

**HEARING BEFORE THE  
COMMITTEE ON WAYS AND MEANS  
SUBCOMMITTEE ON OVERSIGHT  
U.S. HOUSE OF REPRESENTATIVES**

**“Improper Payments in the Administration of  
Refundable Tax Credits”**



**May 25, 2011  
Washington, D.C.**

**Testimony of  
The Honorable J. Russell George  
Treasury Inspector General for Tax Administration**

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THE HONORABLE J. RUSSELL GEORGE  
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION  
*before the*  
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Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee, I thank you for the opportunity to testify on the Internal Revenue Service’s administration of refundable tax credits.

Refundable credits were designed to help low-income individuals reduce their tax burden or to provide incentives for other activities. The Earned Income Tax Credit (EITC), created in 1975, is used to offset the impact of Social Security taxes on low-income families and to encourage them to seek employment rather than welfare.<sup>1</sup> Prior to the enactment of the *Taxpayer Relief Act of 1997*,<sup>2</sup> the tax law did not provide tax credits based solely on a taxpayer’s number of dependent children. Congress then created the Child Tax Credit and the Additional Child Tax Credit (ACTC) because the individual income tax structure did not reduce tax liability enough to reflect a growing family’s reduced ability to pay taxes as family size increased. In addition, the Congress further believed that a tax credit for families with dependent children would reduce their individual income tax burden, better recognize the financial responsibilities of raising dependent children, and promote family values.<sup>3</sup>

More recent refundable credits provide incentives for other activities, such as buying a home, obtaining a college education, and adopting a child. The First-Time Homebuyer Credit (Homebuyer Credit) was enacted to encourage home purchases to stimulate the weak housing market. The American Opportunity Tax Credit allows

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<sup>1</sup> Tax Reduction Act of 1975 § 204, 26 U.S.C § 32.

<sup>2</sup> Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C.A.).

<sup>3</sup> Staff of Joint Committee on Taxation, 105th Cong., General Explanation of Tax Legislation Enacted in 1997 (Comm. Print 1997).

individuals to receive a credit for higher education expenses. The Adoption Credit<sup>4</sup> allows individuals to offset qualified adoption expenses, making adoption possible for some families who could not otherwise afford these expenses.

The two largest refundable credits, the EITC and ACTC, receive a much larger appropriation than the IRS's own budget. For the 2011 Filing Season, the maximum EITC is \$5,666; while the ACTC is generally limited to 15 percent of earned income in excess of \$3,000.<sup>5</sup> The appropriations for these credits in Fiscal Year 2010 were \$54.7 billion for the EITC and \$22.7 billion for the ACTC. In contrast, the IRS's total Fiscal Year 2012 budget request is \$13.3 billion.

These appropriations continue to grow as a result of recent legislative changes that have increased the number of individuals eligible for the credit and the amount individuals can claim. For example, the *American Recovery and Reinvestment Act of 2009* (Recovery Act)<sup>6</sup> temporarily increased for Tax Years<sup>7</sup> 2009 and 2010 the EITC percentage for individuals with three or more children from 40 to 45 percent of the individuals first \$12,570 of earned income. Also, the income limit used for calculating the credit was increased for married individuals filing a joint tax return.

In addition, the Recovery Act temporarily increased the number of individuals eligible for the credit by changing the income threshold for calculating the ACTC for Tax Years 2009 and 2010. Prior to the Congress enacting the Recovery Act, the ACTC would have been limited to 15 percent of earned income over \$12,550. The Recovery Act changed this threshold to 15 percent of earned income over \$3,000. As such, more individuals were eligible to claim the ACTC or a greater amount.

Although each of these refundable credits provides benefits to individuals, the unintended consequence of these credits is that they are often the targets of unscrupulous individuals who file erroneous claims for these credits. In its June 14, 2010, report to TIGTA, the IRS noted that they have found that refundable credits of significant amounts attract fraud.<sup>8</sup> In particular, refundable tax credits present an additional avenue for individuals to commit filing fraud. Nonrefundable tax credits are

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<sup>4</sup> Small Business Job Protection Act of 1996, Pub.L. No. 104-188 110 Stat. 1755 (codified in scattered sections of 26 U.S.C, 42 U.S.C. and 19 U.S.C.).

<sup>5</sup> The ACTC is the refundable portion of the Child Tax Credit. This credit phases out for taxpayers depending upon their income level. Taxpayers with earned income of less than \$3,000 may be eligible for a refundable credit if they have three or more qualifying children and have paid Social Security taxes that exceed their EITC.

<sup>6</sup> Pub. L. No. 111-5, 123 Stat.115.

<sup>7</sup> The 12-month period for which tax is calculated. For most individual taxpayers, the tax year is synonymous with the calendar year.

