Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments

September 29, 2014

Reference Number: 2014-40-093

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 = Risk Circumvention of Agency Regulation or Statute

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EXISTING COMPLIANCE PROCESSES WILL NOT REDUCE THE BILLIONS OF DOLLARS IN IMPROPER EARNED INCOME TAX CREDIT AND ADDITIONAL CHILD TAX CREDIT PAYMENTS

Highlights

Final Report issued on September 29, 2014

Highlights of Reference Number: 2014-40-093 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

The Earned Income Tax Credit (EITC) and Additional Child Tax Credit (ACTC) are refundable credits designed to help low-income individuals reduce their tax burden. The IRS estimated that it paid $63 billion in refundable EITCs and $26.6 billion in refundable ACTCs for Tax Year 2012. The IRS also estimated that 24 percent of all EITC payments made in Fiscal Year 2013, or $14.5 billion, were paid in error.

WHY TIGTA DID THE AUDIT

This audit was initiated because the IRS is required to identify and take actions to address the root causes of improper payments in Federal programs identified as being at high risk for improper payments. The only IRS program identified as a high risk is the EITC. The overall objective of this review was to assess the IRS's efforts to identify and address the root causes of erroneous EITC and ACTC payments.

WHAT TIGTA FOUND

Processes have been developed to identify improper EITC payments and their root causes. However, the IRS has not developed processes to quantify or identify the root causes of improper ACTC payments.

The IRS has continually rated the risk of improper ACTC payments as low. However, TIGTA's assessment of the potential for ACTC improper payments indicates the ACTC improper payment rate is similar to that of the EITC. Using IRS data, TIGTA estimates the potential ACTC improper payment rate for Fiscal Year 2013 is between 25.2 percent and 30.5 percent, with potential ACTC improper payments totaling between $5.9 billion and $7.1 billion. In addition, IRS enforcement data show the root causes of improper ACTC payments are similar to those of the EITC.

Significant changes in IRS compliance processes would be necessary to make any significant reduction in improper payments. Expanded authority to make corrections to tax returns when data obtained from the Department of Health and Human Services indicate the taxpayer's refundable credit claims are not valid would help reduce improper payments. TIGTA estimates such authority could have potentially allowed the IRS to prevent more than $1.7 billion in questionable EITC payments in Tax Year 2012.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS ensure that the results of the ACTC Improper Payment Risk Assessment accurately reflect the high risk associated with ACTC payments, identify the root causes of the improper ACTC payments, and establish a plan to reduce erroneous payments. Furthermore, if correctable error authority is granted, the IRS should contract with the Department of Health and Human Services to obtain the complete National Directory of New Hires database.

In addition, the IRS should work with the Assistant Secretary of the Treasury for Tax Policy to consider a legislative proposal to obtain expanded National Directory of New Hires database authority to systemically verify claims for other income-based refundable credits (*e.g.*, the ACTC).

The IRS agreed with our recommendation to pursue expanded National Directory of New Hire authority. The IRS did not agree with our other recommendations. TIGTA's concerns with the IRS's response to the recommendations are noted in the report.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 29, 2014

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments (Audit # 201340031)

This report presents the results of our review to assess the Internal Revenue Service's efforts to identify and address the root causes of erroneous Earned Income Tax Credit and Additional Child Tax Credit payments. This audit is included in our Fiscal Year 2014 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 in Appendix IX.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. Please contact me if you have questions or Russell Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services).

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Abbreviations

ACTC	Additional Child Tax Credit
CTC	Child Tax Credit
DDV	Due Diligence Visit
EITC	Earned Income Tax Credit
HHS	Department of Health and Human Services
IPERA	Improper Payments Elimination and Recovery Act
IPERIA	Improper Payments Elimination and Recovery Improvement Act
IPIA	Improper Payments Information Act
IRS	Internal Revenue Service
NDNH	National Directory of New Hires
NRP	National Research Program
OMB	Office of Management and Budget
SSN	Social Security Number
TIGTA	Treasury Inspector General for Tax Administration

Background

Refundable credits are designed to help low-income individuals reduce their tax burden or to provide incentives for other activities. The number of these credits has varied over time because some credits are available for a limited period that is set by law. The Internal Revenue Service (IRS) reported that the amount of refundable tax credits claimed by taxpayers has grown from approximately $9.4 billion in Fiscal Year[1] 1993 to more than $104 billion in Fiscal Year 2013.

The two largest refundable credits designed to help low-income individuals are the Earned Income Tax Credit (EITC) and Additional Child Tax Credit (ACTC). The EITC is used to offset the impact of Social Security taxes on low-income families and to encourage them to seek employment. The ACTC is used to adjust the individual income tax structure to reflect a family's reduced ability to pay taxes as family size increases. The EITC and the ACTC combined have increased almost 40 percent from Tax Year[2] 2007 to Tax Year 2012. The IRS estimated that it paid $47.5 billion in refundable EITCs and $16.4 billion in refundable ACTCs for Tax Year 2007 compared to $63 billion and $26.6 billion, respectively, for Tax Year 2012.

The EITC

Congress created the EITC in 1975. Since then, the EITC has been modified a number of times to help improve the administration of the credit and to make the law less complex. For example, the initial eligibility requirements were revised to make taxpayers ineligible to receive the credit when the taxpayer has a Social Security Number (SSN) that is not valid for employment.[3] Congress also implemented a uniform definition of a qualifying child that applied to most child-related tax provisions. Most recently, the EITC was expanded to provide for a temporary increase in the EITC and expansion of the credit for workers with three or more qualifying children.

Taxpayers use Form 1040 (Schedule EIC), *Earned Income Credit*, to report the EITC qualifying child information. Taxpayers must meet specific criteria to qualify for the EITC that includes having a valid SSN. Additional criteria apply for those taxpayers who have qualifying children, including certain age, relationship, and residency tests. The resulting amount of the EITC a

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[1] Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
[2] 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.
[3] Non-U.S. citizens who do not have an employment authorization must prove a valid nonwork reason for requesting an SSN in order to receive one, generally for obtaining Government benefits (Federal, State, or local) to which the individual is entitled.

taxpayer can receive is based on the taxpayer's earned income and the number of qualifying children. Appendix V lists the rules taxpayers must meet to qualify for the EITC.

The ACTC

The Child Tax Credit (CTC) and the ACTC (the refundable portion of the CTC) were enacted by the Taxpayer Relief Act of 1997.[4] Congress believed that a tax credit for families with dependent children would reduce the individual income tax burden for families, better recognize the financial responsibilities of raising dependent children, and promote family values. To qualify for the CTC, a taxpayer must have a qualifying child.[5] Taxpayers use Schedule 8812, *Child Tax Credit*, to compute the ACTC and document whether the children claimed on the tax return who have an Individual Taxpayer Identification Number[6] meet the qualifying eligibility tests of substantial presence in the United States. The amount of the ACTC a taxpayer may receive, if any, is dependent on the total amount of the taxpayer's CTC and the taxpayer's earned income.

The CTC can reduce an individual's taxes owed by as much as $1,000 for each qualifying child.[7] Because the CTC is nonrefundable, the amount that can be claimed is limited to an individual's reported tax liability. The ACTC is the refundable portion of the CTC and is provided to qualifying individuals even if no income tax is withheld or paid; that is, the credit can exceed the tax liability. Appendix VI lists the basic eligibility and qualifying child requirements for the CTC and the ACTC.

Like the EITC, Congress has changed the CTC and the ACTC several times since they were enacted in Calendar Year 1997. These changes allowed more families to be eligible for the ACTC. For example, the American Recovery and Reinvestment Act of 2009[8] reduced the minimum earned income amount used to figure the ACTC to $3,000.[9] Reducing the amount to $3,000 expanded the number of taxpayers who could then qualify for the ACTC as well as increased the amount of the ACTC they could receive. The $3,000 minimum earned income amount has been extended by law through Tax Year 2017.

[4] Pub. L. No. 105-34, 111 Stat. 788.
[5] A qualifying child for purposes of the CTC is a child who must be claimed as a dependent on your tax return and meets other specific eligibility tests, such as relationship, age, filing status, and support. See Appendix VI for qualifying criteria.
[6] An Individual Taxpayer Identification Number is an IRS-issued identification number available to individuals who are required to have a Taxpayer Identification Number for tax purposes but who do not have and are not eligible to obtain an SSN because they are not authorized to work in the United States.
[7] The CTC amount has been $1,000 since Tax Year 2003.
[8] Pub. L. No. 111-5, 123 Stat. 115.
[9] Taxpayers must deduct the minimum earned income amount from their earned income before applying the percentage allowed to figure the refundable ACTC.

Improper payments of refundable credits

The Office of Management and Budget (OMB) defines an improper payment as any payment that should not have been made, was made in an incorrect amount, or was made to an ineligible recipient. Various ways have been put forth to identify, measure, and reduce Federal improper payments, including laws specifically addressing improper payments, an Executive Order, and guidance by certain oversight agencies such as the OMB. In addition, agency Inspectors General serve a role by evaluating agency information related to improper payments. For example:

- The *Improper Payments Information Act (IPIA) of 2002*[10] requires Federal agencies, including the IRS, to estimate the amount of improper payments and report to Congress annually on the causes of and the steps taken to reduce improper payments.
- The *Improper Payments Elimination and Recovery Act (IPERA) of 2010,*[11] enacted on July 22, 2010, amended the IPIA by strengthening agency reporting requirements and redefining "significant improper payments." Significant is defined as gross annual improper payments, *i.e.*, the total amount of overpayments plus underpayments, made in the program during the fiscal year reported that exceeded a) both 2.5 percent of program outlays and $10 million of all program or activity payments or b) $100 million.
- Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*, signed by the President on November 20, 2009, further increases Federal agencies' accountability for reducing improper payments while continuing to ensure that Federal programs serve and provide access to their intended beneficiaries.
- The *Improper Payments Elimination and Recovery Improvement Act (IPERIA) of 2012,*[12] enacted in January 2013, further expanded agency improper payment requirements to foster greater agency accountability. The IPERIA requires the OMB to designate the programs with the most egregious cases of improper payments as high-priority and requires agencies to develop additional or supplemental measures for tracking progress in reducing improper payments in these programs.

