



*Improvements Are Needed to Ensure the  
Health Coverage Tax Credit Is Properly  
Claimed on Tax Returns*

**September 24, 2009**

**Reference Number: 2009-40-137**

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TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

September 24, 2009

**MEMORANDUM FOR** COMMISSIONER, WAGE AND INVESTMENT DIVISION

**FROM:** *Michael R. Phillips*  
Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – Improvements Are Needed to Ensure the Health Coverage Tax Credit Is Properly Claimed on Tax Returns  
(Audit # 200940011)

This report presents the results of our review of the Internal Revenue Service (IRS) processing of the Health Coverage Tax Credit (HCTC). The overall objective of this review was to assess the effectiveness of the process used by the IRS to determine whether individuals are eligible to receive the HCTC. This audit was conducted as part of our Fiscal Year 2009 Annual Audit Plan under the major management challenge of Providing Quality Taxpayer Service Operations and Taxpayer Protection and Rights.

*Impact on the Taxpayer*

The HCTC is a provision of the Trade Adjustment Assistance Reform Act of 2002.<sup>1</sup> It was created to cover a substantial portion of the cost of health care for workers who lost their jobs due to foreign trade and who receive benefits through the Trade Adjustment Assistance or Alternative Trade Adjustment Assistance programs as well as eligible recipients of pensions that are being paid by the Pension Benefit Guaranty Corporation. In Tax Year 2007, there were approximately 26,800 participants. The IRS has implemented a number of processes in an attempt to ensure eligible individuals accurately claim the HCTC. However, improvements are needed to ensure individuals claiming the HCTC on their annual tax return accurately compute the credit. The IRS needs to implement a process to identify inaccurate HCTC claims at the time a tax return is filed to prevent erroneous refunds from being issued.

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<sup>1</sup> Pub. L. No. 107-210, 116 Stat. 933.



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### Synopsis

The IRS administers the HCTC in partnership with other Federal agencies, States, and the private health care industry. State workforce agencies, through the Department of Labor, and the Pension Benefit Guaranty Corporation are responsible for identifying potentially eligible individuals. The IRS is responsible for ensuring that potentially eligible individuals meet program requirements<sup>2</sup> and ensuring the accuracy of the credit being claimed.

The IRS has implemented a number of processes in an attempt to ensure eligible individuals accurately claim the HCTC. In addition, we determined that the advance monthly process ensures individuals met requirements prior to participation and that the credit is being accurately calculated. This is significant because the majority of individuals claiming the HCTC and the majority of the funds paid (\$80 million of the \$100 million) for Tax Year 2007 were paid as an advance monthly credit.

However, improvements are needed to ensure individuals claiming the HCTC on their annual tax returns accurately compute the credit. Claiming the HCTC via the filing of a tax return presents the highest risk for errors because the credit is being determined by the taxpayer as opposed to the IRS, which computes the amount for claimants participating in the advance monthly payment option. Our statistically valid sample of 82 tax returns for individuals who claimed the HCTC on their 2006 tax return identified that 59 (72 percent) did not have the required documentation attached.

Further, processes are not effective to identify and prevent individuals from erroneously claiming the HCTC on their tax returns. Our review identified 1,260 individuals who appear to have

***Our review identified 1,260 individuals who appear to have erroneously claimed \$1.8 million in HCTCs.***

erroneously claimed on their annual Tax Year 2007 tax returns about \$1.8 million in HCTC advance monthly payments. These individuals erroneously claimed on their tax returns the amount of advance monthly payments the IRS paid on their behalf. However, the IRS has developed successful post-processing criteria and has the data to identify erroneous HCTC claims at the time a tax return is filed. The IRS needs to move identification from post

examination to upfront processing to prevent erroneous HCTC claims at the time a tax return is filed. The IRS identifying erroneous HCTC claims could result in funds put to better use of more than \$9 million over 5 years. Developing such a process will improve the effectiveness of the HCTC Program as it continues to expand.

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<sup>2</sup> The IRS must verify the potentially eligible individual is a recipient of benefits from the Trade Adjustment Assistance program, the Alternative Trade Adjustment Assistance program, or the Pension Benefit Guaranty Corporation; cannot receive Medicare (is not age 65 or older); is not in prison; cannot be claimed as a dependent on someone's return; and has a qualified health plan.



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### Recommendations

We recommended that the Commissioner, Wage and Investment Division, develop a process to ensure that taxpayers who claim the HCTC on electronically filed (*e-filed*) tax returns and paper-filed tax returns are providing the required documentation in support of their HCTC claim and, if not, the credit should be disallowed as indicated on the Health Coverage Tax Credit (Form 8885). In addition, a process should be developed to identify erroneous HCTC claims based on the criteria used to select taxpayers for examination and reject *e-filed* tax returns or forward paper-filed tax returns to the Error Resolution function at the time the tax return is filed.

### Response

IRS management agreed with two of our recommendations and agreed with the premise of our third recommendation. The IRS has an *e-file* project underway to improve the HCTC process in the future and will reject tax returns if the U.S. Individual Income Tax Transmittal for an IRS *e-file* Return (Form 8453) is not attached. Until then, the IRS will continue requesting that taxpayers file a Form 8453 with the required documentation attached. Also, the IRS will provide reminders to employees in the Error Resolution function regarding the necessity of taxpayers attaching documentation to a return claiming the HCTC and, if the documentation is not attached, the IRS will disallow the credit. In addition, the IRS agreed with the premise of our third recommendation but proposed an alternative corrective action. Specifically, the IRS will identify potentially erroneous claims during processing, program additional error codes, inform taxpayers of their appeal rights, and request that taxpayers provide documentation to prove their claims. We agree that the IRS' proposed alternative corrective action will satisfy the intent of our recommendation.

