TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

The Passage of Late Legislation and Incorrect Computer Programming Delayed Refunds for Some Taxpayers During the 2011 Filing Season

September 28, 2011

Reference Number: 2011-40-128

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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THE PASSAGE OF LATE LEGISLATION AND INCORRECT COMPUTER PROGRAMMING DELAYED REFUNDS FOR SOME TAXPAYERS DURING THE 2011 FILING SEASON

Highlights

Final Report issued on September 28, 2011

Highlights of Reference Number: 2011-40-128 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

One of the challenges the Internal Revenue Service (IRS) confronts each year in processing tax returns is the implementation of new tax law changes. The passage of three significant tax laws affected the 2011 Filing Season. As of April 30, 2011, the IRS received 130.7 million individual income tax returns and issued approximately 98.2 million refunds totaling $277.1 billion.

WHY TIGTA DID THE AUDIT

The filing season is critical for the IRS because it is during this time that most taxpayers file their tax returns and contact the IRS if they have questions about specific tax laws or filing procedures. The overall objective of this review was to evaluate whether the IRS timely and accurately processed individual paper and electronically filed tax returns during the 2011 Filing Season.

WHAT TIGTA FOUND

The IRS timely processed the majority of individual income tax returns during the 2011 Filing Season. However, because of the late passage of legislation, taxpayers claiming certain deductions or itemizing deductions were delayed in filing their individual tax returns. Electronic Return Originators held approximately 6.5 million electronically filed tax returns and the IRS had received and held approximately 100,000 paper tax returns until February 14.

As of April 30, 2011, the IRS had identified 775,723 tax returns with $4.6 billion claimed in fraudulent refunds and prevented the issuance of $4.4 billion (96 percent) of those fraudulent refunds. The IRS also selected 199,854 tax returns filed by prisoners for fraud screening, a 256 percent increase compared to last year.

However, our review found that implementing some legislative provisions such as the First-Time Homebuyer Credit, Adoption Credit, Nonbusiness Energy Property Credits, and Plug-in Electric and Alternative Motor Vehicle Credits resulted in an inability to identify 140,596 taxpayers erroneously claiming $140.2 million when tax returns are processed. In addition, 26,649 taxpayers had their Homebuyer Credit inaccurately processed, $5.8 million in repayment amounts was not assessed, and $675,063 in repayment amounts was erroneously assessed.

WHAT TIGTA RECOMMENDED

TIGTA made a number of recommendations. The most significant included that the IRS ensure taxpayers identified as erroneously claiming the credits and deductions detailed in the report are entitled to claim them, initiate a recovery program for erroneously paid claims, revise the programming for Homebuyer Credit repayments, and seek math error authority for certain credits detailed in the report.

The IRS agreed with 12 of 14 recommendations and plans to take corrective action. For the two disagreed recommendations, TIGTA continues to believe the IRS needs to take action. Related to our recommendation to establish a Homebuyer Credit Entity Section for each taxpayer who received the Homebuyer Credit rather than grouping information by primary and secondary Social Security Number, the lack of IRS action could result in continued problems, with delays in refunds to some taxpayers. For the issue of allocating installment repayments, TIGTA does not agree that the IRS's issuance of an alert will ensure that tax examiners accurately allocate installment repayments.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 28, 2011

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Passage of Late Legislation and Incorrect Computer Programming Delayed Refunds for Some Taxpayers During the 2011 Filing Season (Audit # 201140029)

This report presents the results of our review to evaluate whether the Internal Revenue Service (IRS) timely and accurately processed individual paper and electronically filed tax returns during the 2011 Filing Season.[1] This review is included in our Fiscal Year 2011 Annual Audit Plan and addresses the major management challenge of Implementing Health Care and Other Tax Law Changes.

The IRS agreed with 12 of our 14 recommendations. For the two disagreed recommendations, we continue to believe the IRS needs to take action. Related to our recommendation to establish a Homebuyer Credit Entity Section for each taxpayer who received the Homebuyer Credit rather than grouping information by primary and secondary Social Security Number, the lack of IRS action could result in continued problems with delays in refunds to some taxpayers. For the issue of allocating installment repayments, we do not agree that the IRS's issuance of an alert will ensure that tax examiners accurately allocate installment repayments. These issues are discussed in more detail in the report.

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

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.

[1] See Appendix VI for a glossary of terms.

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Appendices

Abbreviations

e-file(d); e-file(ing)	Electronically file(d); electronic filing
IRS	Internal Revenue Service
MeF	Modernized *e-File*
QMV	Qualified Motor Vehicle
SSN	Social Security Number
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year

Background

The filing season[1] is critical for the Internal Revenue Service (IRS) because it is during this time that most taxpayers file their income tax returns and contact the IRS if they have questions about specific tax laws or filing procedures. As of April 30, 2011, the IRS received 130.7 million individual income tax returns. One of the challenges the IRS confronts each year in processing tax returns is the implementation of new tax law changes. Before the filing season begins, the IRS must identify new tax law and administrative changes and, when necessary, revise the various tax forms, instructions, and publications. It must also reprogram its computer systems to ensure tax returns are accurately processed. Problems with tax return processing could delay refunds, affect the accuracy of accounts, and generate incorrect notices. Along with the usual required updates,[2] three significant tax laws affected the 2011 Filing Season:

The IRS received 130.7 million individual tax returns as of April 30, 2011. Three significant tax laws affected the 2011 Filing Season.

- ***<u>Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010</u>***[3] – Enacted on December 17, 2010, this law extended a number of tax deductions and credits, including the Earned Income Tax Credit and the American Opportunity Tax Credit. This new law required the IRS to reprogram its computer systems to accommodate three provisions extended by this law: 1) State and local sales tax deduction, 2) higher education tuition and fees deduction, and 3) educator expenses deduction. As a result, taxpayers who claimed one or more of these three deductions or who itemized deductions on their U.S. Individual Income Tax Return (Form 1040), Itemized Deductions (Schedule A), were unable to file their tax returns until February 14, 2011. Based on historical filing patterns, the IRS anticipated the filing delay would affect approximately 9 million taxpayers; however, only approximately 6.6 million taxpayers were affected as of February 14, 2011.
- ***<u>Housing and Economic Recovery Act of 2008</u>***[4] – Enacted on July 30, 2008, this law includes a provision that requires taxpayers who purchased a home between April 9 and December 31, 2008, and claimed the First-Time Homebuyer Credit (Homebuyer Credit) to begin repaying the credit on their Tax Year (TY) 2010 tax return. The credit is

[1] See Appendix VI for a glossary of terms.
[2] Each year, the tax products must be updated to reflect current tax rates, exemption amounts, and cost of living adjustments as show in Revenue Procedures.
[3] Pub. L. No. 111-312 124 Stat. 3296 (2010).
[4] Pub. L. No. 110-289 122 Stat. 2654 (2008).

intended to be repaid over 15 years, in equal annual installments. More than 1.5 million taxpayers were required to begin repaying the credit on their TY 2010 tax returns.

- ***The Patient Protection and Affordable Care Act (Affordable Care Act)***[5] – Enacted on March 23, 2010, this law included a provision that increased the Adoption Credit from $12,150 to $13,170 and made the tax credit refundable.[6]

Figure 1: Summarization of Repayments and Claims for the First-Time Homebuyer Credit and Claims for the Adoption Credit as of April 30, 2011

	Tax Returns With These Credits as of April 30, 2011	Amount Repaid/Claimed as of April 30, 2011
First-Time Homebuyer Credit		
• *Taxpayers Reporting Homebuyer Credit Installment Repayments*	792,554	$378 million repaid
• *Taxpayers Filing New Claims for the Homebuyer Credit*	271,390	$1.9 billion claimed
Adoption Credit	72,330	$895 million claimed

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of 2011 Filing Season tax return volumes through April 30, 2011.

During the 2011 Filing Season, the IRS processed individual income tax returns at four Wage and Investment Division Submission Processing sites.[7] All four sites processed paper individual income tax returns, and all but the Atlanta, Georgia, Submission Processing Site also processed electronically filed (*e-filed*) individual income tax returns. Andover, Massachusetts, and Philadelphia, Pennsylvania, also processed *e-filed* individual income tax returns.

This review was performed at the Wage and Investment Division Headquarters in Atlanta, Georgia; the Submission Processing function offices in Lanham, Maryland; and the Austin Submission Processing Site in Austin, Texas, during the period December 2010 through June 2011. 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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[5] Pub. L. No. 111-148 124 Stat. 119 (2010).
[6] A refundable tax credit is a tax credit that is treated as a payment and can be refunded to the taxpayer. Refundable credits can create a Federal tax refund that is larger than the amount a person actually paid in taxes during the year.
[7] Submission Processing sites in Fresno, California; Atlanta, Georgia; Kansas City, Missouri; and Austin, Texas.

Results of Review

The Majority of Individual Income Tax Returns Were Timely Processed; However, Late Legislation Caused a Delay in Processing Some Tax Returns

> ***Programming to implement late legislation required Electronic Return Originators to hold approximately 6.5 million e-file tax returns to be transmitted on February 14, 2011.***

The IRS timely processed the majority of individual income tax returns during the 2011 Filing Season and issued associated tax refunds within the required 45 calendar days of the April 18, 2011, due date. The majority of taxpayers could begin filing their TY 2010 tax returns on January 14, 2011. However, because of the late passage of the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* (enacted December 17, 2010), taxpayers claiming certain deductions or itemizing deductions (see page 1) had to wait until February 14, 2011, to file their individual tax returns. The delay affected both taxpayers who *e-filed* and paper filed. The IRS reported it had Electronic Return Originators hold approximately 6.5 million *e-file* tax returns for transmission until February 14, 2011. In addition, as of February 11, 2011, the IRS had received and held for processing approximately 100,000 paper tax returns.

As of April 30, 2011, the IRS received nearly 130.7 million tax returns. Of those, 105 million (80 percent) were *e-filed* and nearly 25.8 million (20 percent) were filed on paper (a decrease of 28.1 percent in paper-filed returns from this time last year).[8] In addition, nearly 98.2 million tax refunds totaling approximately $277.1 billion were issued. Figure 2 presents a summary of tax return filing statistics as of April 30, 2011.

[8] The IRS anticipated receiving fewer tax returns early in the filing season due to some tax returns being held for processing until February 14, 2011.

