



*Some Refundable Credits Are Still Not
Classified and Reported Correctly as a High
Risk for Improper Payment by
the Internal Revenue Service*

May 13, 2019

Reference Number: 2019-40-039

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



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HIGHLIGHTS

SOME REFUNDABLE CREDITS ARE STILL NOT CLASSIFIED AND REPORTED CORRECTLY AS A HIGH RISK FOR IMPROPER PAYMENT BY THE INTERNAL REVENUE SERVICE

Highlights

Final Report issued on May 13, 2019

Highlights of Reference Number: 2019-40-039 to the Commissioner of Internal Revenue.

IMPACT ON TAXPAYERS

The Improper Payments Elimination and Recovery Act of 2010 and subsequent legislation strengthened agency reporting requirements and redefined "significant improper payments" in Federal programs. The Office of Management and Budget has declared the Earned Income Tax Credit (EITC) Program a high-risk program that is subject to reporting in the Department of the Treasury Agency Financial Report. The IRS estimates that 25.06 percent (\$18.4 billion) of EITC payments were issued improperly in Fiscal Year 2018.

WHY TIGTA DID THE AUDIT

This audit was initiated because TIGTA is required to assess the IRS's compliance with the reporting requirements contained in the Improper Payments Elimination and Recovery Act of 2010; Executive Order 13520, *Reducing Improper Payments*; and the Improper Payment Elimination and Recovery Improvement Act of 2012. The objective of this review was to determine whether the IRS complied with annual improper payment reporting requirements for Fiscal Year 2018.

WHAT TIGTA FOUND

The IRS provided all required EITC improper payment information for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2018*. The IRS has not reduced the overall EITC improper payment rate to less than 10 percent, but it has been approved for this exception to the annual reduction target reporting requirement. As an

alternative, the Department of the Treasury and the Office of Management and Budget collaborated on the development of a series of EITC supplemental measures for use in lieu of reduction targets.

The IRS continues to incorrectly rate the improper payment risk associated with the Additional Child Tax Credit, the American Opportunity Tax Credit, and the Premium Tax Credit. The incorrect rating allows the IRS to circumvent the reporting of required information for these programs to the Department of the Treasury for inclusion in the Agency Financial Report.

TIGTA identified over 2.2 million tax returns with an income discrepancy of \$1,000 or greater from what was reported on the tax returns that were not selected for further review by the IRS. These taxpayers received over \$10.1 billion, which included \$6.0 billion in EITCs and over \$1.9 billion in Additional Child Tax Credits.

Finally, TIGTA identified that the IRS has initiated corrective actions in an effort to address prior deficiencies reported by TIGTA. These efforts are resulting in the improved identification and recovery of erroneous EITC payments.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS implement a process to systemically identify and evaluate tax returns filed by individuals who have nonwork Social Security Numbers to prevent erroneous refunds of EITCs and ACTCs.

IRS management agreed with this recommendation and plans to take appropriate corrective actions to identify and evaluate tax returns filed by individuals who use nonwork Social Security Numbers.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 13, 2019

MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Some Refundable Credits Are Still Not Classified and Reported Correctly as a High Risk for Improper Payment by the Internal Revenue Service (Audit # 201940006)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) complied with the annual improper payment reporting requirements for Fiscal Year 2018. This audit is included in our Fiscal Year 2019 Annual Audit Plan and addresses the major management challenge of Reducing Fraudulent Claims and Improper Payments.

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

Copies of this report are also being sent to the IRS managers affected by the report recommendation. If you have any questions, please contact me or Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services).



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Abbreviations

ACTC	Additional Child Tax Credit
AOTC	American Opportunity Tax Credit
EITC	Earned Income Tax Credit
IPERA	Improper Payments Elimination and Recovery Act
IPERIA	Improper Payments Elimination and Recovery Improvement Act
IPIA	Improper Payments Information Act
IRS	Internal Revenue Service
NRP	National Research Program
OMB	Office of Management and Budget
PATH Act	Protecting Americans From Tax Hikes Act of 2015
PTC	Premium Tax Credit
SSA	Social Security Administration
SSN	Social Security Number
TIGTA	Treasury Inspector General for Tax Administration



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Background

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. Agency Inspectors General have responsibility for evaluating agency information related to improper payments. The Improper Payments Information Act (IPIA) of 2002¹ requires Federal agencies, including the Internal Revenue Service (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 IPIA also requires agencies to address whether they have the information systems and other infrastructure needed to reduce improper payments. The annual report must also describe steps the agency has taken to ensure that agency managers are held accountable for reducing improper payments. The following legislation and Executive Order clarified and expanded the IPIA requirements:

- **Executive Order 13520, *Reducing Improper Payments*** – signed by the President on November 20, 2009, it increased Federal agencies’ accountability for reducing improper payments while continuing to ensure that Federal programs serve and provide access to intended beneficiaries. It requires Federal agencies to provide agency Inspectors General with detailed information on efforts to identify and reduce the number of improper payments in Federal programs with the highest dollar value of improper payments.
- **Improper Payments Elimination and Recovery Act (IPERA) of 2010**² – enacted on July 22, 2010, it amended the IPIA by strengthening agency reporting requirements and redefining “significant improper payments” in Federal programs. For Fiscal Year³ 2014 and beyond, significant improper payments are defined as gross annual improper payments (*i.e.*, the total amount of overpayments and underpayments). The gross annual improper payments is the total amount of overpayments plus underpayments made in the program during the fiscal year reported that (a) exceeded both 1.5 percent of program outlays and \$10 million of all program or activity payments or (b) exceeded \$100 million at any percent of program outlays.
- **Improper Payments Elimination and Recovery Improvement Act (IPERIA) of 2012**⁴ – enacted on January 10, 2013, it further expanded agency improper payment requirements to foster greater agency accountability. Like Executive Order 13520, the IPERIA requires the OMB Director to identify a list of high-priority Federal programs.

