



RECOVERY ACT

*Individuals Who Are Not Authorized to
Work in the United States Were Paid
\$4.2 Billion in Refundable Credits*

July 7, 2011

Reference Number: 2011-41-061

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

Redaction Legend:

2(f) = Risk Circumvention of Agency Regulations or Statutes

1 = Tax Return/Return Information



HIGHLIGHTS



INDIVIDUALS WHO ARE NOT AUTHORIZED TO WORK IN THE UNITED STATES WERE PAID \$4.2 BILLION IN REFUNDABLE CREDITS

Highlights

Final Report issued on July 7, 2011

Highlights of Reference Number: 2011-41-061 to the Internal Revenue Service Commissioner for the Wage and Investment Division and the Chief of Criminal Investigation.

IMPACT ON TAXPAYERS

Many individuals who are not authorized to work in the United States, and thus not eligible to obtain a Social Security Number (SSN) for employment, earn income in the United States. The Internal Revenue Service (IRS) provides such individuals with an Individual Taxpayer Identification Number (ITIN) to facilitate their filing of tax returns. Although the law prohibits aliens residing without authorization in the United States from receiving most Federal public benefits, an increasing number of these individuals are filing tax returns claiming the Additional Child Tax Credit (ACTC), a refundable tax credit intended for working families. The payment of Federal funds through this tax benefit appears to provide an additional incentive for aliens to enter, reside, and work in the United States without authorization, which contradicts Federal law and policy to remove such incentives.

WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether potentially fraudulent tax returns filed with ITINs were being properly and consistently worked. Because of the significant volume of these returns claiming the ACTC, we focused on those returns.

WHAT TIGTA FOUND

Claims for the ACTC by ITIN filers have increased from \$924 million in Processing Year 2005 (the calendar year in which the tax return was processed) to \$4.2 billion in Processing Year 2010. Clarification to the law is

needed to address whether or not refundable tax credits such as the ACTC may be paid to those who are not authorized to work in the United States. *****2(f)*****

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Also, employees in the Accounts Management Taxpayer Assurance Program are not taking steps to notify taxpayers when it is obvious their SSNs and names have been compromised. TIGTA also found that a feature on tax preparation software programs which automatically takes the taxpayer identification number and enters it as the identifying number for the taxpayer's Wage and Tax Statements ***2(f)** deter the IRS from matching the wage and *****2(f)*****.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS work with the Department of the Treasury to seek clarification on whether refundable tax credits may be paid to individuals who are not authorized to work in the United States. TIGTA also recommended the IRS require individuals filing with ITINs and claiming the ACTC to provide specific verifiable documentation to support that their dependents meet the qualifications for the credit, including residency, and that questionable Child Tax Credit (CTC) and ACTC claims on ITIN returns *****2(f)*****.

The IRS should also notify taxpayers when their SSNs are compromised and ensure that software packages do not auto-populate an ITIN onto Wage and Tax Statements.

IRS management agreed to discuss with the Department of the Treasury the issue of ITIN filers' ACTC eligibility. The IRS did not agree to require additional documentation to support CTC and ACTC claims on ITIN returns ***2(f)***** *****2(f)*****

*****2(f)***** The IRS is exploring options to alert taxpayers whose SSNs have been compromised and plans to address software that auto-populates an ITIN onto Wage and Tax Statements and take sanctions for noncompliance..



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 7, 2011

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION
CHIEF, CRIMINAL INVESTIGATION

FROM: (for) Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Individuals Who Are Not Authorized to Work
in the United States Were Paid \$4.2 Billion in Refundable Credits
(Audit # 200940031)

This report presents the results of our review to determine whether potentially fraudulent tax returns filed with Individual Taxpayer Identification Numbers (ITIN) were properly and consistently worked. Because of the significant volume of these returns claiming the Additional Child Tax Credit, we focused on returns filed by individuals with ITINs claiming the Child Tax Credit and Additional Child Tax Credit. The cases we reviewed were at the Fraud Detection Centers. This audit is included in our Fiscal Year 2011 Annual Audit Plan and addresses the major management challenges of Tax Compliance Initiatives and Erroneous and Improper Payments and Credits. It also presents selected information related to the Internal Revenue Service's (IRS) implementation of Section 1003 of the American Recovery and Reinvestment Act of 2009 (Recovery Act).¹

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

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

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



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Abbreviations

| | |
|-------|---|
| ACTC | Additional Child Tax Credit |
| AMTAP | Accounts Management Taxpayer Assurance Program |
| CTC | Child Tax Credit |
| EITC | Earned Income Tax Credit |
| FDC | Fraud Detection Center |
| IRS | Internal Revenue Service |
| ITIN | Individual Taxpayer Identification Number |
| SSN | Social Security Number |
| TIGTA | Treasury Inspector General for Tax Administration |
| U.S. | United States |



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Background

Everyone who is employed in the United States (U.S.) is required to have a Social Security Number (SSN). An SSN is a unique, nine-digit identification number used for taxpayer identification, income reporting, and record-keeping purposes. The Social Security Administration issues numbers to all U.S. citizens, permanent residents, and eligible foreign nationals. Generally, only those noncitizens authorized to work in the United States by the Department of Homeland Security can get an SSN.

Any person required to file a tax return is required to include an identifying number, referred to as a taxpayer identification number. For the majority of filers, the taxpayer identification number is the individual's SSN. Non-U.S. citizens who do not have employment authorization must prove a valid reason for requesting an SSN in order to receive one. There are very limited circumstances for this, and these Social Security Cards are marked "Not Valid for Employment."

