TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

RECOVERY ACT

Evaluation of the Internal Revenue Service's Capability to Ensure Proper Use of Recovery Act Funds

November 27, 2009

Reference Number: 2010-41-011

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

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

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HIGHLIGHTS

WHY TIGTA DID THE AUDIT

On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (Recovery Act) was enacted. The provisions in this law are estimated to cost a total of $787 billion over 11 years. Federal agencies across the country will be responsible for distributing billions of dollars of Recovery Act funding to qualified recipients in discretionary and mandatory programs designed to revive the ailing economy and create a more sustainable future.

The Obama Administration has asked Federal agencies to ensure Recovery Act funds are used for authorized purposes and every step is taken to prevent fraud, waste, and abuse. Congress appropriated $7 million to the Treasury Inspector General for Tax Administration to provide oversight and conduct audits of the Internal Revenue Service's (IRS) administration of Recovery Act programs. The objective of this review was to assess the IRS' ability to verify tax return data and taxpayers' eligibility for tax-related Recovery Act benefits and credits.

IMPACT ON TAXPAYERS

The Recovery Act contains 56 tax provisions, 20 individual taxpayer provisions, and 36 business taxpayer provisions. The individual taxpayer provisions will cost nearly $252 billion and provide tax relief to working or retired Americans and their families. The business taxpayer provisions will cost more than $74 billion and provide several tax relief incentives for businesses. The IRS is unable to verify eligibility for the majority of Recovery Act benefits at the time a tax return is processed.

WHAT TIGTA FOUND

The IRS uses certain methods to verify the accuracy and eligibility of tax benefits and credits claimed on tax returns. The validation process can occur 1) before a tax return is processed and before funds have been released or 2) after a tax return is processed and after funds have been released.

The IRS cannot verify the accuracy of all of the legislated requirements before the tax return has completed processing for 39 Recovery Act provisions (13 individual provisions and 26 business provisions). To a great extent, the IRS relies on taxpayers' voluntary compliance with tax laws to accurately report income and claim only those tax benefits and credits to which they are entitled.

Verifying specific eligibility requirements for these 39 provisions would require the IRS to request specific documentation from the taxpayer. The IRS attempts to weigh the potential burden that requiring this documentation could place on taxpayers when implementing provisions. In addition, limitations of its electronic filing program prevent the IRS from transferring supporting (paper) documentation into an electronic format.

We are not including recommendations in this report. We have ongoing and planned audits that will focus on specific Recovery Act benefits and credits. We will include recommendations as appropriate as part of these reviews.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

November 27, 2009

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Evaluation of the Internal Revenue Service's Capability to Ensure Proper Use of Recovery Act Funds (Audit # 200940137)

This report presents the results of our review to assess the Internal Revenue Service's (IRS) ability to verify tax return data and taxpayers' eligibility for tax-related American Recovery and Reinvestment Act of 2009 (Recovery Act)[1] benefits and credits. This audit was included as part of our Fiscal Year 2010 Annual Audit Plan under the major management challenge of Implementing Tax Law Changes.

The Recovery Act provides separate funding to the Treasury Inspector General for Tax Administration through September 30, 2013, to be used in oversight activities of IRS programs. This audit was conducted using Recovery Act funds.

The IRS did not provide a written response to the draft audit report.

Copies of this report are also being sent to the IRS managers affected by the report finding. 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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[1] Pub. L. No. 111-5, 123 Stat. 115 (2009).

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Abbreviations

AMT	Alternative Minimum Tax
IRS	Internal Revenue Service
SSN	Social Security Number
TIGTA	Treasury Inspector General for Tax Administration

Background

On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (Recovery Act)[1] was enacted. The provisions in this law are estimated to cost a total of $787 billion over 11 years. Federal agencies across the country will be responsible for distributing billions of dollars of Recovery Act funding to qualified recipients in discretionary and mandatory programs designed to revive the ailing economy and create a more sustainable future. The Recovery Act contains 56 tax provisions, 20 individual taxpayer provisions, and 36 business taxpayer provisions.

Individual Taxpayer Provisions

The 20 individual taxpayer provisions will cost nearly $252 billion. These provisions provide tax relief to working or retired Americans and their families and include several refundable tax credits, a sales tax deduction on motor vehicles, Alternative Minimum Tax (AMT) relief for middle-income taxpayers, a reduction in taxable unemployment compensation, a payment for Social Security recipients, a credit for government retirees, tax credits that promote investing in renewable sources of energy, and changes to the Health Coverage Tax Credit.

