Processes Were Not Established to Verify Eligibility for Residential Energy Credits

April 19, 2011
Reference Number: 2011-41-038

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

Redaction Legend:
5 = Information concerning a pending law enforcement proceeding (FOIA subsection b(7)(A))
HIGHLIGHTS

PROCESSES WERE NOT ESTABLISHED TO VERIFY ELIGIBILITY FOR RESIDENTIAL ENERGY CREDITS

Highlights

Final Report issued on April 19, 2011

Highlights of Reference Number: 2011-41-038 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

The American Recovery and Reinvestment Act of 2009 (Recovery Act) modified the law related to energy credits to encourage the purchase of energy efficient property and renewable sources of energy for use in a home. The Internal Revenue Service (IRS) cannot verify whether individuals claiming Residential Energy Credits are entitled at the time their tax returns are processed. Inadequate verification increases the risk that taxpayers will be allowed to receive erroneous Residential Energy Credits.

WHY TIGTA DID THE AUDIT

This audit was initiated because TIGTA is required to monitor the IRS's implementation of Recovery Act provisions. More than 6.8 million individuals claimed more than $5.8 billion in Residential Energy Credits on Tax Year 2009 tax returns processed through December 31, 2010. Our review assessed the effectiveness of the IRS's process to identify erroneous Residential Energy Credits.

WHAT TIGTA FOUND

The IRS cannot verify whether individuals claiming Residential Energy Credits are entitled to them at the time their tax returns are processed. The IRS does not require individuals to provide any third-party documentation supporting the purchase of qualifying home improvement products and/or costs associated with making energy efficiency improvements and whether these qualified purchases and/or improvements were made to their principal residence.

Based on our review of a statistically valid sample of 150 tax returns, TIGTA was unable to confirm home ownership for 45 (30 percent) of the taxpayers. Home ownership is required to claim Residential Energy Credits.

Finally, our review identified 362 ineligible individuals who were allowed to erroneously claim $404,578 in Residential Energy Credits on their tax returns. These individuals were allowed to erroneously claim these credits because the IRS did not develop a process to identify prisoners or individuals under the age needed to enter into a contract to purchase a residence. The IRS has data that could have been used to identify these erroneous deductions.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, Wage and Investment Division:

- Revise the Residential Energy Credits (Form 5695) to request specific information supporting key eligibility requirements that could be used to verify requirements were met.

- Examine the tax returns of the 362 individuals TIGTA identified as being in prison or underage to ensure these individuals qualify for the Residential Energy Credits.

- Ensure processes are implemented to identify and review tax returns filed by prisoners or underage individuals to ensure they qualify for Residential Energy Credits claimed.

The IRS agreed with the first and third recommendations and plans to take corrective actions. The IRS partially agreed with the second recommendation. Specifically, the IRS agreed to review the returns of the 362 individuals identified as being in prison or underage and plans to audit those returns that warrant further examination.
April 19, 2011

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Processes Were Not Established to Verify Eligibility for Residential Energy Credits (Audit # 201040109)

This report presents the results of our review to assess the effectiveness of the Internal Revenue Service’s (IRS) process to identify erroneous Residential Energy Credits. This audit was conducted as part of the Treasury Inspector General for Tax Administration Fiscal Year 2010 Annual Audit Plan and addresses the major management challenge of Erroneous and Improper Payments and Credits.

The American Recovery and Reinvestment Act of 2009 (Recovery Act)\(^1\) provides separate funding to the Treasury Inspector General for Tax Administration through September 30, 2013, to be used in oversight activities of IRS programs. This audit was conducted using Recovery Act funds.

Management’s complete response to the draft report is included in 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.

Table of Contents

Background .................................................................................................................. Page 1

Results of Review ..................................................................................................... Page 4

The Internal Revenue Service Cannot Verify Eligibility for Residential Energy Credits at the Time a Tax Return Is Processed ............................................................... Page 4

Recommendation 1 .................................................................................................. Page 5

Erroneous Residential Energy Credits Were Allowed to Ineligible Individuals Even Though the Internal Revenue Service Had Data to Identify These Claims During Tax Return Processing ................................................ Page 6

Recommendations 2 and 3: ............................................................................... Page 7

Appendices

Appendix I – Detailed Objective, Scope, and Methodology ............................ Page 8
Appendix II – Major Contributors to This Report ........................................ Page 11
Appendix III – Report Distribution List .......................................................... Page 12
Appendix IV – Outcome Measure ................................................................... Page 13
Appendix V – Residential Energy Credits (Form 5695) .............................. Page 14
Appendix VI – Management’s Response to the Draft Report ....................... Page 16
**Abbreviations**

