TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

RECOVERY ACT

Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits

March 31, 2011

Reference Number: 2011-41-035

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.

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HIGHLIGHTS

ADMINISTRATION OF THE FIRST-TIME HOMEBUYER CREDIT INDICATES A NEED FOR IMPROVED CONTROLS OVER REFUNDABLE CREDITS

Highlights

Final Report issued on March 31, 2011

Highlights of Reference Number: 2011-41-035 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

Homebuyers who purchased a home in 2008, 2009, or 2010 were able to take advantage of the First-Time Homebuyer Credit (Homebuyer Credit). The Homebuyer Credit allowed eligible taxpayers to claim up to an $8,000 refundable credit on their tax return. Fraudulent and erroneous Homebuyer Credits totaling millions of dollars in refunds were issued, revealing a need for not only stronger controls over claims for the Homebuyer Credit, but also for strengthening controls over all refundable credits.

WHY TIGTA DID THE AUDIT

The President of the United States has called on Federal agencies to ensure that recovery funds are used for authorized purposes and that every step is taken to prevent fraud, waste, error, and abuse. The Internal Revenue Service (IRS) faces significant challenges to ensure that the recovery funds it administers are used for authorized purposes.

This report is the culmination of an audit that was reported in three separate phases as our audit progressed, resulting in two prior interim reports. The overall objective of the review was to determine whether the IRS had controls in place that effectively identified erroneous claims for the Homebuyer Credit.

WHAT TIGTA FOUND

The IRS has taken a number of positive steps to strengthen controls and help prevent inappropriate Homebuyer Credits from being issued. Primary among these controls was the implementation of filters to identify questionable claims for the Credit before they are processed. Additionally, legislation granted the IRS math error authority to deny Homebuyer Credits if proper documentation was not provided by the taxpayer.

However, the implementation of the filters and passage of this legislation occurred after many Homebuyer Credits had already been issued, including fraudulent and erroneous Credits totaling millions of dollars.

Control weaknesses identified in the two prior reports, as well as those identified in this report, allowed potentially erroneous refunds of more than $513 million to be received by taxpayers who most likely did not qualify for the Homebuyer Credit. Furthermore, during this final phase of the audit, TIGTA identified additional IRS employees who made questionable claims for the Credit.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS require taxpayers to provide documentation to support eligibility for all refundable tax credits and to seek legislation that would provide the IRS with math error authority to deny refundable credits when supporting documentation is not provided.

To the extent feasible, the IRS should also ensure that the processing of refundable credits provided for in late legislation be initiated only after sufficient controls can be implemented to protect the Government from erroneous and fraudulent claims for these credits. In addition, the IRS should take additional steps to recover erroneous credits discussed in this report.

IRS management partially agreed with one of our recommendations and agreed with the others. However, even though they agreed, TIGTA believes the IRS management needs to take a much more timely and proactive approach to prevent fraudulent claims for refundable credits than they agreed to take in their response.

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

March 31, 2011

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits (Audit # 201040141)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) has controls in place that effectively identify erroneous claims for the First-Time Homebuyer Credit. The audit addresses the IRS major management challenges of Implementing Health Care and Other Tax Law Changes, and Erroneous and Improper Payments and Credits. It also presents selected information related to the IRS implementation of Section 1006 of the American Recovery and Reinvestment Act of 2009 (Recovery Act).[1] This audit was not initially part of our annual audit plan.

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

IRS management partially agreed with one of the recommendations in our report and agreed with the others. However, in its agreement to our recommendations to require supporting documentation for refundable credits, and to postpone initiation of processing for refundable credits until sufficient controls can be implemented to protect the Government from erroneous and fraudulent claims, the IRS indicated that it is already doing those things we recommended.

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

In our opinion, the IRS needs to take a much more timely and proactive approach to prevent fraudulent claims for refundable credits. These credits are targets for fraud. The IRS should not wait to take action, as it did with the Homebuyer Credit, until after fraudulent claims have been processed to require documentation and seek math error authority to deny credits when supporting documentation is not provided. The TIGTA pointed out the vulnerability of the Homebuyer Credit to fraudulent claims very soon after the passage of the legislation and recommended the IRS require documentation. The IRS initially disagreed and did not take the preventative actions the TIGTA recommended. Because it initially had the legal authority to deny erroneous claims during processing only for mathematical or certain unallowable conditions, the only avenue available for preventing payment of otherwise erroneous claims was through the audit process and use of deficiency procedures that require use of the IRS's limited Examination resources. It was not until after the likely existence of fraud was reported by the TIGTA and Congress had provided additional specific legal authority (math error authority) that the IRS began requiring documentation. However, by this time, millions of dollars in questionable claims for the Homebuyer Credit had already been processed. Based on this experience, we believe the IRS should implement an equivalent process for all refundable credits.

In reference to the 12 separate measurable benefits on tax administration included in our report, the IRS believes that both the population and estimated revenue protection are overstated for the following issues:

- Taxpayers claiming Homebuyer Credits for homes to be purchased in the future.
- Taxpayers showing post office boxes as the address of their new homes.
- Taxpayers not showing a change in address from their old home to their new home.
- Taxpayers showing no purchase date on their claim.

The IRS stated that additional research of third-party data may show that the taxpayers did actually qualify for Homebuyer Credits. However, to verify our projections, we performed third-party research on statistically valid samples to ensure our projections were accurate.

Furthermore, our population and revenue estimates regarding claims with a purchase date in the future were based on actual case work conducted by the IRS. Our population consisted only of those cases for which the IRS issued notices to taxpayers. Using a statistically valid sample of cases worked by the IRS, we analyzed the IRS's rate of disallowance of Homebuyer Credits in the sample and projected it to the population of cases receiving a notice. We found that a high percentage (69 percent) of these Homebuyer Credits was disallowed, and we projected that to the population.

Based on our analysis and the additional work conducted to verify the outcomes, we continue to believe that all measurable benefits included in this report are accurately and fairly presented.

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

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.

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Appendices

Abbreviations

HERA	Housing and Economic Recovery Act of 2008
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration
WHBAA	Worker, Homeownership, and Business Assistance Act of 2009

Background

Section 1006 of the American Recovery and Reinvestment Act of 2009 (Recovery Act)[1] revised and extended the First-Time Homebuyer Credit (Homebuyer Credit) provided for in the Housing and Economic Recovery Act of 2008 (HERA).[2]

In Processing Years 2009 and 2010, the IRS reported issuing Homebuyer Credits of $12.3 billion and $13.7 billion, respectively.

The HERA allowed taxpayers who purchased a principal residence after April 8, 2008, and before July 1, 2009, to claim a credit equal to 10 percent of the purchase price of the home, limited to $7,500. The Homebuyer Credit, as expressed in this Act, served as an interest-free loan to be paid back over a 15-year period beginning 2 years after the Credit was claimed.

Section 1006 of the Recovery Act extended the Homebuyer Credit to include purchases made on or after January 1, 2009, and before December 1, 2009; increased the maximum Credit to $8,000; and eliminated the repayment requirements as long as the taxpayer retains the residence for at least 36 months. Taxpayers qualifying for the revised Homebuyer Credit may claim the $8,000 Credit on either their Tax Year 2008 or 2009 individual income tax returns. Taxpayers may have been confused regarding which version of the Credit they qualified for, and unscrupulous individuals made fraudulent claims for the refundable Credit.[3]

The Worker, Homeownership, and Business Assistance Act of 2009 (WHBAA),[4] signed into law on November 6, 2009, added to the situation by extending and expanding the Homebuyer Credit allowed by the previous Acts.[5] The WHBAA also added documentation requirements for claiming the Credit. The Treasury Inspector General for Tax Administration (TIGTA) reviewed the Internal Revenue Service's (IRS) implementation of the WHBAA as part of our annual audit of the IRS's filing season.

This review focused on the IRS's controls to identify and prevent erroneous claims for the Homebuyer Credit claimed on original U.S. Individual Income Tax Returns (Form 1040). This

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1 Pub. L. No. 111-5, 123 Stat. 115 (2009).
2 Pub. L. No. 110-289.
3 A refundable credit can reduce a taxpayer's liability to zero, and any credit amount over the tax liability can be refunded to the taxpayer. In contrast, a nonrefundable credit can only reduce the tax liability to zero.
4 Pub. L. No. 111-92, 123 Stat 2984 (2009).
5 Under the new law, an eligible taxpayer must buy, or enter into a binding contract to buy, a principal residence on or before April 30, 2010, and close on the home by June 30, 2010. The law maintained that the taxpayer would not be required to repay the Credit and kept the maximum amount at $8,000. For qualifying purchases in 2010, taxpayers have the option of claiming the Credit on either their 2009 or 2010 tax returns.

report is the culmination of an audit that was developed and reported in three separate phases, resulting in two prior interim reports.

The President of the United States has stated that every taxpayer dollar spent on the economic recovery must be subject to unprecedented levels of transparency and accountability. The President has called on Federal agencies to ensure that recovery funds are used for authorized purposes and every step is taken to prevent instances of fraud, waste, error, and abuse.

Congress estimated that $13.6 billion would be paid to taxpayers for the Homebuyer Credit provided for in the HERA. The Joint Committee on Taxation estimated that more than $4.3 billion more would be paid to first-time homebuyers in Fiscal Years 2009 and 2010 as a result of the Recovery Act. In Processing Years 2009 and 2010, the IRS reported that it issued Homebuyer Credits of $12.3 billion and $13.7 billion, respectively.

This review was performed onsite at the IRS Campus[6] in Ogden, Utah. It included a review of individual income tax returns filed nationwide, as well as analysis of data provided by the IRS Wage and Investment Division Headquarters in Atlanta, Georgia; the Submission Processing function offices in Lanham, Maryland, and Cincinnati, Ohio; and the Submission Processing Sites in Fresno, California; Austin, Texas; and Ogden, Utah. This report is the end result of audit work completed by November 2010 and from which two interim reports were already issued.