<sup>8</sup> IRS, Initial Report on Earned Income Tax Credit (EITC) Improper Payments, pursuant to Executive Order 13520: Reducing Improper Payments (June 14, 2010).

limited to the amount of an individual's income tax liability. As such, the maximum benefit an individual will receive if a nonrefundable credit is claimed inappropriately is to fully offset his or her tax liability resulting in owing nothing. Refundable credits do not have such limitations. In essence, individuals can obtain money that they did not earn and to which they are not entitled simply by claiming a refundable tax credit. Refundable credits can result in tax refunds even if no income tax is withheld or paid; that is, the credits can exceed the liability for the tax.

The total amount of improper payments relating to refundable credits far exceeds the amount of fraudulent tax refunds the IRS identifies and stops as part of its Taxpayer Assurance Program. The IRS estimates the improper payments for the earned income tax credit are between \$11 to \$13 billion each year. The IRS's Taxpayer Assurance Program, formerly known as the Questionable Refund Program, was set up to identify and stop fraudulent refunds. As of March 4, 2011, the IRS had identified 335,341 tax returns with \$1.88 billion claimed in fraudulent refunds and prevented the issuance of \$1.82 billion (97 percent) of the fraudulent refunds claimed.

I will now discuss each of these refundable credits, providing improper payment estimates and amounts when available; IRS actions to address these improper payments; and recommendations we have made to reduce these payments.

**Earned Income Tax Credit** – The IRS continues to report that 23 to 28 percent of EITC payments are issued improperly each year. In Fiscal Year 2009, this equated to \$11 to \$13 billion in improper EITC payments. Although the IRS has annually reported billions in EITC improper payments since it began reporting estimates to Congress in 2002, little improvement has been made in reducing these payments. Executive Order 13520, signed by the President on November 20, 2009, further increased agency accountability for reducing improper payments and required the IRS to intensify its efforts and set targets to reduce EITC improper payments. However, in the IRS's June 14, 2010 report to us, the IRS did not include required strategies or quantifiable targets to reduce EITC improper payments. IRS management noted that reduction targets were not set because it has to balance compliance and enforcement resources among all income groups.

We have conducted a number of audits that have identified opportunities to reduce EITC improper payments. We have provided the IRS with specific actions that could be taken to reduce improper payments and allow the IRS to establish measurable reduction targets. While the IRS has implemented some of our recommendations, it has not taken action to address key recommendations aimed at preventing or reducing improper EITC payments. For example, we reported in December 2008 that the IRS

had developed processes to successfully identify billions of dollars in erroneous EITC payments. However, the IRS stated it did not have the resources to implement the processes that would help address many of these cases, resulting in the majority of the improper claims being paid.

We recommended that the IRS develop alternative processes that are less costly than audits to protect revenue associated with erroneous EITC claims at the time a tax return is filed.<sup>9</sup> The IRS agreed with our recommendation, noting that it was continuing its ongoing efforts to identify new alternatives to address erroneous payments. The IRS acknowledged that it cannot fully address EITC noncompliance by simply auditing returns and must pursue alternatives to traditional compliance efforts.<sup>10</sup> However, the IRS has not made any significant progress in developing and implementing these alternatives. This continues to hinder the IRS's ability to reduce the billions of dollars paid in erroneous EITC claims.

Furthermore, the IRS does not require individuals to provide any supporting documentation to verify eligibility for claiming the EITC. In a pilot project the IRS conducted from 2003 to 2006, it required individuals to pre-certify eligibility for claiming the EITC, which included providing specific documentation. This documentation included third-party affidavits, letters on official letterhead from a third party (generally community organizations, churches, etc.), and official records such as school or medical records. At the completion of the pilot, the IRS concluded that requesting this documentation created a burden on the taxpayer,<sup>11</sup> even though this is the same documentation that the IRS requests from individuals as part of EITC examinations.

**Additional Child Tax Credit** – In 2009, we reported a significant increase in ACTC claims by filers who were unable to obtain a Social Security Number or were not eligible to receive a Social Security Number.<sup>12</sup> These individuals were not authorized to work in the United States and filed tax returns using an Individual Taxpayer Identification Number (ITIN).<sup>13</sup> The refundable credit claims made by these filers have grown substantially.

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<sup>9</sup> *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* (Reference Number 2009-40-024, dated December 31, 2008).

<sup>10</sup> IRS, Initial Report on Earned Income Tax Credit (EITC) Improper Payments, Executive Order 13520: Reducing Improper Payments (June 14, 2010).

<sup>11</sup> IRS, Earned Income Tax Credit (EITC) Initiatives: Report on Qualifying Child Residency Certification, Filing Status, and Automated Underreporter Tests (January 2008).