Business Taxpayer Provisions

Although there are 36 provisions amounting to more than $74 billion in costs which are targeted for businesses, this report will focus on 26 that directly affect the filing of tax returns by businesses. These 26 provisions amount to more than $48 billion in costs and reduced revenue to the Government. They provide several tax relief incentives for businesses, encourage the investment in sources of renewable energy, and promote the hiring of unemployed veterans. They also allow for the purchase of bonds to provide for construction, financing, environmental, and manufacturing improvements.

In addition, Congress appropriated $203 million[2] to the Internal Revenue Service (IRS) to oversee the administration of these provisions. The Treasury Inspector General for Tax Administration (TIGTA) was provided $7 million to provide oversight and conduct audits of the IRS' administration of Recovery Act programs. Figure 1 summarizes the 20 Recovery Act individual tax provisions. Figure 2 summarizes the 26 Recovery Act business tax provisions.

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[1] Pub. L. No. 111-5, 123 Stat. 115 (2009).
[2] $123 million for all the tax provisions plus $80 million for the Health Coverage Tax Credit Program.

Figure 1: Summary of Recovery Act Tax Changes for Individual Taxpayers

Recovery Act Tax Change[3]	*Cost in Millions*[4]	*Taxpayers Impacted*[5]	*General Purpose*
Making Work Pay Credit	$ 116,199	116.3 million	Reduce tax burden for working Americans.
Increase in Earned Income Tax Credit	$ 4,663	18.2 million	Raise low-income taxpayers above the poverty line.
Increase in Refundable Portion of Child Tax Credit	$ 14,830	15.6 million	Reduce the financial burden of raising a family.
Increase in Hope Credit[6]	$ 13,907	10.2 million	Help families pay for the costs of higher education.
Computers Allowed as Education Expense for Section 529 Education Saving Accounts	$ 6	5,000	Encourage the purchase of computers for students of higher learning.
Increase in First-Time Homebuyer Credit	$ 6,638	1 million	Encourage buying homes to stimulate the weak housing market.
The First $2,400 of Unemployment Compensation Is Nontaxable	$ 4,740	7.4 million	Reduce the tax burden of unemployed workers.
Additional Deduction for State Sales Tax on Certain Motor Vehicles	$1,684	8.5 million	Encourage the purchase of cars, light trucks, motorcycles, and motor vehicles with a cost less than $49,500.
AMT Relief (Extended Nonrefundable Personal Credits and the AMT Exemption)	$69,759	26 million	Protect millions of middle-income taxpayers, who would otherwise be subject to the AMT.
Modification of Nonbusiness Energy Property Credit	$ 2,034	4.3 million	Encourage the purchase of energy efficient property designed to reduce heat loss during cold months or heat gain during warm months for use in a principal residence.
Modification of Residential Energy Efficient Property Credit	$ 268	1.67 million	Encourage the purchase of renewable sources of energy for use in a home.
Qualified Plug-In Electric Drive Motor Vehicles Credit, Certain Plug-In Electric Vehicles Credit, Conversion Kits, and Alternative Motor Vehicle Credit as a Personal Credit Against the AMT	$ 2,002	8,000	Encourage the purchase of motor vehicles (or the conversion of motor vehicles to those) that operate on clean renewable sources of energy.
Increased Exclusion for Employer Provided Commuter Transit Benefits	$ 192	Less than 8.4 million	Reduce the consumption of fossil fuels by promoting the use of more environmentally friendly commuter transit options.
Health Coverage Tax Credit (12 Sections 1899A – L)	$ 457	50,000	Assist certified retirees and displaced workers with health insurance costs.
$250 Economic Recovery Payment to Certain Individuals	$ 14,225	676,000	Reduce financial burden on individuals receiving Social Security, railroad retirement, disability, or pension benefits.
$250 Special Credit for Certain Government Retirees	$ 218	696,000	Reduce tax burden on government retirees receiving a pension but not eligible for Social Security Benefits.
TOTAL ESTIMATED COST	***$251,822***		

Source: Pub. L. No. 111-5, 123 Stat. 115 (2009) and TIGTA analysis.