¹ Pub. L. No. 107-300, 116 Stat. 2350.

² Pub. L. No. 111-204, 124 Stat. 2224.

³ 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.

⁴ Pub. L. No. 112-248, 126 Stat. 2390.



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For those high-priority programs, the IPERIA requires agencies to develop additional or supplemental measures for tracking progress in reducing improper payments and submit an annual report to the Inspector General of the agency on the steps the agency has taken and plans to take to recover past and prevent future improper payments. The report is also required to be posted on a website accessible to the public.

On June 26, 2018, the OMB issued revisions to Circular A-123 Appendix C, *Requirements for Payment Integrity Improvement*. Circular A-123 Appendix C provides agencies and Inspectors General with guidance on the implementation of the IPIA as amended by the IPERA, IPERIA, and Executive Order 13520. According to the OMB, the goal of the revised Appendix C is to transform the improper payment compliance framework to create a more unified, comprehensive, and less burdensome set of requirements. For example, agencies are compliant with most improper payments reporting requirements through the Agency Financial Report.⁵ The IPERA adds an important component of accountability to the entire spectrum of improper payment efforts. Every year, each agency Inspector General reviews its agency's improper payment reporting in the agency's Agency Financial Report and any accompanying material such as that provided on paymentaccuracy.gov to determine if the agency complies with IPERA and OMB guidance.

Process to identify IRS programs for improper payment risk assessment

The Department of the Treasury (Treasury Department) identifies the programs that the IRS must assess for the risk of improper payments. For Fiscal Year 2018, the Treasury Department selected 18 IRS program fund groups. These funds were selected for assessment based on each fund groups' materiality to the IRS financial statements. However, OMB's revised guidance allows agencies to conduct improper payment risk assessments at least once every three years for programs that are deemed to be a low risk for susceptibility to significant improper payments. The IRS received approval from the Treasury Department to conduct these risk assessments on a three-year rotational schedule starting in Fiscal Year 2018. Appendix IV provides a list of the nine IRS programs for which the IRS completed an improper payment risk assessment for Fiscal Year 2018. On March 20, 2014, the OMB issued additional supplemental improper payment guidance to the Treasury Department clarifying the requirement for annual risk assessments of all refundable tax credits. The OMB guidance clarified that *all refundable credits* are subject to IPERA requirements because they can represent an additional outlay of funds by the Government. Nonrefundable tax credits reduce an individual's tax liability and represent an offset of excess taxes that were already paid to the Government. Therefore, nonrefundable tax credits do not result in an additional budget outlay.

The IRS used the *Qualitative Risk Assessment Questionnaire* for Fiscal Year 2018 (hereafter referred to as the Risk Assessment Questionnaire) and related guidance provided by the

⁵ The Agency Financial Report presents the Treasury Department's financial and performance information for the fiscal year with comparative prior year data, where appropriate.



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Treasury Department to assess the level of risk for each identified program. In response to concerns raised in prior Treasury Inspector General for Tax Administration (TIGTA) reports,⁶ the Risk Assessment Questionnaire was updated in Fiscal Year 2016 in an attempt to provide a more accurate assessment of the risk associated with the programs the Treasury Department identified. The Risk Assessment Questionnaire computes a risk score for each program based on the IRS's response to the questions it contains. The risk score determines whether there is a low, medium, or high risk of improper payments in a program. The Treasury Department establishes the level of risk for a program's improper payments. Based on the risk score, different actions are required by agencies:

- *Low-risk program* – A risk score of 0 to 28 requires agencies to monitor those programs annually through the risk assessment.
- *Medium-risk program* – A risk score of 29 to 44 requires agencies to review payment controls for improvement opportunities.
- *High-risk program* – A risk score of 45 or greater requires agencies to establish a corrective action plan.

The IRS is required to forward the results and documentation supporting the risk assessments performed to the Treasury Department. For any program identified as having a high risk for improper payments, the IRS must also provide the following information for inclusion in the Treasury 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.
- Discussion of any limitations to the IRS's ability to reduce improper payments.

⁶ TIGTA, Ref. No. 2014-40-093, *Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments* (September 2014); TIGTA, Ref. No. 2015-40-044, *Assessment of Internal Revenue Service Compliance With the Improper Payment Reporting Requirements in Fiscal Year 2014* (April 2015); and TIGTA, Ref. No. 2016-40-036, *Without Expanded Error Correction Authority, Billions of Dollars in Identified Potentially Erroneous Earned Income Credit Claims Will Continue to Go Unaddressed Each Year* (April 2016).



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The IRS updated the methodology used to identify and report the Earned Income Tax Credit (EITC)⁷ improper payment rate for Fiscal Year 2018

The OMB has previously identified the EITC as a high-risk program, and as such, an annual risk assessment is not required to be performed. The EITC is currently the only IRS high-risk program and the only program with information included in the Treasury Department's Agency Financial Report. The EITC continues to be the only IRS program that the OMB has identified as a high-priority program.

For Fiscal Year 2018, the IRS changed its improper payment rate calculations to conform to the revised guidance received from the OMB. Specifically, the IRS updated its estimation methodology to add back overclaims recovered through the IRS post-refund activities to the total overclaims amount in deriving the improper payment rate for Fiscal Year 2018. The IRS estimates that 25.06 percent (\$18.4 billion) of EITC payments made in Fiscal Year 2018 were improper payments.