While IRS management acknowledges that the test used to develop our outcome measure is sound for the purposes of identifying potentially erroneous claims, management does not agree that the methodology can be translated to an estimated erroneous claim amounts over the next 5 years as presented in Appendix IV. We believe that our outcome is valid because we applied the IRS' post-processing criteria to identify erroneous claims and their examinations resulted in changes to the amount of the HCTC claimed in 98.5 percent of the cases examined. Management's complete response to the draft report is included as Appendix VI.

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*

<i>e-file(d); e-filing</i>	Electronically file(d); electronic filing
HCTC	Health Coverage Tax Credit
IRS	Internal Revenue Service
PBGC	Pension Benefit Guaranty Corporation



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## *Background*

The Health Coverage Tax Credit (HCTC) was signed into law on August 6, 2002, as a component of the Trade Adjustment Assistance Reform Act of 2002.<sup>1</sup> The intent of the HCTC is to make health coverage more affordable for certain groups of people who otherwise might not be insured.

The HCTC is a refundable tax credit<sup>2</sup> that now pays 80 percent of the qualified health insurance premiums for eligible individuals and their qualified family members. The amount increased from 65 percent to 80 percent under the American Recovery and Reinvestment Act of 2009.<sup>3</sup> The HCTC was created to assist certain workers who lost their jobs due to foreign trade and who receive benefits through the Trade Adjustment Assistance or Alternative Trade Adjustment Assistance programs as well as eligible recipients of pensions that are being paid by the Pension Benefit Guaranty Corporation (PBGC).<sup>4</sup>

***The HCTC is designed to make health coverage more affordable for certain groups of people who otherwise might not be insured.***

The Internal Revenue Service (IRS) administers the HCTC in partnership with other Federal agencies, States, and the private health care industry. State workforce agencies, through the Department of Labor, and the PBGC are responsible for identifying potentially eligible individuals. These agencies transmit records of potentially eligible individuals to the IRS. States provide daily transmissions and the PBGC provides monthly transmissions. The IRS created the HCTC Program Office to oversee the administration of the HCTC. The IRS is responsible for ensuring that potentially eligible individuals meet program requirements<sup>5</sup> and ensuring the accuracy of the credit being claimed.

The HCTC is unique because it is the first time a Federal tax credit is being used to help people who are affected by foreign trade or whose pension plans were taken over by the PBGC afford health insurance coverage. The HCTC can be obtained in the following ways:

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<sup>1</sup> Pub. L. No. 107-210, 116 Stat. 933.

<sup>2</sup> Refundable tax credit means the taxpayer can receive a refund even if they did not owe any taxes or earn any income.

<sup>3</sup> Pub. L. No. 111-5, 123 Stat. 115.

<sup>4</sup> When an employer cannot continue paying pensions to its retirees, the PBGC may be requested to take over the responsibility of paying pension benefits to its retirees.

<sup>5</sup> The IRS must verify the potentially eligible individual is a recipient of benefits from the Trade Adjustment Assistance program, the Alternative Trade Adjustment Assistance program, or the PBGC; cannot receive Medicare (is not age 65 or older); is not in prison; cannot be claimed as a dependent on someone's return; and has a qualified health plan.



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- **Annually** - Individuals can claim the credit on their annual Federal tax return by preparing and including a Health Coverage Tax Credit (Form 8885).<sup>6</sup> For Tax Year<sup>7</sup> 2008, the amount an eligible individual can claim is 65 percent of the total amount of premiums they paid directly to their health plan.
- **Advance Monthly** - Individuals can submit an application to the IRS requesting enrollment in the advance monthly credit option. The IRS ensures the individual meets program requirements including being under age 65 and enrolled in a qualified health plan. Up until May 1, 2009, this option assisted individuals by paying 65 percent of their monthly premiums. On a monthly basis, the individual was responsible for paying the remaining 35 percent of the premium to the IRS; the IRS paid the remaining 65 percent and electronically transmitted the full premium payment directly to the health plan administrator. Individuals participating in this option should not claim the HCTC on their tax returns as they are receiving the credit as an advance payment. Taxpayers receive a Health Coverage Tax Credit (HCTC) Advance Payments (Form 1099-H) that details the total amount of the HCTC the IRS paid during the year.
- **Combination** - Some individuals claim the credit using a combination of claiming the credit on their annually filed tax return and also receiving the advance monthly credit. For example, individuals would claim 65 percent of the amount they paid in premiums on their annual tax return for the months they had to pay the premium directly to the health plan provider while waiting to become registered in the advance monthly HCTC.

Figure 1 shows the number of individuals and the reimbursement options used during Tax Years 2004 through 2007.

**Figure 1: Number of HCTC Participants by Type**

Tax Year	Participants		
	Advance Monthly	Annually	Combination
2004	12,235	8,180	6,700
2005	14,971	5,776	7,069
2006	16,302	5,090	6,077
2007	15,761	4,958	6,116

*Source: IRS HCTC Program Office and IRS Individual Master File.<sup>8</sup>*

<sup>6</sup> See Appendix V for an example of Form 8885.

<sup>7</sup> The year in which tax returns and other tax data are processed.

<sup>8</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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It should be noted that the percentage of eligible individuals that actually participate in the HCTC Program is extremely low. For example, in Tax Year 2007, of the 355,952 individuals that the States and the PBGC identified as potentially eligible, only 26,835 (8 percent) participated (received the HCTC credit). Figure 2 shows the number of potentially eligible individuals versus actual participants for Tax Years 2005 through 2007.

**Figure 2: Potentially Eligible Versus Actual Participants**

Tax Year	Potentially Eligible	Participating	Percentage Participating
2005	348,545	27,816	8%
2006	362,488	27,469	8%
2007	355,952	26,835	8%

Source: IRS Individual Master File.

The American Recovery and Reinvestment Act of 2009 includes a provision requiring the Secretary of the Treasury to conduct a biennial survey of non-HCTC participants. The survey will gather demographic information, inquire as to whether the individual is aware of the HCTC, determine the reason an individual has not enrolled in the program, and inquire as to whether the individual has other coverage. We plan to include a review of the performance of the survey and reporting of results in our Fiscal Year 2010 Annual Audit Plan.