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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

[6] The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

Results of Review

Appropriate Controls Should Be Established Before Refundable Credits Are Issued

In our first two interim reports we discussed three key controls that were not in place before claims for the Homebuyer Credit were processed. Specifically,

- Documentation was not required to substantiate claims for the Homebuyer Credit.
- Filters to identify erroneous claims for the Homebuyer Credit were not implemented until late into the filing season, and the filters were missing some components.
- Information provided on First-Time Homebuyer Credit and Repayment of the Credit (Form 5405) was not entered into IRS computers from paper returns, and date of purchase information from paper and electronic returns was not immediately utilized to verify eligibility for the Credit.

In our first interim report, we discussed that despite the TIGTA's recommendation to do so, the IRS did not require taxpayers to attach documentation to tax returns to verify eligibility before Homebuyer Credits were allowed. In addition, the IRS did not ensure that information on each line of the Form 5405 was transcribed for paper returns and that the information from all Forms 5405 was used to validate claims for the Homebuyer Credit.

IRS management initially stated that a requirement to supply documentation during processing of returns would be burdensome for the taxpayers and the IRS. Nonetheless, the burden of providing documentation to substantiate such a credit is no greater than the burden placed on individuals receiving payments from other Government agencies and on the agencies providing those payments. For example, to receive food stamps, individuals are required to provide the following:

- Identification such as a driver's license, State identification, birth certificate, or alien card.
- Proof of income.
- Proof of amounts spent on child care.
- Rent receipts or proof of mortgage payments.

- Records of utility costs.
- Medical bills for certain household members.

Furthermore, the IRS stated that it did not have math error authority to disallow the Homebuyer Credit during processing even if it did ask for documentation and none was provided. The IRS initially took no steps to obtain this math error authority. After the issuance of the TIGTA's first interim report and congressional hearings on the subject, Congress passed legislation which required documentation for the Homebuyer Credit and provided the IRS with math error authority to disallow the Credit if the documentation was not provided. The IRS required taxpayers claiming the Credit after November 6, 2009, to attach a copy of their U.S. Department of Housing and Urban Development Settlement Statement (Form HUD-1) to support their claim.

Because of the extensive requirements for programming and the late passage of the first bill containing the Homebuyer Credit, IRS management did not initially request or implement the transcription of the Form 5405. Moreover, at the beginning of the 2009 Filing Season, the IRS had not developed and implemented examination filters to identify potentially erroneous claims for the Homebuyer Credit. We believe this may have occurred for two reasons. First, the original legislation was passed in July 2008, giving the IRS only 6 months to develop, test, and implement filters before the filing season began. Second, the original legislation required taxpayers to repay the Homebuyer Credit, so the development of filters was not as urgent as it would have been with a refundable credit which did not require repayment. The lack of filters became more significant with the passage of the Recovery Act in February 2009 because it increased the amount of the Credit and eliminated the repayment requirement. The IRS reported that as of May 17, 2009, it had initiated the use of computerized filters to identify questionable claims for the Homebuyer Credit during processing. The IRS further reported that as a result of implementing these filters, it had initiated pre-refund audits on 190,464 original tax returns claiming the Homebuyer Credit and had disallowed claims totaling approximately $434 million as of September 2010.

However, a significant number of erroneous Homebuyer Credits were processed prior to implementation of the filters and documentation requirements. The erroneous Credits might have been denied if controls were present. For example, in our two previous interim reports, we discussed the following erroneous claims for the Homebuyer Credit. The IRS has taken or agreed to take corrective actions to recover these erroneous Homebuyer Credits.

- Taxpayers claimed Homebuyer Credits although they had not made home purchases but reportedly would in the future. These taxpayers listed home acquisition dates on their Forms 5405 that were subsequent to the dates the claims were processed by the IRS. In response to our interim report, the IRS sent notices to taxpayers with future acquisition dates and reversed the Homebuyer Credit if the taxpayer failed to provide proof of an actual home purchase. We estimate the IRS could potentially recover $97.8 million from 13,448 taxpayers using future home purchase dates.

- Many taxpayers claiming Homebuyer Credits appeared not to be first-time homebuyers based on tax information that indicated they had owned homes within 3 years prior to their new home purchases. These taxpayers claimed deductions or tax credits such as mortgage interest, real estate taxes, mortgage insurance premiums, Residential Energy Credits, or Mortgage Interest Credits on at least one of their prior three tax returns. We estimate that the IRS could potentially recover $326 million from 47,576 taxpayers who had indications of prior home ownership and filed for Homebuyer Credits before the IRS filters were implemented.
- Some taxpayers under the age of 18 claimed Homebuyer Credits, but likely did not purchase homes because contract law generally exempts minors from being legally bound to a contract for such a home purchase. The legislation passed in November 2009 gave the IRS authority to disallow any Homebuyer Credits claimed by taxpayers under age 18. During the 2010 Filing Season, the IRS disallowed $531,134 in Credits claimed by 96 taxpayers under age 18.
- Prisoners received Homebuyer Credits for homes reportedly purchased while incarcerated. We estimate the IRS could potentially recover $7.7 million from 1,084 prisoners who received Credits despite being incarcerated at the time their homes were reported purchased.
- Taxpayers claimed Homebuyer Credits for homes for which at least one other taxpayer also claimed the Credit and the combined amounts for each address exceeded $8,000. We estimate the IRS could potentially recover $11.4 million from 2,587 of these taxpayers claiming Credits to which they were not entitled.
- Some taxpayers claimed Homebuyer Credits for homes purchased before April 9, 2008, the effective date of the HERA legislation. The IRS subsequently initiated controls using information on Form 5405 to identify and disallow such claims prior to them being refunded. We alerted the IRS and in response the IRS sent notices to 2,751 taxpayers who claimed Credits for homes purchased prior to the effective date of the legislation. We estimate that the IRS could potentially recover $17.6 million from taxpayers making these erroneous claims.

See Appendix IV for details of our estimates.

This final report also discusses other erroneous claims, allowed by the IRS prior to the implementation of these controls, for which recovery actions need to be taken. Erroneous claims for refundable credits are not unique to the Homebuyer Credit. The TIGTA recently issued reports discussing erroneous claims for the Additional Child Tax Credit and the Earned Income Tax Credit, and it will soon issue another report discussing erroneous claims for the American Opportunity Credit.

Recommendations

The IRS Commissioner should:

Recommendation 1: Require taxpayers to provide supporting documentation to verify eligibility for all refundable tax credits.

> **Management's Response:** IRS management agreed that this recommendation is appropriate for many refundable credits. The IRS evaluates the administration of each refundable credit based on its unique characteristics. In the case of the Homebuyer Credit, the IRS determined that a requirement for supporting documentation was warranted because the likelihood of fraud was well known and specific legal authority was provided by the law. The IRS continually assesses and evaluates compliance risks, and where it determines that the benefits of this approach outweigh the compliance burden and legal constraints, the IRS will consider using it more broadly.
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> **Office of Audit Comment:** We acknowledge the IRS's agreement to consider a broader use of supporting documentation. However, in our opinion, the IRS needs to take a much more timely and proactive approach to prevent fraudulent claims for refundable credits. These credits are targets for fraud. The IRS should not wait to take action until after fraudulent claims have been processed, as it did with the Homebuyer Credit, to require documentation and seek math error authority to deny credits when supporting documentation is not provided. The TIGTA advised the IRS of the vulnerability of the Homebuyer Credit to fraudulent claims very soon after the passage of the legislation and recommended the IRS require documentation. The IRS initially disagreed and did not take the preventative actions the TIGTA recommended. Because it initially had the legal authority to deny erroneous claims during processing only for mathematical or certain unallowable conditions, the only avenue available for preventing payment of otherwise erroneous claims was through the audit process and use of deficiency procedures that require use of IRS's limited Examination resources. It was not until after the likely existence of fraud was reported by the TIGTA and Congress had provided additional specific legal authority (math error authority) that the IRS began requiring documentation. However, by this time, millions of dollars in questionable claims for the Homebuyer Credit had already been processed. Based on this experience, we believe the IRS should implement an equivalent process for all refundable credits.

Recommendation 2: To the extent feasible, ensure that the processing of refundable credits provided for in late legislation be initiated only after sufficient controls can be implemented to protect the Government from erroneous and fraudulent claims for these credits.

> **Management's Response:** IRS management agreed with this recommendation. To the extent feasible, and as done in the past, for late legislation the IRS will initiate processing of new or revised refundable credits only after it assesses and balances the risk

of erroneous and fraudulent claims against the feasibility and time required to implement appropriate controls, while taking into consideration congressional intent and legislation effective dates.

Office of Audit Comment: Again, while we acknowledge the IRS's agreement to our recommendation, we believe it is important that it not address this issue in the same manner as it has in the past. Hundreds of thousands of questionable claims for millions of dollars in Homebuyer Credits were processed prior to the implementation of Examination filters to identify questionable claims. While the IRS did subsequently run its filters against these refunded claims for consideration of post-refund examination, it will not be able to examine many of these claims because of resource constraints and the applicable statute of limitations.

Legislative Recommendation

Recommendation 3: The IRS Commissioner should seek legislation to provide the IRS with math error authority to deny credits when supporting documentation is not provided for a refundable credit.

Management's Response: IRS management agreed that math error authority is an important compliance tool in many cases. In determining the appropriate administration of each refundable credit, the IRS will explore with its colleagues at the Department of the Treasury Office of Tax Policy whether math error authority is appropriate.

Office of Audit Comment: The IRS needs to take a much more timely and proactive approach to prevent fraudulent claims for refundable credits. These credits are targets for fraud. The IRS should not wait until other refundable credits are enacted to explore the appropriateness of math error authority to deny credits when supporting documentation is not provided.

Individuals Erroneously Received Homebuyer Credits for Homes Purchased From a Related Person

A home purchased from a related person, such as the taxpayer's spouse, parent, grandparent, child, or grandchild, did not qualify the taxpayer for a Homebuyer Credit. Specifically, the taxpayer could not purchase the home from any ancestors or lineal descendents.