This review was performed with information obtained from the Office of the Chief Financial Officer and the Office of Research, Applied Analytics, and Statistics located at the IRS Headquarters in Washington, D.C., and the Small Business/Self-Employed Division's Examination Operations in Philadelphia, Pennsylvania, during the period October 2018 through March 2019. In addition to assessing the IRS's compliance with the improper payment reporting requirements, we also evaluated the effectiveness of the IRS's use of select tools to prevent and recover erroneous refundable credit payments. 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.

⁷ The EITC is used to offset the impact of Social Security taxes on low-income families and to encourage them to seek employment.



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Results of Review

The Internal Revenue Service Is Not in Compliance With Improper Payment Reporting Requirements

The IRS continues to incorrectly rate improper payments associated with the Additional Child Tax Credit (ACTC), American Opportunity Tax Credit (AOTC), and Premium Tax Credit (PTC) as a medium risk. This rating is contrary to the IRS's own National Research Program (NRP), compliance data, and compliance studies, which identify an estimated improper payment amount, as defined by OMB guidance that exceeds the amount that warrants a high-risk rating for each of these credits. As a result, the IRS continues to significantly understate its estimate of improper payments in its reports to the OMB and Congress. Further, the inaccurate risk rating continues to allow the IRS to circumvent the reporting of required information to the Treasury Department for inclusion in the Agency Financial Report. For example, the IRS does not report on:

- The rate and amount of improper payments.
- The causes of improper payments and the agency's plans to address them.
- Reduction targets.
- Limitations to the agency's ability to reduce improper payments, including legislative limitations.

IRS compliance studies identify a high risk of improper payments associated with the ACTC and AOTC, yet the IRS erroneously classifies these as a medium risk

In Fiscal Years 2017 and 2018, the IRS completed an in-depth analysis using the data from its NRP individual income tax reporting compliance studies to provide an overview of taxpayer compliance behavior regarding the ACTC and AOTC. Our review of the IRS's compliance studies found the results to be consistent with TIGTA's prior estimated improper payments for these two credits for which the dollar amount exceeds the IPERA criteria for a high risk of improper payments. Based on the compliance studies conducted by the IRS, the potential ACTC and AOTC improper payment rates⁸ were computed as follows:

⁸ TIGTA estimated the potential ACTC and AOTC improper payment rates using the IRS's estimated overclaims and underclaimed amounts presented in its compliance study reports.



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- ACTC – The IRS estimates that nearly 33 percent (\$8.7 billion) of ACTC payments made during Tax Years 2009 through 2011 were likely improper.
- AOTC – The IRS estimates that over 31 percent (\$5.3 billion) of AOTC payments made during Tax Year 2012 were likely improper.

The potential estimated overclaims and underclaims reported by the IRS in its compliance studies for the ACTC and AOTC confirm that the improper payments, as defined by OMB guidance, meet the IPERA guidelines for rating as a high risk. Programs are to be rated as high risk when they are susceptible to significant improper payments under the IPIA. Per the OMB, significant improper payments are defined as gross annual improper payments in the program exceeding (a) both 1.5 percent of program outlays and \$10 million of all program or activity payments made during the fiscal year reported or (b) \$100 million regardless of the improper payment percentage of total program outlays. OMB Circular A-123 Appendix C, Part I Section C,⁹ requires agencies to institute a systemic method to identify programs susceptible to significant improper payments once every three years. The guidance states:

This systematic method could be a quantitative evaluation based on a statistical sample or a qualitative method (e.g., a risk-assessment questionnaire). Improper payment risk assessments conducted prior to Fiscal Year 2020 may use qualitative or quantitative methods. Beginning in Fiscal Year 2020, programs with outlays for a 12-month period exceeding \$5 billion should use a quantitative evaluation as the systematic method for review. If a program used a qualitative method prior to Fiscal Year 2020, the program may consider continuing to use the method unless the IPERA compliance review has identified that the previously used qualitative method did not reasonably support whether the program's improper payments were above or below the statutory threshold established under IPIA.

OMB Circular A-123 does not direct agencies to use one method of assessment over another unless the risk of improper payment is significant. Rather, the guidance provides agencies an example of the methods that could be used to evaluate risk. Our evaluation of the IRS's improper payment risk assessment methodology has continually shown that the IRS's repeated use of a qualitative evaluation does not provide an accurate assessment of the risk of improper payments. However, the IRS reported in the Fiscal Year 2018 Agency Final Report that it will begin developing a methodology that will quantitatively analyze and estimate improper payments for the ACTC and AOTC. This methodology will use data from the NRP to calculate ACTC and AOTC error rates going forward.

⁹ OMB Circular A-123 Appendix C, Part I Section C, Item 2.



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**Quantitative analysis identifies the risk of improper Net PTC payments as high,
yet the IRS erroneously classifies it as a medium risk**

In Fiscal Year 2015, the OMB established an interagency working group that included representatives from the IRS, the Treasury Department, and the Department of Health and Human Services' Centers for Medicare and Medicaid Services to complete a comprehensive risk assessment for the PTC. The interagency working group agreed that the Centers for Medicare and Medicaid Services would be responsible for assessing risks and developing improper payment error rates for Advance PTC¹⁰ payments, and the IRS would be responsible for assessing risk and, if necessary, developing improper payment error rates for PTC payments made in response to taxpayers reconciling the Advance PTC on their tax returns. Payments of the PTC made due to the reconciliation on the tax return are referred to as the Net Premium Tax Credit, or Net PTC.