Figure 2: Comparative Filing Season Statistics as of April 30, 2011

Cumulative Filing Season Data	2010 Actual	2011 Actual	% Change
Individual Income Tax Returns			
Total Returns Received (in thousands)	129,268	130,706	***1.1%***
Paper Returns Received (in thousands)	35,807	25,756	***-28.1%***
E-Filed Returns Received (in thousands)	93,460	104,951	***12.3%***
Practitioner Prepared	59,784	67,082	***12.2%***
Home Computer	33,677	37,854	***12.4%***
Free File *(also included in Home Computer total)*	3,119	3,054	***-2.1%***
Fillable Forms *(also included in Home Computer total)*	282	410	***45.5%***
Refunds			
Total Number Issued (in thousands)	96,292	98,213	***2.0%***
Total $ (in millions)	$277,983	$277,149	***-0.3%***
Average $	$2,887	$2,822	***-2.3%***
Total Number of Direct Deposits (in thousands)	70,332	74,653	***6.1%***
Total Direct Deposit $ (in millions)	$220,044	$227,211	***3.3%***

Source: IRS 2011 Weekly Filing Season Reports. Totals and percentages may not compute to those presented due to rounding.

The e-filing rate and use of fillable forms is higher; however, use of the Free File Program continues to decrease

This year marks the 21st year of *e-filing*, with the IRS approaching a major milestone of one billion *e-filed* tax returns processed since implementation. As of April 30, 2011, *e-file* volumes were 12.3 percent higher than the volumes for the same period in 2010. The *e-file* volumes increase in Calendar Year 2011 was partially due to the preparer mandate.[9] The largest increase over last year (12.4 percent) is from taxpayers *e-filing* their tax returns from home computers, which includes Free File and fillable forms.

For the third year, the IRS and its private-sector tax software partners are offering Free File Fillable Tax Forms, which opens up the Free File Program to nearly everyone, with no income

[9] Pub. L. No. 111-92 123 Stat. 2984 (2009). This law requires paid preparers who expect to file more than 10 individual tax returns to file electronically in Calendar Year 2011. The IRS is phasing this requirement in through Calendar Year 2012.

limitations. In comparison to the 2010 Filing Season, more taxpayers are taking advantage of this filing option. Approximately 410,000 taxpayers used Fillable Forms, which is an increase of 45.5 percent over the same period in 2010. However, participation in the traditional Free File Program has decreased by 2.1 percent compared to the same period in 2010. The traditional IRS Free File Program is a free Federal online tax preparation and *e-filing* program for eligible taxpayers developed through a partnership between the IRS and the Free File Alliance LLC (a group of private-sector tax preparation companies). The program enables eligible taxpayers to use commercial tax software for free, accessible only through the IRS's web site, IRS.gov.

The IRS continues to transition the e-filing of individual tax returns to the Modernized e-File (MeF) system

The IRS continues the transition from its existing *e-filing* platform, the Legacy *e-File* system, to a modernized, Internet-based system, the MeF system. The MeF system provides real-time processing of tax returns and extensions that will improve error detection, standardize business rules, and expedite acknowledgments for the electronic receipt of tax returns. The IRS first deployed the MeF system for individual tax returns during the 2010 Filing Season. The first phase of the MeF system for individual income tax returns included the Form 1040, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return (Form 4868), and 21 forms and schedules related to the Form 1040 for TY 2009. For the 2010 Filing Season, the MeF system successfully accepted 816,012 individual tax returns for processing.

For the 2011 Filing Season, the MeF system did not provide for the filing of any additional tax forms or schedules. The primary difference between the 2010 and 2011 Filing Season releases is the ability for individual taxpayers to file prior year tax returns. Beginning with the 2011 Filing Season, the MeF system will be able to accept both TY 2009 and TY 2010 tax returns. Appendix V details specific tax forms and schedules that are accepted by the MeF system for individual filers. The number of individual tax returns transmitted through the MeF system as of April 30, 2011, (9.2 million) is significantly lower than the 35 million individual tax returns the IRS anticipated for the 2011 Filing Season. We have a separate review to evaluate the IRS's continued efforts to transition individual tax return *e-filing* to the MeF system. The overall objective of that review is to evaluate the continued implementation of the MeF system to determine whether individual income tax returns will be accurately and timely processed and whether sufficient progress is being made to replace the Legacy *e-File* system. As such, we are not including specific recommendations in this audit report.

More erroneous refunds are being detected and stopped

Unscrupulous taxpayers continue to submit tax returns with false income documents to the IRS for the sole purpose of receiving a fraudulent tax refund from the Government. As of April 30, 2011, the IRS reported that it had identified 775,723 tax returns with more than

$4.6 billion claimed in fraudulent tax refunds and prevented the issuance of more than $4.4 billion (96 percent) of the refunds.[10] This represents a 171 percent increase in the number of fraudulent tax returns identified as of this period last filing season (286,670). Figure 3 shows the number of fraudulent tax returns identified by the IRS for Processing Years 2008 through 2010, as well as the tax refund amounts that were identified and stopped.

Figure 3: Fraudulent Tax Returns and Refunds Identified and Stopped in Processing Years 2008–2010

Processing Year	Number of Fraudulent Refund Tax Returns Identified	Number of Fraudulent Refund Tax Returns Stopped	Amount of Fraudulent Refunds Identified	Amount of Fraudulent Refunds Stopped
2008	380,656	306,128	$1,959,992,377	$1,683,912,973
2009	457,369	369,257	$2,988,945,590	$2,517,094,116
2010	971,511	881,303	$7,300,996,194	$6,931,931,314

Source: IRS fraudulent tax return statistics for Processing Years 2008–2010.

In addition, the screening of prisoner tax returns has increased significantly. In a prior TIGTA review assessing the IRS fraudulent tax return screening process,[11] we reported that the majority of tax returns identified as being filed by prisoners are not sent to a tax examiner for screening to assess the potential that the tax return is fraudulent. As of April 30, 2011, the IRS reported that it had selected 199,854 tax returns filed by prisoners for screening. This represents a 256 percent increase in the number of prisoner tax returns identified and sent to screening when compared with the same period last processing year. Figure 4 shows a comparison of the number of tax returns filed by prisoners that were sent to a tax examiner for screening as of the end of April for Processing Years 2010 and 2011.

[10] The IRS could not prevent the issuance of all fraudulent tax refunds identified since some fraudulent tax returns were subsequently identified as part of a tax refund scheme after they had been processed and the refund had been released.

[11] *Expanded Access to Wage and Withholding Information Can Improve Identification of Fraudulent Tax Returns* (Reference Number 2010-40-129, dated September 30, 2010).

Figure 4: Prisoner Tax Returns Identified for Screening in Filing Seasons 2010 and 2011 (as of the end of April)

Processing Year	Number of Prisoner Tax Returns Identified for Screening	Prisoner Tax Return Percentage Change
2010	56,101	
2011	199,854	256%

Source: IRS fraudulent return statistics for Processing Years 2010 and 2011 as of the end of April.

Not many taxpayers elected to participate in a new pilot which provides the option to receive tax refunds on a prepaid debit card

The Department of the Treasury launched a pilot program this tax season offering taxpayers a safe, convenient, and low-cost financial account for the electronic delivery of Federal tax refunds. The new account option has the potential to streamline the tax administration process. For the pilot, the Department of the Treasury mailed letters to 808,000 taxpayers nationwide who are likely to have low or moderate income. The letters contained different offers inviting these taxpayers to consider activating a MyAccountCard Visa® Prepaid Debit Card in time to have their TY 2010 Federal tax refund direct deposited to the card. The MyAccountCard is a reloadable, prepaid Visa debit card that is accepted everywhere Visa debit is accepted.

The letters mailed to taxpayers about the MyAccountCard contain information about the card's features, including free services and the fee structure for optional services. The information also explains how to sign up and how to use the card to receive a Federal tax refund and conduct everyday financial transactions. As part of the pilot, the Department of the Treasury randomly offered 8 different variations of the MyAccountCard to 101,000 taxpayers each in order to evaluate which product features, fee structures, and marketing messages generate the greatest positive response from taxpayers. The results of the pilot will help determine the benefits and feasibility of a card account as an integrated part of the tax filing and refund process.

As of April 30, 2011, 239 taxpayers took advantage of this option for tax refunds totaling more than $638,000. The response rate appears to be lower than the average direct mail offer rates; however, this program is new for taxpayers and was intentionally not publicized in order not to bias the offer test. In addition, a large percentage of the population has their tax returns prepared by a tax return preparer, and any fee for these services cannot be paid for with the tax refund.

Taxpayers have increased their use of the savings bond and split refund option

Beginning in Calendar Year 2010, taxpayers had the ability to use their tax refunds to purchase United States Series I Savings Bonds by requesting them on their tax returns. Taxpayers may request any portion of their refund that is an exact multiple of $50 and less than $5,000 be used to purchase up to 3 savings bonds for themselves or other persons by simply filling out the Allocation of Refund (Including Savings Bond Purchases) (Form 8888). As of April 30, 2011, 30,263 taxpayers requested savings bond tax refunds totaling more than $10.8 million. This represents a 26 percent increase over the number of taxpayers electing to convert their tax refunds to savings bonds during the same period last filing season.

Taxpayers can also elect to have Federal income tax refunds split and electronically deposited in up to three accounts (checking, savings, or Individual Retirement Arrangement) and up to three different United States financial institutions, including banks, brokerage firms, or credit unions. Form 8888 must be prepared for this option. As of April 30, 2011, 757,561 taxpayers requested split tax refunds totaling more than $3.2 billion between 2 or 3 different checking and savings accounts. The number of taxpayers requesting the split refund option increased 36 percent over the same period in 2010, and the amount of refunds requested increased by almost 35 percent.

Implementing New Laws

Implementing new laws for the 2011 Filing Season required the IRS to update many tax products and perform extensive computer programming in an effort to ensure tax returns would be processed accurately. We selected 25 tax products to review (13 tax forms, 5 instructions, and 7 publications) that required updating due to new laws. Our review determined that the 25 tax products were updated clearly and accurately in accordance with the new tax law provisions. Furthermore, of the significant new or expanded credits/deductions we reviewed, the IRS took actions to minimize taxpayer burden and to reduce the risk of improper claims. For example:

- The IRS developed processes and procedures to assist taxpayers with Homebuyer Credit repayment requirements. For example, the IRS developed and issued Homebuyer Credit notices. These notices provide key information as to the repayment requirement, the amount that has to be repaid, etc.
- The IRS recognized that the provision in the law which made the Adoption Credit refundable could increase the risk of erroneous claims, and it developed a strategy to address these risks. This strategy includes the issuance of guidance on September 29, 2010, requiring taxpayers to complete a Qualified Adoption Expenses (Form 8839) and include one or more adoption-related documents with their TY 2010 tax return supporting the legitimacy of the claim. Because specific documentation had to be attached to the tax return, taxpayers claiming the Adoption Credit had to file paper tax returns. In addition, the IRS corrrectly developed computer programming to ensure that:
    - Taxpayers were not allowed to claim more than the maximum $13,170 in Adoption Credit expenses for each individual child for TY 2010.
    - Taxpayers were not allowed to claim the credit or the credit was reduced if their modified adjusted gross income exceeds a certain level.