Prior to legislation passed in November 2009, the related-party exclusion did not include persons related by marriage. Therefore, if a husband and wife purchased a home from the husband's parents, the wife was eligible for the Homebuyer Credit. However, the legislation passed in November disallowed the Homebuyer Credit for a home purchased from a person related to the taxpayer's spouse.

As discussed earlier, the IRS implemented filters in May 2009 to identify various types of questionable claims for the Homebuyer Credit. However, a filter to identify purchases between related individuals was not included.

We identified 14,186 individual income tax returns (Tax Year 2008) on which taxpayers claimed the Homebuyer Credit using the address of a home once owned by someone who had claimed them or their spouse as a dependent. We performed in-depth analysis on a statistically valid sample of 375 of these claims and determined that 99 (26 percent) were either for purchases from a related person or were claimed when no purchase had actually taken place. The methodology for making our determination is detailed in Appendix V.

We estimate that for Tax Year 2008, at least 3,745 taxpayers received refunds totaling more than $24.8 million in Homebuyer Credits despite indications the taxpayer either purchased their home from a related party or had not actually made a qualifying home purchase. Because our review was limited by the number of years of data we could analyze, this could be a larger problem than we were able to quantify.

The IRS has made efforts to reduce the number of Homebuyer Credit claims for homes purchased from related persons. Form 5405 was revised in December 2009, requiring those claiming the Homebuyer Credit to indicate if they purchased the home from a related person or a person related to their spouse. Notwithstanding, we believe that without focused compliance efforts, taxpayers may continue to make claims for Homebuyer Credits based on homes purchased from related parties.

Recommendation

Recommendation 4: The Director, Reporting Compliance, Wage and Investment Division, should develop a method similar to that used by the TIGTA to identify improper claims for purchases from related persons and conduct examinations as appropriate to ensure the Credits are recovered.

> ***Management's Response:*** IRS management agreed with this recommendation. The IRS has established a method, similar to that used by the TIGTA, to identify improper related-person claims. These claims have been identified and considered for the post-refund examination pool.

Taxpayers Received Homebuyer Credits Without Providing Valid Addresses of Homes They Reported Purchasing

We identified a large number of taxpayers who did not provide a valid home address to claim Homebuyer Credits on their Tax Year 2008 tax returns. These taxpayers listed either a post office box number as their qualifying home address or provided address information indicating a home purchase had not taken place.

The Homebuyer Credit was a refundable tax credit available to qualifying first-time home buyers who purchased a principal residence in the United States. To claim the Credit, taxpayers were instructed to provide the address of the qualifying home on Form 5405. This requirement was waived if the qualifying home address was already listed on the Form 1040.

We identified 7,499 taxpayers who listed a post office box number as their qualifying home address either on the Form 5405 or the Form 1040. We determined 6,726 taxpayers listed the post office box number on the Form 1040 (leaving the address blank on the Form 5405) and 773 taxpayers listed the post office box number on the Form 5405. We analyzed a statistically valid sample of 366 of the 7,499 claims and found the following:

- 314 claims (85.8 percent) were refunded to the taxpayer without any IRS scrutiny.
- 41 claims (11.2 percent) received either pre-refund or post-refund scrutiny.
- 11 claims (3 percent) did in fact provide a legitimate address because the taxpayer listed a valid street address in addition to the post office box number.

We further researched the 314 claims identified in the sample and were able to obtain valid qualifying home addresses for 218 of the claims through sources other than the tax return. Based on the remaining 96 claims for which we were unable to identify valid home addresses, we estimate 1,966 erroneous claims totaling $10.9 million were refunded to taxpayers without any IRS scrutiny.

The IRS has implemented some controls to attempt to reduce the number of claims being released that list post office box addresses. In June 2009, the IRS initiated controls to identify claims listing a post office box on amended tax returns. In February 2010, the IRS implemented additional controls to identify claims listing post office box addresses on original returns for the 2010 Filing Season.

In addition to the taxpayers who listed a post office box number as their qualifying home address, we identified 449 taxpayers who provided an address indicating a home purchase had not taken place. These taxpayers listed an address such as “Undecided” or “To Be Determined” on the Form 5405. We analyzed a statistically valid sample of 208 of the 449 claims and found the following:

- 83 claims (39.9 percent) were refunded to the taxpayer without any IRS scrutiny.
- 125 claims (60.1 percent) received IRS scrutiny either prior or subsequent to the refund.

We further examined the 83 claims identified in the sample and were able to obtain valid home addresses for 18 of the claims. Based on the remaining 65 claims for which we were unable to substantiate legitimate home purchases, we estimate that 140 erroneous claims totaling $1.1 million were released without any IRS scrutiny.

Recommendation

Recommendation 5: The Commissioner, Wage and Investment Division, should perform a review of the claims with invalid addresses that the TIGTA identified and correspond with taxpayers in order to validate the home purchases. The TIGTA has the list of taxpayers previously described and will make it available to IRS functions upon request.

> **Management's Response:** IRS management partially agreed with this recommendation. The IRS will review the list the TIGTA provides and use third-party public property records to validate all home purchases. The IRS will then consider questionable claims for appropriate action.

A Filter Designed to Identify Taxpayers Claiming Homebuyer Credits but Whose Addresses Did Not Change Was Not Programmed Correctly

A filter designed to identify taxpayers who claimed Homebuyer Credits without actually purchasing new homes did not work effectively. Included in the filters the IRS instituted in May 2009 was a filter designed to identify instances where the address on the taxpayer's Form 1040 used to claim the Homebuyer Credit was the same address used by the taxpayer on their previously filed Form 1040.

We found that the filter does not appear to identify all the claims that meet the criterion. We identified 91,887 Homebuyer Credit claims filed on electronic Tax Year 2008 returns that met the IRS's filter criteria. We reviewed a statistically valid sample of 383 returns and found that the IRS filter flagged only 307 (80.2 percent) of those claims.

We further reviewed the 76 claims that were not flagged and found that 62 of the claims were for legitimate home purchases, but 14 were not. Of the 14 claims for which a home purchase had not taken place, the IRS was able to identify and stop 9 by using other filters or post-refund reviews. The remaining five were refunded to taxpayers with no IRS scrutiny. We were unable to determine why the computer programming did not work as planned. However, based on these results, we estimate that 1,199 taxpayers were not identified by IRS filters and received $8.6 million in potentially erroneous refunds without any scrutiny.

Recommendation

Recommendation 6: For Tax Year 2010, the Commissioner, Wage and Investment Division, should modify the programming for the filter to identify taxpayers who did not purchase a home so that it identifies all claims meeting the specified criteria. The TIGTA has a list of the taxpayers who should have been flagged, but were not, and will make it available to the IRS upon request.

> ***Management's Response:*** IRS management agreed with this recommendation. The IRS has already modified the filter criteria. The IRS will review the list of taxpayers the TIGTA provides and use third-party public property records to validate all home purchases. The results will be assessed for appropriate action.

Taxpayers Received Homebuyer Credits Without Providing Valid Acquisition Dates on Form 5405

To claim the Homebuyer Credit, eligible taxpayers were required to complete and file Form 5405. Form 5405 requires the taxpayer to provide, among other information, the date the home was purchased. The instructions provided with the Form clearly indicate that taxpayers must have purchased the home after April 8, 2008, and, in general, before May 1, 2010.

We identified 3,446 electronic Homebuyer Credit claims for which taxpayers did not provide valid acquisition dates on their Forms 5405. We selected and reviewed a statistical sample of 346 claims and determined that 318 claims did not include acquisition dates on the Form 5405 (taxpayers left it blank) and 28 claims contained invalid data (acquisition dates provided were incomplete and/or in a format incompatible with IRS software).

We reviewed the statistical sample of 346 claims on Accurint[7] and were unable to substantiate legitimate home purchases for 120 claims. Of the 120 claims, we determined that 110 had not received any IRS scrutiny either prior or subsequent to the refund being released. Based on the 110 claims in our sample, we estimate that 1,095 taxpayers received $7.7 million in potentially erroneous refunds for which they were not entitled.

We recognize the IRS's efforts to stop claims with invalid acquisition dates. By April 2009, the IRS implemented controls on both electronic and paper returns to identify and stop claims that did not contain acquisition dates within the eligible dates allowed by law.

Recommendation

Recommendation 7: The Director, Reporting Compliance, Wage and Investment Division, should identify those claims for which valid acquisition dates were not supplied and initiate post-refund examinations (including the use of soft notices) to ensure refunds for the invalid

[7] A database maintained by LexisNexis that provides, in part, third-party data listing real estate and property ownership records.

claims are recovered. The TIGTA has the list of taxpayers previously described and will make it available to the IRS upon request.

> ***Management's Response:*** IRS management agreed with this recommendation. The IRS will review the list the TIGTA provides and use third-party public property records to validate all home purchases, including acquisition dates. Invalid acquisition dates will be evaluated to determine the appropriate treatment.

Additional Internal Revenue Service Employees Made Questionable Claims for the Homebuyer Credit

In prior interim reports, we identified and referred 87 IRS employees who appeared not to be first-time homebuyers based on tax information that indicated they had owned homes within 3 years prior to their new home purchases. To qualify as a first-time homebuyer, a taxpayer (or a taxpayer's spouse) may not have previously owned a principal residence for 3 years prior to the purchase date of the home for which the Homebuyer Credit is claimed. The employees we identified had claimed deductions or tax credits such as mortgage interest, real estate taxes, mortgage insurance premiums, Residential Energy Credits, or Mortgage Interest Credits on at least one of their prior three tax returns. We referred the employees to the TIGTA Office of Investigations in August 2009 and February 2010.

