The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

March 2, 2012

Reference Number: 2012-40-028

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

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THE INTERNAL REVENUE SERVICE IS NOT IN COMPLIANCE WITH ALL IMPROPER PAYMENTS ELIMINATION AND RECOVERY ACT REQUIREMENTS

Highlights

Final Report issued on March 2, 2012

Highlights of Reference Number: 2012-40-028 to the Internal Revenue Service Chief Financial Officer.

IMPACT ON TAXPAYERS

The Improper Payments Elimination and Recovery Act of 2010 increased agency accountability for reducing improper payments in Federal programs. The only program the IRS has identified for improper payment reporting is the Earned Income Tax Credit (EITC) Program. The IRS estimates that 21 to 26 percent of EITC payments were issued improperly in Fiscal Year 2011. This equates to $13.7 billion to $16.7 billion in EITC improper payments.

WHY TIGTA DID THE AUDIT

This audit was initiated because the Improper Payments Elimination and Recovery Act of 2010 requires the TIGTA to assess the IRS's compliance with improper payment requirements. The objective of this review was to assess the IRS's compliance with the Improper Payments Elimination and Recovery Act of 2010. The scope of this review was limited to an assessment of EITC information the IRS provided for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2011.*

WHAT TIGTA FOUND

The methodology the IRS uses to estimate the EITC improper payment rate results in a reasonable estimate of EITC overclaims. However, the IRS did not comply with all of the improper payment requirements included in the Improper Payments Elimination and Recovery Act.

The Department of the Treasury identifies the programs for which the IRS must assess the risk of improper payments. The IRS compiles the required information and forwards it to the Department of the Treasury for inclusion in the Department's agency financial report.

Our analysis of the information the IRS provided to the Department of the Treasury showed that the IRS is not in compliance with all Improper Payments Elimination and Recovery Act requirements. The IRS has not established annual EITC improper payment reduction targets and has not computed a gross estimate of EITC improper payments as the estimate does not include underpayments. An underpayment results when an EITC payment is made in an amount less than what an individual is entitled to receive.

The IRS has plans in place to establish EITC reduction targets and is exploring the feasibility of computing an improper payment estimate for EITC underpayments.

WHAT TIGTA RECOMMENDED

TIGTA made no recommendations in this report.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

March 2, 2012

MEMORANDUM FOR THE CHIEF FINANCIAL OFFICER

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

SUBJECT: Final Audit Report – The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements (Audit # 201240011)

This report represents the results of our review to assess the Internal Revenue Service's (IRS) compliance with the Improper Payments Elimination and Recovery Act (IPERA) of 2010.[1] The IPERA requires the Treasury Inspector General for Tax Administration to review annually the IRS's compliance with the IPERA reporting requirements. This audit is included in the Treasury Inspector General for Tax Administration's Fiscal Year 2012 Annual Audit Plan and addresses the major management challenge of Fraudulent Claims and Improper Payments.

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

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. 111-204.

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Abbreviations

EITC	Earned Income Tax Credit
FY	Fiscal Year
IPERA	Improper Payments Elimination and Recovery Act of 2010
IRS	Internal Revenue Service
NRP	National Research Program
TIGTA	Treasury Inspector General for Tax Administration

Background

The Improper Payment Information Act of 2002[1] requires Federal agencies, including the Internal Revenue Service (IRS), to estimate the amount of improper payments made each year. The agencies must report to Congress on the causes and the steps taken to reduce improper payments and address whether they have the information systems and other infrastructure needed to reduce improper payments. Agencies must also describe the steps taken to ensure managers are held accountable for reducing improper payments.

Executive Order 13520 further increases Federal Agency accountability in reducing improper payments

Executive Order 13520, signed by President Obama on November 20, 2009, further increases Federal agencies' accountability for reducing improper payments while continuing to ensure Federal programs serve and provide access to their intended beneficiaries. The Order requires Federal agencies to provide their agency Inspector General detailed information on efforts to identify and reduce the number of improper payments in Federal programs with the highest dollar value of improper payments. The Secretary of the Treasury is required to provide specific information regarding Earned Income Tax Credit (EITC) improper payments to the Office of Management and Budget and the Treasury Inspector General for Tax Administration (TIGTA). The Executive Order requires the TIGTA to assess the level of risk associated with the EITC Program, determine the extent of oversight warranted, and provide the IRS Commissioner with recommendations for modifying the IRS's plan to reduce EITC improper payments.