**A prior Treasury Inspector General for Tax Administration review recommended improvements to ensure accurate processing of the HCTC**

A prior Treasury Inspector General for Tax Administration review of the HCTC Program identified processing improvements that were needed.<sup>9</sup> We recommended that the IRS add a line specifically for the HCTC on the U.S. Individual Income Tax Return (Form 1040) and transcribe information from the paper-filed Form 8885 so that the credit could be identified during initial return processing, allowing systemic computer checks to be performed to reduce the potential for manual input errors or erroneous HCTC claims. Additional recommendations included implementing prerefund systemic validity and compliance checks which would prevent erroneous credits from being issued. IRS management agreed to implement pre and post-refund validity and compliance checks for Tax Years 2004 and 2005. These validity and compliance checks included:

- Prerefund check - a code will be placed on accounts claiming the HCTC more than a certain dollar amount requiring an IRS employee to review the claim before allowing the credit.

<sup>9</sup> *The Health Coverage Tax Credit Was Accurately Processed During the 2004 Filing Season* (Reference Number 2005-40-017, dated December 10, 2004).



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- Post-refund check - taxpayers claiming more than a certain dollar amount will automatically be routed for examination.

This review was performed at the HCTC Project Office in Washington, D.C., and at the HCTC Customer Contact Center in Waterloo, Iowa, during the period November 2008 through June 2009. 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 IRS has implemented a number of processes in an attempt to ensure eligible individuals accurately claim the HCTC. These processes ensure:

- Eligibility records (based on reporting from State workforce agencies or the PBGC) that are identified as invalid are transmitted back to the reporting agency to resolve the error condition. This can happen when records contain data fields with incomplete data or data that are not compatible with the HCTC system.
- Individuals who received the HCTC had an eligibility indicator from the States or the PBGC on their IRS accounts.
- Individuals identified as potentially eligible are sent a *Health Coverage Tax Credit Program Kit* and *Monthly HCTC Registration Form*. This package outlines the requirements to be met to claim the HCTC as well as the necessary documentation to be provided to qualify for participation in the advance monthly HCTC.
- Individuals claiming the HCTC on their tax returns without attaching a Form 8885 will have their electronically filed (*e-filed*) tax returns rejected or paper-filed tax returns sent to the Error Resolution function for correspondence with the taxpayer.
- Individuals claiming the HCTC who are age 65 or older<sup>10</sup> will have their *e-filed* tax returns or paper-filed tax returns sent to the Error Resolution function where the claim is disallowed.

***Processes have been implemented in an attempt to ensure eligible individuals are accurately claiming the HCTC.***

In addition, we determined that the advance monthly process ensures individuals met requirements prior to participation and that the credit is being accurately calculated. This is significant because the majority of individuals claiming the HCTC and the majority of the funds paid out (\$80 million of the \$100 million) for Tax Year 2007 were paid out as an advanced monthly credit. However, improvements are needed to ensure individuals claiming the HCTC on their annual tax returns accurately compute the credit being claimed.

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<sup>10</sup> Individuals are eligible for Medicare at age 65, making them ineligible for the HCTC.



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## **The Internal Revenue Service's Process Ensures Individuals Participating in the Advance Monthly Health Coverage Tax Credit Program Meet Eligibility Requirements**

The IRS has established an effective process to ensure individuals participating in the advance monthly HCTC meet eligibility requirements. We reviewed a judgmental sample of 50 completed applications for the advance monthly HCTC and determined that the required documentation supporting the eligibility requirements was provided for each of the cases. In addition, we reviewed a judgmental sample of 24 completed registration packages in which individuals were denied participation in the monthly HCTC. Our review confirmed that HCTC customer service representatives correctly denied participation to these individuals. Denials resulted from the individuals not having a qualified health plan, not providing required information, and/or not completing the registration form. The HCTC customer service representatives work extensively with individuals to get them registered for the monthly HCTC. Although some of these individuals may not qualify for the advance monthly credit, they could still claim the credit on their Forms 1040.

An individual who wants to participate in the advance monthly payment option is required to complete and return the *Monthly HCTC Registration Form*. An HCTC customer service representative ensures required documentation is provided supporting the individual's eligibility. Specifically, representatives verify that an individual:

The Health Coverage Tax Credit (HCTC)

### Monthly HCTC Registration Form

We recommend you read the Program Kit first to understand the eligibility requirements for the HCTC, find out if you have a qualified health plan, and learn how the monthly HCTC program works.

To register for the monthly HCTC, you'll need to complete the following:

<b>Part I</b>	Give us general information ..... 2 In Part I, you'll tell us general information about yourself.
<b>Part II</b>	Determine your eligibility ..... 2 You'll need to confirm that you are eligible for the HCTC and tell us if your family members are also eligible.
<b>Part III</b>	Provide health plan information ..... 6 To receive the monthly HCTC, you must provide specific information about the health plan coverage for you and your eligible family members.
<b>Part IV</b>	Gather supporting documents to send us ..... 8 In this section, you'll find a list of what to send along with this Registration Form.
<b>Part V</b>	Access your account ..... 9 When you receive the monthly HCTC, you can choose someone to talk to the HCTC Program on your behalf. Tell us if you want to designate someone in Part V.
<b>Part VI</b>	Sign and date this form ..... 10 You must sign and date the form before sending it to us. You'll also find tips on what else to do before mailing your Registration Form.

For Privacy Act and Paperwork Reduction Act Notice, see the back cover. OMB No. 1545-1842

- Is not eligible to receive Medicare benefits (generally cannot be age 65 or older).
- Is not in prison.
- Cannot be claimed as a dependent on someone else's Federal tax return.
- Has a qualified health plan.
- Provided copies of health insurance documents showing policy data, premium amounts, and health plan provider identification.