Subsequent to the two referrals, we completed additional audit tests for issues related to the Homebuyer Credit and identified claims made by 41 IRS employees that appear to be questionable based on the following test criteria:

- The home acquisition date was subsequent to the date the IRS processed the return (the employee listed a future purchase date).
- The home acquisition date was prior to April 9, 2008; the date allowed by the HERA legislation.
- The home address claimed by the employee was an address on which multiple taxpayers claimed the Credit and the combined amounts for each address exceeded the maximum Credit amount of $8,000.
- A post office box number was listed as the address for which the Credit was claimed.
- The new home address was the same address that the employee listed on a previously filed return.
- The employee appeared not to be a first-time homebuyer based on tax information that indicated they had owned a home within 3 years prior to the purchase of the new home (these claims were made on Tax Year 2009 returns and were in addition to the 87 claims previously identified).

Provisions for the Homebuyer Credit were included in the HERA, the Recovery Act, and most recently, the WHBAA. The cases detailed in this report include claims made under one of these three Acts. We referred these 41 IRS employees to the TIGTA Office of Investigations in August 2010.

Action Was Taken to Ensure That Taxpayers Who Were Unaware of the Changes to the Homebuyer Credit Received the Full Credit to Which They Were Entitled

We identified taxpayers who appeared to have not claimed or received the full amount of the Homebuyer Credit to which they may have been entitled. These taxpayers claimed $7,500 rather than $8,000 for homes purchased in Calendar Year 2009.

As a result, the IRS sent 23,437 notices to taxpayers who purchased homes in Calendar Year 2009, received a Homebuyer Credit of $7,500, and had not amended their return to claim an additional amount of Homebuyer Credit. In response to these notices, we estimated that these taxpayers could potentially claim and receive $11.7 million in additional Homebuyer Credits to which they are entitled.

Appendix I

Detailed Objective, Scope, and Methodology

Interim (Phase I) Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine whether the IRS had controls in place that effectively identified erroneous claims for the First-Time Homebuyer Credit (Homebuyer Credit). (In general, this audit is covering post-processing procedures on original returns and both processing and post-processing procedures on amended returns.) Steps I and II were completed as part of TIGTA Audit Report, *The 2009 Filing Season Was Successful Despite Significant Challenges Presented by the Passage of New Tax Legislation* (Reference Number 2009-40-142, dated September 21, 2009), and the results from these steps were included in this report.[1] To accomplish our objective, we:

I. Computer identified 1,129,480 returns processed with the First-Time Homebuyer Credit and Repayment of the Credit (Form 5405) through June 5, 2009, and analyzed 58,741 early filed returns[2] and determined whether certain programming was in place. (To assess the reliability of the computer-processed data, programmers in the TIGTA Office of Information Services validated the data that were extracted, and we verified the appropriate documentation. Judgmental samples were selected and reviewed to ensure that the amounts presented were supported by external sources. As appropriate, data in the selected data records were compared to the physical tax returns to verify that the amounts were supported.)

II. Assessed whether adequate information was provided by the taxpayer and/or transcribed into IRS computer systems and utilized to ensure claims for the Homebuyer Credit could be substantiated.

III. Identified the number of returns that claimed the Homebuyer Credit with a purchase date of the home later than the submission date of the return and determined what the IRS Examination function planned to do with these cases.

   A. Developed computer programs to identify all electronically filed returns with Homebuyer Credit claims with a submission date prior to the acquisition date of the

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[1] Although these steps were not part of the audit work completed as part of this review, we are including them in the detailed scope to provide the reader a reference to what steps were completed to support our conclusions.
[2] Returns processed the week ending January 30, 2009.

home and validated the data by comparing 50 taxpayer accounts to information found on the IRS Individual Master File.[3]

B. Summarized the data to show how many erroneous claims were submitted with a "future" acquisition date and quantified the dollars claimed.

C. Discussed with IRS Examination function management their plans for addressing these Homebuyer Credit claims and why these claims were allowed.

IV. Developed a computer program to identify taxpayers erroneously claiming the Homebuyer Credit.

A. Determined criteria to identify taxpayers who have owned a home within 3 years of requesting the Homebuyer Credit (e.g., taxpayers who claimed points, mortgage interest, mortgage insurance, real estate taxes, the Residential Energy Credit, the Mortgage Interest Credit, and/or the District of Columbia First-Time Homebuyer Tax Credit).

B. Developed the computer program to identify taxpayers who met the same criteria listed in Step IV.A. and claimed the Homebuyer Credit.

C. Evaluated the results of the computer program.

1. Summarized the number of paper and electronic taxpayer claims that were identified by the computer program as potentially erroneous.

2. Assessed the reliability of the program run to accurately identify those taxpayers not qualifying for the Credit by comparing the data from 50 records to information from the IRS Individual Master File.

D. Determined whether the IRS had identified and reviewed (or planned to review) any of the potentially erroneous claims for the Homebuyer Credit identified by our computer program prior to the initiation of its examination filters.

1. Reviewed the tax accounts of a judgmental sample[4] of 50 taxpayers from the computer data to see if the accounts had received scrutiny from either Criminal Investigation or the Examination function relative to their claims for the Homebuyer Credit.

2. Discussed with Examination function management the IRS's plans to work the potentially erroneous claims we identified as post-refund cases.

[3] The IRS database that maintains transactions or records of individual tax accounts.
[4] We selected the 50 cases using a nonstatistical random method from our database of taxpayers filing before the IRS filters were in place and who may have previously owned a home.

V. Identified returns where the age of the taxpayer may indicate a possible erroneous claim.

A. Performed a query on the Data Center Warehouse[5] and identified taxpayers younger than age 18 who claimed the Homebuyer Credit on their return. We validated the data by comparing 30 taxpayer accounts to information found on the IRS Individual Master File.

B. Stratified the returns by age and reviewed any that may indicate the claim is erroneous.

1. Identified 417 taxpayers through July 25, 2009, having an Adjusted Gross Income within the range of the Examination function's filter and reviewed each for Examination function or Criminal Investigation indicators.

2. Identified 165 taxpayers through July 25, 2009, with Adjusted Gross Income greater than the Examination function's filter limit and reviewed each for Examination function or Criminal Investigation indicators.

VI. Identified claims made by Individual Taxpayer Identification Number[6] holders and quantified the results.

A. Performed a Data Center Warehouse query to identify taxpayers with an Individual Taxpayer Identification Number who claimed a Homebuyer Credit.

B. Validated and assessed the reliability of the data by comparing the information from 20 records to the IRS Individual Master File.

VII. Identified IRS controls and programs designed to prevent erroneous Homebuyer Credit claims on amended returns.

A. Determined the specific programs and filters that the IRS uses to identify case work.

B. Determined the documentation that is required to support the claims, particularly considering the President's declaration that every effort should be made to prevent fraud, not just identify it after the fact.

VIII. Determined the IRS's plans for addressing taxpayers who did not claim or receive the proper amount of Homebuyer Credit (purchased a home in Calendar Year 2009, qualified for $8,000, but only claimed $7,500).

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[5] A collection of IRS databases containing various types of taxpayer account information that is maintained by the TIGTA for the purpose of analyzing data for ongoing audits.
[6] An Individual Taxpayer Identification Number is a tax processing number issued by the IRS to individuals who are required to have a U.S. taxpayer identification number but do not have, and are not eligible to obtain, a Social Security Number.

A. Using the TIGTA computer queries, determined the number of taxpayers who claimed and/or received $7,500 even though they potentially qualified for $8,000 because the home was purchased in Calendar Year 2009. We validated the data by comparing 10 taxpayer accounts to information found on the IRS Individual Master File.

B. Determined the number of taxpayers meeting the criteria in Step VIII.A. who filed an amended return for the difference ($500). We determined if the returns were properly identified as taxpayers not having to pay back the Credit (either when originally filed or when amended).

C. Determined the IRS's plans for addressing taxpayers who did not receive the full Homebuyer Credit amount.

IX. Identified and referred to the TIGTA Office of Investigations 53 IRS employees who had indications of prior home ownership and claimed the Homebuyer Credit on their Tax Year 2008 tax return. These employees filed as the primary taxpayer on their return.

Interim (Phase II) Detailed Objective, Scope, and Methodology

The overall objectives of the audits addressed in this interim report were to determine whether the IRS had controls in place that effectively identified erroneous claims for the Homebuyer Credit and to determine whether the IRS had controls in place to ensure claims for the Homebuyer Credit claimed on amended income tax returns were appropriately processed. To accomplish our objectives, we:

I. Identified prisoners who made claims for the Homebuyer Credit and determined whether they received the refund and whether they received appropriate scrutiny from the IRS.

A. Developed computer programs to match prisoners listed on the IRS's 2009 Prisoner File that met our criteria (incarcerated before April 9, 2008, and released after January 1, 2010) with taxpayers who claimed the Homebuyer Credit.[7] We also included prisoners if they claimed more than $7,500 and began their incarceration between April 8, 2008, and January 1, 2009).

B. From the population of 4,608 prisoners identified in Step I.A. who claimed the Credit, we evaluated a statistical sample[8] of 306 to determine if any of the claims were refunded or had received scrutiny from either Criminal Investigation or the Examination function. We assessed the reliability of the data by comparing

[7] From the data in our Data Center Warehouse.
[8] The statistical sample size was selected by using a 95 percent confidence level, a 5 percent precision, and a 30 percent expected error rate.

30 records with the Federal Bureau of Prisons web site and the Prison Inmate Search web site.

C. Researched a judgmental sample[9] of 715 prisoner claims that we considered to be the most egregious and determined whether the claims were refunded and whether they had received scrutiny from either Criminal Investigation or the Examination function.

D. Identified preparers who appear to be routinely filing returns for prisoners claiming the Homebuyer Credit.

E. Determined if prisoners receiving the Homebuyer Credit appeared on the IRS's 2007 Prisoner File and/or the IRS's 2008 Prisoner File.