Many individuals who are not eligible to obtain an SSN earn income in the United States. This presents a problem for tax administration because the Internal Revenue Code requires foreign investors and individuals working without authorization in the United States to file tax returns and pay any Federal income taxes owed. As explained by a former Internal Revenue Service (IRS) Commissioner, "the IRS's job is to make sure that everyone who earns income within our borders pays the proper amount of taxes, even if they may not be working here legally."¹

Individual Taxpayer Identification Number

An Individual Taxpayer Identification Number (ITIN) is available to individuals who are required to have a taxpayer identification number for tax purposes, but do not have and are not eligible to obtain an SSN because they are not authorized to work in the United States. An ITIN is issued by the IRS and looks very similar to an SSN in that it is a nine-digit number. ITINs are issued regardless of immigration status, because both resident and nonresident aliens may have a U.S. filing or reporting requirement under the Internal Revenue Code. ITINs are for Federal tax reporting only and are not intended to serve any other purpose. Even income obtained illegally is subject to income taxes. Therefore, the IRS issues ITINs to help individuals comply with the U.S. tax laws and to provide a means to process and account for tax returns and payments for those not eligible for SSNs. An ITIN does not authorize an individual to work in the United States or provide eligibility for Social Security benefits or the Earned Income Tax Credit (EITC); however, the IRS currently processes claims for the Additional Child Tax Credit (ACTC), a refundable tax credit, filed by taxpayers with ITINs.

¹ Testimony before the House Committee on Ways and Means, February 16, 2006.



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Refundable Credits

Refundable credits can result in refunds even if no income tax is withheld or paid; that is, the credits can exceed the liability for the tax. Two of the largest refundable tax credits are the EITC and the ACTC. The appropriations for these credits in Fiscal Year 2010 were \$54.7 billion for the EITC and \$22.7 billion² for the ACTC. Because concerns were raised by Congress, the Government Accountability Office, and the IRS regarding noncompliance with EITC requirements, a law was passed in Calendar Year 1996 to deny the EITC to individuals who file a tax return without an SSN that is valid for employment.³ As such, filers using an ITIN are not eligible for the EITC. The change in the law was made prior to the establishment of the ACTC.⁴ However, the same law prohibits aliens residing without authorization in the United States from receiving most Federal public benefits, with the exception of certain emergency services and programs.

Nonetheless, IRS management's view is that the law does not provide sufficient legal authority for the IRS to disallow the ACTC to ITIN filers. In addition, the Internal Revenue Code does not require an SSN to claim the ACTC and does not provide the IRS math error authority to deny the credit without an examination. As such, the IRS continues to pay the ACTC to ITIN filers.

The ACTC is the refundable portion of the Child Tax Credit (CTC). The CTC can reduce an individual's taxes owed by as much as \$1,000 for each qualifying child. The ACTC is provided in addition to the CTC to individuals whose taxes owed were less than the amount of CTC they were entitled to claim. The ACTC is always the refundable portion of the CTC, which means an individual claiming the ACTC receives a refund even if no income tax was withheld or paid. As with all refundable credits, the risk of fraud for these types of claims is significant.

Fraud Detection Program

The Accounts Management Taxpayer Assurance Program (AMTAP) is a nationwide program designed to identify fraudulent returns, stop the payment of fraudulent refunds, and refer identified fraudulent refund schemes to Criminal Investigation field offices. This program was transferred in Calendar Year 2009 from Criminal Investigation to the Accounts Management function in the IRS campuses.⁵

One common type of fraudulent refund involves taxpayers fabricating a Wage and Tax Statement (Form W-2) that shows excess withholding, resulting in a tax refund. When one of these potentially fraudulent returns is identified, the IRS contacts the employer or third party to

² Actual refunds for the ACTC processed in Fiscal Year 2010 totaled \$28.3 billion.

³ The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (Pub. L. No. 104-193).

⁴ The Taxpayer Relief Act of 1997 (Pub. L. No. 105-34) established the Child Tax Credit and the Additional Child Tax Credit.

⁵ 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.



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verify wage and withholding information on the return. If the wage information is verified, the refund is issued. However, if the information is determined to be false, the refund is stopped and the return is referred to other IRS functions that are responsible for resolving the issue with the affected taxpayers. The individuals filing these false returns often improperly claim the EITC based on the fictitious wages shown on the Form W-2; they also may claim the ACTC. Again, both of these credits are refundable and can significantly increase the taxpayers' refunds. If a taxpayer's wages and withholding are questionable, the refundable credits they claim are likely questionable as well.

This review was performed at the IRS Campus in Ogden, Utah. It included discussions with personnel in Criminal Investigation and the Accounts Management function. Discussions were also held with the Office of Privacy, Information Protection, and Data Security. The data available to us at the start of the audit were from Processing Year⁶ 2009, when the program was still in Criminal Investigation. However, the issues presented are still applicable to the new AMTAP function. 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 objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

⁶ The calendar year in which the tax return or document is processed by the IRS.



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Results of Review

Tax Law Changes and Questionable Claims Have Resulted in a Rapid Increase in Refunds for Additional Child Tax Credits Claimed by Individuals Who Are Not Authorized to Work in the United States

Although they are not authorized to work in the United States, ITIN filers are receiving billions of dollars in CTCs and ACTCs intended for working families. Prior to Tax Year⁷ 2001, the CTC was only refundable if the taxpayer had three or more qualifying children and Social Security taxes⁸ exceeding any earned income credits. The Economic Growth and Tax Relief Reconciliation Act of 2001⁹ removed these requirements and increased the CTC over time from \$500 to \$1,000 per child, making more families eligible for the refundable portion of the credit (known as the ACTC). Since then, claims for the ACTC by ITIN filers have increased significantly. In Processing Year 2005, 796,000 ITIN filers claimed ACTCs totaling \$924 million. By Processing Year 2008, these claims had risen to 1,526,276 ITIN filers claiming ACTCs totaling \$2.1 billion.

The American Recovery and Reinvestment Act of 2009 (Recovery Act)¹⁰ temporarily increased eligibility by changing the income threshold for calculating the ACTC for Tax Years 2009 and 2010. Prior to the Recovery Act, the ACTC would have been limited to 15 percent of earned income more than \$12,550. The Recovery Act changed this threshold to 15 percent of earned income more than \$3,000. As such, more taxpayers could claim the ACTC or claim a greater amount. In Processing Year 2010, 2.3 million ITIN filers claimed ACTCs totaling \$4.2 billion.¹¹

⁷ A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

⁸ Including one-half of self-employment taxes.