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>e-filed, e-file</td>
<td>Electronically filed; electronic file</td>
</tr>
<tr>
<td>IRS</td>
<td>Internal Revenue Service</td>
</tr>
<tr>
<td>TIGTA</td>
<td>Treasury Inspector General for Tax Administration</td>
</tr>
</tbody>
</table>
Background

The American Recovery and Reinvestment Act of 2009 (Recovery Act)\(^1\) made important changes to the law relating to energy credits. The Recovery Act modified the provisions for both the Nonbusiness Energy Property Credit and the Residential Energy Efficient Property Credit. The modifications to the Nonbusiness Energy Property Credit were to encourage the purchase of energy efficient property for an individual’s principal residence that were designed to reduce heat loss during cold months or heat gain during warm months. The Residential Energy Efficient Property Credit is for use in an individual’s principal or secondary residence to encourage the purchase of renewable sources of energy for use in a home. The amount of both of the Residential Energy Credits allowed reduces an individual’s taxes owed.

- **Nonbusiness Energy Property Credit** – allows individuals to take a credit of 30 percent of the costs paid or incurred in Calendar Year 2009 for energy efficient products for their principal residence with a maximum of $1,500 total for Tax Years 2009 and 2010. Energy efficient products, such as windows and doors, had to be placed in an individual’s existing principal residence. New construction and rental property not owned and occupied by the individual when the energy saving improvements were made do not qualify for this Credit.

- **Residential Energy Efficient Property Credit** – allows individuals to take a credit for investments in alternative energy equipment\(^2\) for their principal residence or secondary residence. This Credit generally equals 30 percent of qualifying alternative energy equipment costs with no dollar limit. Alternative energy equipment, like a geothermal heat pump or wind energy system, could be placed in an individual’s newly constructed or existing principal or secondary residence. However, individuals claiming this Credit for a fuel cell system\(^3\) have to install it in their principal residence to qualify for this Credit. Rental property does not qualify for the Credit.

For both of the above energy credits, the individual’s principal (or secondary, if applicable) residence must be located in the United States. The individual’s principal (or secondary, if applicable) residence can include a house, manufactured home, mobile home, condominium,

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2 Equipment must be placed in service by December 31, 2016.
3 The Credit amount for costs paid for a fuel cell system is limited to $500 for each one-half kilowatt of power capacity.
cooperative apartment, or houseboat. Both credits are claimed on the Residential Energy Credits (Form 5695)\(^4\) that is included with an individual’s U.S. Individual Income Tax Return (Form 1040). Figure 1 identifies the volumes of tax returns and Residential Energy Credits allowed for Tax Year 2009.

**Figure 1: Tax Year 2009 Tax Returns With Claimed Residential Energy Credits Allowed**

<table>
<thead>
<tr>
<th>Type of Tax Return Filed</th>
<th>Volume</th>
<th>Energy Credits Allowed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paper</td>
<td>1,601,687</td>
<td>$1,512,642,024</td>
</tr>
<tr>
<td>Electronic</td>
<td>5,183,701</td>
<td>$4,313,474,451</td>
</tr>
<tr>
<td>Totals</td>
<td>6,785,388</td>
<td>$5,826,116,475</td>
</tr>
</tbody>
</table>

Source: Tax return data for Processing Year 2010 as of Cycle 52 (December 31, 2010).

The 2010 Filing Season review identified some problems with the processing of Residential Energy Credits

The Treasury Inspector General for Tax Administration (TIGTA) 2010 Filing Season report\(^5\) determined that:

- **Individuals were allowed energy credits exceeding the maximum amounts.** Our review identified 171 individuals claiming $453,220 in erroneous Nonbusiness Energy Property Credits for Tax Year 2009. These individuals claimed a credit that exceeded the maximum allowable amount of $1,500 for all filing filing statuses reporting only one principal residence (or $3,000 for married filing jointly in certain circumstances).\(^6\) The audit determined that programming of an electronic file (e-file) reject code had not been implemented to prevent individuals from claiming a Nonbusiness Energy Property Credit exceeding the maximum allowable amount. Internal Revenue Service (IRS) management agreed to ensure computer systems are programmed to identify individuals exceeding the maximum allowable Nonbusiness Energy Property Credit. This included programming to reject e-filed tax returns with this condition.