II. Identified and reviewed claims originating from the same address for more than the maximum amount allowed.

A. Combined information from the Data Center Warehouse and files received from TIGTA Information Services employees to identify 18,832 taxpayers who claimed the Homebuyer Credit on the same address where the total amount of the claim was more than $8,000 per address. We identified valid taxpayers filing electronically who claimed the Credit on their original Tax Year 2008 tax return during Processing Year 2009 as of December 31, 2009.

B. Validated and assessed the reliability and completeness of the computer data by comparing 30 records to IRS Master File[10] data.

C. Selected and reviewed a statistically valid sample[11] of 377 claims to determine whether the claims had received scrutiny from either Criminal Investigation or the Examination function.

D. Selected and reviewed an additional judgmental sample[12] of 256 claims to determine whether the claims had received scrutiny from either Criminal Investigation or the Examination function.

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[9] We selected the 715 cases using a nonstatistical sample including all prisoners whose filing status was something other than joint and who were serving life sentences during the period their home would had to have been purchased. We used a judgmental sample because we did not intend to project the results of this sample to the entire population.

[10] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

[11] The statistical sample size was selected by using a 95 percent confidence level, a 5 percent precision, and a 50 percent expected error rate.

[12] We selected a nonstatistical sample by identifying the top five addresses most used and researched all the taxpayers listing those addresses as their home. We used a judgmental sample because we did not intend to project the results of this sample to the entire population.

E. Added information from the Data Center Warehouse preparer files to the 18,832 taxpayer records to determine if preparers appeared to be filing claims for the same address.

F. Conducted research through third-party sources to verify the top five addresses were not multi-family dwellings or apartment complexes that may have been legitimately claimed by multiple taxpayers.

III. Identified and reviewed claims with acquisition dates prior to the effective date of the HERA.[13]

A. Computer identified 2,751 claims from the IRS's Individual Return Transaction File[14] with an acquisition date prior to April 9, 2008, the effective date of the HERA legislation. We identified original electronic Tax Year 2008 U.S. Individual Income Tax Returns (Form 1040) processed during Processing Year 2009.

B. Assessed the validity and completeness of the computer data by comparing 35 records to IRS Individual Master File information and third-party sources.

C. Selected and reviewed a statistically valid sample[15] of 338 of the 2,751 claims to determine whether they received scrutiny from either Criminal Investigation or the Examination function.

IV. Identified and evaluated controls over amended returns for identifying, stopping, and correcting erroneous claims for the Homebuyer Credit.

A. Reviewed documented procedures (e.g., Internal Revenue Manual, desk procedures) to identify Category A criteria[16] used by the IRS's "1040X" unit when processing amended returns.

B. Worked with TIGTA Information Services programmers to develop a computer program to identify taxpayers with returns on the IRS's Individual Return Transaction File indicating prior home ownership and claiming the Homebuyer Credit on their Tax Year 2008 tax return during Processing Year 2009. The records were obtained from the IRS Master File. We validated the data received by comparing 30 records to IRS Master File data.

[13] Pub. L. No. 110-289.
[14] The IRS computer file containing individual tax return data.
[15] The statistical sample size was selected by using a 95 percent confidence level, a 5 percent precision, and a 50 percent expected error rate.
[16] Category A criteria identifies issues that require a referral to the Examination function classifiers prior to allowing a taxpayer's claim.

C. From a population of 25,970 claims, selected and reviewed a statistically valid sample[17] of 379 claims for indications that the return was identified for meeting Category A criteria and was forwarded to the Examination function for further scrutiny.

V. Identified and referred to the TIGTA Office of Investigations 34 IRS employees who had indications of prior home ownership and claimed the Homebuyer Credit on their Tax Year 2008 tax return. The employees filed as secondary taxpayers on original returns and both primary and secondary filers on amended returns.

Final (Phase III) Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine whether the IRS has controls in place that effectively identify erroneous claims for the Homebuyer Credit. To accomplish our objective, we:

I. Identified and reviewed claims without recorded acquisition dates.

A. Computer identified 3,446 claims from the IRS's Individual Return Transaction File that did not have a recorded acquisition date listed on the Tax Year 2008 Form 5405. We identified original electronic Tax Year 2008 Forms 1040 processed during Processing Year 2009.

B. Assessed the validity and completeness of the computer data by selecting a statistically valid sample[18] of 346 claims and comparing the records to IRS Individual Master File information.

C. Selected and reviewed a statistically valid sample of 346 of the 3,446 claims to determine whether they received scrutiny from either Criminal Investigation or the Examination function.

D. Conducted research through third-party sources for the 346 claims to verify property ownership information and determine whether a home purchase occurred.

II. Identified instances in which the taxpayer purchased their new residence from a related person.

A. Computer identified 14,186 taxpayers from the IRS's Individual Return Transaction File that claimed the Homebuyer Credit on their Tax Year 2008 returns using the

[17] The statistical sample size was selected by using a 95 percent confidence level, a 5 percent precision, and a 50 percent expected error rate.
[18] The statistical sample size was selected by using a 95 percent confidence level, a 5 percent precision, and a 50 percent expected error rate.

address of a taxpayer who had previously claimed them or their spouse as a dependent.

B. Selected and reviewed a statistically valid sample[19] of 375 of the 14,186 claims to assess the validity of the computer data and to determine whether the claims received scrutiny from either Criminal Investigation or the Examination function by comparing the records to IRS Master File information.

C. Conducted research through third-party sources for 151 of the 375 claims[20] to verify property ownership information and to determine whether the claim was based on a home purchased from a related person.

III. Researched questionable claims to determine if the IRS ensures the validity of a home purchase.

A. Using information from the IRS's Individual Return Transaction File, computer identified 61,994 claims, of which 54,117 claims listed an apartment address, 7,499 claims listed a post office box address, and 378 claims had a phrase in the address indicating no home purchase (e.g., Undecided, Unknown, To Be Determined). We identified original electronic Tax Year 2008 Forms 1040 processed during Processing Year 2009.

1. Selected and reviewed a statistically valid sample of 382 (334 were apartments) of the 61,994 claims to validate the computer data and to determine whether the claims had received scrutiny from either Criminal Investigation or the Examination function by comparing the records to IRS Master File information.

2. Conducted research through third-party sources to verify property ownership information for 30 of the 334 claims listing an apartment address.[21]

3. Selected and reviewed a statistically valid sample[22] of 366 of the 7,499 claims listing a post office box address to validate the computer data and to determine

[19] The statistical sample size was selected by using a 95 percent confidence level, a 5 percent precision, and a 50 percent expected error rate.

[20] We selected 151 claims identified from our statistically valid sample of 375. We selected claims that used the address of a taxpayer who had previously claimed the primary taxpayer, had indications that the taxpayer purchased from a direct ancestor or lineal descendant, and received the Homebuyer Credit without any IRS scrutiny. We used the extract from our statistically valid sample because we intended to project the results of this sample to the entire population.

[21] We selected the first 30 of the 334 identified claims using an apartment address. We used a judgmental sample because we did not intend to project the results of this sample to the entire population.

[22] The statistical sample size was selected by using a 95 percent confidence level, a 5 percent precision, and a 50 percent expected error rate.

whether the claims had received scrutiny from either Criminal Investigation or the Examination function by comparing the records to IRS Master File information.

4. Performed a second query of addresses with a phrase indicating no home purchase had occurred after finding additional phrases used by taxpayers (resulting in 449 claims). Selected and reviewed a statistically valid sample[23] of 208 of the 449 claims in which the taxpayer indicated an unknown address to validate the computer data and to determine whether the claims had received scrutiny from either Criminal Investigation or the Examination function.

B. From a population of 139,847 paper returns claiming the Homebuyer Credit, reviewed a statistically valid sample[24] of 524 claims to determine the number of taxpayers who listed a post office box as the address of their newly purchased residence. We identified original Tax Year 2008 Forms 1040 processed during Processing Year 2009.

C. Using information from the IRS's Individual Return Transaction File, computer identified 91,887 taxpayers who listed the same address on their Tax Year 2008 Form 1040 as an address used on a tax return filed in a previous year.

1. Validated and assessed the reliability and completeness of the computer data by comparing 30 records to IRS Master File data.

2. Selected and reviewed a statistically valid sample[25] of 383 claims to determine whether the claims had received scrutiny from either Criminal Investigation or the Examination function.

3. Conduced research through third-party sources for the 383 claims to verify property ownership information and determine whether a home purchase occurred.

IV. Identified and referred to the TIGTA Office of Investigations 41 IRS employees who met additional audit test criteria not identified in the interim reports. These employees listed invalid acquisition dates, questionable or invalid home addresses, or claimed the Homebuyer Credit on their Tax Year 2009 tax return and had indications of prior home

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[23] The statistical sample size was selected by using a 95 percent confidence level, a 5 percent precision, and a 50 percent expected error rate.

[24] The statistical sample size needed using a 95 percent confidence level, a 5 percent precision, and a 50 percent expected error rate was 384 returns. We ordered 600 returns to ensure we received enough. We received and reviewed 524 of the 600 returns, which resulted in an actual confidence level of 95.5 percent, a 4.362 percent precision, and a 50 percent expected error rate.

[25] The statistical sample size was selected by using a 95 percent confidence level, a 5 percent precision, and a 50 percent expected error rate.

ownership. These employees filed as either primary or secondary taxpayers on original returns.

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: the IRS's policies, procedures, and practices related to the identification of erroneous claims for the Homebuyer Credit filed on both original and amended returns. The computer analyses and audit steps described above were designed to test these controls.

Appendix II

Major Contributors to This Report

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Appendix III

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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.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $97,804,405 in erroneous refunds were issued to 13,448 taxpayers for First-Time Homebuyer Credit (Homebuyer Credit) claims based on future home acquisitions (see page 3).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File[1] a computer extract of 19,351 Tax Year 2008 tax returns on which taxpayers claimed Homebuyer Credits for homes which had not yet been purchased, but reportedly would be in the future (the acquisition dates provided on the taxpayers' returns were subsequent to the dates the IRS processed the returns).