The Improper Payments Elimination and Recovery Act of 2010 amends the Improper Payments Act of 2002

On July 22, 2010, President Obama signed into law the Improper Payments Elimination and Recovery Act of 2010[2] (IPERA). The IPERA amends the Improper Payments Information Act of 2002 by redefining the definition of "significant improper payments" and strengthening agency reporting requirements. The IPERA requires the TIGTA to review annually the IRS's compliance with the IPERA reporting requirements. The TIGTA report is due within 120 days of the issuance of the Department of the Treasury agency financial report.

[1] Pub. L. No. 107-300, 116 Stat. 2350.
[2] Pub. L. 111-204.

IPERA process to identify IRS programs for improper payment risk assessment

The Department of the Treasury identified the programs for which the IRS must assess the risk of improper payments. The IRS uses an Improper Payments Elimination and Recovery Risk Assessment Questionnaire for Fiscal Year (FY)[3] 2011 (the Questionnaire) developed by the Department of the Treasury to assess the level of risk within each of the identified programs. The Questionnaire assigns a risk score to each program based on the IRS's response to the questionnaire. The level of risk for improper payments for the program is then based on risk score ranges established by the Department of the Treasury. For example, the Department of the Treasury considers programs with a risk score of 0 to 11 as low risk, 12 to 28 as medium risk, and 29 and greater as high risk. The IRS is required to forward the results and documentation for all risk assessments to the Department of the Treasury. Appendix IV provides a list of the IRS programs the Department of the Treasury identified for an improper payment risk assessment.

For any program identified as having a high risk for improper payments, the IRS must provide the following information to the Department of the Treasury for inclusion in the Department's agency financial report:

- The rate and amount of improper payments.
- The root causes of the improper payments.
- Actions taken to address the root causes.
- Annual improper payment reduction targets.
- A discussion of any limitations to the IRS's ability to reduce improper payments.

During the course of this review, we were provided with documentation showing risk assessments were performed for each of the programs that the Department of the Treasury required the IRS to assess. The EITC is the only high-risk program the IRS has identified and the only program with information included in the agency financial report.

The IRS uses results from its National Research Program (NRP) to compute the improper payment estimate for the EITC

The IRS used results from its NRP to estimate the FY 2011 EITC improper payment rate. The NRP data are used to estimate the total EITC overclaims and total EITC claims. IRS management indicated that the NRP is the primary source of data the IRS uses to estimate taxpayer EITC behavior for the purpose of estimating the improper payment rate. The NRP provides the IRS with compliance information that is statistically representative of the taxpayer population.

[3] A 12-consecutive-month period ending on the last day of any month, except December. The Federal Government's fiscal year begins on October 1 and ends on September 30.

In 2007, the IRS began the process of updating its NRP data by reviewing a stratified, randomly selected sample of individual tax returns. The IRS will use each year's NRP results to update the improper payment rate. Although the updated NRP process will result in a more current estimate of the accuracy of EITC claims, the estimated improper payment rate for a given fiscal year will not be based on current year data. Because of the time it takes to complete the annual NRP, the IRS's annual estimate will be based on data that are approximately three years old. For example, improper payment estimates for FY 2011 are based on Tax Year[4] 2007 tax returns.

The scope of this review was limited to an assessment of EITC information the IRS provided for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2011* as this was the only high-risk program identified by the IRS. The next phase of our review will assess the accuracy and sufficiency of the IRS's preparation of the Improper Payments Elimination and Recovery Risk Assessment Questionnaire for those programs that were not identified as having a high risk for improper payments.

This review was performed at the IRS Headquarters in Washington, D.C., in the Office of Research, Analysis, and Statistics and in the Office of the Chief Financial Officer during the period November 2011 through February 2012. 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.

[4] 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.

Results of Review

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

Our review determined that the IRS did not provide all required IPERA information to the Department of the Treasury for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2011*. Figure 1 provides a summary of our evaluation of IRS compliance with the IPERA.