If additional information is needed, the representative will correspond or contact the individual to explain what is needed. Once the individual is registered, the HCTC Program will issue the individual an invoice each month for 35 percent of



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the monthly premium to be paid to the IRS. Once the taxpayer portion of the payment is received by the IRS, the IRS will include the remaining 65 percent and electronically transmit the full premium payment directly to the health plan administrator. Figure 3 shows the total amounts paid for the monthly and annual programs.

**Figure 3: HCTC Credits Paid by Reimbursement Option  
(in millions)**

Tax Year	Monthly Payments		Annual Filing
	Taxpayer	IRS	
2004	\$31.2 M	\$57.5 M	\$25.3
2005	\$40.3 M	\$70.2 M	\$19.8
2006	\$45.4 M	\$79.0 M	\$20.8
2007	\$46.0 M	\$80.3 M	\$20.7

Source: HCTC Program Office and IRS Individual Master File.

## **Improvements Are Needed to Ensure Individuals Accurately Claim the Health Coverage Tax Credit on Their Tax Returns**

Taxpayers who claim the HCTC on their tax returns present the highest risk for errors. This is because the credit is being determined by the taxpayer as opposed to the IRS, which computes the amount for claimants participating in the advance monthly payment option.

### **Taxpayers often did not attach the required documentation to their tax returns**

Our statistically valid sample of 82 tax returns for individuals who claimed the HCTC on their 2006 tax returns identified that 59 (72 percent) did not have the required documentation attached. We project that 8,040<sup>11</sup> (72 percent) of the 11,167 tax returns with claims totaling \$14.9 million did not have the required documentation attached to the tax return. Below is the breakdown of the 59 returns that either had no documentation or were missing documentation:

***Our review of 82 tax returns identified that 59 (72 percent) did not have required documentation attached to the tax return.***

- 37 **did not have any** of the required documentation attached to the tax return.
- 13 did not have the required proof of payment attached to the tax return.
- 9 did not have required health insurance documentation attached to the tax return.

<sup>11</sup> This is 72 percent of the 11,167 participants who filed an annual return in Tax Year 2006.



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Instructions for the Form 8885 state that individuals claiming the credit on their annual tax return are required to complete the Form 8885 and attach the following documentation:

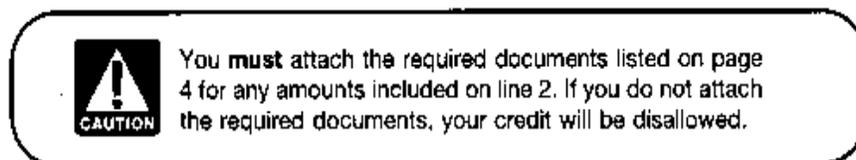
- Health insurance bills supporting the amount billed for the months being claimed.
- Proof of payment (cancelled checks, bank or credit card statements) supporting the amounts paid by the taxpayer during the year.

In some instances, the IRS requires taxpayers to provide documentation in support of items listed on their tax returns. Individuals who file a paper tax return attach the documentation to their tax return. However, individuals who *e-file* are required to attach the documentation to a U.S. Individual Income Tax Transmittal for an IRS *e-file* Return (Form 8453) or U.S. Individual Income Tax Declaration for an IRS *e-file Online Return* (Form 8453-OL). A contributing factor to taxpayers not including required documentation is that the IRS incorrectly allowed taxpayers who claimed the HCTC to electronically sign *e-filed* tax returns. *E-file* procedures state that if taxpayers are required to attach documents to their tax returns, such as the requirement for claiming the HCTC, they are not eligible to electronically sign their tax return with a self-selected Personal Identification Number. However, our review identified that, of the 5,605 Tax Year 2007 *e-filed* tax returns with a claim for the HCTC, 4,196 (75 percent) were incorrectly allowed to electronically sign their tax return.

In Processing Year 2009, the IRS mandated that for all *e-filed* tax returns, the taxpayers must electronically sign their *e-filed* tax returns. This mandate includes those individuals required to attach documents to their tax return. Individuals such as HCTC claimants will be required to continue to attach documentation in support of the HCTC claim to Forms 8453.

Although the IRS requires supporting documentation or it will disallow the credit, its guidelines do not specify how the IRS should use this information to validate the accuracy of the HCTC claims. In addition, despite the IRS' assertion that the credit will be disallowed, a majority of taxpayers in our sample received the HCTC without having to provide the required information. Figure 4 shows the caution statement included on the Form 8885.

**Figure 4: Caution Statement on the Form 8885**



Source: Form 8885.



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**Processes do not effectively prevent erroneous duplicate HCTC claims from individuals who receive advance monthly payments**

The IRS has developed post-processing criteria to identify erroneous duplicate HCTC claims. Using the IRS' post-processing criteria, we identified 1,260 taxpayers that may have erroneously claimed the HCTC totaling about \$1.8 million on their 2007 tax returns. Erroneous claims resulted from taxpayers incorrectly claiming on their tax returns the amount of advance monthly payments the IRS paid. The IRS uses three scenarios to identify taxpayers erroneously claiming the HCTC. For these three scenarios, the taxpayers incorrectly claim a percent of the amount of premiums paid by the IRS through the advance monthly option. Taxpayers participating in the advance monthly option should not claim the HCTC on their tax returns because they are receiving the credit as an advance payment.

***Our review identified 1,260 individuals who appear to have erroneously claimed approximately \$1.8 million in HCTC in Tax Year 2007.***

The IRS developed scenarios used to select tax returns for examination. However, limited resources resulted in the examination of only 500 tax returns selected according to the criteria.

***Although the IRS' criteria for selecting tax returns with a HCTC claim for examination resulted in a change to the HCTC in 98.5 percent of the cases, the IRS has not continued identification and examination of these tax returns.***

Examinations resulted in changes to the amount of the HCTC claimed in 98.5 percent of the cases examined. Unfortunately, the IRS has not continued to identify and examine taxpayers erroneously claiming the HCTC. The IRS indicated that it is very time consuming for the Examination function to perform these reviews.