In an interim report[2] for this audit, the TIGTA recommended the IRS determine which of the future acquisition claims were in fact erroneous and recover any applicable Credits. In response, the IRS sent notices to those taxpayers and reversed the Homebuyer Credit if the taxpayer failed to provide proof of an actual home purchase.

Subsequent to the IRS contacting these taxpayers, we reviewed a statistically valid sample of 377 of the 19,351 claims and found 262 Homebuyer Credits (69.4960 percent) were reversed, indicating the taxpayer did not provide the IRS proof of an actual home purchase. By multiplying 0.694960 by the population of 19,351, we estimated that 13,448[3] erroneous claims were processed by the IRS even though the taxpayer had not purchased a home.

We determined that the 262 claims in our sample totaled $1,905,446 and divided by the sample size of 377, resulting in a sample average of $5,054.23. By multiplying $5,054.23 by the

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[1] A database the IRS maintains that contains information on the individual tax returns it receives.
[2] *The Internal Revenue Service Faces Significant Challenges in Verifying Eligibility for the First-Time Homebuyer Credit* (Reference Number 2009-41-144, dated September 29, 2009).
[3] Our projection is based on a 95 percent confidence level and a precision (range) of ± 892 (12,556 – 14,340 claims).

population of 19,351, we projected that the IRS could potentially recover $97,804,405[4] in erroneous claims.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $325,753,348 in erroneous refunds were issued to 47,576 taxpayers who claimed Homebuyer Credits despite indications that they owned a home within the past 3 years and, therefore, may not qualify as "first-time homebuyers" (see page 3).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File a computer extract of 69,966 taxpayers who claimed Homebuyer Credits on their Tax Year 2008 electronic tax returns but had indications of owning a home within 3 years prior to the purchase of the home for which the Credit applied. The claims identified were processed by the IRS prior to the initiation of its computerized pre-refund Examination filters on May 17, 2009.

To estimate the percentage of these claims the IRS would disallow through examinations, we obtained the IRS's Homebuyer Credit Enforcement Report as of May 21, 2010, which provides data showing the success of IRS examinations. Because specific categories of Homebuyer Credits were unavailable, we used the overall "change rate" for Homebuyer Credits of 68 percent. By multiplying 0.68 by the population of 69,966, we estimated that 47,576 claims would be disallowed through post-refund examinations.

The average proposed dollar change per the Enforcement Report equaled $7,283. However, to ensure our projections were conservative, we used the average claim amount for the 69,966 cases. The 69,966 taxpayers claimed Homebuyer Credits totaling $479,058,098.72, an average of $6,847.01 per claim. By multiplying $6,847.01 by the 47,576 estimated claims, we projected that $325,753,348 in erroneous refunds were released.

Type and Value of Outcome Measure:

- Revenue Protection – Actual; $531,134 of Homebuyer Credits claimed by 96 taxpayers under 18 years of age were appropriately disallowed (see page 3).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File a computer extract of 582 taxpayers under 18 years of age who claimed almost $4 million in Homebuyer Credits. In

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[4] Our projection is based on a 95 percent confidence level and a precision (range) of ± $6,623,583 ($91,180,822 – $104,427,988).

an interim report[5] for this audit, the TIGTA recommended that the IRS implement filters to identify taxpayers under age 18 claiming the Homebuyer Credit.

As a direct result of congressional hearings in October 2009 related to the TIGTA's audit report, subsequent legislation was passed as part of the WHBAA[6] to allow the IRS the authority to disallow Homebuyer Credit claims made by taxpayers under 18 years of age. In addition, the IRS implemented a processing filter designed to identify claims made by underage taxpayers for the Credit.

During the 2010 Filing Season, TIGTA identified 96 taxpayers under 18 years of age that claimed Homebuyer Credits totaling $531,134 that were identified by the IRS during processing and were denied the credit. None of the 96 taxpayers filed as married filing jointly.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $7,654,164 in erroneous refunds were issued to 1,084 prisoners claiming the Homebuyer Credit (see page 3).

Methodology Used to Measure the Reported Benefit:

Using information from the IRS Individual Return Transaction File and the IRS Prisoner File,[7] we identified 4,608 individuals claiming Homebuyer Credits on their Tax Year 2008 returns despite the fact that they were in prison at the time their qualifying home was reportedly purchased.

We reviewed a statistically valid sample of 306 of the 4,608 claims and found that 72 claims (23.5294 percent) were refunded to the prisoners without any IRS scrutiny. By multiplying 0.235294 by the population of 4,608 prisoners claiming the Homebuyer Credit, we estimated 1,084[8] claims were erroneously refunded to prisoners.

We determined that the 72 claims in our sample totaled $508,284 and divided by the sample size of 306, resulting in a sample average of $1,661.06. By multiplying $1,661.06 by the population of 4,608, we projected that prisoners received $7,654,164[9] to which they were not entitled.

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[5] *The Internal Revenue Service Faces Significant Challenges in Verifying Eligibility for the First-Time Homebuyer Credit* (Reference Number 2009-41-144, dated September 29, 2009).
[6] Pub. L. No. 111-92, 123 Stat 2984 (2009).
[7] A computer file maintained by the IRS containing prisoner information. In general, this file contained individuals incarcerated in September 2009 or prior.
[8] Our projection is based on a 95 percent confidence level and a precision (range) of ± 212 (872 – 1,296 claims).
[9] Our projection is based on a 95 percent confidence level and a precision (range) of ± $1,536,059 ($6,118,105 – $9,190,223).

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $11,356,751 of erroneous refunds were issued to 2,587 taxpayers for improper claims of Homebuyer Credits without any IRS scrutiny despite using an address for which multiple taxpayers claimed the Credit (see page 3).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File a computer extract of 18,832 Homebuyer Credit claims on individual electronic Tax Year 2008 income tax returns that listed an address for which at least one other taxpayer also claimed the Homebuyer Credit and the combined amounts of those claims were more than the maximum amount allowed. We determined that the 18,832 claims used only 7,695 addresses total.

We reviewed a statistically valid sample of 377 of the 18,832 claims and found 206 claims (54.6 percent) were refunded by the IRS without any pre-refund or post-refund examination scrutiny. By multiplying 0.546 by the population of 18,832, we projected that 10,282[10] questionable claims were refunded without IRS scrutiny.

We determined that the 206 claims in our sample totaled $1,459,730 and divided by the sample size of 377, resulting in a sample average of $3,871.96. By multiplying $3,871.96 by the population of 18,832, we projected that taxpayers received $72,916,751[11] to which they were not entitled.

To ensure our projections were conservative, we assumed that one claim totaling $8,000 for each of the addresses was legitimate and subtracted 7,695 claims totaling $61,560,000 (7,695 x $8,000) from our outcomes, resulting in 2,587 questionable claims totaling $11,356,751.[12]

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $17,622,548 in erroneous refunds were issued to 2,555 taxpayers for Homebuyer Credit claims based on homes reportedly purchased prior to dates allowed by law (see page 3).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File a computer extract of 2,751 Tax Year 2008 individual electronic income tax returns with claims for Homebuyer Credits listing

[10] Our projection is based on a 95 percent confidence level and a precision (range) of ± 938 (9,344 – 11,220 claims).
[11] Our projection is based on a 95 percent confidence level and a precision (range) of ± $6,776,952 ($66,139,799 – $79,693,703).
[12] Our projection is based on a 95 percent confidence level and a precision (range) of ± $6,776,952 ($4,579,799 – $18,133,703).

acquisition dates prior to April 9, 2008, the effective date of the HERA legislation. As a result, the IRS sent notices to the 2,751 taxpayers and reversed the Homebuyer Credit if the taxpayer failed to substantiate that the home purchase was within the dates allowed by law.

In order to estimate the amount the IRS could potentially recover, we reviewed a statistically valid sample of 338 of the 2,751 claims and found 24 claims (7.1 percent) were already receiving IRS scrutiny or taxpayers had already voluntarily repaid the erroneous credits. Based on the remaining 92.9 percent that were not scrutinized or repaid, we estimate that for Tax Year 2008, approximately 2,555[13] taxpayers filing electronic returns received inappropriate Homebuyer Credits based on homes purchased prior to dates allowed by the law.

We determined that the 314 (338 – 24 = 314) claims in our sample that had not received IRS scrutiny or had been repaid totaled $2,165,185 and divided by the sample size of 338, resulting in a sample average of $6,405.87. By multiplying $6,405.87 by the population of 2,751, we projected that taxpayers received $17,622,548[14] to which they were not entitled.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $24,875,718 in erroneous refunds were issued to 3,745 taxpayers who claimed Homebuyer Credits based on homes purchased from related parties (see page 7).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File a computer extract of 14,186 taxpayers who claimed Homebuyer Credits for what appear to be homes purchased from related persons (see Appendix V for additional information concerning our methodology and scope). These taxpayers filed for Homebuyer Credits on their 2008 electronic tax returns and listed as their newly purchased residence the home address of a taxpayer who had previously claimed them or their spouse as a dependent.

We reviewed a statistically valid sample of 375 of the claims and found 99 claims (26.4 percent) could not be validated through Accurint[15] research as legitimate home purchases and were refunded to the taxpayer without any IRS scrutiny. Of the 99 claims, we determined 39 claims were for homes purchased from a direct ancestor or descendent of the taxpayer and 60 claims were for home purchases that had not actually occurred. By multiplying 0.264 by the population

[13] Our projection is based on a 95 percent confidence level and a precision (range) of ± 71 (2,484 – 2,626 claims).
[14] Our projection is based on a 95 percent confidence level and a precision (range) of ± $633,097 ($16,989,451 – $18,255,645).
[15] A database maintained by LexisNexis that provides, in part, third-party data listing real estate and property ownership records.

of 14,186, we estimate 3,745[16] erroneous claims for Homebuyer Credits were refunded despite indications the taxpayer had not made a qualifying home purchase.