- Tax returns with an Adoption Credit claim were sent to the Examination function and the Adoption Credit portion of the refund was frozen when IRS records indicated that the individual was deceased, the adoptee was deceased, or the adopted child was older than the individual (if the child was not disabled).

The IRS also addressed issues we reported related to whether it timely and accurately processed individual paper and *e-file* tax returns during the 2010 Filing Season.[12] These included:

- Preventing taxpayers from receiving more than the maximum allowable amount for the Nonbusiness Energy Property Credit based on their filing status and multiple residence indicators for TY 2010.
- Identifying taxpayers claiming excessive Qualified Motor Vehicle (QMV) deductions on Schedule A. The IRS implemented controls to identify and freeze the portion of the tax refund relating to the QMV for taxpayers claiming a QMV deduction in excess of a specific dollar amount. Once the freeze is applied, the tax return is sent to a tax examiner to determine if the QMV deduction is legimitate.

However, our review found that implementing late legislation and some legislative provisions presented challenges for the IRS. These challenges resulted in delays in completing computer programming, delays in the ability of taxpayers to file tax returns with certain deductions, and the inability to identify and prevent some erroneous claims at the time tax returns are processed.

Implementing Homebuyer Credit Provisions Continues to Present Challenges for the Internal Revenue Service

We reported in our 2010 Filing Season report that erroneous Homebuyer Credits were claimed by taxpayers with ineligible home purchase dates. As of May 28, 2010, we had identified 10,581 taxpayers claiming $65.6 million in Homebuyer Credits that appeared to be erroneous. During this review, we identified an additional 4,417 taxpayers who filed tax returns during the period May 30 through December 25, 2010, who were allowed $27.8 million in erroneous Homebuyer Credits.

- 2,812 taxpayers were allowed $16.4 million in erroneous Homebuyer Credits as a long-time resident with a purchase date prior to November 7, 2009. To qualify for this Credit, the law specifies that taxpayers must complete the purchase of the new home after November 6, 2009.
- 1,605 taxpayers were allowed $11.4 million in erroneous Homebuyer Credits with a home purchase date subsequent to the filing date of the tax return. To qualify for the

[12] *Verifying Eligibility for Certain New Tax Benefits Was a Challenge for the 2010 Filing Season* (Reference Number 2010-41-128, dated September 30, 2010).

Homebuyer Credit, taxpayers must complete the purchase of the new home before claiming the credit.

We alerted the IRS on February 23, 2011, of our concerns regarding the allowance of erroneous Homebuyer Credits based on ineligible purchase dates. In response, the IRS agreed to use third-party property records by July 2011 to verify whether the taxpayers we identified were entitled to the credit and to continue identifying erroneous claims based on ineligible purchase dates.

In addition, the IRS experienced difficulties in implementing its Homebuyer Credit repayment process. As of April 30, 2011, we identified 26,649 taxpayers for whom their Homebuyer Credit was inaccurately processed, which resulted in the IRS not assessing more than $5.8 million in repayment amounts owed but not paid and $675,063 erroneously assessed as a repayment amount in excess of what was owed by the taxpayer. These difficulties resulted in:

- Significant delays in providing refunds to taxpayers with repayment requirements.
- Inaccurate processing of repayments, including erroneously refunding repayments back to taxpayers and not properly assessing repayment amounts owed but not paid.
- Crediting taxpayers for more than the actual amount repaid and erroneously assessing higher amounts than required to be repaid.

Taxpayers with repayment requirements experienced significant refund delays

Refunds for some taxpayers with Homebuyer Credit repayment requirements were delayed up to 4 months or more because of programming issues. As early as March 23, 2011, the IRS reported that programming issues were affecting a small percentage of taxpayers with Homebuyer Credit repayment requirements. The IRS announced that it had assigned additional staff and resources to address the issues promptly. These programming issues primarily affected:

- Taxpayers who filed as married filing jointly and received the Homebuyer Credit on a 2008 home purchase.
- Taxpayers who received the Homebuyer Credit and sent in payments for more than the amount that was required.
- Taxpayers who received the Homebuyer Credit and were reporting the sale or disposition of their principle residence.

Due to programming errors, refunds were delayed for some taxpayers with Homebuyer Credit repayment requirements.

On May 20, 2011, the IRS announced that, while several programming issues had been resolved, it was still encountering issues such as mismatches related to the names or Social Security Numbers (SSN) on either the TY 2008 or the TY 2010 tax return and problems with a repayment amount that did not match the expected repayment amount for some taxpayers. The IRS reported that as of May 23, 2011, there were approximately 9,000 taxpayers whose tax returns were still being held as unresolved. However, the IRS was unable to provide a definitive number of taxpayers who were affected by programming errors.

In our review of the repayment of Homebuyer Credits,[13] we identified concerns related to the processing of Homebuyer Credits. ***********************2(f)****************** ***************************************2(f)************************************* ***************************************2(f)************************************* ***************************************2(f)*********************************. The IRS's current practice is to associate Homebuyer Credit Entity information for a primary and secondary taxpayer under the primary taxpayer's SSN, instead of separating each taxpayer's Homebuyer Credit information under his or her own SSN. The Entity Section contains Homebuyer Credit data for the primary and secondary taxpayer (for married taxpayers filing jointly), including the amount of the credit received and the year in which the home was purchased. The Homebuyer Credit Entity Section will also show the cumulative amount of the credit that has been repaid.

We notified the IRS of our concerns on October 29, 2010. We recommended the IRS modify its computer programming so the Homebuyer Credit information is reflected under the SSN of each taxpayer that received the Homebuyer Credit. The IRS did not agree with this recommendation. This decision contributed to some of the problems that are delaying refunds to taxpayers.

Some Homebuyer Credit repayments were inaccurately processed

Programming errors caused inaccurate processing of some Homebuyer Credit repayments. As of April 30, 2011, we identified 17,857 taxpayers whose Homebuyer Credit repayments were erroneously refunded back to them or whose repayment amounts owed were not properly assessed. The total amount either refunded erroneously or not assessed was more than $4.4 million.

- 1,901 taxpayers who reported either the required repayment amount or more than the required repayment amount had $839,130 of the repayments erroneously refunded.
- 15,956 taxpayers who reported repayment amounts less than the required repayment amount were not properly assessed nearly $3.6 million in additional taxes.

The IRS developed a process to identify taxpayers who do not report the required Homebuyer Credit installment repayment amount as an additional tax on their tax return. The IRS established an amount field[14] on its computer systems, which is the amount the IRS expects the

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[13] *First-Time Homebuyer Credit Repayment Notices Were Incorrect, and the Method Used to Identify Dispositions Is Unreliable* (Reference Number 2011-41-097, dated September 15, 2011).

[14] The IRS calculates this amount based on 1/15th of the First-Time Homebuyer Credit amount received by the taxpayer.

taxpayer to report on the First-Time Homebuyer Credit and Repayment of the Credit (Form 5405). When tax returns are filed, the IRS matches the amount reported as an additional tax on the tax return to the expected amount. If a discrepancy exists, the tax return is sent to the IRS's Error Resolution System function for resolution.

However, early in the 2011 Filing Season, we identified that the field in the IRS's database with the repayment amount expected did not contain an amount for most taxpayers (approximately 80 percent) with a repayment requirement whose tax returns were processed during the period January 22 through February 5, 2011. We alerted the IRS on February 16, 2011, and the IRS responded that the programming was being revised. However, we continued to identify these issues and notified the IRS again in May and June 2011.

Taxpayers were credited for Homebuyer Credit repayment amounts more than what was repaid or were erroneously assessed more than what was required to be repaid

On March 23, 2011, the IRS announced that it had to delay tax refunds to taxpayers who received the Homebuyer Credit for a 2008 home purchase and had a filing status of married filing jointly. Joint filers who claimed the credit are responsible separately for half of the repayment of the credit. The IRS stated that this delay resulted from having to manually split the repayment amount between the two taxpayers listed on the joint tax return. These taxpayers submitted a Form 5405 with their return. Computer programming incorrectly verified the total amount of the repayment for each taxpayer rather than what the joint couple owed together. If the repayment amount was at least equal to the required joint repayment amount, then the programming would credit only the primary taxpayer for the repayment. The secondary taxpayer's account would incorrectly reflect that a repayment was owed because the repayment was not split and instead was credited to only the primary account. As of April 30, 2011, we identified 8,792 taxpayers who were joint filers and received credit for an amount greater than they repaid or were assessed an amount more than they were required to repay.

- 6,027 taxpayers received payment credits totaling $1.4 million more than what they actually repaid. While adjusting the affected tax returns, tax examiners erroneously increased the amount repaid by 50 percent. The computer program did not correctly split repayment amounts between primary and secondary filers.
- 2,765 taxpayers were erroneously assessed $675,063 more than what they were required to repay. While adjusting the affected tax returns, tax examiners erroneously assessed 50 percent more than the taxpayers were required to repay.

On May 9, 2011, we alerted IRS to these conditions. We recommended that the IRS correct the repayment amounts and ensure that programming changes are made to prevent tax examiners from increasing the repayment installment amount without increasing the associated tax liability. The IRS responded that it will correct the repayment amounts for the 8,792 taxpayers we identified. The IRS noted that it issued procedures to tax examiners for processing repayments from joint taxpayers. However, the IRS also responded that the complexity of the Homebuyer Credit and its recordkeeping preclude the recommended programming changes.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Ensure the 4,417 taxpayers identified as claiming the Homebuyer Credit for ineligible past purchase dates or future purchase dates are entitled to claim the credit.

> ***Management's Response:*** IRS management agreed with this recommendation and is taking steps to correct the accounts of 4,417 taxpayers not entitled to the credit. The IRS implemented processes to identify other individuals who had also claimed the credit with a future purchase date or who had claimed the long-time resident credit prior to the implementation date of the provision.

Recommendation 2: Establish a Homebuyer Credit Entity Section for each taxpayer who received the Homebuyer Credit rather than grouping information by primary and secondary SSN.

> ***Management's Response:*** IRS management agreed with the intent of this recommendation. However, the IRS has determined that establishing a Homebuyer Credit Entity Section for each taxpayer who received the Homebuyer Credit, rather than grouping information by primary and secondary SSN, is not needed to address the issues identified in the audit report. The issues outlined in our report were not caused by the absence of First-Time Homebuyer Credit information in the Entity Section of taxpayer accounts.
>
> ***Office of Audit Comment:*** We disagree with the IRS's response to this recommendation. The lack of a unique Homebuyer Credit Entity Section for each individual contributed to some of the problems that delayed refunds to taxpayers. We notified the IRS of our concerns on October 29, 2010, and recommended the IRS modify its computer programming so the Homebuyer Credit information is reflected under the SSN of each taxpayer who received the Homebuyer Credit, but the IRS did not take the recommended action. The lack of IRS action could result in continued problems with delays in refunds to some taxpayers.

Recommendation 3: Ensure that the required Homebuyer Credit installment repayment field is accurately populated with the amount that must be repaid by each taxpayer.