The OMB's improper payment reporting guidance[13] requires agencies that identify programs with a high risk of improper payments to report root causes of these errors using the following three categories:

- Documentation and Administrative Errors – Errors caused by the absence of supporting documentation necessary to verify the accuracy of a payment or errors caused by

[10] Pub. L. No. 107-300, 116 Stat. 2350.
[11] Pub. L. No. 111-204, 124 Stat. 2224.
[12] Pub. L. No. 112-248.
[13] OMB Circular A-123, *Requirements for Effective Measurement and Remediation of Improper Payments*, Part III to Appendix C (Mar. 22, 2010).

incorrect inputting, classifying, or processing of applications or payments by a relevant Federal agency, State agency, or third party who is not the beneficiary.

- Authentication and Medical Necessity Errors – Errors caused by an inability to authenticate eligibility criteria through third-party databases or other resources because no databases or other resources exist, or providing a service that was not medically necessary given the patient's condition.
- Verification Errors – Errors caused by the failure or inability to verify recipient information, including earnings, income, assets, or work status, even though verifying information does exist in third-party databases or other resources (in this situation, as contrasted with "authentication" errors, the "inability" to verify may arise due to legal or other restrictions that effectively deny access to an existing database or resource), or errors due to beneficiaries failing to report correct information to an agency.

For Fiscal Year 2011 reporting and beyond, agencies with programs that are susceptible to significant improper payments under the IPIA are required to report information on the three categories of errors annually in their Performance and Accountability Report or Agency Financial Report. Furthermore, both the IPERA and Executive Order 13520 require the Treasury Inspector General for Tax Administration (TIGTA) to annually review the IRS's compliance with improper payment assessment and reporting requirements.

The process to identify IRS programs for improper payment risk assessment

The Department of the Treasury identifies the programs that the IRS must assess for the risk of improper payments. The IRS used the Improper Payments Elimination and Recovery Risk Assessment Questionnaire for Fiscal Year 2013 (the Questionnaire) and related guidance provided by the Department of the Treasury to assess the level of risk for each identified program. The Questionnaire computes a risk score for each program based on the IRS's response to the questions contained in the Questionnaire. The risk score determines whether there is a low, medium, or high risk of improper payments in a program. The Department of the Treasury establishes the level of risk for improper payments in a program based on the risk score ranges and 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. 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 annual 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.

The EITC has previously been declared a high-risk program by the OMB and as such the annual Improper Payments Elimination and Recovery Risk Assessment Questionnaire is not required to be prepared for this program. The EITC is currently the only IRS program identified as having a high risk for improper payments for the purposes of the IPERA and the only program with information included in the Agency Financial Report. The IRS estimates that 24 percent of all EITC payments made in Fiscal Year 2013, or $14.5 billion, were paid in error.[14] In addition, the IRS estimates that it paid between $124 billion and $148 billion in improper EITC payments in Fiscal Years 2003 through 2013.

This review was performed at IRS National Headquarters Office of Research, Analysis, and Statistics in Washington, D.C., and in the Office of Return Integrity and Correspondence Services in Atlanta, Georgia, during the period May 2013 through July 2014. 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.

[14] The estimated EITC improper payment range for Fiscal Year 2013 was from 22 to 26 percent and from $13.3 billion to $15.6 billion.

Results of Review

Processes Have Been Developed to Identify Root Causes of Improper Earned Income Tax Credit Payments

The IRS has determined that EITC improper payments primarily result from two root causes – authentication and verification. Authentication errors include errors associated with the IRS's inability to authenticate qualifying child requirements, taxpayers' filing status, and EITC claims associated with complex or nontraditional living situations. Verification errors relate to the IRS's inability to identify individuals improperly reporting income to erroneously claim an EITC amount to which they are not entitled. Verification errors include underreporting and overreporting of income by wage earners as well as taxpayers who report they are self-employed. For Fiscal Year 2013, the IRS estimates that 70 percent, or $10.15 billion, in improper EITC payments resulted from authentication errors and the remaining 30 percent, or $4.35 billion, resulted from verification errors.

The IRS uses the following methods to identify the root causes of EITC improper payments:

- **National Research Program (NRP)** – The NRP Individual Income Tax Reporting Compliance Study, also known as the NRP 1040 Study, is performed annually and involves the IRS examining a statistically representative sample of tax returns. The NRP allows the IRS to estimate taxpayers' compliance with the EITC and to estimate the improper payment rate each year. The NRP is designed to ensure consistency, uniformity, and thoroughness in the examination process in order to ensure a reasonable chance to uncover the noncompliance that is actually present on a return. Complete and accurate examination results are the foundation of good estimates.
- **Compliance Studies** – The IRS conducted a series of studies in the 1990s to better understand compliance issues specific to the EITC and to aid EITC administration. These studies culminated in the IRS report *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* (referred to as the 1999 Compliance Study).[15] In addition to providing estimates of EITC overclaims, this report was used to develop strategies to improve the administration of the credit. Since its release, the 1999 Compliance Study has been the authoritative source on the nature of EITC compliance. The IRS recently updated the 1999 Compliance Study using data from the NRP for Tax Years 2006 through 2008. The study results provide information about overall compliance of taxpayers claiming the EITC with specific emphasis on the nature

[15] Dated Feb. 28, 2002.

of errors made. The IRS plans to use the updated study data to further explore and understand the nature of the errors and formulate future actions to address noncompliance.

In response to the IRS's identification of root causes of EITC improper payments, it has developed a strategy in an attempt to reduce EITC improper payments. This strategy focuses on early intervention to ensure that individuals claiming the credit are in compliance with the EITC rules. The IRS's strategy includes:[16]

- ***Education and outreach*** **–** Programs designed to educate taxpayers and tax return preparers on the legal requirements for EITC eligibility so they can apply the law accurately. For example, the IRS hosts annual EITC Awareness Days to market the EITC to lower income taxpayers and the Nationwide Tax Forum EITC Training for tax return preparers on EITC due diligence requirements and qualifying child requirements.
- ***Enforcement actions*** **–** Programs intended to contribute to the broader strategy of identifying errors as early in the process as possible, which include math error authority, an automated process to match reported income to third-party documents, and audits.
- ***Paid tax return preparer compliance initiative*** **–** An EITC paid preparer strategy that focuses on tax return preparers who are not compliant with the EITC due diligence requirements. The EITC due diligence requirements are intended to assist tax return preparers in accurately determining their clients' eligibility for the EITC and require that preparers maintain proof that they complied with the due diligence requirements.
- ***Legislative proposals*** **–** The IRS has proposed legislative changes to enable it to put into place processes and programs that are needed to enable it to do its job more effectively and to address the root causes of EITC improper payments.

According to the IRS, the above efforts reached more than 1.8 million taxpayers and 10,000 tax return preparers and identified and protected almost $4 billion in erroneous EITC claims during Fiscal Year 2013.[17] However, despite the IRS's efforts, the estimated EITC improper payment rate has remained relatively unchanged since Fiscal Year 2003 (the first year the IRS was required to report estimates of these payments to Congress), and the amount of EITC claims paid in error has grown. The IRS estimates that improper EITC payments totaled from $9.5 billion to $11.5 billion in Fiscal Year 2003[18] and from $13.3 billion to $15.6 billion in Fiscal Year 2013.[19]

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[16] See Appendices VII and VIII for more details.
[17] See Appendices VII and VIII for detailed results of the various IRS programs to address EITC improper payments.
[18] EITC improper payment estimates obtained from the *Department of the Treasury Performance and Accountability Report for Fiscal Year 2003*.
[19] EITC improper payments estimates obtained from the *Department of the Treasury Fiscal Year 2013 Agency Financial Report* .

The IRS estimates the total EITC paid in error over these 11 years is between $124 billion and $148 billion.

As previously discussed, the IRS has processes to identify the causes of improper EITC payments and to identify erroneous EITC payments. However, the IRS does not have the resources nor does it have alternative compliance tools needed to adequately address the erroneous EITC payments identified. As we have previously reported, the IRS will be unable to make any significant reduction in erroneous payments. In the IRS's April 2014[20] report to TIGTA on its efforts to reduce erroneous EITC payments, IRS management acknowledged the limitations faced in significantly reducing noncompliance using the traditional process of auditing tax returns. The IRS noted that it cannot fully address EITC noncompliance by simply auditing returns and must pursue alternatives to traditional compliance efforts.

Annual Risk Assessments Do Not Accurately Reflect the Risk Associated With Additional Child Tax Credit Improper Payments

Each year since Fiscal Year 2011, the IRS has continually rated the risk of improper payments associated with the ACTC as low. However, our review of the IRS's own enforcement data indicates that the ACTC improper payment rate is similar to that of the EITC. We estimate that the ACTC improper payment rate for Fiscal Year 2013 is between 25.2 percent and 30.5 percent, with potential ACTC improper payments totaling between $5.9 billion and $7.1 billion.

The Department of the Treasury has selected the ACTC as one of the revenue program funds[21] for which the IRS must perform a risk assessment to assess the level of improper payment risk. The Department of the Treasury selected the ACTC based on its materiality to the IRS's financial statements. On March 20, 2014, the OMB issued supplemental improper payment guidance to the Department of the Treasury clarifying the requirement for annual risk assessments of all refundable tax credits. Although the IRS has conducted the annual risk assessment of the ACTC as required by the Department of the Treasury, the methodology that the IRS uses to conduct the risk assessment continues to provide an inaccurate assessment of the risk of ACTC improper payments.

To determine the potential risk of ACTC improper payments, we used the same data sources and methodologies to the extent possible that the IRS uses to estimate the EITC improper payment rate to compute an estimate of the potential ACTC improper payment rate. For example, we used the results of the IRS's NRP 1040 Study for Tax Year 2009, which is the same study the IRS used to estimate the Fiscal Year 2013 EITC improper payment rate. The IRS was unable to

[20] IRS, *Report on Earned Income Tax Credit (EITC) Improper Payments Executive Order 13520: Reducing Improper Payments* (April 15, 2014).

