed each of them. As explained in more detail below, we did not agree with three of the recommendations. We also do not agree with the revenue protected shown in Figure 3 of your report.

First, we disagreed with your recommendation to ensure the Information to Claim Earned Income Tax Credit After Disallowance, Form 8862, is correct before we allow the claim because the resources necessary to audit all Forms 8862 would preclude IRS audits of more egregious EITC claims. Thus, your dollars must be reduced by FTE or by lost opportunity on what we consider better cases. Moreover, currently, all Forms 8862 are subject to the same rigorous audit screening and selection process as other EITC returns.

Second, we did not comment on your legislative recommendation since the IRS does not generally comment on legislative proposals.



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Lastly, we disagreed with your recommendation to revise the EITC Return Preparer Due Diligence Visit selection process to rely only on the preparer's probability score and volume of EITC tax returns prepared. Although we use a formula that includes these variables, we must consider other important factors in our selection process that also serve to maximize the effectiveness of the limited resources available to conduct these visits and to provide equitable geographic coverage.

We did agree, or partially agree with the remaining recommendations and will implement the majority by 2013. However, we do not believe that there is sufficient basis to conclude that they will significantly reduce EITC improper payments, or achieve the potential dollars protected over 5 years that are shown in Figure 3 of your report. For example, we agreed with your recommendation to conduct a study to identify alternative processes to adjust claims where the data shows the taxpayer does not meet eligibility requirements. However, to date we have no research that supports the \$5.6 billion in potential dollars you estimate may be protected. It is too early in the study to determine the reliability of the third party data for this purpose, thereby making it impractical to estimate the potential outcome from the study. Beyond current information reporting of income, there is not a definitive database that establishes relationships between the claimant and the qualifying child, nor is there a database that contains living arrangements of these individuals.

The IRS plans to analyze the compliance data from the National Research Program (NRP) when it becomes available to validate what are believed to be the root causes of EITC noncompliance, and to identify other possible areas to pursue. Further, we plan to update our comprehensive EITC Compliance Study during 2012 using the newly available NRP data. As a result, we do not agree that it is appropriate or reasonable to establish or report improper payment reduction targets at this time.

Further, there is nothing in your report to substantiate that IRS underpays a significant number of properly-computed EITC claims during returns processing. Since approximately 70 percent of all returns are filed electronically, there is no opportunity for any such IRS errors on these returns. For the residual 30 percent of returns filed on paper, the refund error rate for FY 2009 was 2 percent, which makes it highly unlikely IRS underpayment errors for EITC would be significant. As a result, we do not agree it is necessary or appropriate for IRS to reconfigure its methodology at this time for computing the EITC improper payment rate to include IRS underpayments.

Our comments on your specific recommendations are attached. If you have any questions, please contact me, or a member of your staff may contact Veriinda Paul, Director, Earned Income Tax Credit, Wage and Investment Division, at (404) 338-9042.

Attachment



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Attachment

**RECOMMENDATION 1**

The Deputy Commissioner for Operations Support should establish quantifiable reduction targets and strategies to meet those targets as required by Executive Order 13520.

**CORRECTIVE ACTION**

The IRS' return preparer initiative is our most promising avenue to substantially reduce erroneous EITC payments. As discussed, 66 percent of all EITC tax returns, and most EITC tax returns with errors are prepared by tax return preparers. We are in the first year of a three year ramp-up of this initiative. After the program is fully established, we will have a baseline against which we can set meaningful reduction targets.

**IMPLEMENTATION DATE**

September 15, 2013

**RESPONSIBLE OFFICIAL**

Director, Earned Income Tax Credit, Wage and Investment Division

**CORRECTIVE ACTION MONITORING PLAN**

We will monitor this corrective action as part of our internal management control.

**RECOMMENDATION 2**

The Deputy Commissioner for Operations and Support should use the NRP sample to estimate instances in which the IRS incorrectly pays less in EITC than the taxpayer claims (underpayments).

**CORRECTIVE ACTION**

We will explore whether this recommendation is possible and practical. Underpayments happen so infrequently in the National Research Program (NRP) sample that IRS may not be able to use NRP audit results to construct a statistically valid estimate of a population total. Furthermore, there is nothing in your report or otherwise to substantiate that IRS underpays a significant number of properly-computed EITC claims. Also, since approximately 70 percent of all returns are filed electronically, there is no opportunity for any such IRS errors on these returns. For the residual 30 percent of returns filed on paper, the refund error rate was 2 percent during Fiscal Year 2009, which makes it highly unlikely IRS underpayment errors for EITC are significant.

**IMPLEMENTATION DATE**

September 15, 2013





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**RESPONSIBLE OFFICIAL**

Director, Earned Income Tax Credit, Wage and Investment Division

**CORRECTIVE ACTION MONITORING PLAN**

We will monitor this corrective action as part of our internal management control.