Figure 1: IRS Compliance With Improper Payment Requirements for the Earned Income Tax Credit Program[5]

IPERA Requirement	Provided by the IRS
Conduct a program-specific risk assessment for each program or activity that conforms with Section 3321 of Title 31 U.S.C.	Yes[6]
Publish an improper payment estimate for the EITC.	Yes
Publish a programmatic corrective action plan for the EITC.	Yes
Describe the steps taken to ensure the agency managers and programs are held accountable for eliminating and reducing improper payments.	Yes
Publish annual reduction targets for the EITC and discuss progress toward meeting those targets.	No
Report an improper payment rate of less than 10 percent for the EITC.	No
Report on efforts to recapture EITC improper payments.	Yes

Source: The TIGTA's review of IRS EITC information provided to the Department of the Treasury for inclusion in the Department of the Treasury Agency Financial Report Fiscal Year 2011 issued November 15, 2011.

According to the IPERA, agencies that are not in compliance with the requirements in Figure 1 must submit a plan to Congress describing the actions that the agency will take to become compliant.

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[5] The scope of this assessment was limited to an evaluation of the completeness of the improper payment information provided by the IRS to the Department of the Treasury.

[6] During the course of this review, we were provided with documentation showing risk assessments were performed for each of the programs the Department of the Treasury required the IRS to assess. The next phase of our review will assess the accuracy and sufficiency of the performance of these risk assessments.

Noncompliance with IPERA reporting requirements increases the risk that the IRS will not significantly reduce EITC improper payments

As we previously reported, the IRS has made little improvement in reducing EITC improper payments since being required to report estimates of these payments to Congress in 2002.[7] The IRS acknowledges that further reductions in the EITC error rate will be difficult to achieve. Figure 2 presents the IRS's estimated EITC improper payments for FY 2003 through FY 2011.

Figure 2: EITC Improper Payments for Fiscal Years 2003 to 2011

Fiscal Year	Minimum Improper Payments[8] Percentage	Maximum Improper Payments Percentage	Minimum Improper Payments Dollars (Billions)	Maximum Improper Payments Dollars (Billions)
2003	25%	30%	$9.5	$11.5
2004	22%	27%	$8.6	$10.7
2005	23%	28%	$9.6	$11.4
2006	23%	28%	$9.8	$11.6
2007	23%	28%	$10.4	$12.3
2008	23%	28%	$11.1	$13.1
2009	23%	28%	$11.2	$13.3
2010	24%	29%	$15.3	$18.4
2011	21%	26%	$13.7	$16.7

Source: Department of the Treasury Performance and Accountability Reports for FY 2003 through FY 2010 and the FY 2011 Agency Financial Report.

Although the IRS reported a slightly lower EITC improper payment rate for FY 2011, IRS management informed us that the decrease in the FY 2011 improper payment rate cannot necessarily be attributed to a reduction in the amount of EITC improper payments. A number of factors can cause the improper payment rate and resulting dollar estimate to fluctuate from year to year. For example, the IRS changed the way it estimates EITC improper payments since it first began reporting the estimate in FY 2003. Prior to FY 2010, the IRS computed a range for the EITC improper payment rate using two basic assumptions.

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[7] TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year* pp. 3–4 (Feb. 2011).

[8] For FY 2005 through FY 2009, the IRS computed the minimum and maximum improper payment rates (referred to as the upper and lower bounds) using different sets of assumptions concerning the compliance of EITC claimants who fail to show up for the NRP audit.

- The IRS computed the maximum improper payment rate using the assumption that the EITC claims of individuals who did not respond to the IRS notice of audit were incorrect, thus resulting in an overpayment.
- The IRS computed the minimum improper payment rate using an overpayment amount for those taxpayers who did not respond to the notice of audit. This overpayment amount was computed using the assumption that the audit results for taxpayers who did not responded to the notice of audit were the same as those who did respond.

In FY 2010, continuing to use data gathered annually through the NRP, the IRS began using a new methodology for computing the improper payment amount. The annual sample along with the new methodology allows the IRS to calculate a point estimate for the improper payment amount with three percent precision and a 90 percent confidence rate as required by the IPERA. This new methodology accounts for the taxpayers who do not respond to the notification of audit through the application of sophisticated statistical formulas and techniques rather than the previous assumptions that were used.

In addition, legislative changes to the EITC and changes in the economy also directly impact the number and amount of EITC claims filed each year. The estimated improper payment rate and resulting dollar estimate will increase or decrease as the number of EITC claims received in a given tax year increases or decreases.