The HCTC Project Office also completed a Compliance Review in September 2008, which showed the demographic information on HCTC cases examined for possible erroneous payments for 2006 and 2007. This review identified compliance problems dealing with insufficient documentation and taxpayers receiving duplicate claims.

Figure 5 shows the number of taxpayers and the potential amounts of HCTCs erroneously claimed on their annual tax returns that were previously paid to the health plan providers by the IRS through the advance monthly program.



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**Figure 5: Potential Erroneous HCTC Claims for Tax Year 2007**

Scenario	Number of Taxpayers	Amount of the HCTC
<b>1</b>	80	\$ 87,516
<b>2</b>	700	\$1,051,284
<b>3</b>	480	\$ 664,812
<b>Total</b>	1,260	\$1,803,612

Source: IRS Return Processing Individual Master File.

For the cases identified in Figure 5, the taxpayers received the HCTC through participation in the advance monthly method; however, they erroneously claimed the credit again for the same months when filing their annual tax return. Taxpayers can claim only those payments made to their health plan provider for the months that they did not receive any payments from the IRS.

The IRS has the data to identify erroneous HCTC claims at the time a tax return is filed. For example, at the end of each tax year, the IRS prepares and sends a Health Coverage Tax Credit Advance Payments (Form 1099-H) (see Figure 6) to each individual that participated in the monthly HCTC Program. This form notifies program participants of the total amount that the IRS has paid to the health plan provider on their behalf. The IRS can use the information from the Form 1099-H to identify individuals who may be erroneously claiming the credit when filing their annual tax returns for the same months in which they participated in the monthly HCTC Program. This could result in funds put to better use totaling a potential \$9 million over 5 years. Developing such a process will improve the effectiveness of the Program as it continues to expand.

**Figure 6: Health Coverage Tax Credit (HCTC) Advance Payments (Form 1099-H)**

7171 <input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED		OMB No. 1545-1813	
ISSUER'S/PROVIDER'S name, street address, city, state, ZIP code, and telephone no.		1 Amount of HCTC advance payments	2008
		2 No. of mos. HCTC advance payments received	Form 1099-H
ISSUER'S/PROVIDER'S federal identification no.	RECIPIENT'S identification number	3 Jan.	9 July
		4 Feb.	10 Aug.
RECIPIENT'S name		5 Mar.	11 Sept.
Street address (including apt. no.)		6 Apr.	12 Oct.
City, state, and ZIP code		7 May	13 Nov.
		8 June	14 Dec.
Form 1099-H    Cat. No. 34912D    Department of the Treasury - Internal Revenue Service			
Do Not Cut or Separate Forms on This Page		Do Not Cut or Separate Forms on This Page	

**Copy A**  
For Internal Revenue Service Center File with Form 1096. For Privacy Act and Paperwork Reduction Act Notice, see the 2008 General Instructions for Forms 1099, 1098, 5498, and W-2G.

Source: IRS Forms and Publications.

In February 2009, the President signed into law the American Recovery and Reinvestment Act of 2009 which made several amendments to the HCTC. These amendments will further expand the



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number of individuals potentially eligible for the credit, extend the length of time some participants remain eligible for the credit, and increase the amount the IRS pays for the credit. Some of these amendments include:

- Increasing the percentage the IRS will pay from 65 percent to 80 percent.
- Providing payments for monthly premiums paid prior to the commencement of the advance payments.
- Expanding the eligibility to Trade Adjustment Assistance recipients not enrolled in training programs.
- Continuing the eligibility for family members after certain events, such as Medicare eligibility, or death of or divorce from the HCTC participant.

### ***Recommendations***

The Commissioner, Wage and Investment Division, should:

**Recommendation 1:** Develop a process to ensure taxpayers who claim the HCTC on *e-filed* tax returns are providing the required documentation in support of their HCTC claim and, if not, the credit should be disallowed as indicated on the Form 8885.

**Management's Response:** IRS management agreed with our recommendation. The IRS will continue requesting that taxpayers file a Form 8453 with the required documentation attached. The IRS has an *e-file* project underway to improve this process in the future. Modernized e-file will allow taxpayers or tax preparers to attach the Form 8885 and other required documentation to their *e-filed* tax returns beginning with Filing Season 2013 and will reject the return if the form is not attached.

**Recommendation 2:** Ensure taxpayers claiming the HCTC on paper-filed tax returns attach required documentation and, if not, the IRS should disallow the credit as indicated on the Form 8885.

**Management's Response:** IRS management agreed with our recommendation. The IRS will provide reminders to employees in the Error Resolution function regarding the necessity of attaching documentation to a return claiming the HCTC. If the documentation is not attached, the IRS will disallow the credit. The IRS will also continue allowing taxpayers the ability to provide the correct documentation to support their claim. If the taxpayers fail to do so in response to a request for documentation, the IRS will disallow the credit.

**Recommendation 3:** Develop processes to identify erroneous HCTC claims based on criteria used to select taxpayers for examination and reject *e-filed* tax returns or forward paper-filed tax returns to the Error Resolution function at the time the tax return is filed.



*Improvements Are Needed to Ensure the Health Coverage Tax Credit Is Properly Claimed on Tax Returns*

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**Management's Response:** IRS management agreed with the premise of this recommendation. The IRS will identify potentially erroneous claims during processing and allow taxpayers an opportunity to provide the required documentation to prove their claim. The IRS will program additional error codes and the thresholds reflective of the tests outlined in this report, inform taxpayers of their appeal rights, and request that taxpayers provide documentation to prove their claims. In addition, while IRS management acknowledges that the test used to develop our outcome measure is sound for the purposes of identifying potentially erroneous claims, management does not agree that the methodology can be translated to an estimated erroneous claim amounts over the next 5 years as presented in Appendix IV.