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[3] AMT relief includes 2 provisions and the Plug-In Vehicle section includes 4 provisions for a total of 20 provisions.
[4] Estimated over 11 years (2009 through 2019) by the Joint Committee of Taxation, *JCX-19-09*, February 12, 2009.
[5] Estimated by the TIGTA based on historical statistics from Tax Year 2006 and Tax Year 2009 projections.
[6] This is the American Opportunity Tax Credit.

Figure 2: Summary of Recovery Act Tax Changes for Business Taxpayers

Recovery Act Tax Change[7]	Cost in Millions[8]	General Purpose
Extension and Modification of Renewable Energy Production Tax Credit	$ 13,143	Extend eligibility dates of credit for eligible taxpayers.
Election of Investment Tax Credit in Lieu of Production Tax Credit	$ 285	Allow electricity producing facilities to choose between either investment or production tax credits.
Removal of Limitations on Certain Energy Credits	$ 604	Increase potential credits by eliminating dollar caps for certain property.
Advanced Energy Investment Credit	$ 1,647	Encourage the manufacturing of advanced energy projects by providing a 30-percent credit for qualifying property.
Modification of Tax Credit for Alternative Refueling Property	$ 54	Increase potential credit by raising cap limits.
Extension of Bonus Depreciation for an Additional Year and Election to Accelerate Recognition of Research and Development Credits in Lieu of Bonus Depreciation	$ 5,879	Allow temporary benefit to recover costs faster than ordinary depreciation and allow businesses to choose recognition of a portion of credits instead of depreciation.
Extension of Enhanced Small Business Expensing for an Additional Year	$ 41	Allow businesses to quickly recover capital expenses in lieu of depreciation.
5-Year Carryback of Net Operating Losses for Small Business	$ 947	Allow greater time period to use operating losses.
Small Business Estimated Tax Payment Relief	$ 0	Reduce required estimated tax payments for certain small businesses.
Debt Instrument Rule Changes (Delayed Recognition of Certain Cancellation of Debt Income and Rule Modification on High-Yield Discount Obligations)	$1,622	Allow deferral and ratable recognition of cancellation of debt income and allow deductions for indebtedness.
Small Business Capital Gains	$ 829	Increase percentage excluded of gain for qualified long-term small business stock.
Temporary Reduction of the S Corporation Built-In Gains Holding Period	$ 415	Reduce required holding period for assets of taxable corporations converting to S corporations.
Incentives to Hire Unemployed Veterans and Disconnected Youth	$ 231	Broaden targeted groups for purposes of the Work Opportunity Credit.
Treatment of Certain Ownership Changes for Purposes of Limitations on Net Operating Loss Carry Forwards and Certain Built-In Losses	$ 3,163	Clarified rules for companies who are restructuring pursuant to the Emergency Economic Stabilization Act and application of Section 382.
Clarification of Regulations Related to Limitations on Certain Built-In Losses Following an Ownership Change	- $ 6,977 (gain)	Repealed the liberalized rules in the tax code that allowed claiming of losses incurred by prior owner.
New Markets Tax Credit	$ 815	Encourage qualified equity investment by increasing amount of available credits.

[7] Debt Instrument rule changes and the Modification of Tax-Exempt Interest Expense Rules of Financial Institutions include 2 provisions each for a total of 26 provisions.
[8] We were unable to accurately estimate the number of business taxpayers impacted by each of the provisions.

Recovery Act Tax Change[7]	*Cost in Millions[8]*	*General Purpose*
Modification of Tax-Exempt Interest Expense Rules of Financial Institutions (DeMinimus Safe Harbor Exception and Small Issuer Exception)	$ 3,234	Reduce tax burden of financial institutions by modifying rules for investments in tax-exempt municipal bonds.
AMT Relief for Costs of Issuing Bonds	$ 555	Reduce financial burden on taxpayers by modifying and suspending the AMT for certain private activity bonds.
Clean Renewable Energy Bonds	$ 578	Provide financing of tax credit bonds for qualified renewable energy facilities that generate electricity.
Qualified Energy Conservation Bonds	$ 803	Provide financing of tax credit bonds for government programs and initiatives to reduce greenhouse gas emissions.
Recovery Zone Bonds	$ 5,371	Encourage investment in economic recovery zones for tax credit bonds.
Qualified School Construction Bonds	$ 9,877	Encourage issuance of tax credit bonds for construction, rehabilitation, repair, or acquisition of land for public school facilities.
Qualified Zone Academy Bonds	$ 1,045	Provide additional funds for tax credit bonds to finance renovations and other improvements for qualified zone academies.
Build America Bonds	$ 4,348	Allow State and local governments the option of issuing tax credit bonds instead of tax-exempt governmental obligation bonds.
TOTAL ESTIMATED COST	***$ 48,509***	

Source: Pub. L. No. 111-5, 123 Stat. 115 (2009) and Joint Committee on Taxation JCX-19-09, dated February 12, 2009.