[21] The IRS's custodial activity includes revenues collected and refunds disbursed. However, in this report the general term "revenue" is used in place of "custodial." The revenue program funds for which the IRS performed risk assessments generally represent specific individual tax credits or refund payments.

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provide an estimate of the amount of ACTC overclaims recovered through compliance programs for Tax Year 2009; therefore, we used the same ratio of overclaims recovered to improper payments that the IRS used to compute its Fiscal Year 2013 EITC improper payment rate.[22] Finally, we computed the estimated amount of potential ACTC improper payments by applying our estimate of the potential ACTC improper payment rate to the OMB budget estimates that are consistent with the budget estimates used by the IRS to compute Fiscal Year 2013 EITC improper payments. Figure 1 shows the methodology we used to estimate the potential ACTC improper payment rate for Fiscal Year 2013.

Figure 1: Methodology Used to Compute the Potential ACTC Improper Payment Rate for Fiscal Year 2013

Potential ACTC Improper Payment Rate =	***ACTC Improper Payments – ACTC Overclaims Recovered*** / ***Total ACTC Claims***
ACTC Improper Payments – The amount of the difference between the amount of the ACTC claimed by the taxpayer on his or her tax return and the amount the taxpayer should have claimed based on NRP results for Tax Year 2009. This amount includes ACTC overclaims and ACTC underpayments. This amount totaled $8.07 billion.	
ACTC Overclaims Recovered – The amount of ACTC overclaims that the IRS prevents from being paid through activities such as math error processing and prerefund examinations or recovers after being paid through Automated Underreporter document matching and post-refund examinations. This amount was estimated by applying the ratio of EITC overclaims recovered to EITC improper payments from the IRS's Fiscal Year 2013 EITC improper payment rate calculation. Using the EITC overclaims recovered ratio of 13.5 percent, we estimated the ACTC overclaims recovered to total $1.09 billion.	
Total ACTC Claims – The amount of the ACTC claimed on all tax returns based on the NRP results for Tax Year 2009. This amount totaled $25.03 billion.	
Potential ACTC Improper Payment Dollars =	***Estimated ACTC Claims*** *x* ***Potential ACTC Improper Payment Rate***

Source: TIGTA analysis of Tax Year 2009 1040 NRP ACTC data and the IRS's calculation of the Fiscal Year 2013 EITC improper payment rate.

The IPERA defines a program as having significant improper payments when improper payments exceed both 2.5 percent of program outlays and $10 million of all program or activity payments made during the fiscal year reported or $100 million at any percent of program outlays.

[22] The IRS ratio of EITC overclaims recovered to EITC improper payments for Fiscal Year 2013 was 13.5 percent.

Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments

Audit results indicate a high degree of noncompliance with ACTC eligibility requirements

The IRS's rating of the ACTC as low risk for significant improper payments is contrary to its own enforcement data, which show that in Fiscal Year 2013 the IRS adjusted[23] over $347 million of ACTC claims on returns also claiming the EITC. Our review of EITC closed audit data found that there is a close relationship between taxpayers' compliance with the EITC and the ACTC. According to the IRS, 283,806 (59 percent) of the 482,468 tax returns it audited in Fiscal Year 2013 with an EITC claim also included an adjustment record for the ACTC. Figure 2 shows the results of the IRS's EITC audits.

Figure 2: Results of EITC Audits of Tax Returns That Also Include an ACTC Adjustment – Fiscal Year 2013

Audit Disposition	Number of Returns	ACTC Dollars Adjusted	Percentage of Returns Adjusted
EITC/ACTC Tax Returns Audited	**283,806**	**$347,844,351**	**100%**
ACTC Disallowed[24]	*279,306*	*$350,324,178*	*98.41%*
Additional ACTC Allowed	*2,916*	*($2,479,827)*	*1.03%*
No Change	*1,584*	*0*	*0.56%*

Source: IRS Examination Operational Automated Database.[25]

When we provided our estimate of the potential ACTC improper payment rate to IRS management as well as our concern that the risk assessment process did not accurately reflect the risk associated with ACTC payments, the IRS raised the following concerns related to our estimate. We do not agree with the IRS's conclusions. We respond to each concern below.

- **An assessment of the ACTC improper payment rate must also include an assessment of the validity of the CTC.**

  In March 2014, the OMB issued improper payment guidance to the IRS clarifying that *all refundable credits* are subject to IPERA requirements as they represent an additional outlay of funds by the Government. The CTC is a nonrefundable credit that reduces an individual's tax liability and represents an offset of excess taxes that were already paid to the Government and therefore does not result in an additional budget outlay. The ACTC

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[23] The ACTC can be adjusted if it was not claimed or if it was claimed incorrectly on the taxpayer's tax return.
[24] Includes full disallowance of 269,561 returns for a total of $342,622,748 and partial disallowance of 9,745 returns for a total of $7,701,430
[25] Provided by the IRS on February 27, 2014.

is a refundable tax credit and therefore represents an additional expense or outlay to the Government because it is paid in excess of a taxpayer's net tax liability. As a result, it is appropriate per OMB guidance to consider only the refundable ACTC for purposes of assessing the risk of improper payments and estimating the improper payment rate.

- **The NRP 1040 Study was not designed to meet IPERA precision requirements for computing an ACTC improper payment rate.**

  Our estimate of the potential ACTC improper payment rate was computed to show that the IRS's improper payment risk assessment process should have ranked the ACTC Program as a high risk instead of low risk. We agree that the NRP 1040 Study was not designed to meet IPERA precision requirements. However, the 2,041 ACTC claims that the IRS audited as part of the NRP 1040 Study were selected by the IRS as part of a statistically valid sample of all Forms 1040, *U.S. Individual Income Tax Return.* As such, these tax returns are representative of the general tax return population for Tax Year 2009.

- **The potential ACTC improper payment rate does not account for recovered revenue.**

  Our ACTC improper payment rate does account for recovered revenue. As we previously mentioned, the IRS was unable to provide us the data for the ACTC for Tax Year 2009. As such, we estimated the ACTC overclaims recovered using the same ratio of overclaims recovered to improper payments that the IRS used to compute the Fiscal Year 2013 EITC improper payment rate. Therefore, our calculation of the potential ACTC improper payment rate is consistent with the IRS's calculation of the EITC improper payment rate.

Prior audits raise concerns with the reliability of the IRS's improper payment risk assessment process

In January 2013, TIGTA reported that the IPERA risk assessment process did not provide a reliable assessment of improper payment risk for IRS revenue program funds.[26] Specifically, we concluded that the risk assessments were not performed in compliance with Department of the Treasury guidelines and that the Questionnaire did not effectively address risks associated with tax refund payments.

In response to our audit recommendations, the IRS met with the Department of the Treasury to revise the risk assessment Questionnaire for revenue funds. In addition, the IRS Office of the Chief Financial Officer established guidelines for retaining risk assessment documentation and

[26] TIGTA, Ref. No. 2013-40-015, *Improper Payments Elimination and Recovery Act Risk Assessments of Revenue Programs Are Unreliable* (Jan. 2013).

worked with the business unit executives to ensure that the appropriate subject matter experts were identified and participated in the review process.

In March 2014, we reported[27] that the IRS performed risk assessments for each of the 25 program fund groups identified by the Department of the Treasury for review for Fiscal Year 2013 – six administrative program funds and 19 revenue program funds.[28] However, we again concluded that the process still may not provide a valid assessment of improper payments in tax administration because the EITC remains the only revenue program fund to be considered a high risk for improper payments despite numerous indicators that other refundable tax credits, *e.g.*, the ACTC, also potentially result in significant improper payments.

Recommendation

Recommendation 1: The Commissioner, Wage and Investment Division, should ensure that the results of the ACTC Improper Payment Risk Assessment accurately reflect the high risk associated with ACTC payments and provide a reliable estimate of improper payments. Completion of the ACTC Improper Payment Risk Assessment should include an evaluation of available NRP and enforcement data when determining the overall risk of improper payments.

> ***Management's Response:*** The IRS disagreed with this recommendation. IRS management stated that the Improper Payment Risk Assessment is completed for the ACTC following the guidance of the Department of Treasury and the OMB. The IRS stated that the assessment questionnaire and scoring methodology reflect operational risks associated with administration of the credit. The IRS already considers enforcement data and overall risks associated with administration of the ACTC by its inclusion in the Tax Gap estimate.
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> ***Office of Audit Comment:*** As we have repeatedly reported, the risk assessment process performed by the IRS does not provide a reliable assessment of improper payments. The IRS has previously acknowledged this in its response to a prior review. Moreover, the IRS's own enforcement data clearly contradicts the IRS conclusion that the risk of ACTC improper payments is low.

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[27] TIGTA, Ref. No. 2014-40-027, *The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply With the Improper Payments Elimination and Recovery Act* (Mar. 2014).
[28] The EITC Program has been declared a high-risk program for improper payments by the OMB; therefore, no formal risk assessment is required for it.

Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments

Data Show Root Causes of Additional Child Tax Credit Improper Payments Are Similar to Those of the Earned Income Tax Credit

The IRS indicated that it does not have the same level of detail regarding the source of ACTC errors as it does for EITC claims. The IRS noted that for the NRP EITC audits, all aspects related to the credit are verified as part of the audit. As a result, the IRS has very detailed information about the condition that caused the EITC claim to be in error. Although the IRS has not developed a strategy to identify the root causes of ACTC improper payments, we believe it has information that indicates that the root causes are similar to those of the EITC. As discussed previously, 283,806 (59 percent) of the 482,468 EITC tax returns the IRS audited in Fiscal Year 2013 also included an adjustment record for the ACTC. The IRS adjusted the ACTC on 282,222 (99.4 percent) of these 283,806 EITC returns.

The correlation between causes of EITC and ACTC improper payments results from the commonality in many of the eligibility requirements. Figure 3 is a comparison of the eligibility requirements for the EITC and the ACTC.