- **The IRS was unable to accurately track and account for both types of energy credits claimed on the Form 1040.** Our review identified that the IRS cannot accurately track and account for both types of energy credits claimed on the Form 1040 with two additional tax credits. The IRS has programming in place to

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\(^4\)Appendix V provides an example of Form 5695.


\(^6\)If a taxpayer and his or her spouse owned and lived apart in separate main homes, they may each qualify for $1,500.
identify tax returns with any amount claimed on this line. Tax examiners then review the
tax returns and move the amounts into appropriate fields. The Form 5695 has two
credits, the Nonbusiness Energy Property Credit and the Residential Energy Efficient
Property Credit. The IRS combines the amounts for these two credits into one field,
Residential Energy Credits. Combining the two credits into one total
impairs the IRS’s ability to accurately report the number of claims and the respective
amounts paid for the Nonbusiness Energy Property Credit and the Residential Energy
Efficient Property Credit.

Recovery Act activities require a high level of scrutiny, and taxpayer dollars spent on economic
recovery must be subject to unprecedented levels of transparency and accountability. Federal
agencies are required to ensure Recovery Act funds are used for authorized purposes and
appropriate measures are taken to prevent fraud, waste, and abuse. As such, the TIGTA is
required to monitor the IRS’s implementation of Recovery Act provisions, and this audit was
conducted to meet those requirements.

This review was performed at the Wage and Investment Division Headquarters in
Atlanta, Georgia, and the Submission Processing Site in Kansas City, Missouri, during the period
September 2010 through February 2011. We conducted this performance audit in accordance
with generally accepted government auditing standards. Those standards require that we plan
and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for
our findings and conclusions based on our audit objective. We believe that the evidence
obtained provides a reasonable basis for our findings and conclusions based on our audit
objective. Detailed information on our audit objective, scope, and methodology is presented in
Appendix I. Major contributors to the report are listed in Appendix II.
Results of Review

The Internal Revenue Service Cannot Verify Eligibility for Residential Energy Credits at the Time a Tax Return Is Processed

The IRS cannot verify whether individuals claiming Residential Energy Credits are entitled to them at the time their tax returns are processed. The IRS does not require individuals to provide any third-party documentation supporting the purchase of qualifying home improvement products and/or costs associated with making energy efficiency improvements and if these qualified purchases and/or improvements were made to their residence. Instead, the IRS relies on individuals claiming the Residential Energy Credits to comply with tax laws and to provide correct information on their tax returns. Figure 2 shows the key requirements for claiming Residential Energy Credits that the IRS cannot verify at the time a tax return is processed.

Figure 2: Key Residential Energy Credit Requirements the IRS Is Unable to Verify

<table>
<thead>
<tr>
<th>Key Requirement</th>
<th>Can the IRS Verify When the Tax Return Is Processed?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual Purchased a Qualified Energy Saving Product and/or Made Energy Efficiency Improvements</td>
<td>No</td>
</tr>
<tr>
<td>Cost of Energy Saving Improvements</td>
<td>No</td>
</tr>
<tr>
<td>Energy Saving Improvements Made to the Individual's Home</td>
<td>No</td>
</tr>
<tr>
<td>Time Period Costs/Improvements Made</td>
<td>No</td>
</tr>
</tbody>
</table>

Source: IRS procedures and tax form instructions.

Individuals with no record of owning residential property claimed erroneous Residential Energy Credits

We reviewed a statistically valid sample of 150 tax returns from individuals who were allowed Residential Energy Credits. We did not project a noncompliance rate to the population using this sample because of the potential for omissions or errors in this type of third-party reporting.

Our computer analysis of 6,466,981 Tax Year 2009 tax returns with Residential Energy Credits processed between January 1, 2010, and July 23, 2010, identified 302,063 (5 percent) that did not show any indication of home ownership. Residential Energy Credits claimed on these tax returns totaled more than $234 million.
Our research of third-party data for a statistically valid sample of 150 of these 302,063 tax returns identified:

- 105 (70 percent) for which the individuals owned a home.
- 45 (30 percent) for which the individuals had no record of owning a home. These individuals claimed $30,201 in potentially erroneous Residential Energy Credits, resulting in a net tax effect of $29,962. To determine if the individuals claiming these credits owned a principal residence, we used the same third-party vendor information that the IRS uses when examining questionable tax returns. The third-party vendor receives property deed data from all of the 50 States, and the District of Columbia and the Virgin Islands. Most States send property deed data monthly to this third-party vendor, with some States providing the data more frequently.