This review was performed at the Austin Submission Processing Site in Austin, Texas, the Ogden Submission Processing Site in Ogden, Utah, and was discussed with the IRS Recovery Act Team responsible for overseeing the IRS' administration of the Recovery Act, executives in the Submission Processing function, and personnel in the Wage and Investment Division Headquarters during the period June 2009 through September 2009. We relied on the Recovery Act tax legislation, Vice President Biden's May 2009 Quarterly Report on the Recovery Act, and other documents from Recovery.gov. We conducted this review 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.

Results of Review

The President and Congress have announced their commitment to spending recovery dollars with an unprecedented level of transparency and accountability. To accomplish this, the Obama Administration has established five broad requirements that all agencies must follow in order to meet crucial accountability objectives. Posted on Recovery.gov, the third requirement asks Federal agencies to ensure Recovery Act funds are used for authorized purposes and that every step be taken to prevent instances of fraud, waste, and abuse. Guidance on identifying, prioritizing, and mitigating implementation risks associated with implementing Recovery Act programs is also provided. In assessing their risks, agencies receiving funds for Recovery Act programs are asked to consider:

- Do they have sufficient resources to achieve program objectives and ensure awards are properly made in accordance with statutory and regulatory requirements?
- Are existing internal controls sufficient to mitigate the risk of fraud, waste, and abuse?

Implementing tax legislation

When Congress develops a piece of tax legislation, it considers and decides which requirements taxpayers must meet to qualify for a given tax benefit. Such requirements may include having a certain income level or filing status, having dependent children, having a certain profession, not being employed, etc. Some requirements limit the time period during which a given credit or deduction is available. Others require the taxpayer to purchase something, such as a home with the First-Time Homebuyer Credit or energy efficient home improvements with the Residential Energy Credit.

Once Congress enacts tax legislation, the IRS reviews the law to determine what actions it must take to correctly implement the law to ensure legislated requirements will be satisfied. The IRS Legislative Analysis Tracking Implementation Services office is responsible for managing the implementation, planning, and monitoring of legislation having significant impact on the IRS. Actions the IRS takes in response to new legislation often include creating new tax forms, updating publications, revising internal operating procedures, and updating programs for processing tax returns.

Methods the IRS uses to validate tax return data

The IRS uses certain methods to verify the accuracy and eligibility of tax benefits and credits claimed on tax returns. The validation process can occur 1) before a tax return is processed and before funds have been released or 2) after a tax return is processed and after funds have been released.

Before a Tax Return Has Completed Processing

The ability of the IRS to verify the accuracy and eligibility of tax benefits and credits before a tax return has completed processing and prior to release of funds is the most efficient and effective approach for the IRS. In recent testimony before Congress, the General Accountability Office stated:

> *Our work has shown that building internal controls in up front is of the utmost importance and that fraud prevention is the most efficient and effective means to minimize fraud, waste, and abuse. Once federal dollars are disbursed fraudulently or improperly, the government is only likely to recover a few pennies on the dollar. Thus, preventive controls are the most important component of a fraud prevention system. These controls prevent ineligible individuals and questionable firms from gaining access to government funds in the first place.*[9]

Preventive identification efforts on the part of the IRS include the development of computer programs to detect errors on electronically filed tax returns before they are accepted. Specifically, electronically filed tax returns are put through a number of validations which check for more than 600 possible errors before the IRS accepts the tax return. Data files used for data validation include files from the Social Security Administration and the Department of Defense. When errors are detected, the tax returns are rejected back to the transmitter to be corrected. Errors include incorrect Social Security Numbers (SSN) for dependents, incorrect birthdates, numbers in alphabetic fields, and invalid zip codes.

Once a tax return is received (paper filed) or accepted (electronically filed) by the IRS, selected information from the tax return is validated and/or verified by the IRS. Checks include verifying the mathematical correctness of the tax return and identifying other potential errors. If a tax return is identified as not passing validation/verification, the tax return is forwarded to the IRS Error Resolution function to be manually reviewed and corrected.