In April 2016, we first reported that the IRS's methodology to assess the PTC does not include a quantitative assessment and, as such, its assessment of an improper payment risk associated with the PTC is unreliable. In Fiscal Year 2017 and now for Fiscal Year 2018, the IRS continues to use a qualitative assessment and incorrectly rates the improper payment risk associated with the Net PTC as medium. However, in October 2018, the IRS completed a quantitative analysis of the Net PTC using the NRP data to calculate a Net PTC error rate for Tax Year 2014 tax returns (the first year for which the PTC was available) in response to a recommendation to an audit completed by the Government Accountability Office.¹¹ According to the IRS's own analysis of its compliance data, the estimated error rate was 41 percent (\$440 million) of Net PTC payments. The IRS's analysis confirmed that Net PTC improper payments, as defined by OMB definition, would likely exceed the improper payment reporting thresholds of a high risk.

IRS management cautioned that the Net PTC error rates may change as additional compliance data become available. Although the NRP sample provides unbiased estimates of compliance, the number of returns claiming Net PTC in the Tax Year 2014 sample used for the analysis was small and the margin of error for the Net PTC overclaim percentage is approximately ± 18 percentage points. We reported in December 2018, a total of \$3.7 billion claimed in Advance PTCs was in excess of the amount of PTCs to which taxpayers were entitled. Of this amount, a total of \$1 billion is not required to be repaid.¹²

¹⁰ Advance Premium Tax Credit is a tax credit that is paid in advance to a taxpayer's insurance company to help cover the cost of premiums.

¹¹ GAO. Ref. No. GAO-17-467, *Improper Payments: Improvements Needed in CMS and IRS Controls over Health Insurance Premium Tax Credit* (July 2017).

¹² The Affordable Care Act limits the amount of tax that individuals with income between 100 percent and 400 percent of the Federal Poverty Level will have to repay.



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Assessment of Fiscal Year 2018 Compliance With Earned Income Tax Credit Improper Payment Reporting Requirements

As previously noted, the OMB has identified the EITC as a high-risk program. As such, the IRS is required to report annually on its efforts to reduce EITC improper payments. Our review confirmed that the IRS provided all required EITC improper payment information to the Treasury Department for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2018*. The IRS has not reduced the overall EITC improper payment rate to less than 10 percent; however, it has been approved for this exception to the annual reduction target reporting requirement. As an alternative, the Treasury Department and the OMB collaborated on the development of a series of EITC supplemental measures for use in lieu of reduction targets. The OMB approved these supplemental measures on August 27, 2014, and the measures were published in the *Department of the Treasury Agency Financial Report Fiscal Year 2014* as required. The supplemental measures are:

- **The Annual Error Rate** – identifies the percentage of total EITC payments that were improper.
- **The Amount of Revenue Protected** – shows the total value of erroneous payments prevented or recovered through compliance activities.
- **The Amount of Revenue Protected From Paid Preparer Treatments** – shows dollars erroneously or fraudulently claimed by paid tax preparers but not paid out or recovered by the Treasury Department.
- **The Number of Preparer Due Diligence Penalties Proposed** – reflects the effectiveness of the Treasury Department efforts to ensure that paid tax preparers are submitting accurate, nonfraudulent EITC claims on behalf of taxpayers.

Figure 1 provides a summary of our evaluation of IRS compliance with the various improper payment reporting requirements, including the reporting of supplemental measures.

Figure 1: IRS Compliance With Improper Payment Requirements for the EITC Program for Fiscal Year 2018

Improper Payment Requirement	Source of Requirement	Provided by IRS
Conduct a program-specific risk assessment for each program or activity identified by the Treasury Department.	IPERA	Yes
Publish an improper payment estimate for the EITC.	IPERA	Yes
Report an improper payment rate of less than 10 percent for the EITC.	IPERA	No
Provide the methodology for identifying and measuring EITC improper payments.	Executive Order	Yes



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Improper Payment Requirement	Source of Requirement	Provided by IRS
Publish EITC improper payment supplemental measures in lieu of annual reduction targets for the EITC.	OMB / Treasury Department	Yes
Provide plans and supporting analysis for meeting the reduction targets for EITC improper payments.	Executive Order	Yes
Publish a programmatic corrective action plan for the EITC.	IPERA	Yes
Report on actions the IRS intends to take to prevent future EITC improper payments.	IPERIA	Yes
Report on efforts taken or planned to recapture EITC improper payments.	IPERA / IPERIA	Yes
Provide plans and supporting analysis for ensuring that the initiatives undertaken do not unduly burden program access and participation by eligible beneficiaries.	Executive Order	Yes
Provide required EITC information for posting to the paymentaccuracy.gov website.	Executive Order / IPERIA	Yes
Submit quarterly reports to TIGTA and the Council of the Inspectors General on Integrity and Efficiency and make available to the public a report on EITC improper payments identified by the agency.	Executive Order	N/A ¹³

Source: TIGTA's review of IRS EITC information provided to the Treasury Department for inclusion in the Department of the Treasury Agency Financial Report Fiscal Year 2018.