> ***Management's Response:*** IRS management agreed with this recommendation. Error Resolution System programming is in place to retrieve and retain the data to be displayed by the Error Resolution System, provided the data are available in the National Account Profile First-Time Homebuyer Credit database for the taxpayer filing the return.

A programming change to the National Account Profile data file, on April 16, 2011, corrected the problem.

Recommendation 4: Ensure that the tax accounts are corrected for the 17,857 taxpayers who had their Homebuyer Credit repayment erroneously refunded or who owed repayment amounts that were not paid and were not properly assessed.

Management's Response: IRS management agreed with this recommendation. The IRS has revised programming and actions have been taken to recover Homebuyer Credit repayments erroneously refunded and repayment amounts that were not paid or not properly assessed.

Recommendation 5: Ensure that the tax accounts are corrected for the 8,792 taxpayers who received an amount greater than they repaid or who were assessed an amount more than they were required to repay.

Management's Response: IRS management agreed with this recommendation and has already completed the necessary actions to correct the accounts. Actions taken include adjusting the tax and issuing the appropriate notification to the 2,765 taxpayers whose tax was affected. The accounts of the remaining 6,027 taxpayers were adjusted to reflect appropriate repayment amounts. Final adjustments to the accounts were completed in late July 2011.

***Recommendation 6*:** Ensure that programming changes are made to prevent tax examiners from increasing the installment repayment amount without increasing the associated tax liability.

Management's Response: IRS management disagreed with this recommendation. Systemically preventing tax examiners from increasing the repayment installment amount is undesirable because taxpayers may pay more than the required amount. The IRS has issued procedures instructing tax examiners of the process to follow when joint filers each have to repay the First-Time Homebuyer Credit. A Servicewide Electronic Research Program alert (110446) was issued on June 15, 2011, to reinforce the correct procedures.

Office of Audit Comment: We do not agree that the IRS's issuance of an alert will ensure that tax examiners accurately allocate installment repayments. Our recommendation for a systemic process would identify situations in which tax examiners erroneously increase installment repayment amounts without increasing the associated tax liability. For example, it would identify if the IRS received a payment of $100 but the tax examiner erroneously allocated the payment as $150. Our recommendation was to ensure these types of errors are systemically identified.

Taxpayers Are Erroneously Receiving the Adoption Credit, and the Authority to Address Adoption Credit Noncompliance Is Limited

Our analysis of Adoption Credit processing controls identified that although the IRS requires taxpayers to attach documentation to their tax returns supporting Adoption Credit claims, it does not have math error authority to deny the credits if documentation is not provided. As a result, tax returns without required documentation must be sent to the Examination function, increasing costs for the IRS and burden for the taxpayer. In addition, some taxpayers are erroneously receiving the Adoption Credit. As of April 30, 2011, there were 736 taxpayers who erroneously received more than $4 million in Adoption Credits. Figure 5 provides an analysis of the erroneous Adoption Credit claims that were not sent to the Examination function.

Figure 5: Erroneous Adoption Credit Claims as of April 30, 2011

Type of Erroneous Claim	Number of Claims	Number Not Sent to Exam	Total Dollar Amount of Erroneous Claims Not Sent to Exam
Inaccurate Unused Adoption Credit Amount Claimed[15]	11,925	499	$3,342,708
Claimed Over the Maximum Limit Per Child Over Multiple Years	658	237	$694,309
Total	**12,583**	**736**	**$4,037,017**

Source: TIGTA analysis of the Individual Return Transaction File and sample review of individual tax returns.

Some refunds were delayed and IRS additional resources were used because the IRS did not have math error authority to reject claims with insufficient documentation

As previously stated, the IRS does not have math error authority to deny the Adoption Credit at the time tax returns are processed if required documentation is not provided. Without this authority, the IRS must deny the credit using the examination process after initial processing of the returns and related refunds.

[15] Prior to TY 2010, the Adoption Credit was a nonrefundable credit that was limited to the amount of the tax liability on the tax return. Individuals were allowed to carry any unused amount forward for 5 years. An additional 600 of the 11,925 claims had inaccurate unused Adoption Credit claims but were excluded from being sent to the Examination function because they did not meet IRS examination criteria.

On October 29, 2010, we recommended that the IRS work with the Department of the Treasury to seek legislation from Congress for math error authority. However, the IRS did not agree with the recommendation and responded that it had developed and implemented sufficient filters and compliance tools to handle potential Adoption Credit fraud. These filters and compliance tools include identification of tax returns that do not meet specific requirements for claiming the Adoption Credit. All tax returns that do not meet one or more of these requirements are sent to the Examination function for review.

As of April 30, 2011, the IRS had received 72,330 individual tax returns claiming more than $895 million in Adoption Credits. Of the 72,330 Adoption Credit claims, 41,591 (58 percent) met IRS documentation criteria for sending the tax return to its Examination function. These claims either had no required documentation attached to the tax return or the documentation was invalid or insufficient.[16]

Math error processing to deny the claims without required documentation at the time the tax return was processed would have been less burdensome on taxpayers than the post-processing examinations. For example, taxpayers would have been notified of the denial of the Adoption Credit during processing and informed that they could provide the IRS with the necessary documentation in support of their eligibility. The IRS has a goal to resolve these responses within 30 days of receipt of the information supporting the individual's disagreement with the adjustment.

The IRS was unable to provide an average time period for resolving Adoption Credit claims sent for post-processing examinations. The IRS will not have this information until the end of the fiscal year because of the limited number of cases closed to date. However, the IRS estimates that after tax returns are identified as not meeting the documentation requirements and are selected for examination, taxpayers should receive notification within 3 to 4 weeks. They have 30 days to respond to the IRS's request for the required documentation. Once the IRS receives the information, it does not have a specific time period within which to resolve the case.

Taxpayers erroneously claimed unused Adoption Credit amounts

Prior to TY 2010, the Adoption Credit was a nonrefundable credit that was limited to the amount of the tax liability on the tax return. Taxpayers were allowed to carry any unused amount forward for 5 years. Taxpayers were allowed to claim the Adoption Credit for qualified adoption expenses plus any amounts carried forward from prior years up to a maximum limit of $12,150 for each child in TY 2009. Our review identified that taxpayers erroneously carried forward Adoption Credit amounts. For example:

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[16] We identified an additional 684 claims with no required documentation attached or with invalid or insufficient documentation that were not sent to the Examination function. ****************2(f)**********************
*************2(F)*****.

For TY 2009, Taxpayer A had $10,000 in qualified adoption expenses, but his tax liability was only $5,000. Therefore, he claimed an Adoption Credit of $5,000, leaving $5,000 in unused Adoption Credit to be carried forward to the next year. Then, in TY 2010, Taxpayer A had $1,000 in new qualified adoption expenses. He claimed $1,000 in new expenses but claimed $6,000 in unused Adoption Credit carried forward from the previous year, for a TY 2010 Adoption Credit total of $7,000. Thus, Taxpayer A overstated the amount of unused Adoption Credit for which he was eligible. He should have claimed $1,000 in new expenses and $5,000 in unused Adoption Credit, for a TY 2010 Adoption Credit total of $6,000.[17]

As of April 30, 2011, we found that 11,925 tax returns overstated unused Adoption Credit claims by $110.8 million. The IRS caught the majority of these overstated claims. However, we identified 499 tax returns with overstated claims that the IRS did not identify and send to the Examination function. As a result, these taxpayers received $3.3 million in erroneous Adoption Credits.

We issued an Email Alert to the IRS on April 5, 2011, that some taxpayers who overstated their unused Adoption Credit claims had not been selected for audit. We recommended that the IRS implement procedures to send all tax returns with overstated Adoption Credit claims to the Examination function and to freeze the refund. IRS management responded that they reviewed the computer programming and found that it was not working as intended; the IRS implemented programming corrections on April 12, 2011.

Taxpayers claimed Adoption Credits over the maximum limit per child for multiple years

We analyzed individual tax returns claiming the Adoption Credit in TYs 2008 and 2009 and identified 658 taxpayers who claimed Adoption Credits for the same child that exceed the allowable amount. For example:

Taxpayer A was allowed to claim the credit for qualified adoption expenses of up to $11,650 for TY 2008 and up to $12,150 for TY 2009 for the same child. In TY 2008, Taxpayer A received $11,650 for qualified adoption expenses for 1 child, plus $15,000 carried forward from TY 2007. In TY 2009, Taxpayer A again received $12,150 for the same child, plus $20,000 carried forward from TY 2008. In total, Taxpayer A received $58,800 in Adoption Credit for the same child, when Taxpayer A was only entitled to a maximum of $12,150 for the child.[18]

These taxpayers erroneously received more than $2.2 million in Adoption Credits for 658 children. Although the IRS has a process to ensure taxpayers do not claim adoption

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[17] This is an example of a hypothetical situation.
[18] This is an example of a hypothetical situation.

expenses in excess of the allowed amount in any one tax year, the taxpayers were not limited in the amount of unused Adoption Credit claimed from a prior year. In addition, prior to this filing season, the IRS did not have a process to ensure taxpayers do not claim in excess of the allowed amount when claiming the same child over multiple tax years.

We issued an Email Alert to the IRS on February 17, 2011, and recommended that the IRS develop a process to prevent taxpayers from receiving more than the allowable maximum amount of the Adoption Credit for each child when claiming the credit over multiple tax years. The IRS responded that for the 2011 Filing Season, it has examination filters in place to address taxpayers claiming more than the allowable amount after the first year of an Adoption Credit claim. In December 2010, the IRS had identified 421 of the 658 taxpayers we identified. The remaining 237 taxpayers who were not identified by the IRS had claims totaling more than $694,000.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 7: Verify the claims on the 499 tax returns that claimed an incorrect amount of unused Adoption Credit and were not sent to the Examination function to determine what portion of the Adoption Credit was appropriate.

> ***Management's Response:*** IRS management agreed with this recommendation and has included these cases in their Fiscal Year 2012 Examination plan. The IRS will review these returns and conduct examinations when warranted.

Recommendation 8: Verify the claims on the 237 tax returns that claimed over the maximum limit over multiple years but were not selected for audit by the Examination function to determine what portion of the Adoption Credit was appropriate.

> ***Management's Response:*** IRS management agreed with this recommendation and has included these cases in their Fiscal Year 2012 Examination plan. The IRS will review these returns and conduct examinations when warranted.

Legislative Recommendation

The Commissioner, Wage and Investment Division, should:

Recommendation 9: Work with the Department of the Treasury to seek math error authority from Congress for Adoption Credit claims with insufficient documentation.

> ***Management's Response:*** IRS management agreed with this recommendation and will discuss it with the Department of the Treasury, Office of Tax Policy.