After a Tax Return Has Been Processed

After a tax return has been processed and subsequent to the release of funds, the IRS has limited means by which it can validate the accuracy of tax benefits and credits previously claimed. The IRS can match third-party documents to information listed on the tax return. For example, the IRS receives third-party wage and earnings information including Wage and Tax Statements (Form W-2) and Miscellaneous Income (Form 1099). The IRS Automated Underreporter Program matches these third-party documents to wage and earnings reported on an individual's

[9] *American Recovery and Reinvestment Act: GAO's Role in Helping to Ensure Accountability and Transparency* (GAO-09-453T, dated March 2009).

tax return to ensure the accuracy of reporting. If a discrepancy exists, the IRS sends correspondence to the taxpayer for confirmation and submission of additional tax owed. For business taxpayers, recent legislation requires credit card companies to provide information to the IRS regarding businesses that receive credit card payments. The IRS expects to be able to use this information to match against income that businesses report on their tax returns.

In addition, the IRS can perform an audit of the taxpayer records by a field examination, office audit, or correspondence audit. Field examinations include reviews of complex issues that require a face-to-face interview at a taxpayer's home or business. Office audits are conducted at local IRS offices and focus on less complex issues than field examinations but more complex issues than correspondence audits. Correspondence audits focus on simple issues on individual tax returns and are conducted by mail. In all cases, taxpayers are asked to provide the documentation necessary to verify a variety of selected issues that may include certain tax benefits and credits claimed on a tax return.

The Internal Revenue Service Is Unable to Verify Eligibility for the Majority of Recovery Act Benefits at the Time a Tax Return Is Processed

The IRS cannot verify the accuracy of all of the legislated requirements for 13 of the 20 Recovery Act tax benefits/credits for individual taxpayers and all of the 26 provisions for businesses before the tax return has completed processing. The IRS relies on taxpayers to comply with tax laws and provide correct information on their tax returns, including accurately reporting income and claiming only those tax benefits and credits to which they are entitled. Verifying specific eligibility requirements for these 39 provisions[10] would require the IRS to request specific documentation from the taxpayer.

Figure 3 summarizes Recovery Act tax provisions that affect individual taxpayers and Figure 4 summarizes Recovery Act tax provisions that affect business taxpayers. These figures show whether the IRS can verify all the requirements included in the tax legislation that a taxpayer must meet to qualify for the Recovery Act tax benefit or credit before the tax return has completed processing or after the tax return has been processed. Some of the provisions are not included in these figures as noted below:

- In Figure 3, 3 of the 20 individual provisions are not included. These include a one-time, $250 payment to Social Security, disability, and railroad retirement recipients which the Social Security Administration is responsible for issuing. The remaining two provisions (Computers Allowed as Education Expense for Education Savings Accounts and Increased Exclusion for Employer Provided Commuter Transit Costs) are not reported on an individual tax return. In addition, we combined the two AMT provisions on one line.

[10] These 39 provisions include 13 individual provisions and 26 business provisions.

- In Figure 4, 10 of the 36 business provisions are not included because they do not directly affect the filing of tax returns by businesses.

Individual and business provisions have multiple requirements that have to be met to qualify for the tax benefit or credit. For a number of Recovery Act provisions, the IRS can verify many of the requirements that need to be met to qualify for the tax benefit or credit before a tax return has completed processing. In Figures 3 and 4:

- A "No" in column two indicates that the IRS cannot verify one or more of the requirements to qualify for the specific provision.
- A "Yes" in column two indicates that the specific Recovery Act requirements can be computer validated before a tax return has completed processing. A "Yes" followed by an asterisk (*) indicates that other requirements from previous non-Recovery Act legislation relating to the Recovery Act tax benefit or credit cannot be validated. For example, the IRS can validate the Recovery Act requirement that provides for an increase in the Earned Income Tax Credit for individuals with three or more children. However, to be eligible for the Earned Income Tax Credit, the following requirements must be met:
    - The qualifying child (or children) must have lived with the taxpayer in the United States for more than one-half of the tax year.[11]
    - If the taxpayer does not have a qualifying child, the taxpayer must have lived in the United States for more than one-half of the tax year.[12]

The above requirements cannot be validated without an audit of the taxpayer's records.