[Notwithstanding Earlier Income and Withholding Reporting, a Majority of Discrepancies Are Still Not Addressed Due to Limited Resources](#)

Our analysis of Tax Year 2017 tax returns identified over 22.8 million Tax Year 2017 tax returns that claimed the EITC and/or ACTC. We matched Forms W-2, *Wage and Tax Statement*, received by the IRS as of December 27, 2018, to the wages reported on the 22.8 million tax returns to evaluate whether the income reported by the taxpayers on these tax returns was supported by third-party Forms W-2. We identified over 2.2 million tax returns with an income discrepancy of \$1,000 or greater from what was reported on the returns to what was reported on Forms W-2 that were not selected for further review by the IRS. Refunds associated with these tax returns totaled over \$10.1 billion, which included \$6.0 billion in EITC and over \$1.9 billion in ACTC. For 278,174 of the returns, we identified that the IRS received no third-party Forms W-2 supporting the wages reported on the returns (for which over \$1.0 billion in EITCs

¹³ Effective for Fiscal Year 2014 forward, the dollar threshold for which agencies are required to report quarterly high-dollar improper payments is \$25,000 per individual. Because the maximum EITC an individual can receive is well below the \$25,000 threshold, the IRS would not be required to report any quarterly high-dollar payments for Fiscal Year 2014 forward.



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and/or ACTCs was paid). Figure 2 shows the type of income discrepancy on the 2.2 million returns that the IRS did not select for review.

**Figure 2: Tax Year 2017 Tax Returns With a Wage Discrepancy
That Were Not Selected for Either Fraud or Examination Review¹⁴**

Wage Discrepancy Type	Returns	Refunds Received	EITC Received	ACTC Received
Returns – No Form(s) W-2 Received Supporting Wages Reported	278,174	\$1,187,961,097	\$792,354,216	\$248,826,661
Returns – Forms W-2 received:				
More Income Reported on Return	563,916	\$2,748,108,753	\$1,649,361,223	\$563,446,176
Less Income Reported on Return	1,430,894	\$6,253,273,499	\$3,583,230,613	\$1,172,386,071
Total	2,272,984¹⁵	\$10,189,343,349	\$6,024,946,052	\$1,984,658,908

Source: TIGTA analysis of Individual Master File,¹⁶ Information Returns Master File,¹⁷ and Form W-2 data for tax returns processed as of May 3, 2018, for which the wage discrepancy was \$1,000 or greater.

The amount of EITC and ACTC a taxpayer receives is directly related to the amount of income reported on the tax return. As such, some taxpayers may be motivated to erroneously report more or less income to increase the amount of refundable credits they could receive. However, as we continue to report, IRS compliance resources are limited. Consequently, the IRS does not address the majority of potentially erroneous EITC claims despite having established processes that identify billions of dollars in potentially erroneous EITC payments. TIGTA is conducting a separate audit of the IRS’s NRP cases to identify and quantify the reasons taxpayers’ claims are adjusted.

¹⁴ Some of the discrepancies we identified could be the result of employers not submitting accurate Forms W-2 to the IRS and may not necessarily be erroneous. The actual amount of the refund will only be known if returns with income discrepancies are identified and reviewed to determine the validity of the income reported in support of refundable credits claimed.

¹⁵ Total includes 170,516 tax returns where taxpayers entered “HSH,” which indicates they received wages as a household employee.

¹⁶ The IRS database that maintains transactions or records of individual tax accounts.

¹⁷ Creates a Master File of current tax year information returns and maintains access to nine prior years.



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The IRS continues to request additional authority (referred to as correctable error authority or math error authority) that would allow it to correct tax returns with identified erroneous refundable credit claims during processing

The Protecting Americans From Tax Hikes Act of 2015 (PATH Act)¹⁸ requires employers and third parties to file Form W-2 and report nonemployee income on Form 1099-MISC, *Miscellaneous Income*, by January 31 each year. The PATH Act also prohibits the IRS from issuing tax refunds prior to February 15 when the tax return includes the EITC or the ACTC. Although the PATH Act gives the IRS more time to verify these claims before refunds are issued, it did not expand the IRS's authority to systemically correct erroneous claims that are identified at the time tax returns are processed. The IRS must still audit each tax return to prevent or recover these unsupported refundable credits.

As we have continued to report in our annual assessment of IRS efforts to reduce improper refundable credit payments, the IRS's use of traditional compliance tools is not resulting in any significant reduction in refundable credit improper payments. Currently under the Internal Revenue Code, the IRS can use its math error authority¹⁹ to address erroneous EITC claims by systemically correcting mathematical or clerical errors such as correcting entries made on the wrong line on the tax return or mathematical errors in computing income or the EITC. The IRS must conduct an audit to address potentially erroneous refundable credit claims for which it does not have math error authority. The IRS estimated that it costs \$1.67 to resolve an erroneous EITC claim using math error authority, compared to \$425.22 to conduct a pre-refund audit. 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.

The IRS has repeatedly requested additional authority that would allow it to correct tax returns during processing when:

- The information provided by the taxpayer does not match the information contained in Government databases (*e.g.*, income information reported on the tax return does not match Form W-2 information the IRS receives from the Social Security Administration (SSA)).
- The taxpayer has exceeded the lifetime limit for claiming a deduction or credit. For example, in January 2018, we reported that billions of dollars in potentially erroneous AOTCs continue to be issued. This included our identifying over 600,000 tax returns for which a student claimed had already been claimed for the AOTC for four years.²⁰ We

¹⁸ Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, 129 Stat. 2242 (2015).

¹⁹ Correctable error authority and math error authority are synonymous. Both terms can be used to describe the IRS's authority to systemically correct erroneous claims at the time tax returns are processed.

²⁰ The American Recovery and Reinvestment Act of 2009 (Pub. L. No. 111-5, § 1001, 123 Stat. 115, subsequently amended by the Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296) allows the AOTC for the first four years of postsecondary education.