The Office of Management and Budget has established five broad requirements that all agencies must follow in order to meet accountability objectives relating to Recovery Act funds. These requirements are posted on Recovery.gov. The third requirement is that Federal agencies ensure Recovery Act funds are used for authorized purposes and take steps needed to mitigate instances of fraud, waste, and abuse. The IRS has not established processes to ensure individuals are appropriately claiming Residential Energy Credits. In addition to the IRS not requesting any third-party information to verify Residential Energy Credits claimed, the Form 5695 does not require individuals to provide the information, which could serve as a deterrent for those individuals who intend to erroneously claim these credits.

IRS management noted that they had no plans during Filing Season 2010 to select and perform post-processing reviews focusing on individuals that claim Residential Energy Credits. However, in its Compliance 2011 Plan, the IRS states that it will review 5

Recommendation

**Recommendation 1:** The Commissioner, Wage and Investment Division, should revise the Form 5695 to request specific information supporting key eligibility requirements that could be used to verify requirements were met and may serve as a deterrent for those individuals who intend to erroneously claim these credits. For example, the Form 5695 revisions could include requiring the address of the residence for which the qualified energy-saving product and/or energy efficiency improvement was made, whether the product and/or improvement was made to their principal or secondary residence, and whether the residence was new construction or an existing structure.

**Management’s Response:** IRS management agreed with this recommendation. Form 5695, Residential Energy Credits, will be revised to request specific information concerning the property, such as requiring the specific address, whether the property was
the primary or secondary residence, and whether the improvements were made as part of building a new home or modifying an existing home.

**Erroneous Residential Energy Credits Were Allowed to Ineligible Individuals Even Though the Internal Revenue Service Had Data to Identify These Claims During Tax Return Processing**

We identified 362 ineligible individuals who were allowed to erroneously claim $404,578 in Residential Energy Credits on their tax returns. This occurred because the IRS did not develop a process to identify prisoners or individuals who were under the age needed to enter into a contract to purchase a residence claiming the credits. Moreover, the IRS has data that could have been used to identify these erroneous credits.

Figure 3 below shows the breakdown of the ineligible individuals who were allowed the Residential Energy Credits.

![Figure 3: Breakdown of Ineligible Individuals](image)

<table>
<thead>
<tr>
<th>Type of Ineligible Claimant</th>
<th>Number of Individuals</th>
<th>Amount Allowed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prisoner</td>
<td>262</td>
<td>$343,487</td>
</tr>
<tr>
<td>Underage</td>
<td>100</td>
<td>$61,091</td>
</tr>
<tr>
<td>Total</td>
<td>362</td>
<td>$404,578</td>
</tr>
</tbody>
</table>

*Source: TIGTA analysis of IRS computer files.*

**Prisoners were erroneously allowed $343,487 in Residential Energy Credits in Tax Year 2009 even though they were in prison for the entire year**

We determined that 262 prisoners who filed tax returns as single or head of household were allowed Residential Energy Credits totaling $343,487, although they were in prison for all of Tax Year 2009 when these energy-saving improvements were purportedly purchased. The IRS has data that can be used to identify prisoners erroneously claiming these credits.

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6 Figure 3 illustrates the number of ineligible individuals for whom the IRS allowed erroneous Residential Energy Credits on their Tax Year 2009 tax returns. We subsequently evaluated the tax effect of the IRS allowing these erroneous Residential Energy Credits and determined that 350 of 362 ineligible individuals’ taxes were lowered by $397,158 as a result. See Appendix IV for more details.
Underage individuals were erroneously allowed $61,091 in Residential Energy Credits

We identified 100 individuals under the age of 18 (26 of these were under the age of 14) who were allowed $61,091 in Residential Energy Credits. The youngest individual receiving the credit was 3 years old. Contract law generally exempts children under the age of 18 from being bound by the terms of a contract. Therefore, it is unlikely that these individuals would have entered into an arms-length transaction for the purchase of a residence. The IRS has data that can be used to identify underage individuals erroneously claiming these credits.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 2: Examine the tax returns of the 362 individuals we identified as being in prison or underage to determine whether these individuals qualify for the Residential Energy Credits.

Management’s Response: IRS management partially agreed with this recommendation. The IRS will review the returns of the 362 individuals identified as being in prison or underage and will audit those returns that warrant further examination.

Recommendation 3: Ensure processes are implemented to identify and review tax returns filed by prisoners or underage individuals to ensure they qualify for Residential Energy Credits claimed.