Taxpayers Received Erroneous Nonbusiness Energy Property Credits in Excess of the Maximum Amount Allowed

As of April 30, 2011, we have identified 111,710 taxpayers who erroneously claimed in excess of $76.3 million in Nonbusiness Energy Property Credits. Processes were not developed to ensure taxpayers did not claim more than the maximum allowed $1,500 for the credit for both TY 2009 and TY 2010. In addition, we identified 94 taxpayers filing as married who erroneously claimed in excess of $111,000. These taxpayers were allowed to erroneously claim more than the maximum allowed $3,000 for both TY 2009 and TY 2010.

The American Recovery and Reinvestment Act (Recovery Act)[19] modified the provision for the Nonbusiness Energy Property Credit. The modifications were to encourage the purchase of energy efficient property for an individual's principal residence that were designed to reduce heat loss during cold months or heat gain during warm months. The Nonbusiness Energy Property Credit allows taxpayers to take a credit of 30 percent of the costs paid or incurred in Calendar Year 2010 for energy efficient products for their principal residence, with a maximum of $1,500 (or $3,000 for married taxpayers filing jointly under certain circumstances).[20]

We alerted the IRS on February 23, 2011, of the above condition and recommended that the IRS immediately develop a process to prevent taxpayers from receiving more than the allowable maximum amount of the Nonbusiness Energy Property Credit. We also recommended the IRS initiate a recovery program for the 111,689 taxpayers that we had identified as claiming more than the allowable maximum amount of the credit as of that point in time. The IRS responded that it had confirmed with Wage and Investment Division Chief Counsel that the IRS does not have the requisite math error authority needed to deny Nonbusiness Energy Property Credits claimed in excess of the $1,500 lifetime limitation provided by Internal Revenue Code Section 25C. The IRS will test a sample of 500 cases from the total number of erroneous claims we identified. The results will be analyzed to determine the volume of cases to be worked based on business results and resource availability.

Recommendation

The Commissioner, Wage and Investment Division, should:

***Recommendation 10*:** Initiate a recovery program for the review of the 111,804 taxpayers that we identified as claiming more than the 2-year maximum limit of the Nonbusiness Energy Property Credit to recover the $76.4 million in erroneous credits refunded.

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[19] Pub. L. 111-5, 123 Stat. 115 (2009).

[20] If a taxpayer and his or her spouse owned and lived apart in separate main homes, they may each qualify for $1,500.

Management's Response: IRS management agreed with this recommendation. As TIGTA notes in the report, the IRS does not have the legal authority to automatically adjust these returns with math error authority. Recovery of the credits must be accomplished by the use of deficiency procedures, which can be a resource-intensive process. The IRS will build upon the findings of the subset of these returns that have been identified for audit to develop a program that will leverage available resources to maximize recoveries of the credits claimed in excess of allowable limits.

Legislative Recommendation

The Commissioner, Wage and Investment Division, should:

Recommendation 11: Work with the Department of the Treasury to seek math error authority from Congress to prevent the overpayment of credits subject to lifetime limits spanning multiple tax periods.

Management's Response: IRS management agreed with this recommendation and will discuss it with the Department of the Treasury, Office of Tax Policy.

Taxpayers Continue to Erroneously Claim Qualified Plug-in Electric and Alternative Motor Vehicle Credits

The Recovery Act included a number of provisions that encourage the purchase of motor vehicles (or the conversion of motor vehicles to those) that operate on clean renewable sources of energy. In a prior review,[21] we identified taxpayers claiming erroneous plug-in electric and alternative motor vehicle credits. We recommended that the IRS develop a process to ensure taxpayers are not erroneously claiming credits with nonqualifying vehicle makes and models. The IRS agreed with this recommendation and noted that for the 2011 Filing Season, examiners would be performing a review of the make and model of the vehicle claimed on each Qualified Plug-in Electric Drive Motor Vehicle Credit (Form 8936) and disallow any clearly nonqualifying motor vehicles.

However, we continue to identify taxpayers using nonqualifying vehicles to erroneously claim plug-in electric vehicle credits. As of April 30, 2011, we identified 23,639 taxpayers erroneously claiming $32 million in plug-in electric and alternative motor vehicle credits.[22] This includes:

- 723 taxpayers erroneously claimed more than $2 million on Forms 8936 for nonqualifying vehicles. These erroneous claims accounted for 83 percent of all claims on Forms 8936.

[21] *Individuals Received Millions of Dollars in Erroneous Plug-in Electric and Alternative Motor Vehicle Credits*, (Reference Number 2011-41-011, dated January 21, 2011).
[22] All of the volumes reported on are *e-filed* tax returns.

- 21,353 taxpayers erroneously claimed nearly $27.7 million on an Alternative Motor Vehicle Credit (Form 8910) for nonqualifying vehicles. These erroneous claims accounted for 52 percent of all claims on Form 8910.
- 1,563 taxpayers erroneously claimed more than $2.2 million on a Qualified Plug-in Electric and Electric Vehicle Credit (Form 8834) for nonqualifying vehicles. These erroneous claims accounted for 78 percent of all claims on Form 8834.

Recommendation

The Commissioner, Wage and Investment Division, should:

Recommendation 12: Initiate actions to recover the $32 million in plug-in electric and alternative motor vehicle credits claimed by the 23,639 taxpayers the TIGTA identified as having erroneously claimed these credits.

> ***Management's Response:*** IRS management agreed with this recommendation and has taken steps to address the potential noncompliance in the taxpayer segment. The Director, Reporting Compliance, Wage and Investment Division, and the Director, Campus Reporting Compliance, Small Business/Self-Employed Division, have included a sample of these cases in the Fiscal Year 2012 Examination plan. The IRS will evaluate the results achieved through audits of the selected sample of returns and will adjust the plan accordingly to maximize the effective use of examination resources.

Legislative Recommendation

The Commissioner, Wage and Investment Division, should:

Recommendation 13: Work with the Department of the Treasury to seek math error authority from Congress to deny Qualified Plug-in Electric Drive Motor Vehicle Credits for nonqualifying makes of motor vehicles.

> ***Management's Response:*** IRS management agreed with this recommendation and will discuss it with the Department of the Treasury, Office of Tax Policy.

Taxpayers Appear to Be Erroneously Claiming Motor Vehicle Deductions

The Recovery Act provides taxpayers with a QMV deduction, which is an additional deduction for State sales tax and excise tax on the purchase of certain motor vehicles. For TY 2009 only, taxpayers could deduct State sales tax and excise tax for qualified motor vehicle purchases made after February 16, 2009, and before January 1, 2010. The expiration date for the QMV deduction was December 31, 2009.

As of April 30, 2011, there were 437,332 taxpayers who claimed more than $606.8 million in QMV deductions on TY 2010 tax returns. In our opinion, the circumstances for which an individual can claim a QMV deduction on a TY 2010 tax return are unusual. As such, there should not be a large number of these claims. Specifically, for TY 2010, an individual may claim the QMV deduction for a vehicle that was purchased in 2009, but State and local sales taxes were paid after December 31, 2009. In other words, an individual purchased a new vehicle in 2009 but did not pay sales or excise tax until 2010.

We alerted IRS management on February 23, 2011, of our concerns related to the high volume of TY 2010 QMV deductions and the possibility that taxpayers were erroneously claiming this deduction. The IRS indicated that its research group will perform additional analysis relating to the 127,577 QMV deductions we had identified as of February 20, 2011, to determine the validity of the QMV deductions claimed on Schedule A and Standard Deduction for Certain Filers (Schedule L). The IRS responded on July 5, 2011, that its research group was unable to determine the validity of these claims, but it will be performing examinations on 1,000 of these tax returns.

States requiring sales tax be paid at the time of vehicle purchase may be an indicator of taxpayers erroneously claiming Motor Vehicle deduction

*********************************2(f)**
*********************2(f)*******************. Taxpayers do not have to provide any third-party documentation to support that they actually purchased a qualified motor vehicle and, if a qualified vehicle was purchased, the date the vehicle was purchased and the date and the amount paid of sales and excise taxes. *************************2(f)****************
2(f)*************************.

Many States require that sales tax be paid to the motor vehicle dealer at the time of purchase. Claims from taxpayers in these States provide the IRS with information that could be used to identify potentially erroneous QMV deductions. For example, California, Florida, Illinois, and Texas are examples of four States that have this requirement. We identified 136,036 taxpayers who reside in these States and claimed the QMV deduction in TY 2010. If the taxpayers who reside in these States also purchased their vehicle in these States, they could have potentially received more than $235 million in erroneous QMV deductions since they would not have paid the sales tax in 2010 for a 2009 purchase made in these States. Figure 6 provides a breakdown of four States where sales tax or excise tax is due at the time of purchase.

Figure 6: Taxpayers Residing in States That Require Sales Tax to Be Paid at the Time of Purchase and Claiming the QMV Deduction in TY 2010 for Motor Vehicles Purchased in 2009

State	Number of Taxpayers	Total Qualified Motor Vehicle Tax Deduction Claimed	Estimated Tax Impact
California	56,839	$112,554,249	$11,255,425
Florida	26,360	$40,865,822	$4,086,582
Illinois	18,872	$29,612,446	$2,961,245
Texas	33,965	$52,698,667	$5,269,867
Total Claims	**136,036**	**$235,731,184**	**$23,573,119**

Source: TIGTA analysis of the IRS's Individual Return Transaction File.

A prior review identified that processes did not ensure excessive deductions were identified

We previously reported that the process to identify potentially erroneous QMV deductions was not effective. The IRS failed to identify 4,257 taxpayers claiming an excessive (as defined by the IRS) QMV deduction during tax return processing so it could hold and prevent the possible issuance of erroneous tax refunds. These taxpayers claimed a total of more than $151.1 million in QMV deductions. The TIGTA also identified 473 taxpayers for which information that the IRS maintains identifies them as ineligible to claim about $1.02 million in QMV deductions they were allowed. These taxpayers were in prison, deceased, or underage. Finally, the processes that the IRS established to verify the QMV deductions claimed on 3,026 individual tax returns the IRS identified as excessive are also resulting in the erroneous release of tax refunds. Our testing identified that the IRS does not ensure tax examiners are taking the necessary steps to verify the QMV deductions.

We monitored the IRS's progress in verifying potentially erroneous QMV deductions claimed on 7,756 individual tax returns. Based on our analysis of tax records, an examination has not been initiated on 2,506 (32 percent) of the 7,756 taxpayers' tax returns. Assessments totaling more than $3 million in tax were made for 2,034 taxpayers. Figure 7 shows a breakdown of our analysis of the 7,756 individual tax returns identified in our prior review.

Figure 7: Taxpayers Indentified in a Prior TIGTA Review and Referred to IRS for Verification of QMV Deductions

Category	Total Identified	Number With Examinations Not Initiated	Number With Examination Indicators	Number With Assessments	Total Dollar Amount Assessed
Excessive Claims	4,257	2,073	2,184	106	$142,689
Ineligible Taxpayers	473	337	136	66	$0[23]
Refunds Released	3,026	96	2,930	1,862	$3,038,966
Total	**7,756**	**2,506**	**5,250**	**2,034**	**$3,181,655**

Source: TIGTA analysis of the IRS's Master File as of May 28, 2011.