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estimate these taxpayers received more than \$1 billion in erroneous AOTCs. The number of potentially erroneous AOTC claims that the IRS can audit is dependent on available resources. According to IRS management, as of August 21, 2017, the IRS has completed audits of 7,047 returns associated with Tax Years 2015 and 2016 claims resulting in assessments totaling more than \$8.8 million.

- The taxpayer has failed to include documentation with his or her return that is required by statute.

Actions Are Being Taken to Address Our Prior Recommendations

Our review identified that the IRS has initiated corrective actions in an effort to address prior deficiencies reported by TIGTA. These efforts are resulting in the improved identification and recovery of erroneous EITC payments. For example:

- **A pilot program was initiated to identify and address erroneous EITC claims by individuals issued a “nonwork” Social Security Number (SSN).**²¹ In July 2017,²² we reported that the IRS still had not established processes to prevent individuals who have a nonwork SSN from receiving the EITC. As a result, 49,310 individuals who are not authorized to work in the United States received almost \$117.7 million in potentially erroneous EITCs in Tax Year 2014. In response, the IRS initiated a pilot program to identify 500 tax returns with EITC claims during processing in which claimants were issued a nonwork SSN and, as such, do not qualify for the EITC.²³ The claimant is asked to provide documentation that he or she no longer has a nonwork SSN (now has one that is valid for work) and as such qualifies for the EITC claimed. If the claimant cannot provide the documentation or fails to respond to the notice, the IRS will disallow the credit. The Tax Cuts and Jobs Act, enacted in December 2017,²⁴ changed the requirements for the ACTC to now require a valid SSN for each qualifying dependent to claim the credit.²⁵

For the 2018 Filing Season, IRS management indicated that they identified 341 tax returns for which taxpayers agreed that they were not entitled to the EITC or did not

²¹ A nonwork SSN is issued for obtaining Federal benefits (e.g., Medicaid or food stamps) and is not valid for work. The SSA has issued almost eight million “NOT VALID FOR EMPLOYMENT” SSNs since 1972 to individuals who do not have authorization to work in the United States.

²² TIGTA, Ref. No. 2017-40-042, *Processes Do Not Maximize the Use of Third-Party Income Documents to Identify Potentially Improper Refundable Credit Claims* (July 2017).

²³ The Personal Responsibility and Work Opportunity Reconciliation Act of 1996, enacted August 22, 1996, requires individuals claiming the EITC to have a valid-for-work SSN and authorizes the IRS to deny claims to those individuals who file using an invalid SSN. The taxpayer, spouse (if married filing jointly), and each qualifying child must have a valid SSN to be eligible to claim the EITC.

²⁴ Pub. L. 115-97, 131 Stat. 2054.

²⁵ Individuals without a valid SSN may claim a credit of up to \$500.



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provide a valid response within the suspense time frame. As a result, the IRS protected approximately \$1.3 million in revenue. For the 2019 Filing Season, the IRS expanded the testing to 1,000 selections over a 10-week period.

- **Interim processes are being developed in an effort to better use SSA transcript information to identify and recover erroneous refundable credit claims.** In response to our prior audit recommendations, the IRS has taken steps to use SSA Self-Employment income information to improve its audit selection process. Since December 2016, all SSA Self-Employment transcripts meeting basic criteria (*i.e.*, questionable Schedule C, *Profit or Loss From Business (Sole Proprietorship)*, and refundable credits claimed) have been transcribed and included in the established processes of filtering and classifying returns for examinations. In Calendar Year 2017, the IRS developed methods to scan the SSA Self-Employment income adjustment records and convert the images to digital data as an interim solution. As of September 2018, the IRS has created 1,468 exam cases from 11,552 leads through the scanning process.

The development of the fully digital transfer from the SSA to the IRS has required steady cooperation between the agencies. The IRS originally anticipated that the new memorandum of understanding would be signed in February 2019. However, the implementation of the project has been delayed. According to the IRS, the SSA started its development efforts. However, programming will not be completed until after the memorandum of understanding has been signed. IRS management expects the memorandum of understanding to be signed by the end of Fiscal Year 2019.

Recommendation

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Based on the results of the nonwork SSN pilot conducted in Processing Years²⁶ 2018 and 2019, implement a process to systemically identify and evaluate tax returns filed by individuals who have nonwork SSNs to prevent erroneous refunds of EITCs and ACTCs.

Management's Response: The IRS agreed with this recommendation and plans to continue the pilot to identify and evaluate tax returns for potential inclusion in its annual compliance plan where nonwork SSNs are used.

²⁶ The calendar year in which the tax return or document is processed by the IRS.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS complied with the annual improper payment reporting requirements for Fiscal Year¹ 2018. This review evaluated the IRS's compliance with the reporting requirements contained in the IPERA of 2010;² Executive Order 13520, *Reducing Improper Payments*;³ and the IPERIA of 2012.⁴ The scope of this review included an assessment of the information that the IRS provided for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2018*. To accomplish our objective, we:

- I. Reviewed the *Department of the Treasury Agency Financial Report Fiscal Year 2018*, published on November 15, 2018, to determine if the IRS was in compliance with the improper payment reporting requirements for Fiscal Year 2018. We compared the information contained in the Agency Financial Report to the improper payment reporting requirements outlined in Appendix C to OMB Circular A-123, *Requirements for Payment Integrity Improvement*,⁵ guidance on improper payment reporting.
 - A. Determined if the IRS was in compliance with IPERA reporting requirements.
 - B. Determined if the IRS was in compliance with IPERIA reporting requirements.
 - C. Determined if the IRS was in compliance with Executive Order 13520 reporting requirements.
 - D. Reviewed information that the IRS provided to the Treasury Department for posting to the paymentaccuracy.gov website.
 - E. Determined if the information included in the *Department of the Treasury Agency Financial Report Fiscal Year 2018* relative to EITC improper payments accurately reflects the underlying information from the IRS and was posted to paymentaccuracy.gov or other Internet locations as required.
 - F. Evaluated the adequacy of the IRS's updated methodology to calculate the EITC improper payment rate and dollar amount. Specifically, we determined if the IRS

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 Pub. L. No. 111-204, 124 Stat. 2224.