We determined that the 99 claims in our sample totaled $657,578 and divided by the sample size of 375, resulting in a sample average of $1,753.54. By multiplying $1,753.54 by the population of 14,186, we projected that taxpayers received $24,875,718[17] to which they were not entitled.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $10,893,047 in erroneous Homebuyer Credit claims were issued to 1,966 taxpayers for which the taxpayers listed post office box numbers as the qualifying home address (see page 8).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File a computer extract of 7,499 Tax Year 2008 individual electronic income tax returns with Homebuyer Credit claims listing a post office box number as the qualifying home address.

We reviewed a statistically valid sample of 366 of the 7,499 claims and found 96 claims (26.2295 percent) could not be validated through Accurint research as legitimate home purchases and were refunded to the taxpayer without any IRS scrutiny. By multiplying 0.262295 by the population of 7,499, we estimated that 1,966[18] erroneous claims for Homebuyer Credits were released despite indications the taxpayer had not made a qualifying home purchase.

We determined that the 96 claims in our sample totaled $531,652 and divided by the sample size of 366, resulting in a sample average of $1,452.60. By multiplying $1,452.60 by the population of 7,499, we projected that taxpayers received $10,893,047[19] to which they were not entitled.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $1,068,683 in erroneous Homebuyer Credit claims were issued to 140 taxpayers for which the taxpayer did not provide a valid qualifying home address (see page 8).

[16] Our projection is based on a 95 percent confidence level and a precision (range) of ± 625 (3,120 – 4,370 claims).
[17] Our projection is based on a 95 percent confidence level and a precision (range) of ± $4,339,181 ($20,536,537 – $29,214,899).
[18] Our projection is based on a 95 percent confidence level and a precision (range) of ± 330 (1636 – 2,296 claims).
[19] Our projection is based on a 95 percent confidence level and a precision (range) of ± $2,044,754 ($8,848,293 – $12,937,801).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File a computer extract of 449 Tax Year 2008 individual electronic income tax returns where the taxpayer did not provide a valid qualifying home address on the First-Time Homebuyer Credit and Repayment of the Credit (Form 5405).

We reviewed a statistically valid sample of 208 of the 449 claims and found that 65 (31.25 percent) could not be validated as a legitimate home purchase and were refunded to the taxpayer without any IRS scrutiny. By multiplying 0.3125 by the population of 449, we estimated that 140[20] Homebuyer Credit claims were released despite indications the taxpayer had not made a qualifying home purchase.

We determined that the 65 claims in our sample totaled $495,070 and divided by the sample size of 208, resulting in a sample average of $2,380.14. By multiplying $2,380.14 by the population of 449, we projected that taxpayers received $1,068,683[21] to which they were not entitled.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $8,636,459 in erroneous refunds were issued to 1,199 taxpayers who may not have purchased new homes but were not scrutinized by the IRS (see page 10).

Methodology Used to Measure the Reported Benefit:

The IRS implemented filters in May 2009 to identify instances where the address on the taxpayer's claim for the Homebuyer Credit was the same address used by the taxpayer on a previous year tax return. Use of the same address from a previous year gave indication that the taxpayer did not in fact purchase a new home.

We obtained from the IRS Individual Return Transaction File a computer extract of 91,887 taxpayers who listed the same address on their 2008 tax returns as an address used by the taxpayer on previously filed tax returns.

We reviewed a statistically valid sample of 383 of the 91,887 claims and found 5 questionable claims (1.3055 percent) could not be validated through Accurint research as legitimate home purchases and were released to the taxpayer without any IRS scrutiny. By multiplying 0.013055 by the 91,887 claims, we estimated that 1,199[22] erroneous claims were refunded without any IRS scrutiny.

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[20] Our projection is based on a 95 percent confidence level and a precision (range) of ± 21 (119 – 161 claims).
[21] Our projection is based on a 95 percent confidence level and a precision (range) of ± $160,330 ($908,353 – $1,229,013).
[22] Our projection is based on a 95 percent confidence level and a precision (range) of ± 1,044 (155 – 2,243 claims).

We determined that the 5 claims in our sample totaled $36,000 and divided by the sample size of 383, resulting in a sample average of $93.99. By multiplying $93.99 by the population of 91,887, we projected that taxpayers received $8,636,459[23] in erroneous refunds.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $7,667,832 in erroneous refunds were issued to 1,095 taxpayers for Homebuyer Credit claims even though the taxpayers failed to provide an acquisition date for the purchased home (see page 11).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File a computer extract of 3,446 Tax Year 2008 individual electronic income tax returns with Homebuyer Credit claims where the taxpayer did not provide an acquisition date for the newly purchased home on the Form 5405.

We reviewed a statistically valid sample of 346 of the 3,446 claims and found 110 claims (31.7919 percent) could not be validated through Accurint research as legitimate home purchases and were refunded to the taxpayer without any IRS scrutiny. By multiplying 0.317919 by the population of 3,446, we estimated that 1,095[24] erroneous claims were refunded without any IRS scrutiny.

We determined that the 110 claims in our sample totaled $769,900 and divided by the sample size of 346, resulting in a sample average of $2,225.14. By multiplying $2,225.14 by the population of 3,446, we projected that taxpayers received $7,667,832[25] to which they were not entitled.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; $11,718,500 in additional Homebuyer Credits owed to 23,437 taxpayers (see page 13).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Return Transaction File a computer extract of 48,580 taxpayers who claimed Homebuyer Credits of only $7,500 each for homes purchased in Calendar Year 2009 even though the law allowed for up to an $8,000 credit. We believed it was likely taxpayers were unaware that changes to provisions of the law increased the maximum

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[23] Our projection is based on a 95 percent confidence level and a precision (range) of ± $7,652,953 ($983,506 – $16,289,412).
[24] Our projection is based on a 95 percent confidence level and a precision (range) of ± 161 (934 – 1,256 claims).
[25] Our projection is based on a 95 percent confidence level and a precision (range) of ± $1,157,206 ($6,510,626 – $8,825,038)

amount of the Homebuyer Credit from $7,500 to $8,000 for homes purchased in Calendar Year 2009.

In an interim report[26] for this audit, the TIGTA recommended that the IRS contact taxpayers who may have been entitled to an additional refund amount. In response, the IRS sent 23,437 notices to taxpayers who purchased homes in Calendar Year 2009, received a credit of $7,500, and had not amended their return to claim additional Homebuyer Credits.

By multiplying $500 of potential refund owed to 23,437 taxpayers, we estimated that taxpayers could be entitled to receive $11,718,500 of additional Homebuyer Credits.

[26] *The Internal Revenue Service Faces Significant Challenges in Verifying Eligibility for the First-Time Homebuyer Credit* (Reference Number 2009-41-144, dated September 29, 2009).

Appendix V

Methodology to Identify Individuals Erroneously Receiving Homebuyer Credits for Homes Purchased From Related Persons

We identified 14,186 individual tax returns (Tax Year 2008) on which taxpayers claimed the First-Time Homebuyer Credit (Homebuyer Credit) on their returns using the address of a taxpayer who had previously claimed them or their spouse as a dependent. In other words, these taxpayers identified their new home purchase as the prior home of a taxpayer who had previously claimed them or their spouse as a dependent.

The data we accessed to identify dependent history were limited. We were able to computer analyze dependents claimed on tax returns only between Tax Years 2002 and 2008. Therefore, in general, we were able to analyze only Homebuyer Credit claims made by taxpayers who were in their early to mid-twenties. Because of this, we believe that we are able to identify only a small portion of the problem.

Claimants were instructed to include the address of the qualifying home on their First-Time Homebuyer Credit and Repayment of the Credit (Form 5405). This requirement was waived if the qualifying home address was already listed on the U.S. Individual Income Tax Returns (Form 1040). We compared the qualifying home address to the address of taxpayers who had listed the claimant as a dependent in the past. While the 14,186 claims have indications of a purchase from a related person, the fact that they were a dependent does not necessarily mean they were related for purposes of the Homebuyer Credit.

To further determine how many erroneous claims for the Homebuyer Credit resulted from homes that were actually acquired from a related person, we analyzed a statistically valid sample of 375 of the 14,186 claims. We initially found that the claims fell in one of three categories:

- 241 claims used the address of a taxpayer who had previously claimed the primary taxpayer as a dependent.
- 27 claims used the address of a taxpayer who had previously claimed the taxpayer's spouse as a dependent.
- 107 claims in which the primary taxpayer had claimed the future spouse as a dependent.

We did not take exception to the third category (107 claims) because, after further analysis, we determined that these claims likely qualified for the Homebuyer Credit. For these cases, it appears that the primary taxpayer had previously claimed the spouse as a dependent, then later married and purchased a home together.

In addition, we did not consider the 27 claims as exceptions because the purchase occurred prior to November 2009, when the legislation denying purchases from taxpayers related by marriage was enacted.

We further analyzed the 241 claims of taxpayers whose new home address was the address of a taxpayer who had previously claimed the claimant as a dependent to determine whether they were related. We found 197 of the 241 claims were based on homes purchased from an ancestor or lineal descendent and further found that 156 of the 197 claims resulted in refunds. We researched the 156 claims and determined that 151 (97 percent) claims did not have any IRS compliance activity before or after the refund.

We conducted additional research on the 151 cases using Accurint[1] to obtain supplementary information on these cases and to further determine the legitimacy of these claims. Based on our research, we found the following:

- 39 appear to be related person purchases.
- 19 are questionable but only because the taxpayers and their "parents" are co-owners of the new residences.
- 60 appear not to have purchased a home at all.
    - 33 appear to still be living in their parents' house.
    - 27 appear to be living away from home at different residences that they do not own.
- 33 appear to have made legitimate home purchases.

Based on our statistical sample of 375 returns, we estimate that for Tax Year 2008, 3,745 taxpayers received refunds totaling more than $24.8 million in Homebuyer Credits despite indications the taxpayer either purchased their home from a related party or had not actually made a qualifying home purchase. As noted earlier, this may be a larger problem than these numbers indicate.