- A "N/A" in column three indicates that the specific Recovery Act requirements for this provision cannot be verified by a third-party document (e.g., a Form W-2 or Form 1099-INT) because no such document is reported to the IRS. However, a "N/A" followed by an asterisk (*) represents that one or more requirements from past (non-Recovery Act) legislation for this Recovery Act tax benefit or credit can be verified by a third-party document.

[11] Internal Revenue Code Section 32(c)(1)(A)(i) and Section 32(c)(1)(A)(ii)(I).
[12] Internal Revenue Code Section 32(c)(1)(A)(ii)(I).

Figure 3: Assessment of the IRS' Ability to Verify the Accuracy and/or Eligibility of Recovery Act Individual Taxpayer Provisions

Recovery Act Tax Change	When Can the IRS Verify?		
	Before the Tax Return Has Completed Processing	Through Third-Party Document Matching	Through Audit of the Taxpayers' Records
Making Work Pay Credit	***2(f)***	***2(f)***	Yes
Increase in Earned Income Tax Credit	***2(f)***	***2(f)***	Yes
Increase in Refundable Portion of Child Tax Credit	***2(f)***	***2(f)***	Yes
Increase in Hope Credit (also known as The American Opportunity Tax Credit)	***2(f)***	***2(f)***	Yes
Increase in First-Time Homebuyer Credit	***2(f)***	***2(f)***	Yes
The First $2,400 of Unemployment Compensation Is Nontaxable	***2(f)***	***2(f)***	Yes
Additional Deduction for State Sales Tax on Certain Motor Vehicles	***2(f)***	***2(f)***	Yes
AMT Relief (2 provisions)	***2(f)***	***2(f)***	Yes
Modification of Nonbusiness Energy Property Credit	***2(f)***	***2(f)***	Yes
Modification of Residential Energy Efficient Property Credit	***2(f)***	***2(f)***	Yes
Qualified Plug-In Electric Drive Motor Vehicles Credit	***2(f)***	***2(f)***	Yes
Certain Plug-In Electric Vehicles Credit	***2(f)***	***2(f)***	Yes
Conversion Kits	***2(f)***	***2(f)***	Yes
Treatment of Alternative Motor Vehicle Credit as a Personal Credit Against the AMT	***2(f)***	***2(f)***	Yes
Expansion of Health Coverage Tax Credit	***2(f)***	***2(f)***	Yes
Special $250 Credit for Certain Government Retirees	***2(f)***	***2(f)***	Yes

Source: Pub. L. No. 111-5, 123 Stat. 115 (2009).

The requirements for business tax returns can be even more difficult to validate due to the complexity of the tax returns and the number of supporting schedules and documents associated with the tax returns. In most cases, it would be very burdensome to require a business to include all the necessary supporting documentation to validate the claim at the time the tax return is filed.

Figure 4: Assessment of the IRS' Ability to Verify the Accuracy and/or Eligibility of Recovery Act Business Taxpayer Provisions

Recovery Act Tax Change[13]	When Can the IRS Verify?		
	Before the Tax Return Has Completed Processing	Through Third-Party Document Matching	Through Audit of the Taxpayers' Records
Extension and Modification of Renewable Energy Production Tax Credit	***2(f)***	***2(f)***	Yes
Election of Investment Credit in Lieu of Production Credit	***2(f)***	***2(f)***	Yes
Removal of Dollar Limitations on Certain Energy Credits	***2(f)***	***2(f)***	Yes
Advanced Energy Investment Credit	***2(f)***	***2(f)***	Yes
Modification of Tax Credit for Alternative Refueling Property	***2(f)***	***2(f)***	Yes
Extension of Bonus Depreciation for an Additional Year and Election to Accelerate Recognition of Research and Development Credits in Lieu of Bonus Depreciation	***2(f)***	***2(f)***	Yes
Extension of Enhanced Small Business Expensing for an Additional Year	***2(f)***	***2(f)***	Yes
5-Year Carryback of Net Operating Losses for Small Business	***2(f)***	***2(f)***	Yes
Small Business Estimated Tax Payment Relief	***2(f)***	***2(f)***	Yes
Debt Instrument Rule Changes (Delayed Recognition of Certain Cancellation of Debt Income and Rule Modification on High-Yield Discount Obligations)	***2(f)***	***2(f)***	Yes
Small Business Capital Gains	***2(f)***	***2(f)***	Yes
Temporary Reduction of the S Corporation Built-In Gains Holding Period	***2(f)***	***2(f)***	Yes
Incentives to Hire Unemployed Veterans and Disconnected Youth	***2(f)***	***2(f)***	Yes
Clarification of Regulations Related to Limitations on Certain Built-In Losses Following an Ownership Change	***2(f)***	***2(f)***	Yes
Treatment of Certain Ownership Changes for Purposes of Limitations on Net Operating Loss Carryforwards and Certain Built-In Losses	***2(f)***	***2(f)***	Yes
New Markets Tax Credit	***2(f)***	***2(f)***	Yes
Clean Renewable Energy Bonds	***2(f)***	***2(f)***	Yes
Qualified Energy Conservation Bonds	***2(f)***	***2(f)***	Yes
Recovery Zone Bonds	***2(f)***	***2(f)***	Yes
Qualified School Construction Bonds	***2(f)***	***2(f)***	Yes