Management’s Response: IRS management agreed with this recommendation. The IRS has processes in place to identify returns filed by prisoners, underage individuals, and others that are questionable and appear to improperly claim credits and deductions. Although these processes were developed to provide more stringent screening for higher risk returns claiming refundable credits, such as the Earned Income Tax Credit, the First-Time Homebuyer Credit, and the Adoption Credit, that screening process is not restricted to those high-risk items. The Residential Energy Credits, along with other items of income, deductions, and credits, are also subject to review and contribute to the factors evaluated in selecting returns for examination.

The IRS continuously assesses and evaluates compliance risks in meeting the goal of a balanced compliance program that strategically addresses the most egregious noncompliance across all taxpayer segments. As part of the IRS’s ongoing research efforts and its 2011 American Recovery and Reinvestment Act Examination plan, it will review a sample of Residential Energy Credit cases in a post-refund environment. Those warranting examination will be selected for audit, and the results will be factored into future American Recovery and Reinvestment Act examination plans.
Detailed Objective, Scope, and Methodology

The overall objective of this review was to assess the effectiveness of the IRS’s process to identify erroneous Residential Energy Credits. To accomplish this objective, we:

I. Determined the actions taken by the IRS to identify erroneous Residential Energy Credit claims.
   A. Participated in a walkthrough at the IRS Submission Processing Site in Kansas City, Missouri, to determine efforts taken by IRS functions to identify erroneous Residential Energy Credit claims.
   B. Interviewed IRS management and analysts in the Code and Edit, Error Resolution, and Examination functions to identify steps taken to verify the accuracy of Residential Energy Credit claims.
   C. Reviewed Internal Revenue Code Section 25C (Nonbusiness Energy Property Credit), Internal Revenue Code Section 25D (Residential Energy Efficient Property Credit), and Internal Revenue Manual sections pertaining to the processing of individual income tax returns with Residential Energy Credits, as well as IRS tax forms and publications used to process individual tax returns with Residential Energy Credits.

II. Determined whether individuals are accurately claiming Residential Energy Credits on their tax returns.
   A. Selected a statistically valid sample of 150 tax returns of 302,063 Tax Year 2009 individual tax returns with allowed Residential Energy Credits and no indicators of home ownership and rental property ownership to assess the actions taken by the IRS to validate these tax credits. The returns were processed on the IRS’s Individual Master File/Individual Return Transaction File between January 1, 2010, and

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1 To assess the reliability of the computer data processed through July 23, 2010, the TIGTA Office of Information Services validated the data that were extracted from IRS systems and we verified the accuracy of the data by comparing judgmental samples of data to the IRS information residing on the Integrated Data Retrieval System. The Integrated Data Retrieval System is an IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer’s account records.

2 The Individual Master File contains general entity information for individual taxpayers such as name, address, and Social Security Number. The Individual Return Transaction File contains data transcribed from individual tax forms and accompanying schedules. The Individual Return Transaction File data were extracted from the IRS’s mainframes and a run-to-run balancing was used, which involves documenting the records read in and written out at each step of the file processing to ensure all records were received and loaded.
July 23, 2010. We used attribute sampling to calculate the minimum sample size \( n \), which was rounded to 150:

\[
n = \left( \frac{Z^2 \cdot p \cdot (1-p)}{A^2} \right)
\]

- **Z** = Confidence Level: 90 percent (expressed as 1.65 standard deviation)
- **p** = Expected Rate of Occurrence: 5 percent
- **A** = Precision Rate: ±3 percent

1. Used the third-party property research tool to identify property records to determine whether allowed Residential Energy Credits met the legal requirements of Internal Revenue Code Sections 25C and 25D.

III. Determined whether the IRS allowed ineligible individuals to claim Residential Energy Credits.

A. Matched 6,466,981 Tax Year 2009 individual income tax returns with Residential Energy Credits to the IRS’s 2009 Prisoner File\(^3\) to identify prisoners. We validated the accuracy of the data from the match by comparing a judgmental sample of 25 of the individuals identified as prisoners to the information residing on the IRS’s Integrated Data Retrieval System.