<sup>12</sup> *Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims* (Reference # 2009-40-057, dated March 31, 2009).

<sup>13</sup> An ITIN is available to individuals who are required to have a taxpayer identification number for tax purposes, but do not have and are not eligible to obtain a Social Security Number because they are not authorized to work in the United States.

For Tax Year 2000, a total of 62,000 ITIN filers received \$62 million in ACTCs. This has since grown to 2.3 million ITIN filers claiming ACTCs totaling \$4.2 billion in 2010.<sup>14</sup> This increase is due in part to changes in the law which changed the eligibility criteria and calculation. Another reason for the increase in claims is that a significant number of individuals are filing returns for multiple years to obtain the ACTC for prior year tax returns (e.g., filing for Tax Years 2007, 2008, and 2009). In 2010, approximately 238,000 ITIN filers submitted over 608,000 tax returns for multiple years and claimed just over \$1 billion in ACTC on those tax returns. Moreover, in our analysis of tax returns processed in 2010, we found that some individuals have also submitted duplicate tax returns for multiple years to multiple IRS processing centers and received ACTC refunds.

Along with the increase in claims for the ACTC, there has been an increased demand for ITINs in order to file these returns. For Fiscal Year 2011, the IRS estimates they will expend a significant amount of resources to process over 2.2 million ITIN applications.<sup>15</sup>

Prior to 1996, filers using an ITIN were entitled to claim the EITC. However, concerns were raised by the Government Accountability Office, the IRS, and the Congress regarding noncompliance with EITC requirements. The law was subsequently changed to deny the EITC to individuals who file a tax return without a Social Security Number that is valid for employment.<sup>16</sup> Specifically, the *Personal Responsibility and Work Opportunity Reconciliation Act of 1996*,<sup>17</sup> prohibits individuals residing without authorization in the United States from receiving most Federal public benefits as that term is defined in the Act. The Act also amended 26 U.S.C. § 32 (c) to require that claims for the credit be filed by taxpayers using SSNs. As such, filers using an ITIN are not eligible for the EITC.

The change in the law prohibiting EITC to filers using an ITIN was made prior to the creation of the ACTC and other refundable credits. However, the law also prohibits individuals residing without authorization in the United States from receiving most

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<sup>14</sup> *Budget Hearing with the Treasury Inspector General for Tax Administration, Hearing Before the H. Comm. on Appropriations, Subcm. on Financial Services and General Government*, 112th Cong. (Apr. 15, 2011) (statement of J. Russell George).

<sup>15</sup> ITIN processing uses the full time equivalent of 463 IRS employees.

<sup>16</sup> The Social Security Administration will issue a Social Security card that notes "NOT VALID FOR EMPLOYMENT" to individuals from other countries who: (1) are lawfully admitted to the United States without work authorization but with a valid non-work reason for needing a Social Security Number or (2) need a number because of a State or Federal law requiring a Social Security Number to obtain benefits to which an individual has already established entitlement.

<sup>17</sup> Pub. L. No. 104-193, 110 Stat. 105 (codified in scattered sections of 42 U.S.C., 21 U.S.C., 8 U.S.C., and 7 U.S.C.).

Federal public benefits, with the exception of certain emergency services and programs, and defines a public benefit as:

Any grant, contract, loan, professional license, or commercial license provided by an agency of the United States or by appropriated funds of the United States; and any retirement, welfare, health, disability, public or assisted housing, postsecondary [sic] education, food assistance, unemployment benefit, or any other similar benefit for which payments or assistance are provided to an individual, household, or family eligibility unit by an agency of the United States or by appropriated funds of the United States.<sup>18</sup>

The current situation with the ACTC appears similar to that which preceded the prohibition of the EITC to ITIN filers. Both the EITC and the ACTC are calculated based on a percentage of earned income and both are refundable. Both are paid by an agency of the United States by appropriated funds. Billions of dollars in ACTC are being provided to ITIN filers without verification of eligibility, and IRS employees have raised concerns about the lack of an adequate process for identifying and addressing improper claims.<sup>19</sup>

IRS management's view is that the *Personal Responsibility and Work Opportunity Reconciliation Act of 1996* does not provide sufficient legal authority for the IRS to disallow the ACTC to ITIN filers. Currently the Internal Revenue Code Title 26 U.S.C. section 24 does not require taxpayers to use a Social Security Number to claim the credit and does not provide the IRS with math error authority to deny the credit without an examination.<sup>20</sup>

As such, legislation would be needed to clarify whether a Social Security Number that is valid for employment is needed in order to claim the ACTC, consistent with requirements for the EITC. If the ACTC may not be paid, the IRS should be provided with math error authority to disallow associated claims for the credits. We estimate that allowing the ACTC only to those filers who are eligible to live and work in the United States (*i.e.*, those with a Social Security Number that is valid for employment) would reduce Federal outlays by approximately \$4.2 billion annually.<sup>21</sup>

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<sup>18</sup> 8 U.S.C. § 1611(c)(1)(a)(b).