Quantifiable targets to reduce EITC improper payments were not established as required by the IPERA

Of continued concern is the IRS's noncompliance in establishing required quantifiable targets to reduce EITC improper payments. In our February 2011 report, the IRS agreed with our recommendation to establish EITC improper payment reduction targets.[9] In their response, IRS management stated that the IRS's return preparer initiative is its most promising avenue to substantially reduce erroneous EITC payments. Management noted that the IRS was in the first year of a three-year ramp-up of this initiative and indicated that the IRS will have a baseline against which it can set meaningful reduction targets after the program is fully established. However, the IRS did not provide details on when or how it plans to measure the impact of the tax return preparer strategy on EITC improper payments.

As we noted in our previous report, the IRS had just begun implementing the tax return preparer strategy and did not anticipate the strategy would be fully implemented until 2014. According to information contained in the *Department of the Treasury Agency Financial Report Fiscal Year 2011*, the IRS estimates it will pay an additional $35 billion to $43 billion in improper EITC payments in FYs 2012 through 2014. Without targets to reduce EITC improper payments as

[9] TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year* pp. 6–8 and 10 (Feb. 2011).

required by the IPERA, there is a lack of accountability for the IRS to eliminate payment error, waste, fraud, and abuse.

The Estimate of the Earned Income Tax Credit Improper Payment Rate Provides a Reasonable Estimate of Overclaims

The methodology used to compute the FY 2011 EITC improper payment rate provides a reasonable estimate of the percentage and amount of EITC overpayments. The formula used by the IRS to compute the EITC improper payment rate is shown in Figure 3.

Figure 3: EITC Improper Payment Rate Formula

$$\frac{\textit{Total Overclaims} - \textit{Total Claims Protected/Recovered}}{\textit{Total EITC Claims}}$$
Total Overclaims – the difference between the amount of the EITC claimed by the taxpayer on his or her tax return and the amount the taxpayer should have claimed.
Total Claims Protected/Recovered – the amount the IRS prevents (protects) in EITC overclaims through various activities including math error processing and pre-refund examinations. This data element also includes the amount the IRS recovers in overclaims that were erroneously paid. Recovery activities include Automated Underreporter examinations and post-refund examinations.
Total EITC Claims – the amount of EITC claimed on all tax returns.

Source: IRS Improper Payment Estimates for the Earned Income Tax Credit: Methodology for the Fiscal Years 2011–2014 Update dated July 2011.

The IRS uses the results of audits conducted as part of the NRP to estimate the EITC improper payment rate. The IRS Office of Research, Analysis, and Statistics determined the EITC sample size and selected a statistically valid sample of 2,219 tax returns with EITC claims filed during Tax Year 2007. The IRS Examination function conducted detailed audits of the sampled tax returns. The Office of Research, Analysis, and Statistics then used the results of the audits to estimate the EITC overclaims, EITC claims recovered, and total EITC claims for the formula in Figure 3.

Our analysis of these estimates shows that the IRS accurately reflects the results of the audits that were conducted for the purpose of estimating the EITC improper payment rate. In addition, our statistician independently verified that the NRP sample size is sufficient to measure the statistical reliability of results. The statistician also concluded that the related formulas and calculations were accurate and consistent and that a multiyear strategy is an acceptable approach to conduct the study. Finally, the statistician concluded that the formula used to compute the EITC overpayment rate will provide a reasonable estimate of EITC overpayments.

However, as we have previously reported, the EITC improper payment calculation does not include an estimate of EITC underpayments. Underpayments include EITC payments made to individuals that are less than the individual is entitled to receive. By not including EITC underpayments in the estimate of EITC improper payments, the IRS could be understating the rate and/or dollar value of improper payments being made. The IRS disclosed in the *FY 2011 Agency Financial Report* that it did not include EITC underpayments in its estimate of EITC improper payments. The report states that underpayments were not included because they "do not appear with sufficient frequency in the statistically valid test data to have a measurable effect on the estimate."

In our prior review, we recommended that the Deputy Commissioner for Operations Support use the NRP sample to estimate instances in which the IRS incorrectly pays less in the EITC than the taxpayer claims (underpayments). IRS management agreed in concept with this recommendation and will explore whether using the NRP sample is possible and practical. IRS management indicated that underpayments happen so infrequently in the NRP sample that the IRS may be unable to use NRP audit results to construct a statistically valid estimate of a population total.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to to assess the IRS's compliance with the IPERA.[1] The IPERA requires the TIGTA to review annually the IRS's compliance with the IPERA reporting requirements.