[13] Debt Instrument Rule Changes and the Modification of Tax-Exempt Interest Expense Rules of Financial Institutions include 2 provisions each for a total of 26 provisions.

Recovery Act Tax Change[13]	When Can the IRS Verify? Before the Tax Return Has Completed Processing	Through Third-Party Document Matching	Through Audit of the Taxpayers' Records
Qualified Zone Academy Bonds	***2(f)***	***2(f)***	Yes
Build America Bonds	***2(f)***	***2(f)***	Yes
Modification of Tax-Exempt Interest Expense Rules of Financial Institutions (DeMinimus Safe Harbor Exception and Small Issuer Exception)	***2(f)***	***2(f)***	Yes
AMT Relief for Costs of Issuing Bonds	***2(f)***	***2(f)***	Yes

Source: Pub. L. No. 111-5, 123 Stat. 115 (2009) and TIGTA analysis.

The IRS attempts to weigh the potential burden that providing documentation can place on taxpayers when implementing provisions. In addition, limitations of its electronic filing program prevent the IRS from transferring supporting (paper) documentation into an electronic format. For example, on November 25, 2008, we issued a memorandum to the Commissioner, Wage and Investment Division, and recommended that the IRS require taxpayers to provide documentation to verify the purchase of a house for the purpose of claiming the First-Time Homebuyer Credit. In response, the IRS stated that our recommendation would be unnecessarily burdensome and would potentially exclude as many as 2 million taxpayers from electronically filing.

It should be noted that the IRS was not provided with math error authority[14] to stop the payment of erroneous First-Time Homebuyer Credit claims. As such, if the IRS identifies an erroneous claim, an audit must be performed. The TIGTA has reported previously on the benefits of expanding math error authority to allow the IRS to disallow taxpayer claims at the time a tax return is processed.[15] As of July 25, 2009, we have identified 73,799 taxpayers who may have incorrectly claimed $504 million in the First-Time Homebuyer Credit. Expansion of math error authority would allow the IRS to efficiently disallow erroneous taxpayer claims during the processing of a tax return and prior to the release of funds.

[14] Math error authority allows the IRS to systemically disallow certain taxpayer claims at the time a tax return is processed.
[15] See Appendix IV for a list of reports issued in Fiscal Years 2008 and 2009.

We are not including recommendations in this report. We have ongoing and planned audits that will focus on specific Recovery Act benefits and credits. We will include recommendations as appropriate as part of these reviews.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to assess the IRS' ability to verify tax return data and taxpayers' eligibility for tax-related American Recovery and Reinvestment Act (Recovery Act)[1] benefits and credits. This review is being conducted in response to the mandate that agencies ensure Recovery Act funds are used for authorized purposes and steps are taken to prevent instances of fraud, waste, error, and abuse. To accomplish our objective, we:

I. Identified which Recovery Act tax provisions impact individual taxpayers and assessed the IRS' ability to ensure only eligible taxpayers receive Recovery Act funds.

   A. For each tax provision, determined its general purpose, the estimated cost to the United States Government, and the estimated number of taxpayers affected.

   B. Identified and described the process the IRS uses to implement tax legislation and the methods it uses to validate tax return data.

   C. Assessed the IRS' ability to verify the accuracy of tax return data and ensure that only eligible taxpayers receive Recovery Act tax benefits in accordance with Recovery Act legislation.