[1] A database maintained by LexisNexis that provides, in part, third-party data listing real estate and property ownership records.

Appendix VI

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

COMMISSIONER
WAGE AND INVESTMENT DIVISION

RECEIVED
MAR 25 2011

MAR 25 2011

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report - Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits (Audit # 201040141)

We have reviewed the Treasury Inspector General for Tax Administration's (TIGTA) draft report of the administration of the First-Time Homebuyer Credit (FTHBC). We appreciate your acknowledgment of the positive steps we have taken to strengthen controls and to help prevent inappropriate Homebuyer Credits from being issued. We also appreciate TIGTA's recognition of the many challenges the IRS faced in implementing the four legislative iterations of this credit. Despite the challenges faced, we were able to provide over $27 billion dollars to almost 3.9 million taxpayers through the end of 2010.

The IRS recognizes there is the potential for both fraud and errors whenever a refundable tax credit, such as the FTHBC, is enacted into law or modified in some fashion. As with any tax credit, we must administer a balanced program that delivers the benefits the legislation envisioned, in the intended time frame, while ensuring that appropriate and prudent controls are in place to minimize errors and fraud.

The FTHBC was first established in 2008 to stimulate economic growth and has been modified by three subsequent tax law changes that crossed tax years. These legislative modifications changed not only the credit type and amounts, but also the eligibility requirements and the effective dates of the credit. The initial credit for home purchases during 2008 was up to $7,500 and was the equivalent of an interest free loan that taxpayers were required to repay in 15 equal installments beginning with their return for the 2010 Tax Year. Such a refundable credit with a pay-back requirement presents less of an enforcement and control risk than those with no such pay-back requirement.

2

The IRS's first challenge in administering the FTHBC was reacting to the various versions of the credit subsequently enacted by the Congress. A second version of the FTHBC was enacted in the American Recovery and Reinvestment Act of 2009, which required IRS to immediately implement an increase in the credit amount to $8,000 that included no pay-back requirement for homes purchased through November 2009. Further, the new law allowed the revised credit to be claimed on Tax Year 2008 returns and did not repeal or revise the previous FTHBC for homes purchased in 2008 that also were required to be claimed on Tax Year 2008 returns. These changes were effective on the date of enactment in February 2009, during the height of the 2009 Filing Season. This required the IRS to undertake immediate and significant changes to its forms, instructions, returns processing systems, error resolution procedures, and enforcement-related controls to address the revised FTHBC, while simultaneously accepting and processing claims for the prior version of the FTHBC. It should be noted that because IRS initially only had the legal authority to deny erroneous claims during processing for mathematical or certain unallowable conditions, the only avenue available for preventing payment of an otherwise erroneous claim was through the audit process and use of deficiency procedures that require use of IRS' limited Examination resources.

The Worker, Homeownership, and Business Assistance Act of 2009 was enacted in November 2009, just prior to the 2010 Filing Season. This legislation, which changed the law effective November 7, 2009, extended the FTHBC to homes purchased through April 30, 2010, allowed the credit to be claimed by long-time homeowners, required taxpayers to attach documentation to establish eligibility, and provided IRS with expanded math error authority to deny certain erroneous claims during processing. The FTHBC was revised again by the Homebuyer Assistance and Improvement Act, which was passed in July 2010. This Act extended the time period to close on a home in a binding contract on April 30, 2010, from June 30 to September 30, and was enacted after the initial deadline had expired. These legislative changes also left little time for IRS implementation and required the same kind of immediate and significant revisions to IRS systems, procedures, and controls as noted above.

The timing and differences in the various legislative provisions also created complexity and confusion for taxpayers and return preparers, as well as the real estate industry. The IRS addressed this challenge by providing timely, understandable, and extensive outreach and education to the public. Nevertheless, this complexity undoubtedly contributed to numerous errors and erroneous claims.

Also, because the FTHBC was the largest refundable credit for individuals at the time, it was an attractive target for fraud. Finding effective compliance treatments for the FTHBC posed the same kind of challenges we face with other refundable credits - the credit has a number of eligibility rules and the Federal Government generally lacks real-time in-house, or third party data sources necessary to verify taxpayers' eligibility. Further, each new piece of FTHBC legislation brought new issues; our compliance strategy evolved with both experience gained and the tools made available at the time. Compliance efforts included limited math error authority, the development of filters to identify erroneous claims, examinations, criminal investigations, and, eventually, expanded math error authority and the ability to require documentation. We continue to address high risk claims in our post refund math error and examination work not addressed by our pre-refund treatments. Through January 2011, the IRS exercised extended math error authority on over 370,000 returns, completed examinations of over 400,000 returns which protected over $1.3 billion, and identified over 200 criminal schemes.

In recent years, the IRS has assumed a growing role with refundable credits. Despite some recurring compliance issues, which we are taking action to address, the administration of each credit must be evaluated on the credit's own unique attributes. Additionally, the IRS must consider available resources, burden to IRS and taxpayers, and the credit's place in overall tax administration.

The challenges related to FTHBC were significant and many lessons were learned that we have already applied while implementing recently passed legislation with other new credits. We have taken timely corrective actions to shore up any weaknesses we identified internally or which TIGTA brought to our attention. The FTHBC tax provisions brought relief to millions of taxpayers across the country, and we are proud of the role IRS played in its implementation.

With reference to the twelve separate measurable benefits on tax administration included in your report, our responses are below. Note that we believe both the population and estimated revenue protection is overstated for the population of taxpayers with future purchase dates, Post Office Box addresses, those not showing a change in address, and those with no purchase date. Additional information may show that the taxpayers did qualify for the credit. The IRS is matching information provided by taxpayers with third party data to verify its accuracy. We will be able to quantify this expected overstatement when we have completed our third party data match and analysis.

Our comments to your specific recommendations are attached. If you have any questions, please contact me, or a member of your staff may contact Robin L. Canady, Director, Strategy and Finance, Wage and Investment Division, at (404) 338-8801.

Attachment

Attachment

The IRS Commissioner should:

RECOMMENDATION 1:
Require taxpayers to provide supporting documentation to verify eligibility for all refundable tax credits.

CORRECTIVE ACTION
We agree that this recommendation is appropriate for many refundable credits. We evaluate the administration of each refundable credit based on its unique characteristics. In the case of the FTHBC, we determined that such a requirement was warranted because the likelihood of fraud was well known and specific legal authority was provided by the law. We continuously assess and evaluate compliance risks, and where we determine that the benefits of this approach outweigh the compliance burden and legal constraints, we will consider using it more broadly.

IMPLEMENTATION DATE
Implemented and ongoing.

RESPONSIBLE OFFICIAL
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A

RECOMMENDATION 2:
To the extent feasible, ensure that the processing of refundable credits provided for in late legislation be initiated only after sufficient controls can be implemented to protect the Government from erroneous and fraudulent claims for these credits.

CORRECTIVE ACTION
We agree with this recommendation. To the extent feasible, and as we have in the past, for late legislation we will initiate processing of new or revised refundable credits only after we assess and balance the risk of erroneous and fraudulent claims against the feasibility and time required to implement appropriate controls, while taking into consideration Congressional intent and legislative effective dates.

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL
N/A

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

2

RECOMMENDATION 3:
The IRS Commissioner should seek legislation to provide the IRS with math error authority to deny credits when supporting documentation is not provided for a refundable credit.

CORRECTIVE ACTION
We agree that math error authority is an important compliance tool in many cases. In determining the appropriate administration of each refundable credit, we will explore with our colleagues at the Department of Treasury Office of Tax Policy whether math error authority is appropriate.

IMPLEMENTATION DATE
Implemented and Ongoing.

RESPONSIBLE OFFICIAL
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A

RECOMMENDATION 4:
The Director, Reporting Compliance, Wage and Investment Division, should develop a method similar to that used by the TIGTA to identify improper claims for purchases from related persons and conduct examinations as appropriate to ensure the Credits are recovered.

CORRECTIVE ACTION
We agree with this recommendation. The IRS has established a method, similar to that used by the Treasury Inspector General for Tax Administration (TIGTA), to identify improper related person claims. These claims have been identified and considered for the post refund examination pool.

IMPLEMENTATION DATE
April 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 5:
The Commissioner, Wage and Investment Division, should perform a review of the claims with invalid addresses that the TIGTA identified and correspond with taxpayers in order to validate the home purchases. The TIGTA has the list of taxpayers described above and will make it available to IRS functions upon request.

CORRECTIVE ACTION
We partially agree with this recommendation. We will review the list TIGTA provides and use third-party public property records to validate all home purchases. We will then consider questionable claims for appropriate action.

IMPLEMENTATION DATE
April 15, 2012

RESPONSIBLE OFFICIAL
Director, Earned Income Tax Credit, Wage and Investment Division
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 6:
For Tax Year 2010, the Commissioner, Wage and Investment Division, should modify the programming for the filter to identify taxpayers who did not purchase a home so that it identifies all claims meeting the specified criteria. The TIGTA has a list of the taxpayers who should have been flagged, but were not, and will make it available to the IRS upon request.

CORRECTIVE ACTION
We agree with this recommendation. We have already modified the filter criteria. We will review the list of taxpayers TIGTA provides and use third-party public property records to validate all home purchases. The results will be assessed for appropriate action.

IMPLEMENTATION DATE
April 15, 2012

RESPONSIBLE OFFICIAL
Director, Earned Income Tax Credit, Wage and Investment Division
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 7:
The Director, Reporting Compliance, Wage and Investment Division, should identify those claims for which valid acquisition dates were not supplied and initiate post-refund examinations (including the use of soft notices) to ensure refunds for the invalid claims are recovered. The TIGTA has the list of taxpayers described above and will make it available to the IRS upon request.

CORRECTIVE ACTION
We agree with this recommendation. We will review the list TIGTA provides and use third-party public property records to validate all home purchases, including acquisition dates. Invalid acquisition dates will be evaluated to determine the appropriate treatment.

IMPLEMENTATION DATE
April 15, 2012

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