Figure 3: Comparison of the Eligibility Requirements for the EITC and the ACTC for Tax Year 2013

Eligibility Test	The EITC	The ACTC
Relationship	Son, daughter, stepchild, foster child, or a descendant of any of them (for example, your grandchild). Brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of any of them (for example, your niece or nephew). Adopted child. An adopted child is always treated as your own child. The term "adopted child" includes a child who was lawfully placed with you for legal adoption.	Same
Joint Return	The child does not file a joint return for the year (or files jointly to claim a refund).	Same
Age	A qualifying child must be: ➢ *Under* age 19 at the end of Tax Year 2013 and younger than you (or your spouse, if filing jointly); ➢ *Under* age 24 at the end of Tax Year 2013, a student, and younger than you (or your spouse, if filing jointly); or ➢ Permanently and totally disabled at any time during 2013, regardless of age.	A qualifying child must be: ➢ *Under* age 17 at the end of the tax year.

Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments

Eligibility Test	The EITC	The ACTC
Residency[29]	The child must have lived with the claimant in the United States for more than half of the year.	The child must have lived with claimant for more than half of the year.[30]
Qualifying Child Required?	No	Yes
SSN Required?	Yes	No – The IRS allows Individuals issued an Individual Taxpayer Identification Number to receive the ACTC.

Source: IRS Publication 972, Child Tax Credit, and IRS Publication 596, Earned Income Credit (EIC), for use in preparing Tax Year 2013 Returns.

Recommendation

Recommendation 2: The Commissioner, Wage and Investment Division, should, as required by the IPERA, identify the root causes of the improper ACTC payments, determine if tools and/or resources are available to address erroneous ACTC payments, and establish a plan to reduce the erroneous payments and then meet that plan.

> ***Management's Response:*** The IRS disagreed with this recommendation and stated that the OMB acknowledges that it already conducts analysis of the Tax Gap that incorporates these credits. According to the IRS, refundable tax credit noncompliance is included in the Tax Gap estimate and in the assessment and regular updating of its compliance strategies. The IRS considers available tools, resources, and alternative treatment options when preparing and updating compliance strategies. The IRS stated that reduction of erroneous payments is a primary goal of those activities.
>
> ***Office of Audit Comment:*** Because of the substantial number and amount of ACTC improper payments, excluding this credit from the IRS's assessment results in a substantial understatement of improper payments. We estimate this understatement to be in the range of $5.9 billion to $7.1 billion. If the IRS includes improper payments in its Tax Gap study, it should be clear on what portion of the Tax Gap is due to improper payments. Furthermore, the IRS advised us that the Tax Year 2006 Tax Gap estimation methodology did not estimate the number or amount of disallowed ACTC claims. Instead, it provides an aggregate estimate for the net misreported amount for all tax

[29] Exceptions apply.
[30] There are some exceptions to the residence test, which can be found in IRS Publication 972.

credits. As such, it cannot ensure that its Tax Gap strategy accurately identifies and addresses the causes of ACTC improper payments as required by the IPERA. The IPERA requires agencies to identify the root causes for improper payments for all programs for which improper payments exceed both 2.5 percent of program outlays and $10 million of all program or activity payments made during the fiscal year reported or $100 million.

New Compliance Processes Are Needed to Make Any Significant Reduction in Improper Payments

As we have previously reported,[31] the IRS continues to report significant improper EITC payments each year. For example, $13.3 billion to $15.6 billion in erroneous EITC payments were estimated to have been paid in Fiscal Year 2013. Compliance resources are limited, and additional alternatives to traditional compliance methods have not been developed. Consequently, the IRS does not address the majority of potentially erroneous EITC claims. This is despite the fact that the IRS has processes that successfully identify billions of dollars in potentially erroneous EITC payments. For example, the IRS identified more than 6.6 million potentially erroneous EITC claims totaling approximately $21.6 billion for Tax Year 2011. ************************************2*************************************
*****************2**************.

In addition to limited compliance resources and the reliance on traditional compliance methods, statutory requirements further limit the IRS's ability to ensure that EITC claims are valid before they are paid. The Internal Revenue Code requires the IRS to process tax returns and pay any related tax refunds within 45 calendar days of receipt of the tax return or the tax return due date, whichever is later. Because of this requirement, the IRS cannot conduct extensive eligibility checks similar to those that occur with other Federal programs that typically certify eligibility prior to the issuance of payments or benefits.

Some actions have been taken to address recommendations made in a prior TIGTA report

In our Fiscal Year 2009 report,[32] we recommended the IRS conduct a study to identify alternative processes that will expand its ability to effectively and efficiently address erroneous EITC claims for which data show that the taxpayer does not meet the EITC qualifying child relationship and/or residency tests. We also recommended that the IRS work with the Assistant Secretary of the Treasury for Tax Policy to obtain the authority necessary to implement alternative processes

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[31] TIGTA, Ref. No. 2014-40-027, *The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply With the Improper Payments Elimination and Recovery Act* (Mar. 2014).
[32] TIGTA, Ref. No. 2009-40-024, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* (Dec. 2008).

to adjust erroneous EITC claims for which data show that the taxpayer does not meet the EITC qualifying child relationship and/or residency tests.

In response to our recommendations, the IRS analyzed the information included in the Federal Case Registry[33] and found that, although the information in the registry provides information as to a child's custodial/noncustodial parent, the database cannot be solely relied upon to systemically adjust a potentially erroneous EITC claim.

Math error authority is not sufficient to effectively address erroneous EITC claims

The IRS, in conjunction with the Assistant Secretary of the Treasury for Tax Policy, has requested additional authority (hereafter referred to as correctable error authority) to systemically disallow a tax claim, including the EITC, when information contained in reliable Government data sources does not support the claim. According to the IRS, reliable Government data sources include information obtained from the Social Security Administration, the Department of Health and Human Services (HHS), the Federal Bureau of Prisons, and the States' Departments of Corrections. The IRS requested correctable error authority as part of its Fiscal Year 2015 budget submission. However, as of May 2014, the IRS has not been provided any additional authority or tools to expand its ability to prevent the issuance of improper EITC payments.

Currently, under the Internal Revenue Code, the IRS can use its math error authority to address erroneous EITC claims by systemically correcting mathematical or clerical errors on EITC claims, such as correcting entries made on the wrong line on the tax return or mathematical errors in computing income or the EITC. In addition, the IRS can use math error authority to adjust an EITC claim if a qualifying child's SSN is not valid. However, the majority of potentially erroneous EITC claims the IRS identifies do not contain the types of errors for which it has math error authority. For example, the IRS identified approximately 6.6 million potentially erroneous EITC claims totaling approximately $21.6 billion in Tax Year 2011 for which it does not have math error authority. In Tax Year 2011, the IRS used math error authority to identify and systemically correct only 270,492 (.009 or less than 1 percent)[34] of more than 27.4 million EITC claims. The 270,492 returns claimed the EITC totaling $314 million.

While the IRS has the authority to audit potentially erroneous EITC claims for which it does not have math error authority, doing so is more costly than the math error process. The IRS estimates that it costs $1.50 to resolve an erroneous EITC claim using math error authority compared to $278 to conduct a prerefund audit.[35] In addition, the number of potentially erroneous EITC claims the IRS can audit is further reduced by its need to allocate its limited

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[33] The Federal Case Registry is a national database that aids the administration and enforcement of child support laws. It consists of records that identify children, custodial parties, noncustodial parents, and putative (assumed) parents along with other relevant information.
[34] An additional 59,024 EITC claimants received approximately $21 million more in EITCs than claimed.
[35] Cost to use math error authority as of June 25, 2014, as provided by the IRS. The IRS provided the cost of a prerefund audit based on Fiscal Year 2010 financial data, which are the most current estimate available.

resources among the various segments of taxpayer noncompliance to provide a balanced tax enforcement program. As a result, billions of dollars in potentially erroneous EITC claims go unaddressed each year.

National Directory of New Hires Wage and Employment Data Along With Correctable Error Authority Could Significantly Reduce Improper Payments

Significant changes in IRS compliance processes would be necessary to reduce improper payments. Expanded authority to make corrections to tax returns when data obtained from the HHS indicate the taxpayer's refundable credit claims are not valid would significantly reduce improper payments. For example, the information could be used at the time tax returns are filed to identify those individuals who claim the EITC based on wages that do not appear to be valid. For example, our review of Tax Year 2012 tax returns identified more than $1.7 billion in potentially erroneous EITC claimed on tax returns with no third-party Forms W-2, *Wage and Tax Statement*, received by the IRS supporting the wages reported. As we have noted previously, the IRS estimates that verification errors, *i.e.*, underreporting and overreporting of income by wage earners, account for 30 percent, or $4.35 billion, of EITC improper payments.

The IRS is granted the authority to use the National Directory of New Hires (NDNH) to verify EITC claims. However, the IRS does not have the authority to systemically disallow an EITC claim that is not supported by NDNH data (***************2********************). Therefore, the IRS must audit the EITC claims it identifies for which NDNH data indicate the income reported is potentially erroneous. The number of EITC claims the IRS can audit is limited to available resources and the need to provide a balanced enforcement program. As such, the IRS's use of the NDNH to identify potentially erroneous EITC claims is limited to only those EITC claims it has the resources to address. The IRS does not have the authority to use the NDNH to verify any other refundable credit.

The Social Security Act, 42 U.S.C. Section 653 (i) (3), grants authority to the Secretary of the Treasury to use the HHS NDNH to verify an individual's claim of employment with regard to the EITC. The Act states:

> *The Secretary of the Treasury shall have access to the information in the National Directory of New Hires for purposes of administering section 32 of the Internal Revenue Code of 1986, or the advance payment of the earned income tax credit under section 3507 of such Code, and verifying a claim with respect to employment in a tax return.*

The NDNH is a national database of wage and employment information. The NDNH file contains the following information:

- **<u>New Hire (W-4) File</u>:** The New Hire File contains information on all newly hired employees reported by employers to each State Directory of New Hires. Federal agencies report directly to the NDNH.

- **Quarterly Wage (QW) File:** The Quarterly Wage File contains quarterly wage information on individual employees from the records of State workforce agencies and Federal agencies.
- **Unemployment Insurance (UI) File:** The Unemployment Insurance File contains unemployment insurance information on individuals who have received or applied for unemployment benefits as reported by State workforce agencies.