1. Matched only Prisoner File individuals with a filing status of single or head of household.

2. Matched only Prisoner File individuals in prison for all of Tax Year 2009.

B. Matched 6,466,981 Tax Year 2009 individual income tax returns with Residential Energy Credits to the IRS’s National Account Profile\(^4\) to identify individuals under age 18. The computer file of tax return data was assessed for reliability by the TIGTA Office of Information Services. The National Account Profile data were assessed for reliability by the TIGTA Data Center Warehouse. We validated the accuracy of the data by reviewing a judgmental sample of 25 individuals whose age is less than 18 and comparing the data to the information residing on the IRS’s Integrated Data Retrieval System.

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\(^3\) The Federal Bureau of Prisons and individual States voluntarily provide the IRS with the information for the Prisoner File, and the IRS receives most of the data to update the file in August and September. The TIGTA has previously reported concerns with the reliability of the data in the Prisoner File and, as such, our analysis is only as reliable as the data on which it is based.

\(^4\) The National Account Profile contains IRS and Social Security Administration information for name control, date of birth, and date of death for each taxpayer identification number.
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 American Recovery and Reinvestment Act of 2009;\(^5\) the Internal Revenue Manual; the *Standards for Internal Control in the Federal Government*;\(^6\) and the IRS’s policies, procedures, and practices for processing Residential Energy Credits. We evaluated these controls by interviewing IRS tax processing personnel, examining applicable information, and reviewing samples of tax returns with Residential Energy Credits.

\(^6\) *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1).
Processes Were Not Established to Verify Eligibility for Residential Energy Credits

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)
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Appendix III

Report Distribution List

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Office of the Commissioner – Attn: Chief of Staff  C
Deputy Commissioner for Services and Enforcement  SE
Deputy Commissioner, Wage and Investment Division  SE:W
Director, Customer Account Services, Wage and Investment Division  SE:W:CAS
Director, Accounts Management, Wage and Investment Division  SE:W:CAS:AM
Director, Filing and Payment Compliance, Wage and Investment Division  SE:W:CP:FPC
Director, Submission Processing, Wage and Investment Division  SE:W:CAS:SP
Chief Counsel  CC
National Taxpayer Advocate  TA
Director, Office of Legislative Affairs  CL:LA
Director, Office of Program Evaluation and Risk Analysis  RAS:O
Office of Internal Control  OS:CFO:CPIC:IC
Audit Liaison: Chief, Program Evaluation and Improvement, Wage and Investment Division  SE:W:S:PRA:PEI
Appendix IV

**Outcome Measure**

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

**Type and Value of Outcome Measure:**

- Revenue Protection – Actual; $397,158. This amount is based on 350 ineligible individuals who were allowed to erroneously claim Residential Energy Credits on their tax returns (see page 6).

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

We used computer analysis to identify 362 individuals who were in prison or under the age needed to enter into a contract to purchase a residence and were allowed to erroneously claim these credits. Revenue Protection is comprised of 262 individuals in prison with a tax effect of $343,487 and 88 of 100 underage individuals with a tax effect of $53,671, with the remaining 12 underage individuals having no tax effect from the allowed Residential Energy Credits on their tax returns. Thus, the IRS erroneously allowed 350 (262 + 88 = 350) ineligible individuals to receive the benefit of Residential Energy Credits on their tax returns which lowered their tax by $397,158 ($343,487 + $53,671 = $397,158). Despite having the data available, the IRS did not develop a process to identify these individuals who filed tax returns erroneously claiming these credits.
Residential Energy Credits (Form 5695)