Recommendation

The Commissioner, Wage and Investment Division, should:

Recommendation 14: Require taxpayers who claimed a QMV deduction in TY 2010 to provide documentation for proof of purchase of a qualified vehicle, including the date any State sales or excise tax was paid.

> **Management's Response:** IRS management agreed with this recommendation. The Director, Reporting Compliance, Wage and Investment, will work with the Director, Campus Reporting Compliance, Small Business/Self-Employed Division, to include a sample in the Fiscal Year 2012 Examination plan. Documentation will be requested as part of the examination. The results of these examinations will be used to determine if further examinations are warranted. The IRS will evaluate the results achieved through audits of the selected sample of returns and will adjust the plan accordingly to maximize the effective use of examination resources.

[23] Individual tax returns were examined and closed without change to the amount of tax.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate whether the IRS timely and accurately processed individual paper and *e-filed* tax returns during the 2011 Filing Season.[1] To accomplish our objective, we:

I. Identified new tax legislation and administrative changes for the 2011 Filing Season that would have the greatest potential effect on individual taxpayers.

   A. Reviewed tax forms, instructions, and publications to determine whether they were accurately updated with the changes.

   B. Reviewed tax return processing procedures and change documentation to determine whether adequate controls were included to accurately process the new tax provisions during tax return processing.

II. Identified volumes of paper and *e-filed* tax returns received through April 30, 2011, from the IRS Weekly Filing Season reports that provide a year-to-date comparison of scheduled return receipts to actual return receipts. The reports also provide a comparison to 2010 receipts for the same time period.

III. Determined whether the IRS correctly implemented new tax legislation that affected the processing of individual tax returns during the 2011 Filing Season. We used computer analysis of 100 percent of the TY 2010 individual income tax returns processed nationally on the Individual Return Transaction File between January 1 and April 30, 2011,[2] to identify returns affected by recent tax legislation and determined if they were processed correctly. We electronically identified:

   A. First-Time Homebuyer Credit (Homebuyer Credit).

      1. Electronically identified 792,554 TY 2010 tax returns reporting installment payments of $367 million on First-Time Homebuyer Credit and Repayment of the Credit (Form 5405) and reviewed a sample of 30 tax returns to determine whether the installment payment was properly posted to the Individual Master File

[1] See Appendix VI for a glossary of terms.

[2] To assess the reliability of computer-processed data, programmers in the TIGTA Office of Information Services validated the data that were extracted and we verified the data with appropriate documentation. Judgmental samples were reviewed to ensure that the amounts presented were supported by external sources. As appropriate, data were compared to the physical tax returns to verify that the amounts were supported.

account. We performed computer analysis on the 792,554 TY 2010 tax returns to determine if tax returns were processed correctly.

2. Electronically identified 32,091 TY 2010 tax returns for taxpayer who received the Homebuyer Credit for homes purchased in 2008 but did not report an installment payment on Form 5405. We reviewed a random sample of 30 tax returns to determine whether additional tax was assessed for the unreported installment payment. We performed computer analysis on the 32,091 TY 2010 tax returns to determine whether they were processed correctly.

3. Electronically identified 271,390 TY 2010 tax returns claiming nearly $1.9 billion in Homebuyer Credits on Form 5405.

B. Expansion of the Adoption Credit.

1. Identified 72,330 taxpayers claiming $895,031,504 in Adoption Credits on Qualified Adoption Expenses (Form 8839) and U.S. Individual Income Tax Returns (Form 1040), Line 71b. We performed computer analysis to evaluate these individual tax returns to determine whether they were properly processed.

2. Determined whether individual tax returns were processed correctly and taxpayers were not allowed to claim over the TY 2010 $13,170 Adoption Credit limit, the Adoption Credit was properly reduced when modified adjusted gross income was within the phase-out range, and the Adoption Credit was not allowed when modified adjusted gross income was above the phase-out range.

3. Determined whether refunds were correctly frozen and taxpayer notices were properly issued. We identified 42,309 tax returns meeting criteria to have the Adoption Credit portion of the refund frozen and the tax return sent to the Examination function for further processing. We reviewed Individual Master File account information for the 42,309 taxpayers to determine whether refunds were frozen and tax returns were sent to the Examination function.

C. Electronically identified all TY 2009 tax returns that reported unused Adoption Credit amounts carried forward. We matched all TY 2010 tax returns claiming an amount carried forward to the related TY 2009 return and identified TY 2010 returns claiming unused Adoption Credits for which no unused Adoption Credit was reported in TY 2009. Also, we identified TY 2010 returns claiming unused Adoption Credit amounts that were overstated from TY 2009.

D. Nonbusiness Energy Property Credit.

1. Identified and evaluated 5,293,296 tax returns claiming the Nonbusiness Energy Property Credit and determined whether the individual previously claimed the Nonbusiness Energy Property Credit in TY 2009.

2. Matched all TY 2010 tax returns claiming Nonbusiness Energy Property Credits to tax returns claiming the credit in TY 2009 to identify taxpayers who claimed Nonbusiness Energy Property Credits over the statutory limit for TY 2009 and TY 2010.

E. Qualified Plug-in Electric Drive Motor Vehicle Credit.

1. Identified and evaluated 866 tax returns filing a Qualified Plug-in Electric Drive Motor Vehicle Credit (Form 8936) to determine whether the credit was claimed for: vehicles with nonqualifying years, placed-in-service dates, or makes and models; an excessive number of vehicles; or a vehicle for which other (multiple) claims were made.

IV. Determined if the corrective actions implemented by the IRS in response to prior TIGTA reports[3] accurately resolved problems that were identified and followed up on findings identified in those reports.

A. Homebuyer Credit.

1. Determined whether IRS management initiated corrective actions for tax returns claiming the Homebuyer Credit as a long-time resident for purchase dates prior to November 7, 2009.

   a) Electronically identified 2,812 TY 2009 tax returns processed between May 28 and December 31, 2010, that were allowed to erroneously claim the Credit as a long-time resident for purchase dates prior to November 7, 2009.

   b) Determined whether processes were established to identify errors on tax returns for this condition and if the description in the notice sent to the taxpayer accurately described the condition identified.

2. Determined whether IRS management initiated corrective actions for tax returns claiming the Homebuyer Credit for a future home purchase.

   a) Electronically identified 1,605 TY 2009 tax returns processed between May 28 and December 31, 2010, that were allowed to erroneously claim the Credit for a future purchase date.

   b) Determined whether processes were established to identify errors on tax returns for this condition and if the Taxpayer Notice Code description accurately described the condition identified.

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[3] *Verifying Eligibility for Certain New Tax Benefits Was a Challenge for the 2010 Filing Season* (Reference Number 2010-41-128, dated September 30, 2010), and *Individuals Received Millions of Dollars in Erroneous Plug-in Electric and Alternative Motor Vehicle Credits* (Reference Number 2011-41-011, dated January 21, 2011).

B. Plug-in Electric Vehicle Credits and Alternative Motor Vehicle Credit.

   1. Determined whether IRS management initiated corrective actions to ensure that the computer systems and tax return processing procedures were updated to identify and disallow vehicles with nonqualifying years, placed-in-service dates, or makes and models; excessive multiple vehicle claims; and multiple claims for the same vehicle, including programming to reject *e-filed* returns with these conditions.

   2. Determined whether IRS management initiated corrective actions to track and account for vehicle credits claimed on Qualified Plug-in Electric and Electric Vehicle Credit (Form 8834), Alternative Motor Vehicle Credit (Form 8910), and Form 8936 for paper-filed tax returns.

   3. Identified and evaluated 2,001 tax returns with a Form 8834 to determine whether the credit was claimed for: vehicles with nonqualifying years, placed-in-service dates, or makes and models; an excessive number of vehicles; or a vehicle for which other (multiple) claims were made.

C. Identified and evaluated 41,085 tax returns with a Form 8910 to determine whether the credit was claimed for: vehicles with nonqualifying years, placed-in-service dates, or makes and models; an excessive number of vehicles; or a vehicle for which other (multiple) claims were made.

D. Nonbusiness Energy Property Credit.

   1. Determined whether IRS management initiated corrective actions to ensure that the computer systems and tax return processing procedures were updated to identify individual claims exceeding the maximum allowable Nonbusiness Energy Property Credit amount, including programming to reject *e-filed* tax returns with this condition.

   2. Electronically analyzed tax returns claiming the Nonbusiness Energy Property Credit to verify that the processes had been implemented to prevent claims exceeding the maximum amount allowed.

E. Qualified Motor Vehicle Tax Deduction.

   1. Determined whether IRS management effectively identified erroneous Qualified Motor Vehicle Tax deductions claimed on Itemized Deductions (Schedule A) (Form 1040) and Standard Deduction for Certain Filers (Schedule L) (Form 1040 or Form 1040-A[4]).

[4] Another version of the U.S. Individual Income Tax Return.

2. Electronically identified 427,332 taxpayers claiming $606,823,690 in Qualified Motor Vehicle Tax deductions on Schedules A or Schedules L for TY 2010.

V. Identified the interim results for the Wage and Investment Division's Accounts Management function fraudulent tax return statistics.

A. Obtained the Questionable Refund Program Workload Comparison Summary Report as of April 30, 2011, to identify the interim IRS fraudulent tax return statistics for the 2011 Filing Season.

B. Obtained the Questionable Refund Program Workload Comparison Summary Report for Processing Year 2010 and reviewed a prior TIGTA report[5] to obtain IRS fraudulent tax return statistics and determined the number of erroneous refunds identified and stopped for Processing Years 2008 through 2010.

VI. Determined whether taxpayers were using the savings bond option for direct purchase of savings bonds from their refunds and whether taxpayers significantly increased their use of the split refund option by electronically identifying and counting the tax returns filed with Allocation of Refund (Including Savings Bond Purchases) (Form 8888).

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: controls over information processing – we reviewed the Work Requests and Error Resolution Internal Revenue Manuals for controls over the tax law changes under review. Accurate and timely recording of transactions and events – we monitored the timeliness of returns processing using the IRS's Report of Individual Income Tax Returns Received and Processed and the Miscellaneous Monitoring Report. Appropriate documentation of transactions and internal controls – when appropriate, we used the IRS's Individual Return Transaction File and the Integrated Data Retrieval System to review return transaction records and posted transactions. We also evaluated the controls that are incorporated directly into computer applications to help ensure the validity, completeness, and accuracy of transactions and data during application processing of tax returns for the 2011 Filing Season.

[5] *Interim Results of the 2009 Filing Season* (Reference Number 2009-40-058, dated March 30, 2009).