⁹ Pub. L. No. 107-16, 115 Stat. 38.

¹⁰ Pub. L. No. 111-5, 123 Stat. 115 (2009).

¹¹ These figures are from the Individual Master File, while the figures used in Appendix IV and in other places throughout this report are from the IRS Return Transaction File. The Master File and Return Transaction File are both IRS databases that store various types of taxpayer account information. The Return Transaction File data are not as current because they do not include subsequent adjustments or amended/duplicate return information processed in a given year. For Processing Year 2010, we used the Master File data because we wanted the most accurate ACTC figures for the most current year. We did not use the Master File for all years because some data were not readily available on the Master File, such as CTC claims and wage information. We reconciled the ACTC claims on the Master File against the Return Transaction File for Processing Year 2010 and, as expected, found the Master File data contained more claims. For Processing Year 2010, the Return Transaction File contained 2,179,764 ACTC claims amounting to \$4,002,767,115. The Master File data showed 2,330,279 claims amounting to \$4,191,154,694. Based on this information, the other Return Transaction File figures presented throughout this report are also likely understated.

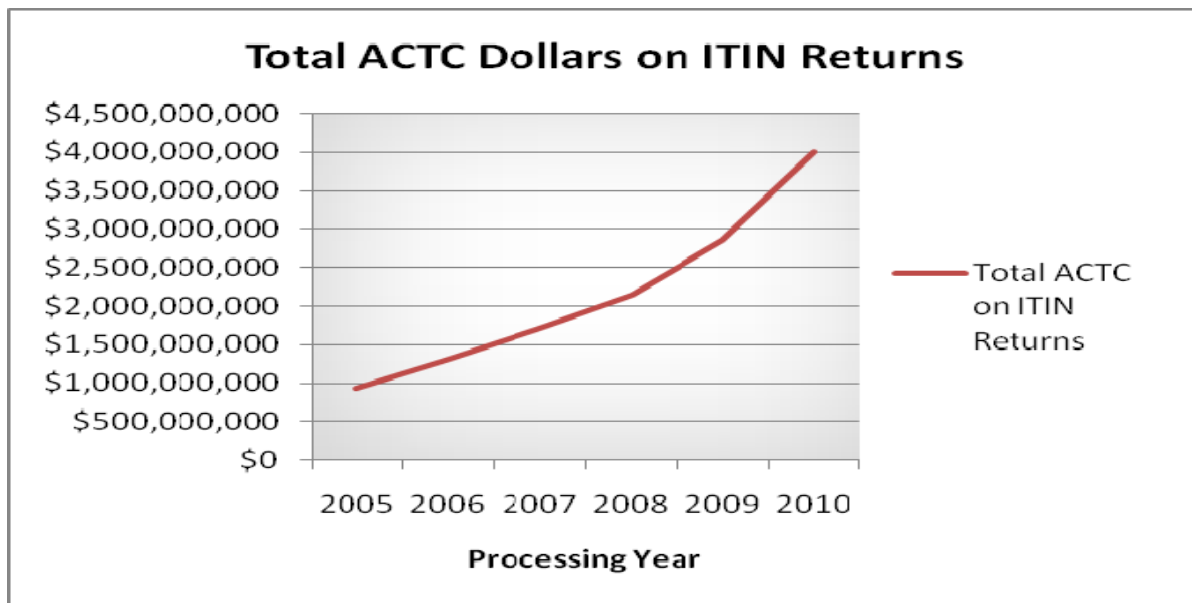


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The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010¹² extends the increased eligibility through Tax Year 2012. Figure 1 shows the dollar amount in ACTCs paid to ITIN filers over the last 6 years.

Figure 1: Total Claims for the ACTC on Returns Filed With ITINs



Source: Analysis of the IRS Return Transaction File. For comparative purposes, this chart presents Processing Year 2010 figures from the Return Transaction File rather than those from the IRS Master File reported earlier. See footnote 11.

Another reason for the increase is that a significant number of individuals are filing multiple claims to obtain the ACTC for prior year tax returns (e.g., filing Tax Years 2007, 2008, and 2009 returns at the same time). In Processing Year 2010, approximately 238,000 ITIN filers submitted more than 608,000 tax returns for multiple years at the same time and claimed just more than a billion dollars in ACTCs on those returns. The ACTC claims for these individuals for the combined tax periods can be substantial. However, not all of these claims were refunded because of the statute of limitations rules that apply. The average amount claimed per single return for the ACTC to ITIN filers in Processing Year 2010 was approximately \$1,800. However, nearly 9,000 taxpayers claimed a total of \$10,000 or more in ACTCs by filing multiple tax periods. *****1*****.

Moreover, in our analysis of returns filed in Processing Year 2010, some individuals had submitted duplicate tax returns for multiple years to multiple IRS processing centers and

¹² Pub. L. No. 111-312, 124 Stat. 3296.



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received ACTC refunds. ***** 1 *****

The payment of Federal funds through this tax benefit appears to provide an additional incentive for aliens to enter, reside, and work in the United States without authorization, which contradicts Federal law and policy to remove such incentives. At the time the Taxpayer Relief Act of 1997¹³ was enacted, guidance would have been beneficial on how the IRS would implement the refundable portion of the CTC while complying with the prohibitions contained in the Personal Responsibility and Work Opportunity Reconciliation Act of 1996.

In a prior Treasury Inspector General for Tax Administration (TIGTA) report,¹⁴ we recommended legislation to clarify whether an SSN which is valid for employment is needed in order to claim the ACTC, consistent with the requirements for the EITC. Both credits are calculated based on a percentage of earned income and both are refundable. We continue to believe the legislation is needed to ensure compliance with both laws.¹⁵

Legislative Recommendation

Recommendation 1: The Commissioner, Wage and Investment Division, should work with the Department of the Treasury’s Office of Tax Policy to seek clarification on whether or not refundable tax credits (or the refundable portion of tax credits) such as the ACTC may be paid to those who are not authorized to work in the United States. If these credits may not be paid, math error authority is needed for the IRS to disallow associated claims for the credits. Based on claims made in Processing Year 2010, disallowance of the ACTC to filers without a valid SSN would reduce Federal outlays by approximately \$8.4 billion over 2 years.¹⁶

Management’s Response: IRS management agreed with the recommendation and will discuss with the Department of the Treasury’s Office of Tax Policy their views of the current state of the law regarding the eligibility for the CTC and the ACTC.