<table>
<thead>
<tr>
<th>Part I</th>
<th>Nonbusiness Energy Property Credit (See instructions before completing this part.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Were the qualified energy efficiency improvements or residential energy property costs for your main home located in the United States? (see instructions)</td>
</tr>
<tr>
<td></td>
<td>Caution: If you checked the &quot;No&quot; box, you cannot claim the nonbusiness energy property credit. Do not complete Part I.</td>
</tr>
<tr>
<td>2</td>
<td>Qualified energy efficiency improvements (see instructions)</td>
</tr>
<tr>
<td>a</td>
<td>Insulate materials or system specifically and primarily designed to reduce the heat loss or gain of your home.</td>
</tr>
<tr>
<td>b</td>
<td>Exterior windows (including certain storm windows) and skylights.</td>
</tr>
<tr>
<td>c</td>
<td>Exterior doors (including certain storm doors).</td>
</tr>
<tr>
<td>d</td>
<td>Metal roof with appropriate painted coatings, or asphalt roof with appropriate coating, that are specifically and primarily designed to reduce the heat gain of your home, and the roof meets or exceeds the Energy Star program requirements in effect at the time of installation.</td>
</tr>
<tr>
<td></td>
<td>2a</td>
</tr>
<tr>
<td></td>
<td>2b</td>
</tr>
<tr>
<td></td>
<td>2c</td>
</tr>
<tr>
<td></td>
<td>2d</td>
</tr>
<tr>
<td>3</td>
<td>Residential energy property costs (see instructions).</td>
</tr>
<tr>
<td>a</td>
<td>Energy-efficient building property.</td>
</tr>
<tr>
<td>b</td>
<td>Qualified natural gas, propane, or oil furnace or hot water boiler.</td>
</tr>
<tr>
<td>c</td>
<td>Advanced main air circulating fan used in a natural gas, propane, or oil furnace.</td>
</tr>
<tr>
<td></td>
<td>3a</td>
</tr>
<tr>
<td></td>
<td>3b</td>
</tr>
<tr>
<td></td>
<td>3c</td>
</tr>
<tr>
<td>4</td>
<td>Add lines 2a through 3c.</td>
</tr>
<tr>
<td></td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td>Multiply line 4 by 30% (.30).</td>
</tr>
<tr>
<td></td>
<td>5</td>
</tr>
<tr>
<td>6</td>
<td>Maximum credit amount. (If you jointly occupied the home, see instructions).</td>
</tr>
<tr>
<td></td>
<td>6</td>
</tr>
<tr>
<td>7</td>
<td>Enter the smaller amount of line 5 or line 6.</td>
</tr>
<tr>
<td></td>
<td>7</td>
</tr>
<tr>
<td>8</td>
<td>Enter the amount from Form 1040, line 4b, or Form 1040NR, line 43.</td>
</tr>
<tr>
<td></td>
<td>8</td>
</tr>
<tr>
<td>9</td>
<td>Enter the total, if any, of your credits from Form 1040, line 47 through 50, and Schedule R, line 26; or Form 1040NR, lines 44 through 48.</td>
</tr>
<tr>
<td></td>
<td>9</td>
</tr>
<tr>
<td>10</td>
<td>Subtract line 9 from line 8. If zero or less, stop. You cannot take the nonbusiness energy property credit.</td>
</tr>
<tr>
<td></td>
<td>10</td>
</tr>
<tr>
<td>11</td>
<td>Nonbusiness energy property credit. Enter the smaller of line 7 or line 10.</td>
</tr>
<tr>
<td></td>
<td>11</td>
</tr>
</tbody>
</table>
Processes Were Not Established to Verify Eligibility for Residential Energy Credits

Before You Begin Part II:
Figure the amount of any of the following credits you are claiming:
- Credit for the elderly or the disabled.
- District of Columbia first-time homebuyer credit.
- Qualified plug-in electric vehicle credit.
- Qualified plug-in electric drive motor vehicle credit.
- Alternative motor vehicle credit.

Part II Residential Energy Efficient Property Credit (See instructions before completing this part.)
Note: Skip lines 12 through 21 if you only have a credit carryforward from 2008.

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>Qualified solar electric property costs</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Qualified solar water heating property costs</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Qualified small wind energy property costs</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Qualified geothermal heat pump property costs</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Add lines 12 through 15</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Multiply line 16 by 30% (.30)</td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Qualified fuel cell property costs</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>Multiply line 18 by 30% (.30)</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>Kilowatt capacity of property on line 18 above ▷</td>
<td>$1,000</td>
</tr>
<tr>
<td>21</td>
<td>Enter the smaller of line 19 or line 20</td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>Credit carryforward from 2008. Enter the amount, if any, from your 2008 Form 5695, line 28</td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>Add lines 17, 21, and 22</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>Enter the amount from Form 1040, line 45, or Form 1040NR, line 43</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>1040NR Blanks: Enter the total, if any, of your credits from Form 1040, lines 47 through 50, line 11 of this form; line 12 of the Line 11 worksheet in Pub. 977 (see instructions); Form 8589, line 11; Form 6900, line 13; Form 6684, line 15; Form 6690, line 16; Form 6694, line 17; Form 6695, line 18; and Schedule R, line 24.</td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>Subtract line 25 from line 24. If zero or less, enter --0-- here and on line 27</td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>Residential energy efficient property credit. Enter the smaller of line 23 or line 25</td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>Credit carryforward to 2010. If line 27 is less than line 23, subtract line 27 from line 23</td>
<td></td>
</tr>
</tbody>
</table>