Analysis identified more than $1.7 billion in potentially erroneous EITC claimed on tax returns with no Forms W-2 to support wages

Because of its current processes for using the NDNH, the IRS was only able to resolve approximately $20 million in potentially erroneous EITC claims on 3,728 tax returns between January and June 2013. However, the NDNH could be used to identify and resolve many more claims. Our analysis of the 26.7 million EITC claims received by the IRS for Tax Year 2012 identified approximately 23.6 million (88 percent) tax returns with EITC claims totaling more than $53.8 billion for which the taxpayer claimed wages as the source income to support the EITC. Of the 23.6 million tax returns with wages reported, we identified 676,992 (3 percent) tax returns for which third-party Forms W-2 were not sent to the IRS by the employer for either the taxpayer and/or spouse listed on the tax return.[36] These 676,992 tax returns claimed EITCs totaling more than $1.7 billion. We forecast the IRS could prevent the payment of more than $8.5 billion in questionable EITC claims over the next five years.[37]

The IRS initially found the NDNH data to be valuable in identifying tax returns for which the income used to claim the EITC was potentially fraudulent. However, the IRS believes it is no longer cost beneficial to continue to use the NDNH to verify EITC claims. As such, it has decided not to renew the contract to use NDNH data with the HHS for Fiscal Year 2015. The IRS's decision to discontinue the NDNH contract is based on two primary factors:

- Improvements in the IRS's fraud detection filters to incorporate the characteristics of EITC claims the NDNH helps identify have increased the IRS's ability to more accurately detect EITC claims that appear to be based on potentially fraudulent income.
- The use of the NDNH does not result in a significant resource savings because the IRS must continue to incur additional resource costs to verify the income and subsequently audit EITC claims even when NDNH data indicate the claim is erroneous. For example, the average cost to obtain NDNH data is more than $1.6 million per fiscal year. During

[36] Some of the tax returns we identified could also be the result of employer errors or employer nonreporting.
[37] See Appendix IV. The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.

the period January 1, 2013, through June 30, 2013,[38] the IRS submitted NDNH data requests for 136,175 EITC claims totaling more than $787 million. However, the IRS was only able to close 3,728 (2.7 percent) claims totaling more than $20 million based exclusively on NDNH data. The remaining 132,447 (97.3 percent) EITC claims required the IRS to use additional resources other than NDNH data to verify the claim and close the case because either the NDNH contained no data for the taxpayer or the data were not sufficient to verify the amount of income claimed.

The NDNH data have the potential to significantly reduce EITC improper payments

The IRS can use NDNH data during the processing of tax returns to significantly increase its ability to identify potentially erroneous EITC claims on tax returns with unsupported wages. However, to realize the full potential of NDNH data, the IRS needs to:

- Obtain the authority to systemically disallow EITC claims for which NDNH data do not support the claim. Through legislative proposals, the IRS has requested correctable error authority to deny taxpayers' claims without conducting an audit when reliable Government data sources do not support information on the tax return. However, the IRS has not yet been granted this authority.
- Modify the processes it uses to obtain and use NDNH data. The IRS process to obtain NDNH data is a transactional manual process and is limited to the verification of only electronically filed tax returns with an EITC claim. If it obtained a copy of the complete NDNH database, the IRS could systemically verify all EITC claims to the NDNH.

Figure 4 provides a comparison of the IRS's current transactional-based processes to use the NDNH to identify a potentially erroneous EITC claim compared to the systemic processes that could be implemented if the IRS obtained a copy of the NDNH database.

[38] The IRS obtains NDNH data for EITC claims filed between January and June each year. After this period, the IRS has access to income information documents filed by third parties, including employers, for use in verifying income.

Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments

Figure 4: Comparison of Existing NDNH Processes to Identify Potentially Erroneous EITC Claims to a Systemic NDNH Process

Existing NDNH Processes to Identify Potentially Erroneous EITC Claims	Potential Systemic NDNH Processes to Identify Potentially Erroneous EITC Claims
The IRS evaluates EITC claims for potential fraud using established fraud filters.	The IRS evaluates all EITC claims regardless of fraud potential.
EITC claims with specified characteristics are suspended from processing and NDNH data are requested from the HHS for the taxpayer.	The IRS systemically matches all EITC claims for which income reported is wages to an NDNH file the IRS obtains from the HHS to verify the taxpayer's claim of employment.
The IRS evaluates the NDNH data and determines the income claimed is potentially erroneous.	The IRS identifies those EITC claims for which the NDNH indicates the taxpayer was not employed during the tax year.
The IRS conducts additional analysis to verify the amount of income claimed.	The IRS systemically disallows the EITC claim on the basis that the claim is unsubstantiated.
The IRS audits the EITC claim on those tax returns for which the income claimed is determined to be erroneous.	Taxpayer is sent a notice detailing adjustment made to the tax return and is provided with a telephone number and mailing address to contact the IRS if he or she questions the validity of the adjustment.

Source: Existing processes provided by the IRS. Potential systemic processes are a hypothetical example of how the IRS could use the NDNH if correctable error authority was provided.

Receiving a copy of NDNH data rather than using a transaction-based process may result in a lower cost to the IRS. The cost to obtain NDNH data under the current information sharing agreement with the HHS includes a set user fee and an additional transactional-based component. As such, the cost to obtain NDNH data increases as the number of data requests sent to the HHS increases. The cost to obtain NDNH data under this current information sharing agreement averaged more than $1.6 million a year for Fiscal Years 2010 through 2013. By receiving a complete copy of NDNH data, the IRS can eliminate the transactional cost associated with the existing agreement. Because the IRS has not pursued this option, the potential cost savings of doing so is unknown.

It should be noted that the IRS has processes in place for taxpayers to dispute systemic adjustments. For example, our review of this process in July 2011[39] found that when the IRS makes math error adjustments to a taxpayer's tax return, it sends a notice, generally a Computer

[39] TIGTA, Ref. No. 2011-40-059, *Some Taxpayer Responses to Math Error Adjustments Were Not Worked Timely and Accurately* (Jul. 2011).

Paragraph 11 Notice (Balance Due (Over $5.00)) or a Computer Paragraph 12 Notice (Overpayment of $1.00 or More), to the taxpayer explaining the error(s) identified and the amount of any resulting adjustment(s). The math error notice includes an account statement showing how the changes affected the tax return and showing the corrected tax return information compared to what was reported on the original tax return. In addition, the math error notice provides both a telephone number and mailing address for the taxpayer to contact the IRS if he or she questions the validity of the adjustments.

Taxpayers who question the validity of the adjustments are given 60 calendar days from the date of the notice to respond to the IRS disputing the validity of the adjustments made to their tax returns. During this 60-day period, the IRS will place a freeze on the taxpayer's account to prevent the issuance of the portion of the refund associated with the error(s) identified or prevent the initiation of collection action resulting from any balance due. Once a math error adjustment is made, any subsequent action depends on the response from the taxpayer and can include:

- **Agreed Response:** The taxpayer agrees with the math error adjustments made to his or her tax return. This includes taxpayers who do not respond to the IRS notice. The IRS removes the freeze from the taxpayer's account, which will then release any refund or initiate collection of a balance due of taxes.
- **Substantiated Response:** The taxpayer disagrees with the math error adjustments and either provides the IRS with written correspondence/documentation or information via telephone contact supporting his or her disagreement. The IRS agrees with the taxpayer based on the information provided and reverses the math error adjustments. The IRS removes the freeze from the taxpayer's account, which will release any refund or initiate collection of a balance due of taxes.
- **Unsubstantiated Response:** The taxpayer disagrees with the math error adjustments. However, the taxpayer does not provide adequate support for his or her disagreement. Generally, the IRS reverses the math error adjustments and places an examination freeze on the taxpayer's account resulting in his or her tax return being referred to the Examination function for further review.

Recommendations

If the IRS is granted correctable error authority, the Commissioner, Wage and Investment Division, should:

Recommendation 3: Contract with the HHS to obtain a complete copy of the NDNH database for use during tax return processing to systemically identify unsupported wages reported on tax returns to erroneously claim the EITC.

> ***Management's Response:*** The IRS disagreed with this recommendation. The IRS stated that the cost of obtaining the limited NDNH is significant and, under current

limitations on the IRS's use of the data, the IRS does not consider it to be a cost-beneficial tool. The IRS also disagreed with our outcome measure of $1.7 billion in potential cost savings, stating that the outcome is contingent on the IRS receiving expanded legislative authority and that its review of data from the recent EITC Compliance Study covering Tax Years 2006 through 2008 found that a significant portion of EITC claims on returns with reported wages and no Form W-2 were accurate or disallowed for reasons other than misreported income.

Office of Audit Comment: The IRS's disagreement is not consistent with its response to Recommendation 4 of this report in which the IRS states that it is pursuing expanded NDNH authority for use of the entire NDNH database as well as correctable error authority. Moreover, the EITC Compliance Study to which the IRS refers above excludes many EITC claims, such as fraudulent claims. Our analysis includes all EITC claims for which wages were reported and a Form W-2 was not filed by an employer for either the taxpayer or the taxpayer's spouse.

Legislative Recommendation

Recommendation 4: Work with the Assistant Secretary of the Treasury for Tax Policy to consider a legislative proposal to obtain expanded NDNH authority to systemically verify claims for other income-based refundable credits (*e.g.*, the ACTC) based on NDNH employment data.

Management's Response: The IRS agreed with this recommendation. The IRS stated that the *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals* presents a legislative request for expanded use of the NDNH database. The IRS's proposal would amend the Social Security Act to expand IRS access to NDNH data for general tax administration purposes, including data matching and verification of taxpayer claims during return processing. The IRS believes this proposal addresses the recommendation.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to assess the IRS's efforts to identify and address the root causes of erroneous EITC and ACTC payments. To accomplish our objective, we:

I. Determined what actions the IRS has taken to identify the root causes of improper payments for the EITC and the ACTC and the results of its efforts.

   A. Contacted the Office of Research, Analysis, and Statistics and the Office of Return Integrity and Correspondence Services to obtain copies of refundable credit studies conducted from Tax Year[1] 2008 to the present, including any NRP Compliance Studies for the past five years.