¹³ Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).

¹⁴ Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims (Reference Number 2009-40-057, dated March 31, 2009).

¹⁵ IRS management previously agreed to discuss with the Department of the Treasury’s Office of Tax Policy the merits of amending the Internal Revenue Code to limit eligibility for the CTC and ACTC to individuals who have an SSN that is valid for employment. A bill was recently introduced in the U.S. Senate (S.577 – Child Tax Credit Integrity Preservation Act of 2011) to clarify eligibility for the child tax credit. It would require a taxpayer to provide an SSN that is valid for employment in order to claim the CTC and ACTC.

¹⁶ Changes made to the ACTC in the Recovery Act were effective through Tax Year 2012. If no further changes are made, the eligibility requirements revert to previous levels and would result in fewer individuals qualifying for the ACTC.



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Refundable credits are often the targets of unscrupulous individuals, who file erroneous claims for these credits. *****2(f)*****

Erroneous or fraudulent claims are not unique to the ACTC, nor are they unique to ITIN filers. However, ITIN filers are much more likely to claim the ACTC than other individual taxpayers. We found that in Processing Year 2010, 72 percent of all ITIN filers claimed the ACTC, while only 14 percent of non-ITIN filers claimed the ACTC.

In a prior report,¹⁷ TIGTA noted that billions of dollars in CTCs and ACTCs are being provided to ITIN filers without verification of eligibility. *****2(f)*****

TIGTA issued a report on the First-Time Homebuyer Credit.¹⁸ That report discusses a need for improved controls over all refundable credits. In it, we recommended that the IRS require taxpayers to provide supporting documentation to verify eligibility for all refundable credits and that the IRS seek legislation to be given math error authority to deny credits when supporting documentation is not provided for a refundable credit. IRS management agreed that requiring supporting documentation is appropriate for many refundable credits and that math error authority is an important compliance tool in many cases. They stated that the IRS evaluates the administration of each refundable credit based on its unique characteristics. IRS management further stated that 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, it will consider requiring documentation. Given the significant amounts at risk and the compliance risks associated with the ACTC, we believe a requirement for supporting documentation is warranted.

We reviewed a statistically valid sample of 250 Processing Year 2009 refund returns filed by taxpayers with ITINs that were selected through the Electronic Fraud Detection System¹⁹

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

18 Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits (Reference Number 2011-41-035, dated March 31, 2011).

19 The Electronic Fraud Detection System is a computer system that automates the identification of potentially fraudulent electronically filed tax returns, increases data available for analysis, and assists in the development of information related to paper and electronic refund schemes.



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screening process as potentially fraudulent. Approximately 91 percent (228) of these returns contained claims for the CTC or ACTC. The amount of the CTCs and ACTCs on these returns was \$569,000.

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Another area responsible for reviewing ACTC claims by individuals with ITINs is the IRS Examination function. Examination function officials informed us that approximately 95 percent of the ITIN cases they currently work contain ACTC issues. The assessment rate on ITIN cases worked in the Examination function during Fiscal Year 2010 was very high; 91 percent resulted in additional assessments. However, the Examination function currently works these cases after refunds have been issued, and the volume of cases worked is relatively low compared to the number of ITIN filers claiming the ACTCs overall.

*****2(f)*****

The Examination function informed us that the ITIN Operation in Austin, Texas, is its primary source of referrals of questionable ITIN returns for auditing. ITINs are only issued to resident

20 Although these cases were worked prior to the transition of the Questionable Refund Program to the AMTAP, we confirmed that the AMTAP function would have handled the cases in the same manner.

21 Audit assessments on these cases totaled \$243,125 and the total amounts collected were \$73,939, of which \$39,024 were refund offsets.



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have the authority to require documentation to claim a credit and to refer questionable or unverifiable claims to its Examination function prior to issuance of refunds.

Recommendation 3: The Commissioner, Wage and Investment Division, should ensure CTC and ACTC claims on ITIN returns with questionable wages and withholding are verified in the AMTAP function or referred to the Examination function for verification.

Management's Response: IRS management disagreed with this recommendation. Questionable CTC and ACTC claims are identified earlier in the processing stream by the Submission Processing function and referred to the Examination function for verification under deficiency procedures. IRS management stated that verification of CTC and ACTC claims is beyond the scope and authority of the AMTAP.

Office of Audit Comment: We believe the scope of the AMTAP function's responsibilities in reviewing documentation and verifying data with third parties is within the control of the IRS. Even without math error authority, if the IRS required documentation to support eligibility for the ACTC on tax returns with ITINs, the scope of the AMTAP function could be expanded to identify potentially erroneous or fraudulent claims and refer them to the Examination function before refunds are issued.

Recommendation 4: The Commissioner, Wage and Investment Division, should ensure that, when possible, questionable CTC and ACTC claims on ITIN returns identified by or referred to the Examination function are worked *****2(f)*****

Management's Response: IRS management agreed with this recommendation. The Submission Processing and Examination functions have procedures in place for the referral and evaluation of questionable CTC and ACTC claims prior to issuance of the refund. It should also be noted that the majority of the IRS's EITC examinations also include the CTC and/or ACTC as an issue.

Taxpayers Are Not Notified When Their Social Security Numbers Are Compromised

In March 2011, the Federal Trade Commission reported that for the eleventh year in a row identity theft was the number one consumer complaint nationwide. Identity theft occurs when someone uses personally identifiable information, such as an individual's name, SSN, credit card numbers, or other account information, to commit fraud and other crimes. Identity theft affects tax administration when an individual intentionally uses the identity of another person to file a false tax return or fraudulently obtain employment.