**Office Audit Comment:** We agree that the IRS' proposed alternative corrective action to identify erroneous claims will satisfy the intent of our recommendation. We also believe that our outcome is valid because we applied the IRS' post-processing criteria to identify erroneous claims and their examinations resulted in changes to the amount of the HCTC claimed in 98.5 percent of the cases examined.



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*Improvements Are Needed to Ensure the Health Coverage Tax Credit Is Properly Claimed on Tax Returns*

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## **Appendix I**

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

Our overall objective was to assess the effectiveness of the process used by the IRS to determine whether individuals are eligible to receive the HCTC. To accomplish our objective, we:

- I. Evaluated actions taken in response to a prior Treasury Inspector General for Tax Administration review.<sup>1</sup>
  - A. Determined whether the IRS pursued adding a line on the U.S. Individual Income Tax Return (Form 1040) for the HCTC.
  - B. Determined whether the IRS implemented systemic validity and compliance checks to verify that taxpayers claimed the correct credit amount on their Health Coverage Tax Credit (Form 8885).
  - C. Evaluated whether IRS procedures have been updated to include instructions to properly process cases after the credit claimed on the Form 1040/Form 8885 is disallowed.
- II. Assessed the effectiveness of the IRS process to resolve rejects resulting from transmission of files from the States and the PBGC containing potentially eligible individuals.
  - A. Identified the system used to transmit the eligibility data and obtained systems availability records to identify how often the system is unavailable, and if there is a backup plan for transmitting data when the system is unavailable.
  - B. Reviewed reject reports to identify the approximate number of reject occurrences to determine the volume of individuals potentially affected.
  - C. Determined whether procedures were established for correcting records rejected during the transmission of potentially eligible individuals and identified the types of errors that cause reject conditions.
- III. Assessed the filtering process used by the HCTC Program to ensure it accurately identified eligible individuals contained in the files sent from the States and the PBGC.
  - A. Identified the criteria used by the HCTC Program to automatically eliminate certain records from the transmission of potentially eligible individuals.

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<sup>1</sup> *The Health Coverage Tax Credit Was Accurately Processed During the 2004 Filing Season* (Reference Number 2005-40-017, dated December 10, 2004).



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- B. Analyzed the file of individuals eliminated during the filtering process to verify the reasons they were eliminated and determined whether the removal was supported.
  - C. Determined whether the HCTC Program notified the individuals eliminated by the filtering process that they were not eligible for the HCTC.
- IV. Assessed the effectiveness of the process to ensure individuals are identified and notified of their eligibility.
- A. Evaluated the process for adding the eligibility indicator to the individuals' accounts on the HCTC system.
  - B. Identified how the HCTC Fulfillment Center is notified to mail the HCTC Program Kits, what information is provided, and how the system is updated to show a Kit was sent.
  - C. Determined the impact if individuals do not receive the HCTC Program Kit and identify other methods that can be used to notify individuals of their eligibility.
  - D. Evaluated the potential reasons more individuals are not participating in the HCTC Program.
- V. Evaluated the procedures used by the HCTC Program to perform the End of Month Eligibility Reviews and determined whether the HCTC system is properly updated to reflect the correct eligibility.
- VI. Assessed the process used to verify individuals registering for the Advance Monthly Credit method met all of the required eligibility criteria (age, cannot be claimed as someone's dependent, is not imprisoned, and has a qualified health plan).
- A. Selected a judgmental sample of 50 completed applications declared "eligible" by the HCTC Program and evaluated the registration form and attached documentation to verify that the proper decision was made by the HCTC Program. These cases were selected from an IRS Individual Master File extract of 28,801 taxpayers that claimed the HCTC for Tax Year 2006. We used a judgmental sample to verify that the proper decision was made based on the attached documentation.
  - B. Selected a judgmental sample of 24 completed applications declared "not eligible" for the HCTC and evaluated the registration and attached documentation to verify that the proper decision was made by the HCTC Program. These cases were selected from a population of 2,884 applications declared "not eligible" for HCTC in Fiscal Year 2008. We used a judgmental sample to verify that the proper decision was made based on the information contained in the case files.
  - C. Evaluated the procedures for denying eligibility for the HCTC and whether these individuals can appeal the decision.



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*Improvements Are Needed to Ensure the Health Coverage Tax Credit Is Properly Claimed on Tax Returns*

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- VII. Assessed the effectiveness of IRS processes to ensure individuals claiming the HCTC on their annual Federal tax return met required eligibility criteria.
- A. Identified procedures to ensure the individuals claiming the HCTC when filing either a paper tax return or electronic tax return are eligible.
  - B. Selected a statistically valid sample of 200 HCTC accounts that included 82 annual filers (electronic and paper) from an IRS Individual Master File extract of 28,801 taxpayers that claimed the HCTC for Tax Year 2006. We validated the extract by comparing the sampled records to the taxpayer's tax returns. We determined whether the individuals attached the required Form 8885, provided proof of a qualified health plan, provided proof of payments made, met age requirements, cannot be claimed as someone's dependent, and were not imprisoned. We used a statistical sample because we wanted to project the number of cases with errors. We used attribute sampling to calculate the minimum sample size (n),<sup>2</sup> which we rounded to 200:  
$$n = (Z^2 p(1-p))/(A^2)$$

Z = Confidence Level:	95 percent (expressed as 1.96 standard deviation)
p = Expected Rate of Occurrence:	2 percent
A = Precision Rate:	±2 percent
- VIII. Assessed the effectiveness of updating the Master File<sup>3</sup> with the eligibility indicators and evaluated the process of inputting the eligibility indicator and determined whether the Master File accurately reflected the correct status.

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<sup>2</sup> The formula  $n = (Z^2 p(1-p))/(A^2)$  is from *Sawyer's Internal Auditing - The Practice of Modern Internal Auditing*, 4th Edition, pp. 462-464.