   B. Reviewed reports provided by the IRS to determine if root causes for EITC and ACTC improper payments were identified. We evaluated the root causes identified by the IRS to determine if causes identified were actually root causes or just symptoms of root causes.

   C. Reviewed the Department of the Treasury's Agency Financial Reports for Fiscal Years[2] 2012 and 2013 to identify changes made between the two reports, and determined if the causes the IRS identified for EITC improper payments are the same as reported in the Executive Order and other studies.

   D. Reviewed data available on the IRS Office of Research, Analysis, and Statistics NRP and Compliance Data Warehouse websites to obtain guidance on conducting the annual NRP review, information available on the NRP methodology, format of the NRP electronic audit case files, and instructions to obtain direct access to NRP review data or how to obtain a data extract of the NRP review data.

   E. Determined information, if any, the Office of Return Integrity and Correspondence Services uses and actions taken based on the data obtained in Steps I.B, I.C, and I.D above to identify the causes of taxpayer noncompliance with the EITC and the ACTC. Specifically, we:

      1. Discussed what efforts have been taken to identify root causes of improper payments for the EITC and the ACTC or refundable credits in general and any

[1] 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.
[2] Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.

reasons why efforts have not been made to identify root causes.

2. Obtained and reviewed copies of relevant documentation to include methodology, procedures, and reports unavailable on the websites.

F. Obtained access to NRP data through a TIGTA Strategic Data Services Division extract request and performed analysis of the types of information available to identify the reasons the EITC and the ACTC were denied and to verify the IRS's assessment of the root causes for improper payments.

II. Determined what actions the IRS has taken to address the identified root causes for EITC and ACTC improper claims.

A. Reviewed the results of TIGTA and Government Accountability Office reports related to the EITC and the ACTC issued over the past five years to determine any IRS efforts to identify root causes or if any root causes were identified by TIGTA or the Government Accountability Office.

B. Reviewed the IRS's study results of the feasibility of using the Federal Case Registry dated October 2011 to identify potentially erroneous EITC claims.

C. Reviewed IRS guidance to determine what policies and procedures the IRS has in place to address the identified root causes.

D. Interviewed IRS personnel for current and planned efforts to address the identified root causes. Based on the IRS's input, we researched current initiatives, determined if EITC claims are analyzed for income misreporting to include overreported and underreported income, and determined if the IRS's initiatives present new alternatives or rely on traditional compliance efforts.

1. Identified math error authorizations and determined if the IRS has presented any additional requests for tax policy changes.

2. To determine how the IRS is using the NDNH, we met with the HHS and the IRS to determine if the IRS has restricted NDNH access and the amount the IRS pays for access to the NDNH. We obtained and reviewed a copy of the Memo of Understanding that the IRS has with the HHS for use of the NDNH. We also reviewed the IRS's current periodic report submitted to the HHS on the effectiveness of the NDNH in identifying potentially false EITC claims.

E. Analyzed what action the IRS has taken to measure the impact of any actions taken, assessed the challenges the IRS faces in addressing the root causes identified, and determined if the IRS's efforts to address noncompliance are appropriate to address the identified root causes.

III. Determined if there are root causes for EITC or ACTC improper payments that the IRS has not identified.

A. Reviewed legislation and IRS guidance to determine the EITC and ACTC eligibility requirements.

B. Conducted tests to identify additional root causes for improper refundable credits.

1. Analyzed applicable Taxpayer Notice Code volumes for Tax Year 2011 returns.

2. Requested the Dependent Database[3] rule break volumes for Tax Year 2011.

C. Evaluated potential fraud.

1. Identified Tax Year 2012 returns claiming the EITC and wages on the Individual Return Transaction File and matched to the Individual Master File[4] to identify those individuals who actually received the credit.

2. Matched the tax returns identified in Step III.C.1 to the Tax Year 2012 Form W-2 File to identify returns for which the wages claimed on the tax return are not supported by a third-party Form W-2. We quantified the number of returns and amount of the EITC claimed on tax returns for which the wages are not supported.

IV. Determined an ACTC improper payment rate. Using data from the IRS NRP 1040 Study for Tax Year 2009 and the OMB budget reports used by the IRS to estimate EITC improper payments, we computed the potential ACTC improper payment rate and dollars for Fiscal Year 2013. To the extent possible, we used the same methodology the IRS uses to estimate the EITC improper payment rate and dollars to compute the potential ACTC improper payment rate. The potential ACTC improper payment rate was computed with the assistance of the TIGTA contract statistician.

Data validation methodology

During this review, we relied on data extracted from the IRS's Individual Master File for Tax Year 2012, Individual Returns Transaction File for Processing Year[5] 2013, and the Form W-2 File for Tax Year 2012 located on the TIGTA Data Center Warehouse. We also relied on a data extract of Tax Year 2012 Forms 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*,[6] from the IRS's Information Returns

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[3] The Dependent Database is a risk-based audit selection tool used by the IRS to identify tax returns for audit. The Dependent Database scoring system uses business rules to identify EITC noncompliance at the point of filing through use of internal and external data elements.
[4] The IRS database that maintains transactions or records of individual tax accounts.
[5] The calendar year in which the tax return or document is processed by the IRS.
[6] We specifically requested information on Form 1099-R with a Distribution Code 3 for disability income.

Processing database and a data extract of Tax Year 2008 EITC NRP data from the IRS's Compliance Data Warehouse that was provided by the TIGTA Office of Investigations' Strategic Data Services Division. Additionally, we used Tax Year 2009 1040 NRP data that were provided by the IRS's NRP staff. We were able to verify a random sample of each data set to the IRS's Integrated Data Retrieval System. As a result of our testing, we determined the data used in our review were sufficiently reliable.

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 that the following internal controls were relevant to our audit objective: controls in place to identify and address the root causes of erroneous EITC and ACTC payments. We evaluated these controls by interviewing management, reviewing policies and procedures, and reviewing the process used to identify root causes and any initiatives taken to address root causes identified.

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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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:

- Funds Put to Better Use – Potential; $1,712,725,533 in questionable EITC claims paid on 676,992 Tax Year[1] 2012 tax returns; $8,563,627,665[2] in questionable EITC claims issued over five years (see page 17). This outcome is potential because it depends on whether the IRS is granted correctable error authority and obtains the complete NDNH database to verify these claims.[3]

Methodology Used to Measure the Reported Benefit:

We conducted computer analysis of the Tax Year 2012 Individual Master File to identify 26,715,006 tax returns that received EITC totaling $61,989,202,110.[4] Of the 26,715,006 tax returns, approximately 23,571,365 (88 percent) included EITCs totaling $53,773,385,436 for which the taxpayers claimed wages on Line 7 of their Form 1040 as the source of EITC supporting income.

We matched the 23,571,365 tax returns to the IRS's Form W-2 File on the TIGTA Data Center Warehouse for Tax Year 2012 using both the primary and secondary SSNs to determine if a Form W-2 was on file that would support the wages being claimed on Line 7 of the Form 1040.[5] Of the 23,571,365 tax returns with wages reported, we identified 676,992 (3 percent) tax returns for which third-party Forms W-2 were not sent to the IRS by the employer for either the taxpayer and/or spouse listed on the tax return.[6] These 676,992 tax returns received EITC totaling

[1] 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.
[2] The five-year forecast for potential funds put to better use is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.
[3] The amount may also be affected by employer reporting errors or employer nonreporting.
[4] Our analysis did not include taxpayers who had an EITC reversed on their account.
[5] We removed tax returns on which disability payments were reported on the Form 1040, Line 7 – Wages which were supported by Forms 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, with a Distribution Code 3 for disability income.
[6] Some of the tax returns we identified could also be the result of nonreporting of income and withholding by the employer.

$1,712,725,533. We forecast that the IRS could prevent the issuance of $8,563,627,665 in questionable EITC claims over the next five years ($1,712,725,533 x 5).

This outcome is achievable if: 1) the IRS is granted expanded legislative authority to systemically disallow EITC claims based on NDNH employment results and 2) the IRS obtains an entire copy of the NDNH database for use during tax return processing to systemically identify unsupported wages reported on tax returns to erroneously claim the EITC.

The actual amount of questionable EITC claims the IRS will identify and prevent is dependent on the actions the IRS takes to obtain needed authority and access to NDNH data and will not be known until such authority and data use are implemented.

Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments

Appendix V

Earned Income Tax Credit Eligibility Rules

Taxpayers claiming the EITC must meet specific criteria to qualify for the credit. Additional criteria apply for those taxpayers who have qualifying children. Figure 1 lists the basic EITC eligibility requirements. Figure 2 shows the additional eligibility tests of age, relationship, residency, and joint return requirements that must be met by taxpayers claiming the EITC with a qualifying child. The maximum EITC available for Tax Year 2013 ranges from $487 for taxpayers with no qualifying children to $6,044 with three or more qualifying children.

Figure 1: Basic EITC Eligibility Requirements

First, you must meet all the rules in this column	Second, you must meet all the rules in *one* of these columns, whichever applies		Third, you must meet the rule in this column
	Rules if you have a qualifying child	**Rules if you do not have a qualifying child**	
1. Your adjusted gross income must be less than: • $46,227 ($51,567 for married filing jointly) if you have three or more qualifying children, • $43,038 ($48,378 for married filing jointly) if you have two qualifying children, • $37,870 ($43,210 for married filing jointly) if you have one qualifying child, or • $14,340 ($19,680 for married filing jointly) if you do not have a qualifying child. 2. You must have a valid SSN. 3. Your filing status cannot be married filing separately. 4. You must be a U.S. citizen or resident alien all year. 5. You cannot file Form 2555, *Foreign Earned Income*, or Form 2555-EZ*, Foreign Earned Income Inclusion* (relating to foreign earned income). 6. You must have earned income. 7. Your investment income must be $3,300 or less.	8. Your child must meet the relationship, age, residency, and joint return tests. 9. Your qualifying child cannot be used by more than one person to claim the EITC. 10. You cannot be a qualifying child of another person.	11. You must be at least age 25 but under age 65. 12. You cannot be the dependent of another person. 13. You cannot be a qualifying child of another person. 14. You must have lived in the United States more than half of the year.	15. Your earned income must be less than: • $46,227($51,567 for married filing jointly) if you have three or more qualifying children, • $43,038 ($48,378 for married filing jointly) if you have two qualifying children, • $37,870 ($43,210 for married filing jointly) if you have one qualifying child, or • $14,340 ($19,680 for married filing jointly) if you do not have a qualifying child.