The scope of this review was limited to an assessment of the information the IRS provided for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2011*. The next phase of our review will assess the accuracy and sufficiency of the IRS's improper payment risk assessment and evaluation process.

To accomplish our objective, we:

I. Determined if the *Department of the Treasury Agency Financial Report Fiscal Year 2011* complied with the IPERA reporting requirements. We compared the information contained in the agency financial report to the IPERA reporting requirements outlined in Office of Management and Budget Circular A-123, *Management's Responsibility for Internal Control*, guidance on improper payment reporting. We also compared the information provided by the IRS to the Department of the Treasury to the information contained in the agency financial report to ensure the information was accurately reflected in the report. In addition, we reviewed prior TIGTA audit reports on the IRS's compliance with improper payment reporting requirements.

II. Evaluated the accuracy and reasonableness of the IRS's estimate of the EITC improper payment rate. We assessed the statistical validity of the methodology the IRS used to estimate the EITC overclaims and total EITC claims used to compute the EITC improper payment rate. We also compared the EITC overclaims provided by the Office of Research, Analysis, and Statistics for the statistically valid sample of 2,219 EITC claims to the EITC overclaim amounts on the IRS Master File[2] to ensure the data used by the IRS to compute the EITC overclaim rate was valid. In addition, we reviewed prior TIGTA audit reports on the validity of the IRS's sample selection and design for the NRP.

[1] Pub. L. 111-204.
[2] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: controls in place to ensure the IRS met the reporting requirements established in the IPERA.

Appendix II

Major Contributors to This Report

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

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Appendix IV

Internal Revenue Service Programs Identified for Improper Payment Risk Assessments

The following IRS programs were identified by the Department of the Treasury for improper payment risk assessments for FY 2011.

IRS Program	Type of Program	Level of Risk Identified
Refund Collection	Revenue	Low
Stimulus Disbursements	Revenue	Low
Earned Income Tax Credit Disbursements	Revenue	High
Child Tax Credit Payments	Revenue	Low
Health Care Credit Payments	Revenue	Low
Alternative Minimum Tax Credit Refunds	Revenue	Low
Home Buyers Credit Refunds	Revenue	Low
Corporation Refunds	Revenue	Low
Recovery Act Payments	Revenue	Low
Grants for Investments in Qualified Theraputic Projects in Lieu of Tax	Revenue	Low
Informant Reimbursement	Revenue	Low
Affordable Health Care Program	Administrative	Low
Recovery Act Administrative Expenses	Administrative	Low
Taxpayer Services	Administrative	Low
Tax Law Enforcement	Administrative	Low
Operations Support	Administrative	Low
Information Technology Investments/ Business Systems Modernization	Administrative	Low
Health Insurance Tax Credit	Administrative	Low
Federal Tax Lien Revolving Fund	Administrative	Low

IRS Program	Type of Program	Level of Risk Identified
Special Fund User Fees	Administrative	Low
Private Collection Agent Program	Administrative	Low
Department of Transportation Federal Highway Administration Allocation Account	Administrative	Low

Appendix V

Management's Response to the Draft Report

CHIEF FINANCIAL OFFICER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

RECEIVED
FEB 28 2012

February 28, 2012

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Pamela J. LaRue
Chief Financial Officer

SUBJECT: Draft Audit Report – The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements (Audit # 201240011)

Thank you for the opportunity to review and respond to the draft report titled, "The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements" (Audit # 201240011).

We are pleased with your acknowledgement that the methodology used to compute the FY 2011 EITC improper payment rate provides a reasonable estimate of the percentage and amount of EITC overpayments. Furthermore, consistent with your recommendation in the report titled, "Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year" (Report # 2011-40-023 issued February 7, 2011), we are continuing to implement our return preparer initiative aimed at substantially reducing erroneous EITC payments. As previously noted, FY 2011 was the first year of a three-year ramp-up of this initiative and we expect to have a baseline against which we can set meaningful reduction targets after the program is fully established by FY 2014.

If you have any questions, please contact Peter Rose, Associate Chief Financial Officer, Corporate Planning and Internal Control, at (202) 622-4508.