Although the IRS created the ITIN to help individuals who cannot legally obtain an SSN comply with the U.S. tax laws, the fact remains that these individuals generally cannot obtain a job in the United States without an SSN. Therefore, these individuals may either fabricate an SSN or improperly use someone else's SSN (and sometimes their name) to obtain employment. These



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SSNs may also be used for other purposes, such as to obtain credit, which can cause significant hardships to the lawful taxpayers to whom these SSNs belong.

In the process of validating wages and withholding, AMTAP function employees are in a unique position to identify cases in which a taxpayer's SSN has been compromised. In reviewing the Forms W-2 attached to the returns, these employees can see that an SSN was used to gain employment that did not belong to the person filing the return. We selected a statistically valid sample of 250 cases which had been subject to the wage and withholding verification.²² Forty-two of those returns did not have the Form W-2 available for review. The remaining 208 returns contained 257 Forms W-2. Among the 257 Forms W-2, we found 56 with indications of potential identity theft:²³

- 51 of the Forms W-2 listed the filing individual's name and the SSN of someone other than the individual filing the return.
- 5 of the Forms W-2 contained the name and SSN of someone other than the individual filing the return.

These 56 Forms W-2 contained the SSNs (and sometimes names) of 45 different taxpayers. In a prior report,²⁴ we recommended that the IRS establish a process to notify taxpayers when there is evidence that the taxpayers' identities have been compromised. Since that report, procedures have been established to identify some potential identity theft and, in some cases, notify taxpayers. However, the IRS took no steps to inform 30 of the 45 taxpayers previously discussed that their SSNs had been compromised, or to even notate the identity theft on the taxpayers' accounts. Identity theft indicators had been placed on the accounts of 15 of the 45 taxpayers. However, the indicator was placed on five of these accounts because the taxpayer contacted the IRS about the identity theft.

In cases of identity theft, the sooner a taxpayer can be made aware of a possible stolen identity, the better. Without a process in place to timely notify taxpayers when there is evidence of identity theft, taxpayers' credit cards, bank accounts, and other related accounts could be at risk.

Recommendation

Recommendation 5: The Commissioner, Wage and Investment Division, should implement procedures that are proactive in timely alerting taxpayers when the IRS has become aware that a

²² The cases included in our review were worked prior to the transition of this function from Criminal Investigation to the AMTAP function.

²³ The remaining 201 Forms W-2 contained the following: 66 had an SSN that was apparently fabricated (Social Security Administration records showed the SSNs had not been issued to anyone), 8 had no entry for the SSN, and the remaining 127 had ITINs listed on the Form W-2.

²⁴ *Procedures Need to Be Developed for Collection Issues Associated With Individual Taxpayer Identification Numbers* (Reference Number 2010-40-040, dated March 29, 2010).



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taxpayer's identity has potentially been stolen. At a minimum, those taxpayers whose names and SSNs have both been compromised should be notified.

Management's Response: IRS management agreed with this recommendation and is exploring options in this area. Any significant process change must be thoroughly vetted prior to implementation, due to the impact on affected taxpayers. The IRS has initiated a study to determine if additional cases of potential identity theft, including situations similar to those identified in this audit, can or should be marked with identity theft account indicators. The IRS currently has a series of account indicators that identify taxpayers who have been victims of identity theft and frequently updates the procedures for handling these cases. The indicators streamline the taxpayer assistance process and help mitigate future account problems by issuing notices to taxpayers of their potentially compromised identities, as well as additional steps the taxpayer can take to protect their identities.

*****2(f)*****
*****2(f)*****
*****2(f)*****

The IRS generally uses automated methods to ensure that wages and withholding on tax returns are accurate. The automated system employed by the IRS to accomplish this matches Form W-2 income and withholding information provided directly to the IRS by the employer with information provided by taxpayers on their tax returns. When a mismatch occurs, the IRS may contact the taxpayer to determine the reason for the mismatch. *****2(f)*****
*****2(f)*****
*****2(f)*****
*****2(f)*****
*****2(f)*****
*****2(f)*****
*****2(f)*****
*****2(f)*****
*****2(f)*****

In 2005, returns filed with an ITIN reported wages of more than \$28.5 billion and income tax withholding of more than \$1.16 billion. In 2010, these numbers grew to about \$60 billion and \$1.78 billion, respectively.

25 The IRS database that maintains information provided by employers on Forms W-2. This information includes wages and other compensation paid to employees, tax withholding, 401(K) contributions, Social Security/Medicare taxes paid, etc.



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In a prior report,²⁶ we recommended and the IRS agreed to develop a cross-referencing process to match ITIN tax returns to the related Forms W-2 on the Information Returns Master File. In order to accomplish this, the IRS must have the ITIN as well as the SSN provided to the employer (which is available from the Form W-2 included with the tax return). ***2(f)*****

These tax preparation software packages automatically populate the identification number on the electronic Form W-2 (for e-filed tax returns) with the identification number reported on the tax return; i.e., the ITIN. This occurs even though there is an SSN on the actual Form W-2 that does not belong to the individual filing the return.

TIGTA also previously reported this issue and the IRS agreed to coordinate with electronic tax software preparation companies to initiate actions to limit the auto-populate feature of the taxpayer identification numbers on Forms W-2 associated with e-filed ITIN tax returns.

*****2(f)*****

*****2(f)*****

*****2(f)*****

²⁶ Procedures Need to Be Developed for Collection Issues Associated With Individual Taxpayer Identification Numbers (Reference Number 2010-40-040, dated March 29, 2010).

²⁷ In addition, we identified 1,039,282 Forms W-2 filed for Tax Year 2009 for which the identifying number on the form contained an ITIN (per the Information Returns Master File), which indicates that the individual provided an ITIN to their employer rather than an SSN.



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Recommendation

Recommendation 6: The Commissioner, Wage and Investment Division, should take steps to ensure tax preparation software packages do not auto-populate an ITIN onto Forms W-2 instead of asking for the taxpayer identification number as shown on the Forms W-2. The IRS should not accept ITIN returns prepared with software that is not compliant with this requirement.