<sup>3</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



*Improvements Are Needed to Ensure the Health Coverage Tax  
Credit Is Properly Claimed on Tax Returns*

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**Appendix II**

*Major Contributors to This Report*

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)  
Russell P. Martin, Director  
Edward Gorman, Audit Manager  
Denise M. Gladson, Senior Auditor  
Sharla Robinson, Senior Auditor  
Stephen Elix, Auditor  
Jonathan Lloyd, Auditor  
Marcus D. Sloan, Auditor  
Martha Stewart, Information Technology Specialist



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*Improvements Are Needed to Ensure the Health Coverage Tax  
Credit Is Properly Claimed on Tax Returns*

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**Appendix III**

*Report Distribution List*

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Services and Enforcement SE:W  
Deputy Commissioner, Wage and Investment Division SE:W  
Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division  
SE:W:ETARC  
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP  
Program Manager, Health Coverage Tax Credit, Wage and Investment Division SE:W:HCTC  
Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PRA:PEI  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Office of Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis RAS:O  
Office of Internal Control OS:CFO:CPIC:IC  
Audit Liaison: Chief, Program Evaluation and Improvement, Wage and Investment Division  
SE:W:S:PRA:PEI



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*Improvements Are Needed to Ensure the Health Coverage Tax Credit Is Properly Claimed on Tax Returns*

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## **Appendix IV**

### *Outcome Measure*

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

#### **Type and Value of Outcome Measure:**

- Funds Put to Better Use – Potential; \$9 million associated with 6,300 taxpayers who may erroneously claim the HCTC over the next 5 years (see page 7).

#### **Methodology Used to Measure the Reported Benefit:**

To determine the number of taxpayers incorrectly receiving the HCTC twice in a tax year, we obtained an IRS Individual Master File<sup>1</sup> extract for Tax Year 2007 containing all HCTC participants. We eliminated nonrelevant accounts in order to analyze only cases where the taxpayer participated in both the monthly and annual HCTC Programs. Because individuals suspected of claiming the credit twice follow three distinct patterns, we used three separate math tests (originally developed by the HCTC Program Office) to obtain the population of individuals incorrectly claiming the credit twice. The three math tests identify amounts claimed on the Health Coverage Tax Credit (Form 8885) that equal a percent of IRS payments made during the advance monthly HCTC.

These math tests resulted in 1,260 cases containing approximately \$1.8 million in potentially erroneous refunds and credits issued by the IRS in Tax Year 2007. Based on these results, we estimate that over the next 5 years, 6,300 HCTC participants (1,260 x 5 years) will receive more than \$9 million (\$1.8 million x 5 years) from the IRS as a result of erroneous HCTC claims.

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<sup>1</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



*Improvements Are Needed to Ensure the Health Coverage Tax Credit Is Properly Claimed on Tax Returns*

**Appendix V**

*Health Coverage Tax Credit (Form 8885)*

<p>Form <b>8885</b></p> <p>Department of the Treasury Internal Revenue Service</p> <p>Name of recipient (if both spouses are recipients, complete a separate form for each spouse)</p>	<p><b>Health Coverage Tax Credit</b></p> <p>► Attach to Form 1040, Form 1040NR, Form 1040-SS, or Form 1040-PR.</p>	<p>OMB No. 1545-0074</p> <p><b>2007</b></p> <p>Attachment Sequence No. <b>134</b></p> <p>Recipient's social security number</p>
<p><b>Before you begin:</b> See Definitions and Special Rules that begin on page 2.</p>		
<p> <b>Do not</b> complete this form if you can be claimed as a dependent on someone else's 2007 tax return.</p>		
<p><b>Part I Complete This Part To See if You Are Eligible To Take This Credit</b></p>		
<p>1 Check the boxes below for each month in 2007 that <b>all</b> of the following statements were <b>true</b> on the <b>first day</b> of that month.</p> <ul style="list-style-type: none"> <li>• You were an eligible trade adjustment assistance (TAA) recipient, alternative TAA recipient, or Pension Benefit Guaranty Corporation (PBGC) pension recipient.</li> <li>• You were covered by a qualified health insurance plan for which you paid the premiums directly to your health plan.</li> <li>• You were <b>not</b> entitled to Medicare Part A or enrolled in Medicare Part B.</li> <li>• You were <b>not</b> enrolled in Medicaid or State Children's Health Insurance Program (SCHIP).</li> <li>• You were <b>not</b> enrolled in the Federal Employees Health Benefits Program or eligible to receive benefits under the U.S. military health system (TRICARE).</li> <li>• You were <b>not</b> imprisoned under federal, state, or local authority.</li> <li>• You were <b>not</b> covered by, or eligible for coverage under, any employer-sponsored health insurance plan (including any employer-sponsored health insurance plan of your spouse) (see the instructions for line 1 on page 3).</li> </ul> <p> <input type="checkbox"/> January    <input type="checkbox"/> February    <input type="checkbox"/> March    <input type="checkbox"/> April    <input type="checkbox"/> May    <input type="checkbox"/> June  <input type="checkbox"/> July    <input type="checkbox"/> August    <input type="checkbox"/> September    <input type="checkbox"/> October    <input type="checkbox"/> November    <input type="checkbox"/> December         </p>		
<p><b>Part II Health Coverage Tax Credit</b></p>		
<p>2 Amount paid for qualified health insurance coverage for all months checked on line 1 (see instructions on page 3). <b>Do not</b> include on line 2 any qualified health insurance premiums paid to "U.S. Treasury-HCTC." Also, <b>do not</b> include any advance payments from Form 1099-H, box 1 . . . . .</p>		<p>2</p>
<p> <b>You must</b> attach the required documents listed on page 4 for any amounts included on line 2. If you do not attach the required documents, your credit will be disallowed.</p>		
<p>3 Enter the total amount of any (a) Archer MSA and health savings account distributions used to pay for qualified health insurance coverage for all months checked on line 1 and (b) National Emergency Grants you received for health insurance in 2007 . . . . .</p>		<p>3</p>
<p>4 Subtract line 3 from line 2. If zero or less, <b>stop</b>; you cannot take the credit . . . . .</p>		<p>4</p>
<p>5 <b>Health coverage tax credit.</b> Multiply line 4 by 65% (.65). Enter the result here and on Form 1040, line 70 (check box c); Form 1040NR, line 64 (check box c); Form 1040-SS, line 9; or Form 1040-PR, line 9 . . . . .</p>		<p>5</p>
<p>For Paperwork Reduction Act Notice, see page 4. <span style="float: right;">Cat. No. 34641D <span style="margin-left: 100px;">Form <b>8885</b> (2007)</span></span></p>		