Source: IRS Publication 596, Earned Income Credit (EIC), for use in preparing 2013 Returns.

Figure 2: Additional EITC Eligibility Tests of Age, Relationship, Residency, and Joint Return Requirements

Eligibility Test	Qualifying Child Criteria
Relationship	Must meet one of the following relationship tests: • Son, daughter, stepchild, foster child, or a descendant of any of them (for example, your grandchild), or • Brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of any of them (for example, your niece or nephew). Adopted child. An adopted child is always treated as your own child. The term "adopted child" includes a child who was lawfully placed with you for legal adoption.
Age	Must meet one of the following age tests: • Under age 19 at the end of Tax Year 2013 and younger than you (or your spouse, if filing jointly), • Under age 24 at the end of Tax Year 2013, a student, and younger than you (or your spouse, if filing jointly), or • Permanently and totally disabled at any time during Tax Year 2013, regardless of age.
Residency	Your child must have lived with you in the United States for more than half of Tax Year 2013.
Joint Return	The child cannot file a joint return for the year. *Exception:* An exception to the joint return test applies if your child and his or her spouse file a joint return only to claim a refund of income tax withheld or estimated tax paid.

Source: IRS Publication 596.

Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments

Appendix VI

Qualifying Child Criteria for the Child Tax Credit or the Additional Child Tax Credit

The CTC can reduce an individual's taxes owed by as much as $1,000 for each qualifying child. For Tax Year 2013, the ACTC is equal to the lesser of the CTC that was not allowed or 15 percent of earned income that is more than $3,000.[1] Figure 1 shows the seven eligibility tests a child must meet to qualify for the CTC or the ACTC.

Eligibility Test	Qualifying Criteria
Age	A qualifying child must be *under* age 17 at the end of the tax year.
Relationship	The child must be the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, a grandchild, niece, or nephew) and an adopted child (includes a child lawfully placed for legal adoption).
Support	The child must not have provided more than one-half of their own support for the tax year.
Dependent	The taxpayer must claim the child as a dependent on the Federal tax return.
Citizenship	The child must be a U.S. citizen, U.S. national,[2] or U.S. resident alien.[3]
Joint Return	The child does not file a joint return for the year (or files joint to claim a refund).
Residence	The child must have lived with claimant for more than one-half of the year.[4]

Source: IRS Publication 972, Child Tax Credit, for use in preparing 2013 returns.

Limitations: The CTC is limited if modified adjusted gross income is above a certain amount (which varies depending on the taxpayer's filing status).[5] In addition, the CTC is generally limited by the amount of the income tax owed as well as any alternative minimum tax owed.

[1] Tax-exempt combat pay is included as earned income when calculating the ACTC.
[2] A U.S. national is an individual who, although not a U.S. citizen, owes his or her allegiance to the United States. U.S. nationals include American Samoans and Northern Mariana Islanders who chose to become U.S. nationals instead of U.S. citizens.
[3] Publication 519, *U.S. Tax Guide for Aliens*, states that an individual will be considered a U.S. resident for tax purposes if they meet the substantial presence test for the calendar year. To meet this test, the individual must be physically present in the United States on at least 31 calendar days during the current year and 183 calendar days during the three-year period that includes the current year and the two years immediately before.
[4] There are some exceptions to the residence test, which can be found in IRS Publication 972.
[5] For married taxpayers filing a joint return, the phase-out begins at $110,000. For married taxpayers filing a separate return, it begins at $55,000. For all other taxpayers, the phase-out begins at $75,000.

Appendix VII

Efforts to Address the Root Causes of Earned Income Tax Credit Improper Payments

The IRS has several programs to address the root causes of EITC improper payments. The IRS considers these programs as part of its overall strategy to ensure compliance with the rules. Many of these programs are aimed at identifying and preventing erroneous payments once a tax return is filed rather than correcting the underlying reason that the error is occurring.

Outreach and Education – Programs designed to educate taxpayers and tax return preparers on the legal requirements for EITC eligibility so they can apply the law accurately.

- *Annual EITC Marketing Campaign* – This campaign, which includes the EITC Awareness Day, targets underserved populations and includes print and media tours.
- *EITC Due Diligence Training Modules* – A web-based initiative in which tax return preparers can earn a certificate of completion.
- *Nationwide Tax Forum EITC Training* – Annual seminars that educate tax return preparers on EITC due diligence requirements and qualifying child requirements.
- *External Stakeholders* – The IRS works with external stakeholders including the tax return preparer community to share information regarding the EITC in an effort to identify trends and improve compliance.

Enforcement – Programs intended to contribute to the broader strategy of identifying errors as early in the process as possible. The IRS's prevention activity focuses on three main areas:

- *Audits* – The IRS identifies returns for examination usually before the refund is released. Because of the refundable nature of the credit, the high error rate, and the high dollar amount associated with the credit, returns with EITC claims are twice as likely to be audited as other individual taxpayer returns. According to the IRS, 70 percent of the examinations the IRS conducts each year are prerefund examinations in which the IRS determines the validity of the EITC claim before the EITC refund is issued. The remaining 30 percent of the examinations are conducted post refund.
- *Math Error* – An automated process performed while tax returns are being processed and before refunds are sent to taxpayers in which the IRS identifies math or other irregularities and automatically prepares an adjusted return for a taxpayer filing on paper and generally rejects electronic returns. The IRS currently has limited legislative authority to use this process.

- *Document Matching* – The IRS matches income claimed on tax returns to income reported by employers and other third parties to identify discrepancies that involve instances in which EITC claimants underreport income.

Figure 1 shows the main EITC compliance activities and the resulting total revenue protected for Fiscal Years[1] 2008 through 2014.

Figure 1: EITC Compliance Activities and Total Revenue Protected (Dollars in Billions) for Fiscal Years 2008 Through 2014

Compliance Activity	Fiscal Year 2008	Fiscal Year 2009	Fiscal Year 2010	Fiscal Year 2011	Fiscal Year 2012[2]	Fiscal Year 2013[3]	Fiscal Year 2014[4]	Fiscal Years 2008–2014 Total
Examination Closures	503,755	508,180	473,999	483,574	487,408	483,139	483,000	**3,423,055**
Math Error Notices[5]	432,797	355,416	341,824	293,450	270,492	240,000	210,000	**2,143,979**
Document Matching	727,916	688,087	904,920	1,178,129	985,172	906,994	907,000	**6,298,218**
Amended Returns[6]	32,473	25,395	19,347	14,317	13,284	8,129	8,000	**120,945**
Total Revenue Protected (in Billions)	**$ 3.74**	**$ 3.79**	**$ 3.87**	**$ 3.75**	**$ 3.95**	**$ 3.84**	**$ 3.69**	**$ 26.63**

Source: The Department of the Treasury's Agency Financial Report for Fiscal Year 2013.

[1] Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
[2] Restated actual.
[3] Preliminary estimates.
[4] Estimated based on Fiscal Year 2013 preliminary data.
[5] The EITC withheld from the claimant; includes decreases in the amount of the EITC claimed as well as disallowance of the full EITC claim.
[6] Amended returns are a subset of Examination Closures.

Appendix VIII

Earned Income Tax Credit Tax Return Preparer Strategy

As part of its efforts to address EITC improper payments, the IRS developed an EITC paid preparer strategy that focuses on tax return preparers who are not compliant with the EITC due diligence requirements. Figure 1 provides results of this strategy for Fiscal Year 2013.

Figure 1: Results of the EITC Tax Return Preparer Strategy for Fiscal Year 2013

Treatment	Description	Program Results	Penalties Proposed *(in millions)*	EITC Revenue Protected *(in millions)*
Due Diligence Visit (DDV)[1]	Prefiling season DDVs	540 visits 86 percent penalty rate	$14.9	$43.8
	Filing season DDVs	300 visits 81 percent penalty rate	Almost $2.9	$7.5
	Filing season follow-up DDVs[2]	27 visits 67 percent penalty rate	More Than $200,000	Not Measured[3]
Knock and Talk Visit	Visits made by auditors and Criminal Investigation agents to educate EITC preparers on EITC laws and due diligence requirements.	105 visits	None[4]	$10.0
EITC Due Diligence Injunction	Court action to prevent egregious preparers from filing future returns.	4 injunctions	$0	$15.4
DDV Warning Letter	Prefiling season letters to advise preparers of EITC due diligence problems.	9,453 letters	$0	$275.1
	Filing season letters to advise preparers of continuing EITC due diligence problems.	1,781 letters	$0	$16.9

Source: The Internal Revenue Service Filing Season 2013 EITC Real Time Return Preparer Initial Finding and Fiscal Year 2013 Executive Order Report.

[1] Field examiners audit EITC preparers to verify that they are meeting their due diligence requirements and assert penalties as warranted.
[2] A filing season follow-up DDV is for continuing noncompliant preparers who received an educational visit.
[3] Insufficient sample size.
[4] Integrated approach for educational purposes.

Appendix IX

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

COMMISSIONER
WAGE AND INVESTMENT DIVISION

SEP 10 2014

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Debra Holland
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments (Audit # 201340031)

Thank you for the opportunity to review and respond to the subject draft report on the challenges of administering the Earned Income Tax Credit (EITC), the Child Tax Credit (CTC), and the Additional Child Tax Credit (ACTC) through traditional tax compliance processes and treatments. To detect and stop potentially fraudulent claims for the credits and to improve taxpayer compliance with the provisions of the Tax Code authorizing them, we continue to explore alternative strategies to supplement the traditional tax administration authority provided to us and to maximize the use of limited compliance resources.