Management's Response: IRS management agreed with this recommendation. The IRS has addressed the auto-population issue with software developers in the past, including the most recent IRS Software Developers Conference in June 2011. The IRS will emphasize on the instructions for Form W-2 that the taxpayer identification number transmitted with electronic returns match the number shown on the copy of Form W-2 provided to taxpayers by their employers. The requirement for manual entry of Form W-2 data on ITIN returns will also be prominently displayed in *Electronic Return File Specifications and Record Layouts for Individual Tax Returns* (Publication 1346). The IRS will also assess return preparation software compliance with the manual input requirement during the 2012 Filing Season.²⁸ If warranted, noncompliance will be addressed by appropriate sanctions that may result in suspension from the program if requisite corrections are not made.

²⁸ The period from January through mid-April when most individual income tax returns are filed.



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Appendix I

Detailed Objectives, Scope, and Methodology

The overall objective of this review was to determine whether potentially fraudulent tax returns filed with ITINs were properly and consistently worked at the Fraud Detection Centers (FDC). Because of the significant volume of these returns claiming the ACTC, we focused on returns filed by individuals with ITINs claiming the CTC and ACTC. To accomplish these objectives, we:

- I. Obtained both ITIN and non-ITIN U.S. Individual Income Tax Return (Form 1040) data from the IRS Return Transaction File and the Individual Master File.¹
 - A. For Processing Years² 2005–2010, obtained the following ITIN information:
 1. Number of ITIN returns filed.
 2. Returns with tax and the dollar amounts.
 3. Returns with refund and no tax along with the dollar amounts of those refunds and associated tax withholding.
 4. Returns claiming the CTC and ACTC along with dollar amounts of these claims.
 - B. For Processing Year 2010, obtained the following ITIN information:
 1. ITIN filers claiming the ACTC on tax returns for multiple years along with the dollar amounts of these claims.
 2. ITIN filers claiming the ACTC on duplicate returns for the same year(s) along with the dollar amounts of these claims.
 - C. For Processing Year 2010, obtained the following non-ITIN statistics:
 1. Number of non-ITIN returns filed.
 2. Returns with tax.
 3. Returns claiming the CTC and ACTC.
 - D. For Processing Year 2010, we validated the IRS Return Transaction File data we received by comparing 25 records selected at random to the IRS Master File data.

¹ The Individual Master File and Return Transaction File are both IRS databases that store various types of taxpayer account information.

² The calendar year in which the tax return or document is processed by the IRS.



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We also had another auditor independently perform the same data analysis that was done in steps A through D above to validate the results of our analysis.

- II. Identified procedures for and issues with verifying information on tax returns with ITINs at the FDCs:
 - A. Researched IRS publications, the Internal Revenue Manual, training information, TIGTA audit reports, and Government Accountability Office audit reports dealing with the subject matter.
 - B. Interviewed IRS personnel associated with processing questionable ITIN refunds and obtained procedures for working ITIN cases at the FDCs.
- III. Determined whether ITIN employment verification procedures were being administered consistently at the FDCs.
 - A. Interviewed FDC employees who work ITIN cases from Ogden, Utah, (fax site) and Fresno, California, (call site) to determine if ITIN procedures were being followed. Also, we determined if these procedures are being followed in Cincinnati, Ohio, (fax site) and Andover, Massachusetts, (call site) through email or phone conversations.
 - B. Reviewed verification procedures (telephone, fax, letters, etc.) and disclosure procedures at these sites to ensure these procedures are adequate and determined whether these procedures are being consistently followed.
- IV. Determined whether returns with ITINs were being properly worked at the FDCs.
 - A. Obtained a statistically valid sample of 250 ITIN returns worked at the FDCs during Processing Year 2009.³
 - B. Performed analysis to quantify the following for each case in the sample:
 - 1. Refund amount.
 - 2. Timeliness of working the case.
 - 3. Type of procedure used to validate the Wage and Tax Statement (Form W-2). (Telephone, letter, or fax).

³ Selected a random sample from the population of 22,137 Electronic Fraud Detection System ITIN cases that had a Disposition Code other than a 0 or 6. We selected these cases with a ± 5 percent precision, a 20 percent expected error rate, and a 95 percent confidence level. This resulted in a sample size of 244. We oversampled (250 cases) in case we could not obtain all requested data. Although these cases were worked prior to the transition of the Questionable Refund Program to the AMTAP, we confirmed that the AMTAP function would have handled the cases in the same manner. The Electronic Fraud Detection System is a computer system that automates the identification of potentially fraudulent electronically filed tax returns, increases data available for analysis, and assists in the development of information related to paper and electronic refund schemes.



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- 4. Whether all tax compliance considerations were made on the case.
5. Whether the refund was correctly released or not.
6. Whether disclosure and identity theft procedures were properly followed.
7. Actions taken by other functions regarding the return.
C. Based on information obtained from the analysis, reviewed our prior reports to determine if previously reported ITIN issues were still a problem (ACTC claims, identity theft issues, auto-populate issues).
V. Determined whether ITIN returns claiming the ACTC were being worked by the IRS Examination function.
A. Reviewed Examination function results on ITIN returns claiming the ACTC.
B. Selected a judgmental sample of 50 Examination cases to determine the collection rate on those cases.
VI. 2(f)
A. Selected a judgmental sample of five tax software packages listed under the Free File section of IRS.gov.
B. 2(f)

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 processing of ITIN returns and the identification of potential erroneous claims pertaining to these returns.