³ Executive Order 13520, *Reducing Improper Payments* (November 20, 2009).

⁴ Pub. L. No. 112-248, 126 Stat. 2390.

⁵ June 2018.



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- revised the methodology used to compute the EITC improper payment rate and dollar amount since Fiscal Year 2017.
- II. Evaluated the adequacy of the IRS's Fiscal Year 2018 risk assessments for revenue program funds identified by the Treasury Department.
- A. Ensured that the required Risk Assessment Questionnaire was completed for each revenue program fund and identified the risk level for each.
 - B. Ensured that the IRS determination of improper payment risk is consistent with the potential ACTC improper payment rate (or noncompliance rate).
 - C. Ensured that the IRS determination of improper payment risk is consistent with the potential AOTC improper payment rate (or noncompliance rate).
 - D. Evaluated the IRS's efforts to evaluate the risk of PTC improper payments.
 - 1. Obtained information regarding the OMB interagency working group's progress on defining PTC improper payments and assessing their risk.
 - 2. Determined the steps the IRS took to assess the risk of PTC improper payments for Fiscal Year 2018. We determined if the process used provides a reasonable assessment of the risk of improper PTC payments for Fiscal Year 2018.
- III. Followed up on select prior audit findings to ensure that the IRS has taken the agreed-upon action to resolve the issues.
- A. Determined if the IRS is now receiving the SSA Self-Employment transcripts through electronic format and its plans for using the electronic transcripts.
 - B. Determined if the IRS has taken action to analyze the available nonwork SSN data and evaluate their usefulness in identifying potentially fraudulent EITC claims.
 - C. Determined if the IRS developed effective processes and procedures to identify and prevent the issuance of EITC and ACTC payments when the income reported on the tax return is not supported by Forms W-2, *Wage and Tax Statement*.
 - 1. Performed further data analysis on the 22 million Tax Year 2017 tax returns claiming the EITC and the ACTC identified in our December 2018 audit report.⁶
 - a. Identified tax returns for which the income claimed is more than that reported on Forms W-2. We quantified the impact of overclaiming income.
 - b. Identified tax returns for which the income claimed was less than reported on Forms W-2. We quantified the impact of underclaiming income.

⁶ TIGTA, Ref. No. 2019-40-013, *Results of the 2018 Filing Season* (December 2018).



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2. Determined if the tax returns were selected for further review to confirm the legitimacy of the wage income reported on the return in support of the EITC or ACTC claimed.
3. Provided examples of the cases above to the IRS for its review and determination as to how the refund bypassed IRS controls.

Data Validation Methodology

During this review, we relied on data extracts obtained from the IRS's Individual Master File,⁷ the Individual Return Transaction File⁸ databases for Processing Year⁹ 2018, and the Forms W-2 File¹⁰ for Tax Year 2017 that were available on TIGTA's Data Center Warehouse.¹¹ Before relying on the data, we ensured that each file contained the specific data elements we requested. In addition, we selected random samples of each extract and verified that the data in the extracts were the same as the data captured in the IRS's Integrated Data Retrieval System.¹² We also performed an analysis to ensure the validity and reasonableness of our data such as ranges of dollar values, transaction dates, and tax periods. Based on the results of our testing, we believe that the data used in our review were 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 ensure that the IRS met the annual improper payment reporting requirements established in the IPERA, Executive Order 13520, and the IPERIA. We tested these controls by reviewing and analyzing relevant documents, data, and calculations related to the preparation of EITC improper payment estimate information.

⁷ The IRS database that maintains transactions or records of individual tax accounts.

⁸ A database the IRS maintains that contains information on the individual tax returns it receives.

⁹ The calendar year in which the tax return or document is processed by the IRS.

¹⁰ The Form W-2 database is created by TIGTA using IRS information reported on Forms W-2 for each tax year.

¹¹ A TIGTA repository of IRS data.

¹² IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



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Appendix II

Major Contributors to This Report

Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services)

Sharla J. Robinson, Acting Director

Linna K. Hung, Audit Manager

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Michael J. Bibler, Auditor



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Appendix III

Report Distribution List

Chief Financial Officer
Deputy Commissioner for Operations Support
Deputy Commissioner for Services and Enforcement
Commissioner, Wage and Investment Division
Chief, Research, Applied Analytics, and Statistics
Director, Office of Legislative Affairs
Director, Office of Program Evaluation and Risk Analysis
Director, Return Integrity and Compliance Services, Wage and Investment Division
Director, Office of Audit Coordination



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Appendix IV

*Internal Revenue Service Programs Identified
for Improper Payment Risk Assessments*

The following IRS programs were identified by the Treasury Department for improper payment risk assessments for Fiscal Year 2018.