We agree with the Treasury Inspector General for Tax Administration (TIGTA) that new and innovative processes are needed to achieve significant reductions in the amount of improper payments. The tax system, as established by the Internal Revenue Code (the Code) is based on the premise that taxpayers will voluntarily comply with its provisions in self-reporting their tax liabilities. The administrative provisions of the Code allow for the examination of tax returns to assess the accuracy of reported liabilities and to serve as an incentive for voluntary compliance. This balancing control, however, is subject to the constraints of limited resources and statutory provisions that assure taxpayers of their rights for the review of assessments of additional tax, or denials of credits by the U.S. Tax Court before the assessments or denials occur. Since February 2005[1], the IRS has submitted legislative proposals that would permit expanded access and use of the National Directory of New Hires database, as recommended by the TIGTA in this report. With the March 2014 release of the administration's Fiscal Year 2015 revenue

[1] *General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals*, 132, February 2005, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2006.pdf

proposals[2], the IRS has submitted legislative proposals for supplemental authority that would provide for correctable error authority, similar to math error authority, in situations when information provided by taxpayers does not match the information contained in government databases. The IRS also requested acceleration of the filing dates of information returns to make the information available to the IRS earlier, the authority to regulate return preparers, increases in return preparer penalties for willful or reckless misconduct, and extending due diligence requirements to include the EITC, CTC, and ACTC.

Considering the unique attributes of refundable credits claimed and payable through the tax system, the IRS has prepared annual risk assessments under the Improper Payments Elimination and Recovery Improvement Act of 2012 (IPERIA) for the specific outlays identified by the Office of Management and Budget (OMB), under guidance provided by the Department of the Treasury. Additional guidance provided by the OMB recognizes Treasury's assertion that there is significant complexity and difficulty in separately reporting the refunded amount of each credit claimed and paid through the tax system. The OMB further acknowledges that the IRS already conducts analysis of the tax gap that incorporates these credits. Refundable tax credit non-compliance is included in the tax gap estimate, and in the assessment and regular updating of our compliance strategies.

Since 2005, the IRS has been reporting separate estimates for the EITC because this program was determined to be high risk under the Improper Payments Information Act, a predecessor to IPERIA. All overclaims of refunds, including refundable credits, are included in the IRS tax gap estimate. The IRS' overall compliance strategy includes efforts to reduce the EITC error rates separately, but also takes into account efforts to improve compliance overall, including refundable credits claimed on the tax return. The OMB confirmed in March 2014 that this is permissible so long as the IRS explains in its Annual Financial Report why there is no further break out. This OMB agreement is based on the recognition of how tax returns are administered, including refundable credits, as being integral to the IRS assessment of compliance with tax reporting requirements. This allows for the appropriate resource focus within the IRS compliance strategy, since the largest component of the tax gap falls outside of traditional refundable tax credit payments. If the IRS compliance strategy required IPERIA reporting and compliance standards for all refundable tax credits, the IRS would need to divert a disproportionate amount of compliance resources to satisfy those requirements

Refundable tax credits differ from other federal outlays, such as federal vendor or grant payments, in that the potential outlay can be fully or partially absorbed by taxpayers' tax liabilities, and can be combined with other refundable and/or non-refundable tax credits in arriving at the net tax due or overpayment to be refunded. Some refundable tax

[2] *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals,* March 2014, 229-230, 245-246, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf

credits, such as income tax withheld from wages, federal tax deposits, and estimated tax payments, are recorded as reductions of receipts rather than as outlays.[3] Refundable tax credits are reported as outlays when they exceed the tax liability and are a part of the refund. When refunds are due; the IRS issues a single payment for the net refund amount.

Another important difference between refundable tax credits and other federal outlays subject to the IPERIA is that taxpayers self-certify their eligibility for the applicable credits through the act of filing a tax return. Amounts reported on tax returns or required tax forms are based on voluntary compliance and are signed by taxpayers under penalty of perjury, attesting that the information provided is complete and accurate. The IRS is legally obligated[4] to refund amounts collected from taxpayers and refundable tax credits Congress has authorized qualifying taxpayers to claim in excess of the taxpayer's income tax liability within 45 days of processing a taxpayer's request. Otherwise, IRS must pay interest to the taxpayer. This contrasts with other contractual or benefit payments where the eligibility for payment and the accuracy of the amount to be paid are reviewed and approved prior to disbursement of the funds.

The IRS has compliance processes in place to identify questionable refunds and stop their issuance. To the extent permitted by law, the IRS uses other government data sources to identify questionable claims for refundable tax credits and address them appropriately. For claims of EITC, CTC, and ACTC, refunds are stopped and the returns are referred to the IRS Examination functions for review. Examiners will contact taxpayers to request documentation to support their claims for the credit(s) and, when taxpayers are found to be ineligible, the examiners will make the requisite adjustments to the return to eliminate the unallowable credit. Claims disallowed by these pre-refund examinations are not improper payments because the refunds were not issued.

In addition to performing examinations of questionable claims, approximately 70 percent of which are performed before the refund is issued, soft notices are used to alert taxpayers to questionable items and encourage improved future compliance. Several fraud detection filters are in place specifically to help detect issues with claims for the EITC, CTC, and ACTC. Last year, the IRS detected specific patterns indicating potential fraud in returns with Individual Taxpayer Identification Numbers and developed filters during the filing season to stop those refunds from being issued.

Approximately 57 percent of returns claiming the EITC are prepared by tax return preparers, and we are supplementing our traditional return preparer initiatives with strategic programs intended to improve compliance with the EITC and other refundable credit provisions. Compliance and warning notices are sent before and during the filing season to preparers who prepare large numbers of returns claiming the EITC to

[3] OMB Circular A-11 Section 20.10
[4] 31 U.S.C § 1324

educate them on their responsibilities and the consequences of non-compliance. Preparer audits are performed by field examiners to ensure preparers are complying with EITC due diligence rules. We are also using data analytics to identify tax return preparers with a history of submitting incorrect or potentially fraudulent tax returns falsely claiming the EITC and related tax credits. Intervention methods used to address these preparers include letters, telephone calls, and site visits, both before and during the filing season, to allow the preparers to immediately adjust their practices. During its pilot year in 2012, this process reduced improper EITC payments by an estimated $198 million. The program was expanded in 2013 and is estimated to have prevented another $590 million in improper payments.

We disagree with the TIGTA's potential outcome measure estimate of $1.7 billion as funds put to better use for two reasons. First, as noted in the report, the outcome cannot be achieved without changes to existing legislation; an action that is beyond the control of the IRS. Second, our review of data from the recent EITC Compliance Study, covering Tax Years 2006 through 2008, found that a significant portion of EITC claims on returns without a Form W-2, *Wage and Tax Statement*, sent to the IRS and with wages reported on the return were either accurate or disallowed for reasons other than misreported wages.

Attached is our response to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Jodi L. Patterson, Director, Return Integrity and Correspondence Services, Wage and Investment Division, at (404) 338-8961.

Attachment

Attachment

Recommendation

RECOMMENDATION 1
The Commissioner, Wage and Investment Division, should ensure that the results of the ACTC Improper Payment Risk Assessment accurately reflect the high risk associated with ACTC payments and provide a reliable estimate of improper payments. Completion of the ACTC Improper Payment Risk Assessment should include an evaluation of available NRP and enforcement data when determining the overall risk of improper payments.

CORRECTIVE ACTION
We disagree with this recommendation. The Improper Payment Risk Assessment is completed for the Additional Child Tax Credit (ACTC) following the guidance of the Department of Treasury and the Office of Management and Budget (OMB). The assessment questionnaire and scoring methodology reflect operational risks associated with administration of the credit. Enforcement data and overall risks associated with administration of the ACTC are already considered by its inclusion in the tax gap estimate.

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A

Recommendation

RECOMMENDATION 2
The Commissioner, Wage and Investment Division should, as required by the IPERA, identify the root causes of the improper ACTC payments, determine if tools and/or resources are available to address erroneous ACTC payments, and establish a plan to reduce the erroneous payments and then meet that plan.

CORRECTIVE ACTION
We disagree with this recommendation. The OMB acknowledges that IRS already conducts analysis of the tax gap that incorporates these credits. Refundable tax credit non-compliance is included in the tax gap estimate and in the assessment and regular updating of our compliance strategies. The IRS considers available tools, resources, and alternative treatment options when preparing and updating compliance strategies. The reduction of erroneous payments is a primary goal of those activities.

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A

Recommendations

If the IRS is granted correctable error authority, the Commissioner, Wage and Investment Division, should:

RECOMMENDATION 3
Contract with the HHS to obtain a complete copy of the NDNH database for use during tax return processing to systemically identify unsupported wages reported on tax returns to erroneously claim the EITC.

CORRECTIVE ACTION
We disagree with this recommendation. The limited National Directory of New Hires (NDNH) data is used now in our filters when third party wage information is not yet available to the IRS on the Information Returns Master File (IRMF). An analysis was performed to determine the extent to which the NDNH data is beneficial in processing claims for the EITC. The analysis revealed that the data was being used on only a small percentage of the claims filed, and that volume is decreasing each year as wage information is posted earlier to the IRMF. The cost of obtaining the limited NDNH is significant and, under current limitations on our use of the data, we do not consider it to be a cost beneficial tool. However, as we respond to the recommendation below, we agree and are pursuing legislative authority to expand our access to and authority for use of the entire NDNH database which will be useful for identifying noncompliance, identity theft, and refund fraud.

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A

Legislative Recommendation

RECOMMENDATION 4
Work with the Assistant Secretary of the Treasury for Tax Policy to consider a legislative proposal to obtain expanded NDNH authority to systemically verify claims for other income-based refundable credits (e.g. ACTC) based on NDNH employment data.

CORRECTIVE ACTION
We agree with this recommendation. The *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals* presents a legislative request for expanded use of the NDNH database. The proposal would amend the Social Security Act to expand IRS access to NDNH data for general tax administration purposes, including data matching and verification of taxpayer claims during return processing. We believe this proposal addresses the recommendation.

IMPLEMENTATION DATE
Implemented

RESPONSIBLE OFFICIAL
Director, Return Integrity and Correspondence Services, Wage and Investment Division

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