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Appendix II

Major Contributors to This Report

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

Kyle R. Andersen, Director

Larry Madsen, Audit Manager

Annette Bates, Lead Auditor

Roy E. Thompson, Lead Auditor

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Laura Paulsen, Auditor

Lance Welling, Auditor



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Assistant Secretary of the Treasury for Tax Policy
Deputy Commissioner, Wage and Investment Division SE:W
Deputy Chief, Criminal Investigation CI
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM
Director, Office of Privacy, Information Protection and Data Security OS:P
Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PRA:PEI
Program Manager, Automated Under Reporter Program, Wage and Investment Division
SE:W:CP:RC:AUR
Program Manager, ITIN Program Office, Wage and Investment Division SE:W:CAS:SP:ITIN
Chief Counsel CC
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Director, Office of Program Evaluation and Risk Analysis RAS:O
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Audit Liaison: CI Senior Analyst, Planning and Strategy CI



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Appendix IV

*Individual Taxpayer Identification Number
Filing Statistics*

| Table 1 - Forms 1040 With ITINs | | | | | | |
|--|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| Return Transaction File | | | | | | |
| Processing Year¹ | 2010 | 2009 | 2008 | 2007 | 2006 | 2005 |
| ITIN Returns | 3.02 M | 2.86 M | 2.55 M | 2.44 M | 2.04 M | 1.55 M |
| Returns With Tax | 713,483 | 797,878 | 788,487 | 868,154 | 736,820 | 539,912 |
| % of Returns With Tax | 24% | 28% | 31% | 36% | 36% | 35% |
| Total Tax | \$870.07 M | \$1.04 B | \$1.02 B | \$1.12 B | \$877.13 M | \$640.01 M |
| Returns With Refund & No Tax | 2.22 M | 1.98 M | 1.68 M | 1.49 M | 1.20 M | 921,511 |
| % of Returns With Refund & No Tax | 73% | 69% | 66% | 61% | 59% | 59% |
| Total Refunds | \$4.93 B | \$4.13 B | \$3.26 B | \$2.64 B | \$1.99 B | \$1.42 B |
| Total Withholding | \$976.64 M | \$1.31 B | \$1.17 B | \$930.43 M | \$702.48 M | \$504.42 M |
| Returns With CTC | 819,737 | 976,620 | 910,404 | 803,997 | 659,409 | 513,804 |
| % of Returns With CTC | 27% | 34% | 36% | 33% | 32% | 33% |
| Total CTC | \$559.11 M | \$741.88 M | \$712.53 M | \$631.02 M | \$501.59 M | \$380.23 M |
| Returns With ACTC | 2.18 M | 1.85 M | 1.53 M | 1.30 M | 1.06 M | 795,705 |
| % of Returns With ACTC | 72% | 65% | 60% | 53% | 52% | 51% |
| Total ACTC | \$4.00 B | \$2.86 B | \$2.14 B | \$1.71 B | \$1.31 B | \$924 M |

Table 1 includes ITIN filing statistics taken from the IRS Return Transaction File (an IRS databases that store various types of taxpayer account information).

¹ The calendar year in which the tax return or document is processed by the IRS.



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Table 2 - Forms 1040 With ITINs (2010)

Return Transaction File (RTF)
& Individual Master File (IMF)²

| | <u>Returns</u> | <u>Dollars</u> |
|--------------------------------|----------------|----------------|
| <i>Returns With ACTC (RTF)</i> | 2.18 M | \$4.00 B |
| <i>Returns Corrected</i> | 2,636 | \$4.38 M |
| <i>Net ACTC</i> | 2.18 M | \$4.00 B |
| <i>Subsequent Claims</i> | 153,151 | \$193 M |
| <i>Total ACTC Claims (IMF)</i> | 2.33 M | \$4.20 B |

Table 2 shows the reconciliation between the Return Transaction File and the Individual Master File.

Table 3 - Forms 1040 Non-ITIN (2010)

Return Transaction File

| | |
|----------------------------|----------|
| <i>Non-ITIN Returns</i> | 138.05 M |
| <i>Returns With Tax</i> | 99.61 M |
| <i>% Returns With Tax</i> | 72% |
| <i>Returns With CTC</i> | 22.88 M |
| <i>% Returns With CTC</i> | 17% |
| <i>Returns With ACTC</i> | 19.10 M |
| <i>% Returns With ACTC</i> | 14% |

Table 3 shows non-ITIN Form 1040 statistics.

² The Returns Transaction File and the Individual Master File are both IRS databases that store various types of taxpayer account information.



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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

WAGE AND INVESTMENT DIVISION

June 16, 2011

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report - Individuals Who Are Not Authorized to Work in the
United States Were Paid \$4.2 Billion in Refundable Credits (Audit #
200940031)

We have reviewed the subject draft report and welcome the opportunity to provide comments. The report accurately describes recent legislative amendments that have contributed to the increase in both the number and amount of claims for the Child Tax Credit (CTC) and its refundable component, the Additional Child Tax Credit (ACTC). Working within the framework of the law, we have established processes and controls to administer the provisions of the Internal Revenue Code (the Code) and are constantly assessing, evaluating, and modifying those processes to ensure they remain effective. It is important to recognize that unlike many other tax benefits, the law does not require the taxpayer or eligible child to have a social security number in order to receive the CTC or the ACTC. The IRS is administering the law accordingly. Legislative changes would be required to deny many of the claims discussed in the report.

The IRS agrees that the requirement for taxpayers to provide supporting documentation to verify eligibility for certain tax benefits could present a deterrent to some individuals who make improper claims. However, as indicated in the report, the IRS does not have the legal authority to deny credits during processing when documentation is not provided. Also, in addition to the obvious resource limitations associated with such a requirement, in the case of the CTC and the ACTC, *****2(f)*****. In most cases, eligibility can *****2(f)*****

The Accounts Management Taxpayer Assurance Program (AMTAP), which is responsible for reviewing refund claims arising from questionable wages and/or with holdings reported on Form



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W-2, Wage and Tax Statement, does not have the legal authority to deny questionable ACTC claims that may also be present on the returns it reviews. Instead, such claims must be referred to the Examination function for verification under the deficiency procedures. *****2(f)*****

The IRS recognizes the prominent role identity theft has assumed as one of the fastest growing crimes in the U.S. and the impact it has on the lives of its victims and has taken a number of steps recently to improve taxpayer service related to this issue. With regard to tax administration, identity theft can manifest itself as a refund-related crime where a perpetrator fraudulently uses the identity of another to claim a refund to which they are not entitled or as an employment-related crime where the identity of another individual is used to obtain employment. In either case, the victim is generally not aware that their identity has been compromised until they have contact with the IRS. We are currently conducting a study to determine the feasibility of expanding the use of account indicators. Indicators are placed on taxpayer accounts when those taxpayers have been identified as victims of identity theft. These indicators streamline the assistance process and help mitigate future account problems. They are also responsible for the generation of notices to the taxpayers, informing them that their Social Security Number and/or other identifying information appears to have been compromised and providing guidance in steps they can take to protect themselves.