Part III Current Year Residential Energy Credits

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>29</td>
<td>Add lines 11 and 27. Enter the result here and on Form 1040, line 52, or Form 1040NR, line 48, and check box c on that line</td>
<td></td>
</tr>
</tbody>
</table>
MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Processes Were Not Established to Verify Eligibility for Residential Energy Credits (Audit # 2010-40-109)

April 1, 2011

We have reviewed your draft report entitled “Processes Were Not Established to Verify Eligibility for Residential Energy Credits.” The Residential Energy Credits, comprised of two separate components, the Nonbusiness Energy Property Credit and the Residential Energy Efficient Property Credit, were claimed by over 6.7 million taxpayers for Tax Year 2009, through December 31, 2010, as noted in your report. Both credits include multiple types of eligible expenditures with differing restrictions and unique criteria that individuals must meet to receive the credits. As with any new tax provision, we continuously adapt our programs as we gain experience with them and identify program weaknesses. We have addressed, or are in the process of addressing, many of the issues identified in the report. During the 2010 Filing Season, processes for paper and e-filed returns were implemented to prevent taxpayers from receiving more than the maximum allowable $1,500 Nonbusiness Energy Property Credit. It is important to note that for many of the potential erroneous claims identified, taxpayers were actually entitled to the credit. We plan to address claimant eligibility for both Residential Energy Credits as we conduct examinations for the years in which the credits were available.

To address your specific recommendations, we will revise Form 5695, Residential Energy Credits, to request that taxpayers provide additional information to verify eligibility for the Residential Energy Credits. We will also review the questionable Residential Energy Credits claimed by prisoners and minors identified in the report. Additionally, as part of our ongoing research efforts and our 2011 ARRA Examination plan, we will review a sample of prisoner and underage Residential Energy Credit claimants, as well as other claims in a post refund environment to determine eligibility for the credit.
We agree with the outcome measure reported in Appendix IV. Our comments to your recommendations are attached.

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

Attachment
RECOMMENDATION 1
The Commissioner, Wage and Investment Division, should revise the Form 5695 to request specific information supporting key eligibility requirements which could be used to verify requirements were met and may serve as a deterrent for those individuals who intend to erroneously claim these credits. For example, the Form 5695 revisions could include requiring the address of the residence in which the qualified energy-saving product and/or energy efficiency improvement was made, whether the product and/or improvement was made to their principal or secondary residence, and whether the residence was new construction or an existing structure.

CORRECTIVE ACTION
We agree with this recommendation. Form 5695, Residential Energy Credits, will be revised to request specific information concerning the property such as, requiring the specific address, whether the property was the primary or secondary residence, and whether the improvements were made as part of building a new home, or modifications to an existing home.

IMPLEMENTATION DATE
April 15, 2012

RESPONSIBLE OFFICIAL
Director, Media and Publications, Wage and Investment Division

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

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 2
Examine the tax returns of the 362 individuals we identified as being in prison or under age to determine whether these individuals qualify for the Residential Energy Credits.

CORRECTIVE ACTION
We partially agree with this recommendation. We will review the returns of the 362 individuals identified as being in prison or under age and will audit those returns that warrant further examination.

IMPLEMENTATION DATE
April 15, 2012
RESPONSIBLE OFFICIALS
Director, Compliance, Wage and Investment Division
Director, Campus Compliance Services, Small Business/Self Employed Division

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

RECOMMENDATION 3
Ensure processes are implemented to identify and review tax returns filed by prisoners or underage individuals to ensure they qualify for Residential Energy Credits claimed.

CORRECTIVE ACTION
We agree with this recommendation. We have processes in place to identify returns filed by prisoners, underage individuals, and others that are questionable, and appear to improperly claim credits and deductions. Although these processes were developed to provide more stringent screening for higher-risk returns claiming refundable credits, such as the Earned Income Tax Credit, the First-Time Homebuyer Credit, and the Adoption Credit, that screening process is not restricted to those high-risk items. The Residential Energy Credit, along with other items of income, deductions, and credits are also subject to review and contribute to the factors evaluated in selecting returns for examination.

We continuously assess and evaluate compliance risks in meeting the goal of a balanced compliance program that strategically addresses the most egregious noncompliance across all taxpayer segments. As part of our ongoing research efforts and our 2011 American Recovery and Reinvestment Act (ARRA) Examination plan, we will review a sample of Residential Energy Credit cases in a post refund environment. Those warranting examination will be selected for audit and the results will be factored into future ARRA Examination plans.

IMPLEMENTATION DATE
June 15, 2012

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

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