II. Identified which Recovery Act tax provisions impact business taxpayers and assessed the IRS' ability to ensure only eligible taxpayers receive Recovery Act funds.

   A. For each tax provision, determined its general purpose and the estimated cost to the United States Government.

   B. Assessed the IRS' ability to verify the accuracy of tax return data and ensure that only eligible taxpayers receive Recovery Act tax benefits in accordance with Recovery Act legislation.

[1] Pub. L. No. 111-5, 123 Stat. 115 (2009).

Appendix II

Major Contributors to This Report

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Appendix III

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Commissioner, Wage and Investment Division SE:W
Deputy Commissioner, Wage and Investment Division SE:W
Director, Customer Assistance, Relationships, and Education, Wage and Investment Division SE:W:CAR
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Director, Media and Publications, Wage and Investment Division SE:W:CAR:MP
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Director, Tax Forms and Publications, Wage and Investment Division SE:W:CAR:MP:T
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 Liaisons: Senior Operations Advisor, Wage and Investment Division SE:W:S
Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PRA:PEI

Appendix IV

Examples - Treasury Inspector General for Tax Administration Reports Issued in Fiscal Years 2008 and 2009 With Issues Related to Math Error Authority

1. *Evaluation of the Planning, Computation, and Issuance of the Recovery Rebate Credit* (Reference Number 2009-40-129, dated September 9, 2009).

The TIGTA identified that legislation did not provide the IRS with math error authority to prevent individuals without valid SSNs from receiving the recovery rebate credit. Although the legislation prohibited individuals without a valid SSN from receiving the rebate credit, the IRS was not provided with math error authority that would have enabled it to effectively prevent the issuance of rebate credits to these individuals at the time a tax return was processed. As a result, the IRS erroneously provided more than $27 million in recovery rebate credits to more than 44,000 taxpayers who did not have a valid SSN.

The TIGTA issued a memorandum to the IRS in September 2008 raising concerns about its lack of math error authority. We recommended the IRS work with the Assistant Secretary of the Treasury for Tax Policy to obtain math error authority for recovery rebate claims on tax returns without a valid SSN. IRS management responded that they had raised concerns to the Assistant Secretary about the lack of math error authority for this issue. However, no legislative proposal was put forth to provide this authority.

2. *Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims* (Reference Number 2009-40-057, dated March 31, 2009).

The TIGTA identified taxpayers without a valid SSN receiving potential Additional Child Tax Credits of almost $1.8 billion on more than 1.2 million tax returns and recommended legislation to clarify whether or not refundable tax credits such as the Additional Child Tax Credit may be paid to filers without a valid SSN and, if these credits may not be paid, to provide IRS math error authority to disallow associated claims for the credits. Disallowance of the Additional Child Tax Credit to filers without a valid SSN would reduce Federal outlays by $8.9 billion over 5 years. The IRS agreed to explore with the Department of the Treasury legislative changes to address the payment of refundable credits to taxpayers who file without an SSN.

3. *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).

The TIGTA identified the IRS could address $5.6 billion in erroneous claims over a 5-year period if it was able to systemically adjust the Earned Income Tax Credit claims with math error authority processing. However, the IRS does not plan to pursue expansion of math error authority to include these cases because it believes that use of probability filters to identify these cases is inconsistent with math error authority. The TIGTA recommended the IRS conduct a study of alternative processes that will expand the IRS' ability to identify and adjust erroneous Earned Income Tax Credit claims for which data show that the taxpayer does not meet the Earned Income Tax Credit qualifying-child relationship and/or residency tests. The IRS agreed to continue its ongoing efforts to identify new alternatives to expand its treatment of Earned Income Tax Credit errors. These efforts include conducting a study of the Federal Case Registry information to determine its accuracy and applicability for exercising existing math error authority to deny the Earned Income Tax Credit during upfront processing of the tax return.

4. *The 2008 Filing Season Was Generally Successful Despite the Challenges of Late and Unexpected Tax Legislation* (Reference Number 2008-40-183, dated September 30, 2008).

The TIGTA identified taxpayers age 70½ or older who improperly claimed and were allowed the Individual Retirement Account deduction and recommended the IRS ensure that the computer systems were programmed to identify taxpayer tax returns claiming Individual Retirement Account deductions for taxpayers age 70½ or older. However, IRS management did not agree citing that they did not have math error authority to enforce this condition.