With respect to the duplicate refund claims addressed in the report, we have taken actions to recover these refunds.

Attached are our responses to your specific recommendations. If you have any questions, please contact me, or a member of your staff may contact Robin L. Canady, Director, Strategy and Finance, at (404) 338-8801.

Attachment

Attachment

LEGISLATIVE RECOMMENDATION

RECOMMENDATION 1:

The Commissioner, Wage and Investment Division, should work with the Department of the Treasury's Office of Tax Policy to seek clarification on whether or not refundable tax credits (or the refundable portion of tax credits) such as the ACTC may be paid to those who are not authorized to work in the United States. If these credits may not be paid, math error authority is needed for the IRS to disallow associated claims for the credits. Based on claims made in Processing Year 2010, disallowance of the ACTC to filers without a valid SSN would reduce Federal outlays by approximately \$8.4 billion over 2 years.

CORRECTIVE ACTION:



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We will discuss with the Department of Treasury's Office of Tax Policy their views of the current state of the law regarding the eligibility for the Child Tax Credit (CTC) and the Additional Child Tax Credit (ACTC).

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL:

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 2:

The Commissioner, Wage and Investment Division, should require individuals filing with ITINs and claiming the ACTC to provide specific verifiable documentation to support that their dependents meet the qualifications for the credit, including residency.

CORRECTIVE ACTION:

We disagree with this recommendation. The IRS does not have the legal authority to verify and disallow the CTC and/or ACTC based on residency of dependents during return processing. **2(f)*****
*****2(f)*****

Questionable claims, including those where dependent residency is an issue, must be addressed through deficiency procedures. The Examination function requests proof of residency and other requisite documentation when the taxpayers are notified their return is being examined.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL:

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 3:

The Commissioner, Wage and Investment Division, should ensure CTC and ACTC claims on ITIN returns with questionable wages and withholding are verified in the AMTAP function or referred to the Examination function for verification.

CORRECTIVE ACTION:

Questionable CTC and ACTC claims are identified earlier in the processing stream by Submission Processing and referred to the Examination function for verification under deficiency procedures. The verification of CTC and ACTC claims is beyond the scope and authority of the Accounts Management Taxpayer Assurance Program.



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IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL:

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 4:

The Commissioner, Wage and Investment Division, should ensure that, when possible, questionable CTC and ACTC claims on ITIN returns identified by or referred to the Examination function are worked *****2(f)*****.

CORRECTIVE ACTION:

We agree with this recommendation. The Submission Processing and Examination functions have procedures in place for the referral and evaluation of questionable CTC and ACTC claims prior to issuance of the refund. It should also be noted that the majority of the Service's EITC examinations also include the CTC and/or ACTC as an issue.

IMPLEMENTATION DATE:

Implemented and ongoing

RESPONSIBLE OFFICIAL:

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 5:

The Commissioner, Wage and Investment Division, should implement procedures that are proactive in timely alerting taxpayers when the IRS has become aware that a taxpayer's identity has potentially been stolen. At a minimum, those taxpayers whose names and SSNs have both been compromised should be notified.

CORRECTIVE ACTION:

We agree with this recommendation and are exploring options in this area. Any significant process change must be thoroughly vetted prior to implementation, due to the impact on affected taxpayers. The IRS has initiated a study to determine if additional cases of potential identity theft, including situations similar to those identified in this audit, can or should be marked with identity theft account indicators. The IRS currently has a series of account indicators that identify taxpayers who have been victims of identity theft and frequently updates the procedures for handling these cases. The indicators streamline the taxpayer assistance process and help mitigate future account problems by issuing notices to taxpayers of their potentially compromised identity, as well as additional steps the taxpayer can take to protect their identity.



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IMPLEMENTATION DATE:

September 15, 2012

RESPONSIBLE OFFICIAL:

Director, Office of Privacy and Information Protection & Data Security

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 6:

The Commissioner, Wage and Investment Division, should take steps to ensure tax preparation software packages do not auto-populate an ITIN onto Forms W-2 instead of asking for the taxpayer identification number as shown on the Forms W-2. The IRS should not accept ITIN returns prepared with software that is not compliant with this requirement.

CORRECTIVE ACTION:

We agree with the recommendation to take steps to ensure tax preparation software packages do not auto-populate an Individual Taxpayer Identification Number (ITIN) onto Forms W-2 , *Wage and Investment Statement*. We have addressed the auto-population issue with software developers in the past, including the most recent IRS Software developers conference in June 2011. The dialog with the developer community was encouraging in that it demonstrated an interest in working with the IRS to disable the auto-population function and require manual entry for Forms W-2 filed with ITIN returns.

We will emphasize on the instructions for Form W-2 that the Taxpayer Identification Number transmitted with electronic returns match the number shown on the copy of Form W-2 provided to taxpayers by their employers. The requirement for manual entry of Form W-2 data on ITIN returns will also be prominently displayed in Publication 1346, *Electronic Return File Specifications and Record Layouts for Individual Tax Returns*

We will also assess return preparation software compliance with the manual input requirement during the calendar year 2012 filing season. If warranted, non-compliance will be addressed by appropriate sanctions that may result in suspension from the program if requisite corrections are not made.

IMPLEMENTATION DATE:

December 15, 2011

RESPONSIBLE OFFICIAL:

Director, Submission Processing, Wage and Investment Division – Update Form 1346
Director, Media & Publications, Wage and Investment Division – Update Form W-2 Instructions
Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division
– Compliance Assessment

CORRECTIVE ACTION MONITORING PLAN:

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