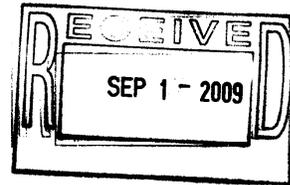
*Improvements Are Needed to Ensure the Health Coverage Tax Credit Is Properly Claimed on Tax Returns*

**Appendix VI**

*Management's Response to the Draft Report*



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
ATLANTA, GA 30308



SEP 01 2009

MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Improvements Are Needed to Ensure  
the Health Coverage Tax Credit Is Properly Claimed on  
Tax Returns (Audit #200940011)

I reviewed the subject draft report and agree, in part, with your recommendations. The IRS has administered the Health Coverage Tax Credit (HCTC) since it was created in 2002. The credit was designed to provide assistance with paying for health insurance to individuals who lost jobs due to foreign competition. Individuals can claim the HCTC, on a monthly basis, as a payment to their health plan equal to 80 percent (up from 65 percent beginning April 17, 2009) of their total monthly premium, or they can pay their health insurance premiums in full during the year and claim 80 percent of their payments on their tax return. Eighty percent of all HCTC claimants choose to claim the credit monthly.

We appreciate your review of the IRS HCTC Program and agree with many of your findings. The IRS completed a Compliance review of the HCTC Program in 2008 and found similar results. This review, along with on-site visits to processing centers around the country, helped improve guidance for processing tax returns claiming the HCTC.

We also appreciate your acknowledgement that many processes are in place to ensure eligible individuals accurately claim the HCTC. As your report states, \$80 million of the \$100 million in HCTC payments made in Tax Year 2007 were paid through the monthly credit option. Your report found no improvements were needed in the IRS effort to ensure individuals were eligible to claim monthly payments. Your findings focused on the 20 percent of HCTC payments claimed on tax returns.



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*Improvements Are Needed to Ensure the Health Coverage Tax Credit Is Properly Claimed on Tax Returns*

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2

We agree with many of your findings on the yearly HCTC program, including the need to attach appropriate documentation to returns that claim the HCTC, and the need to identify potentially erroneous claims earlier. Although we generally agree with your recommendations, we have proposed different corrective actions to address the issues.

Finally, we acknowledge the tests used to develop your outcome measure as sound for purposes of identifying potentially erroneous claims. However, we do not agree that the methodology used to identify potentially erroneous HCTC claims over the next five years can be translated to an estimated erroneous claims amount as presented in Appendix IV. We cannot assume that every taxpayer claiming a credit amount equal to one of their cumulative monthly transactions is claiming the HCTC erroneously. To determine the validity of this assumption, IRS would have to audit each of the 1,260 returns you identified to determine whether or not the claims were actually made in error.

Attached are our comments to your recommendations. If you have questions, please call me at (404) 338-7060, or a member of your staff may contact David R. Williams, Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division, at (202) 622-7990.

Attachment



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*Improvements Are Needed to Ensure the Health Coverage Tax Credit Is Properly Claimed on Tax Returns*

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Attachment

The Commissioner, Wage and Investment Division, should:

**Recommendation 1**

Develop a process to ensure taxpayers who claim the HCTC on *e-filed* tax returns are providing the required documentation in support of their HCTC claim, and if not, the credit should be disallowed as indicated on the Form 8885.

**Corrective Action**

We agree with this recommendation. The IRS will continue requesting that taxpayers file a Form 8453 with the required documentation attached. The IRS has an e-file project underway to improve this process in the future. Modernized e-file will allow taxpayers or tax preparers to attach the Form 8885 and other required documentation to their e-filed tax returns beginning with Filing Season 2013 and will reject the return if the form is not attached.

**Implementation Date:**

January 15, 2013

**Corrective Action Monitoring Plan**

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

**Responsible Official**

Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division

**Recommendation 2**

Ensure taxpayers claiming the HCTC on paper filed tax returns attach required documentation and, if not, the IRS should disallow the credit as indicated on the Form 8885.

**Corrective Action**

We agree with this recommendation. The IRS will provide reminders to employees in the Error Resolution function regarding the necessity of attaching documentation to a return claiming the Health Coverage Tax Credit. If documentation is not attached, the IRS will disallow the credit. The IRS will also continue allowing taxpayers the ability to provide the correct documentation to support their claim. If taxpayers fail to do so in response to a request for documentation, the IRS will disallow the credit.

**Implementation Date**

December 15, 2012



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*Improvements Are Needed to Ensure the Health Coverage Tax Credit Is Properly Claimed on Tax Returns*

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2

**Corrective Action Monitoring Plan**

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

**Responsible Officials**

Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division

Director, Submission Processing, Wage and Investment Division

**Recommendation 3**

Develop processes to identify erroneous HCTC claims based on criteria used to select taxpayers for examination and reject *e-filed* tax returns or forward paper-filed tax returns to the Error Resolution function at the time the tax return is filed.

**Corrective Action**

We agree with the premise of this recommendation; however, we propose an alternative solution. The IRS will identify potentially erroneous claims during processing and allow taxpayers an opportunity to provide the required documentation to prove their claim. The IRS will program additional error codes and thresholds reflective of the tests outlined in this report, inform taxpayers of their appeal rights, and request that taxpayers provide documentation to prove their claims.

**Implementation Date**

January 15, 2011

**Corrective Action Monitoring Plan**

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

**Responsible Official**

Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division