IRS Program	Type of Program	Level of Risk Identified
Headquarters Disbursement Earned Income Credit ¹	Revenue	High
Additional Child Tax Credit	Revenue	Medium
American Opportunity Tax Credit	Revenue	Medium
Premium Tax Credit	Revenue	Medium
Informant Reimbursement	Revenue	Low
Taxpayer Services	Administrative	Low
Tax Law Enforcement	Administrative	Low
Operations Support	Administrative	Low
Business Systems Modernization	Administrative	Low

Source: IRS Office of the Chief Financial Officer.

¹ The EITC Program has been declared a high-risk program for improper payments by the OMB; therefore, no formal risk assessment is required for this revenue fund. The Earned Income Credit and EITC are the same credit.



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Appendix V

Management's Response to the Draft Report




CHIEF FINANCIAL OFFICER

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

May 6, 2019

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Ursula S. Gillis 
Chief Financial Officer

SUBJECT: Response to Draft Audit Report – Some Refundable Credits Are
Still Not Classified and Reported Correctly as a High-Risk for
Improper Payment by the Internal Revenue Service
(Audit #201940006)

Thank you for the opportunity to review and comment on your draft audit report entitled, *Some Refundable Credits Are Still Not Classified and Reported Correctly as a High-Risk for Improper Payment by the Internal Revenue Service*. We continue to administer the refundable tax credit (RTC) programs effectively – including the Earned Income Tax Credit (EITC), the American Opportunity Tax Credit (AOTC), the Additional Child Tax Credit (ACTC), and the Premium Tax Credit (PTC) component of the Affordable Care Act (ACA) – despite significant challenges resulting from the nature of tax credits and the lack of information needed to verify taxpayer eligibility and claims at the time a return is filed. The RTCs' complex and numerous rules make it difficult for taxpayers to sort through complicated family relationships and residency arrangements to determine eligibility. This complexity contributes to the relatively high overclaim rates for these credits. We also lack third-party information that we could use to verify eligibility for the RTCs since the information needed may not be available when returns are processed, may be unreliable, or may not exist. Further, our limited statutory authority prevents pre-refund changes or corrections to taxpayer returns while resource constraints preclude the expansion of existing compliance programs to reduce RTC overclaims significantly or to increase recoveries.

We appreciate your acknowledgement of these challenges and your discussion of potential statutory changes that could help us reduce erroneous claims in a pre-refund environment. We reach out to and educate taxpayers and tax practitioners to reduce fraud and errors and to protect revenue, and we pursue traditional compliance activities where incorrect payments are made. However, we could accomplish more with additional tools. The President's FY 2020 budget submission proposes several legislative changes that would facilitate tax administration. These proposals include: (1) increasing oversight of paid tax return preparers to help reduce the need for



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post-refund enforcement activity, (2) providing more flexible authority for the IRS to address correctable errors when taxpayers claim credits for which they are ineligible or for which they exceed their lifetime limit, or when they fail to submit required documentation, (3) improving clarity in worker classification and information reporting requirements, (4) expanding mandatory electronic filing of Forms W-2, and (5) requiring a Social Security Number (SSN) that is valid for employment to claim EITC, the child tax credit and credit for other dependents.

Each year we evaluate the RTCs and other programs to determine the risk of susceptibility to improper payments. The purpose of the risk assessment process is to evaluate the strength of program controls and to determine overall susceptibility. In FY 2018, our assessments once again indicated that RTC overclaims are not rooted in internal control weaknesses, financial management deficiencies or reporting failures, but instead, result from the eligibility rules and the statutory construction of the credits. We do not agree with your conclusion that Treasury's qualitative risk assessment approach is an attempt to circumvent the reporting requirements of the Improper Payments Elimination and Recovery Act (IPERA). The IRS has published RTC compliance studies that detail overclaim rates by dollar and percentage, including in the FY 2018 Treasury Agency Financial Report (AFR) in Section A: Tax Gap and Tax Burden, pages 147-148.

We have expressed past concerns about the identification of overclaims of refundable tax credits as improper payments based on the definition included in IPERA and related legislation. We reiterate that while we support the intent of IPERA, the nature of the RTCs means that the IRS cannot design and implement effective countermeasures to erroneous RTC payments without additional statutory authority. However, we acknowledge stakeholder concerns and public interest in this matter, so we have committed to analyzing and reporting quantitatively on improper payments for AOTC and ACTC (in addition to the EITC and PTC calculations we already perform), with the intention of having results available to report, as necessary, in the FY 2019 Treasury AFR.

We appreciate your attestation of the actions we have taken to address prior recommendations. These include deploying a pilot program to identify instances in which nonwork SSNs are used in EITC claims and initializing steps to establish a memorandum of understanding with the Social Security Administration to use their self-employment income information to improve the audit process. We plan to continue these efforts in the future, consistent with your recommendation and our ongoing efforts to improve voluntary compliance.

If you have any questions, please contact me at 202-317-6400, or a member of your staff may contact John Pekarik, Associate Chief Financial Officer for Internal Controls, at 202-803-9151.

Attachment



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Attachment

Recommendation

The Commissioner, Wage and Investment Division, should:

Based on the results of the nonwork SSN pilot conducted in Processing Years 2018 and 2019, implement a process to systemically identify and evaluate tax returns filed by individuals who have nonwork SSNs to prevent erroneous refunds of EITCs and ACTCs.

IRS Response

The IRS agrees with the recommendation. We will continue the pilot to identify and evaluate tax returns for potential inclusion in our annual compliance plan where nonwork SSNs are used.

Responsible Official

Director, Refundable Credits Policy and Program Management
Return Integrity and Compliance Services
Wage and Investment Division

Due Date

April 30, 2020