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)
Russell Martin, Director
Tina Parmer, Audit Manager
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Martha Stewart, Senior Information Technology Specialist
Michele Cove, Information Technology Specialist

Appendix III

Report Distribution List

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Deputy Commissioner, Wage and Investment Division SE:W
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Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division SE:W:ETARC
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM
Director, Field Assistance, Wage and Investment Division SE:W:CAR:FA
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Director, Stakeholder Partnership, Education, and Communications, Wage and Investment Division SE:W:CAR:SPEC
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Chief Counsel CC
National Taxpayer Advocate TA
Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PEI
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:PEI

Appendix IV

Outcome Measures

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

For most of the outcomes listed in this appendix, we conducted computer analyses of TY 2010 individual income tax returns that were processed by the IRS Submission Processing sites[1] between January 1 and April 30, 2011, and were posted to the Individual Master File. We have also included two outcomes that were follow-up issues from prior reviews. For these outcomes, we conducted computer analysis of TY 2009 individual income tax returns that were processed by the IRS Submission Processing sites between May 30 and December 25, 2010, and were posted to the Individual Master File.

Type and Value of Outcome Measure:

- Cost Savings (Funds Put to Better Use) – Potential; $16.4 million from 2,812 taxpayers who received erroneous First-Time Homebuyer Credits (Homebuyer Credits) (see page 9).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 2,812 taxpayers who were allowed $16.4 million in Homebuyer Credits when their tax returns were processed during the period May 30 through December 25, 2010. These taxpayers filed a tax return claiming the Homebuyer Credit as a long-time resident with a purchase date prior to November 7, 2009.

Type and Value of Outcome Measure:

- Cost Savings (Funds Put to Better Use) – Potential; $11.4 million from 1,605 taxpayers who received erroneous Homebuyer Credits (see page 9).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 1,605 taxpayers who were allowed $11.4 million in Homebuyer Credits when their tax returns were processed during the period May 30 through December 25, 2010. These taxpayers filed a tax return claiming a Homebuyer Credit for a home which had not yet been purchased, but reportedly would be in the future.

[1] See Appendix VI for a glossary of terms.

Type and Value of Outcome Measure:

- Cost Savings (Funds Put to Better Use) – Potential; $839,130 from 1,901 taxpayers who received erroneous refunds of their Homebuyer Credit repayments (see page 9).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 1,901 taxpayers who reported either the required repayment amount or more than the required repayment amount of their Homebuyer Credit on their tax returns processed during the period January 1 through April 30, 2011, and had $839,130 in Homebuyer Credit repayments erroneously refunded.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $3.6 million from 15,956 taxpayers not assessed Homebuyer Credit repayment amounts that were not paid (see page 9).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 15,956 taxpayers who reported Homebuyer Credit repayment amounts less than the required repayment amount on their tax returns processed during the period January 1 through April 30, 2011. These taxpayers were not assessed nearly $3.6 million in additional taxes for the amount of Homebuyer Credit repayments that was underpaid.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; $1.4 million from 6,027 taxpayers erroneously credited more in Homebuyer Credit repayments than they actually paid (see page 9).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 6,027 taxpayers who received erroneous credit for $1.4 million more in Homebuyer Credit repayments than they actually paid on their tax returns processed during the period January 1 through April 30, 2011, because the repayment amounts were erroneously increased by 50 percent without assessing additional tax for the increased repayment amount.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 2,765 taxpayers were erroneously assessed $675,063 more in Homebuyer Credit installment payments than they were required to pay (see page 9).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 2,765 taxpayers who were erroneously assessed $675,063 more in additional tax than they were required to repay in Homebuyer Credit installment payments on tax returns processed during the period January 1 through April 30, 2011, because the repayment amount was erroneously increased by 50 percent and they were assessed the additional payment amount as additional tax.

Type and Value of Outcome Measure:

- Cost Savings (Funds Put to Better Use) – Potential; 736 taxpayers erroneously received more than $4 million in Adoption Credits (see page 15).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 736 taxpayers who erroneously received more than $4 million in Adoption Credits on tax returns processed during the period January 1 through April 30, 2011.

- 499 taxpayers had overstated Adoption Credit claims that the IRS did not identify and send to the Examination function, resulting in these taxpayers receiving $3.34 million in erroneous Adoption Credits.
- 237 taxpayers claimed Adoption Credits for the same child in TYs 2008 and 2009 that exceeded the allowable amount and the IRS did not identify and send these claims to the Examination function. These taxpayers erroneously received $694,309 million in Adoption Credits for the 237 children.

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 41,591 taxpayers (see page 15).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 72,330 individual tax returns claiming more than $895 million in Adoption Credits processed during the period January 1 through April 30, 2011. Of the 72,330 Adoption Credit claims, 41,591 (58 percent) met IRS documentation criteria for sending the tax return to its Examination function because the IRS did not have math error authority to deny the Adoption Credit at the time the tax return was processed.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; $76.4 million from 111,804 taxpayers claiming erroneous Nonbusiness Energy Property Credits (see page 19).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 111,710 taxpayers who erroneously claimed in excess of $76.3 million in Nonbusiness Energy Property Credits on tax returns processed during the period January 1 through April 30, 2011. These taxpayers claimed more than the maximum allowed $1,500 for the Nonbusiness Energy Property Credit for both TY 2009 and TY 2010. In addition, we identified 94 taxpayers filing as married who erroneously claimed in excess of $111,000 because they were allowed to claim more than the maximum allowed $3,000 for both TY 2009 and TY 2010.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; $32 million from 23,639 taxpayers erroneously claiming plug-in electric and alternative motor vehicle credits on *e-filed* tax returns (see page 20).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify taxpayers who *e-filed* a tax return claiming plug-in electric and alternative motor vehicle credits on Qualified Plug-in Electric and Electric Vehicle Credit (Form 8834), Alternative Motor Vehicle Credit (Form 8910), and Qualified Plug-in Electric Drive Motor Vehicle Credit (Form 8936) on tax returns processed during the period January 1 through April 30, 2011. We identified 23,639 taxpayers erroneously claiming $32 million in these credits with nonqualifying vehicle makes and models.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; $3 million in tax has been assessed for 2,034 taxpayers previously identified in another review[2] with excessive QMV deductions (see page 21).

Methodology Used to Measure the Reported Benefit:

We previously reported that the process to identify potentially erroneous QMV deductions was not effective, and we identified 7,756 taxpayers with potentially erroneous QMV deductions. We reported that we planned to monitor IRS progress in verifying the 7,756 potentially erroneous QMV deductions we had identified and report the amount of increased tax liability for those QMV deductions disallowed during our 2011 Filing Season review. Our analysis identified assessments totaling more than $3 million in tax have been made for 2,034 taxpayers.

[2] *Millions of Dollars in Questionable Qualified Motor Vehicle Deductions Are Being Allowed* (Reference Number 2011-41-037, dated April 15, 2011).

Appendix V

List of Tax Forms and Schedules Processed Through the Modernized E-File System

Form 1040	U.S. Individual Income Tax Return
Schedule A	Itemized Deductions
Schedule B	Interest and Ordinary Dividends
Schedule C	Profit or Loss From Business
Schedule D	Capital Gains and Losses
Schedule E	Supplemental Income and Loss
Schedule EIC	Earned Income Credit
Schedule M	Making Work Pay Credit
Schedule R	Credit for the Elderly or the Disabled
Schedule SE	Self-Employment Tax
Form 1099-R	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
Form 2106	Employee Business Expenses
Form 2210	Underpayment of Estimated Tax by Individuals, Estates, and Trusts
Form 2441	Child and Dependent Care Expenses
Form 4562	Depreciation and Amortization
Form 4868	Application for Automatic Extension of Time to File U.S. Individual Income Tax Return
Form 8283	Noncash Charitable Contributions
Form 8812	Additional Child Tax Credit
Form 8829	Expenses for Business Use of Your Home
Form 8863	Education Credits (American Opportunity and Lifetime Learning Credits)
Form 8880	Credit for Qualified Retirement Savings Contributions
Form 8888	Allocation of Refund (Including Savings Bond Purchases)
Form W-2	Wage and Tax Statement

Appendix VI

Glossary of Terms

Adjusted Gross Income	Income minus certain expenses and deductions.
American Opportunity Tax Credit	A partially refundable Federal tax credit to help parents and college students offset the costs of college.
Electronic Fraud Detection System	An automated system used to maximize fraud detection at the time tax returns are filed to eliminate the issuance of questionable refunds.
Electronic Return Originator	The Authorized IRS *e-file* Provider that originates the electronic submission of a tax return to the IRS. The Electronic Return Originator is usually the first point of contact for most taxpayers filing a tax return using IRS *e-file*.
Filing Season	The period from January 1 through mid-April when most individual income tax returns are filed.
Fiscal Year	A 12-consecutive-month period ending on the last day of any month except December. The Federal Government's fiscal year begins on October 1 and ends on September 30.
Free File Program	A free Federal tax preparation and *e-filing* program for eligible taxpayers developed through a partnership between the IRS and the Free File Alliance LLC. The Alliance is a group of private-sector tax software companies.
Individual Return Transaction File	Contains data transcribed from initial input of the original individual tax returns during return processing.
Individual Master File	IRS database that maintains transactions and records of individual tax accounts.
Integrated Data Retrieval System	Computer application consisting of databases and operating programs that support IRS employees working active tax cases within each business function across the entire IRS. It manages data extracted from the Corporate Account Data Stores, allowing IRS employees to take specific actions on taxpayer account issues, track status, and post transaction updates back to the Master File.

Master File	The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
Processing Year	Calendar year in which the tax return or document is processed by the IRS.
Questionable Refund Program	A nationwide, multi-functional program designed to detect and stop fraudulent claims for refunds on income tax returns.
Submission Processing Site	The data processing arm of the IRS. The sites process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
Tax Year	The 12-month period for which tax is calculated. For most individual taxpayers, the tax year is synonymous with the calendar year.

Appendix VII

Management's Response to the Draft Report

COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

RECEIVED
SEP 16 2011
DAS

September 16, 2011

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR ~~AUDIT~~

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

SUBJECT: Draft Audit Report – The Passage of Late Legislation and Incorrect Computer Programming Delayed Refunds for Some Taxpayers During the 2011 Filing Season (Audit # 201140029)

We have reviewed the subject draft report and appreciate your acknowledgement of our delivery of another successful Filing Season. While the late passage of legislation and its resulting challenges caused the delay of processing some forms until mid-February, the 2011 Filing Season was one of the most successful in recent history. As of August 12, 2011, over 137 million tax returns were processed, with more than 105 million refunds issued. Approximately 108 million of these returns were e-filed, which is a 13 percent increase over last year.

We are working diligently to identify and stop all fraudulent returns and achieved an increase of 171 percent over last year in the number of fraudulent returns identified. This was accomplished, in part, by improved identification and screening of prisoner tax returns. We anticipate that our expanded efforts in this area will have a long-lasting and significant impact in preventing the payment of erroneous or fraudulent refund claims. We will continue to improve our processes and staffing as resources permit.

As of July 2, 2011, we have processed over 4.3 million returns with $30.4 billion in First-Time Homebuyer's Credit (FTHBC) claimed. Erroneous claims for refundable credits, such as the FTHBC and Adoption Credit, are subject to stringent enforcement activity, including both pre-refund and post-refund examination. In Fiscal Year (FY) 2011, through July 22, our Examination functions have completed audits of 180,000 FTHBC returns. We continue to address those returns where the FTHBC claim is either questionable, or not supported by third-party records. Also, for FY 2011, through July 22, our Examination functions have proposed denial or disallowance of $442.6 million in FTHBC claims.

2

The credit for adoption expenses (Adoption Credit) can be the largest refundable credit allowed to individuals by the Tax Code. The lessons we learned in implementing the FTHBC helped us to develop and execute a strong Adoption Credit strategy that balanced compliance and outreach activities. We made access to the credit available to qualified individuals, while identifying and stopping the payment of questionable or erroneous claims. The IRS compliance strategy included a robust outreach and education strategy consisting of the issuance of formal guidance in Revenue Procedures and Notices, posting information on IRS.gov, and outreach to adoption agencies, advocacy groups, taxpayers, preparers, and software developers. We also developed new Examination filters that addressed known and anticipated compliance challenges. Based on the risk associated with this large credit, the IRS required taxpayers to submit documentation of the adoption with their returns when claiming the credit. Returns without documentation, or with insufficient documentation, were examined.

With regard to other deductions and credits addressed in the report, we continue to develop and refine controls that can be used to identify questionable claims during return processing and prevent payment of any erroneous or fraudulent refund claim. As indicated above, erroneous or fraudulent returns identified increased 171% for the year. We have improved our processes to detect more fraudulent claims when the returns are filed. We will use all resources available to ensure fair administration of the tax system while appropriately meeting our responsibility for fiscal stewardship, the need for coverage in all areas, and service to the taxpaying public. As the Treasury Inspector General for Tax Administration correctly observed, in appropriate cases, expanded math error authority could enable us to respond more efficiently to erroneous refundable credit claims. The IRS and the Office of Chief Counsel will discuss the merits of obtaining math error authority and will discuss your recommendations with the Department of Treasury, Office of Tax Policy for consideration as appropriate.

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

Attachment

Attachment

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 1
Ensure the 4,417 taxpayers identified as claiming the Homebuyer Credit for ineligible past purchase dates or future purchase dates are entitled to claim the credit.

CORRECTIVE ACTION
We agree with this recommendation and are taking steps to correct the accounts of 4,417 taxpayers not entitled to the credit. The IRS implemented processes to identify other individuals who had also claimed the credit with a future purchase date, or who had claimed the long time resident credit prior to the implementation date, of the provision.

IMPLEMENTATION DATE
June 15, 2012

RESPONSIBLE OFFICIAL
Director, Accounts Management, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
The IRS will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 2
Establish a Homebuyer Credit Entity Section for each taxpayer who received the Homebuyer Credit rather than grouping information by primary and secondary SSN.

CORRECTIVE ACTION
We agree with the intent of this recommendation. However, we have determined that establishing a Homebuyer Credit Entity Section for each taxpayer who received the Homebuyer Credit, rather than grouping information by primary and secondary Social Security Number, is not needed to address the issues identified in the audit report. The issues outlined in your report were not caused by the absence of First-Time Homebuyer's Credit information in the Entity Section of taxpayer accounts.

IMPLEMENTATION DATE
Implemented

RESPONSIBLE OFFICIAL
Director, Earned Income Tax Credit, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
N/A

2

RECOMMENDATION 3
Ensure that the required Homebuyer Credit installment repayment field is accurately populated with the amount that must be repaid by each taxpayer.

CORRECTIVE ACTION
We agree with this recommendation. Error Resolution System (ERS) programming is in place to retrieve and retain the data to be displayed by the ERS, provided the data is available in the National Account Profile (NAP) First-Time Homebuyer Credit database for the taxpayer filing the return. A programming change to the NAP data file, on April 16, 2011, corrected the problem.

IMPLEMENTATION DATE
Implemented

RESPONSIBLE OFFICIAL
Director, Submission Processing, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
N/A

RECOMMENDATION 4
Ensure that the tax accounts are corrected for the 17,857 taxpayers who had their Homebuyer Credit repayment erroneously refunded or who owed repayment amounts that were not paid and were not properly assessed.

CORRECTIVE ACTION
We agree with this recommendation. The IRS has revised programming, and actions have been taken to recover Homebuyer Credit repayments erroneously refunded and repayment amounts that were not paid or not properly assessed.

IMPLEMENTATION DATE
February 15, 2012

RESPONSIBLE OFFICIAL
Director, Accounts Management, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
The IRS will monitor this corrective action as part of our internal management control system.

3

RECOMMENDATION 5
Ensure that the tax accounts are corrected for the 8,792 taxpayers who received an amount greater than they repaid or who were assessed an amount more than they were required to repay.

CORRECTIVE ACTION
We agree with this recommendation and have already completed the necessary actions to correct the accounts. Actions taken include adjusting the tax and issuing the appropriate notification to the 2,765 taxpayers whose tax was impacted. The accounts of the remaining 6,027 taxpayers were adjusted to reflect the appropriate repayment amounts. Final adjustments to the accounts were completed in late July 2011.

IMPLEMENTATION DATE
Implemented

RESPONSIBLE OFFICIAL
Director, Accounts Management, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
N/A

RECOMMENDATION 6
Ensure that programming changes are made to prevent tax examiners from increasing the installment repayment amount without increasing the associated tax liability.

CORRECTIVE ACTION
We disagree with this recommendation. Systemically preventing tax examiners from increasing the repayment installment amount is undesirable because taxpayers may pay more than the required amount. We have issued procedures instructing tax examiners of the process to follow when joint filers each have to repay the First-Time Homebuyer Credit. A Servicewide Electronic Research Program alert (110446) was issued on June 15, 2011, to the tax examiners in ERS, to reinforce the correct procedures.

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A

4

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 7
Verify the claims on the 499 tax returns that claimed an incorrect amount of unused Adoption Credit and were not sent to the Examination function to determine what portion of the Adoption Credit was appropriate.

CORRECTIVE ACTION
We agree with this recommendation and have included these cases in our Fiscal Year (FY) 2012 Examination plan. We will review these returns and conduct examinations when warranted.

IMPLEMENTATION DATE
July 15, 2012

RESPONSIBLE OFFICIAL
Director, Reporting Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
The IRS will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 8
Verify the claims on the 237 tax returns that claimed over the maximum limit over multiple years but were not selected for audit by the Examination function to determine what portion of the Adoption Credit was appropriate.

CORRECTIVE ACTION
We agree with this recommendation and have included these cases in our FY 2012 Examination plan. We will review these returns and conduct examinations when warranted.

IMPLEMENTATION DATE
July 15, 2012

RESPONSIBLE OFFICIAL
Director, Reporting Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
The IRS will monitor this corrective action as part of our internal management control system.

5

Legislative Recommendation

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 9
Work with the Department of the Treasury to seek math error authority from Congress for Adoption Credit claims with insufficient documentation.

CORRECTIVE ACTION
The IRS will discuss the recommendation with the Department of the Treasury, Office of Tax Policy.

IMPLEMENTATION DATE
December 15, 2012

RESPONSIBLE OFFICIAL
Director, Earned Income Tax Credit, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 10
Initiate a recovery program for the review of the 111,804 taxpayers that we identified as claiming more than the 2-year maximum limit of the Nonbusiness Energy Property Credit to recover the $76.4 million in erroneous credits refunded.

CORRECTIVE ACTION
We agree with this recommendation. As Treasury Inspector General for Tax Administration notes in the report, the IRS does not have the legal authority to automatically adjust these returns with math error authority. Recovery of the credits must be accomplished by the use of deficiency procedures, which can be a resource-intensive process. We will build upon the findings of the subset of these returns that have been identified for audit to develop a program that will leverage available resources to maximize recoveries of the credits claimed in excess of allowable limits.

IMPLEMENTATION DATE
October 15, 2012

RESPONSIBLE OFFICIAL
Director, Reporting Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

Legislative Recommendation

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 11
Work with the Department of the Treasury to seek math error authority from Congress to prevent the overpayment of credits subject to lifetime limits spanning multiple tax periods.

CORRECTIVE ACTION
The IRS will discuss the recommendation with the Department of the Treasury, Office of Tax Policy.

IMPLEMENTATION DATE
December 15, 2012

RESPONSIBLE OFFICIAL
Director, Earned Income Tax Credit, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 12
Initiate actions to recover the $32 million in plug-in electric and alternative motor vehicle credits claimed by the 23,639 taxpayers the TIGTA identified as having erroneously claimed these credits.

CORRECTIVE ACTION
We agree with this recommendation and have taken action to address the potential non-compliance in this taxpayer segment. The Director, Reporting Compliance, Wage and Investment Division (W&I), and the Director, Campus Reporting Compliance, Small

Business/Self-Employed Division (SB/SE), have included a sample of these cases in the FY 2012 Examination plan. We will evaluate the results achieved through audits of the selected sample of returns and will adjust the plan accordingly to maximize the effective use of examination resources.

IMPLEMENTATION DATE
March 15, 2012

RESPONSIBLE OFFICIAL
Director, Reporting Compliance, Wage and Investment Division
Director, Campus Reporting Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

Legislative Recommendation

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 13
Work with the Department of the Treasury to seek math error authority from Congress to deny Qualified Plug-in Electric Drive Motor Vehicle Credits for nonqualifying makes of motor vehicles.

CORRECTIVE ACTION
The IRS will discuss the recommendation with the Department of the Treasury, Office of Tax Policy.

IMPLEMENTATION DATE
December 15, 2012

RESPONSIBLE OFFICIAL
Director, Submission Processing, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 14
Require taxpayers who claimed a QMV deduction in TY 2010 to provide documentation for proof of purchase of a qualified vehicle, including the date any State sales or excise tax was paid.

CORRECTIVE ACTION
We agree with this recommendation. The Director, Reporting Compliance, W&I, will work with the Director, Campus Reporting Compliance, SB/SE, to include a sample in the FY 2012 Examination plan. Documentation will be requested as part of the examination. The results of these examinations will be used to determine if further examinations are warranted. We will evaluate the results achieved through audits of the selected sample of returns and will adjust the plan accordingly to maximize the effective use of examination resources.

IMPLEMENTATION DATE
July 15, 2012

RESPONSIBLE OFFICIAL
Director, Reporting Compliance, Wage and Investment Division
Director, Campus Reporting Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.