<sup>19</sup> *Actions Are Needed to Ensure Proper Use of Individual Taxpayer Identification Numbers and to Verify or Limit Refundable Credit Claims* (Reference Number 2009-40-057, dated March 31, 2009).

<sup>20</sup> Math error authority statutorily allows the IRS to correct tax return errors during processing, including calculation errors and entries that are inconsistent or exceed statutory limits and assess additional tax without using deficiency procedures.

<sup>21</sup> Changes made to the ACTC in the Recovery Act are effective through Tax Year 2012. If no further changes are made, the eligibility requirements revert to previous levels and would result in fewer individuals qualifying for the ACTC.

**American Opportunity Tax Credit** – Also as part of our Recovery Act oversight, we are in the process of completing a review assessing the effectiveness of the IRS’s processes to identify erroneous American Opportunity Tax Credit (AOTC) claims. The Recovery Act amended the Hope Scholarship Credit<sup>22</sup> to allow a refundable tax credit—the AOTC. The AOTC allows individuals to receive a credit for higher education expenses up to \$2,500 per student per year for Tax Years 2009 and 2010, with up to \$1,000 being refundable. The IRS requires no documentation to be provided to verify eligibility, including whether an individual claimed as a student even attends a required accredited educational institution. Our review is identifying significant improper payments being made to taxpayers claiming the credit and using ineligible students.<sup>23</sup>

**Adoption Credit** –The Adoption Credit was changed to increase the amount from \$12,150 to \$13,170 and also made the credit refundable. Recognizing that this could increase the risk for erroneous claims, the IRS developed a strategy to attempt to reduce this risk. As part of this strategy, the IRS requires individuals to verify eligibility by attaching documentation to their tax returns in support of an adoption.

However, our analysis of the IRS’s Adoption Credit processing controls identified that, while the IRS requires individuals to provide documentation that verifies their eligibility, the IRS does not have the authority to deny the Adoption Credit if the documentation is not provided. Without this math error authority, the IRS cannot deny the credit during processing of the tax return, but must instead deny the credit post-processing through the examination process, which is a much more costly, resource-intensive, and burdensome process.

On October 29, 2010, we alerted IRS management and recommended that they work with the Department of the Treasury to request from Congress math error authority to deny Adoption Credit claims that lacked documentation. The IRS did not agree with this recommendation because it believed that it had developed and implemented sufficient filters and compliance tools to handle potential Adoption Credit fraud. This has resulted in a significant number of Adoption Credit claims being sent to its post-processing Examination function. As of April 28, 2011, the IRS has received 72,656 individual claims for more than \$897 million in Adoption Credits. Of these, 42,399 (58 percent) either had no required documentation or the documentation was invalid or

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<sup>22</sup> The Hope Credit was included as part of the Taxpayer Relief Act of 1997, and was established to assist middle-class families with the costs associated with a college degree. The credit is set forth at 26 U.S.C. § 25A (a).

<sup>23</sup> An eligible student must be enrolled in a program that leads to a degree, certificate, or other recognized educational credential, and be enrolled at least half time for at least one academic period during the year. Students are not eligible if they have already completed the first four years of post-secondary education or if they have been convicted of a felony for possessing or distributing a controlled substance.

insufficient. According to IRS procedures, each of these claims will be sent to the Examination function for further review.

Math error authority to deny those claims without required documentation at the time the tax return was processed would have been less burdensome on individuals than post-processing examinations. Individuals would have been immediately notified of the denial of the Adoption Credit. These individuals would have been informed that they can provide the IRS with required documentation in response to the denial to support their eligibility. If the individual provides the IRS with required documentation supporting their eligibility for the Adoption Credit the IRS has a goal to resolve these responses within 30 days of receipt of the documentation.

In comparison, the IRS was unable to provide an average timeframe for resolving Adoption Credit claims sent for post-processing examinations. The IRS will not have this information until the end of this fiscal year because of the limited number of Adoption Credit examinations closed to date. However, the IRS estimates that an individual would receive notification that documentation is needed to support eligibility for claiming the Adoption Credit within three to four weeks after his or her tax return is received in the Examination function. The individual then has 30 days to respond to the IRS's request for required documentation. Once the IRS receives the information, the IRS does not have a specific time goal for closing the case subsequent to receipt of the information.

**Homebuyer Credit** – As part of our Recovery Act oversight, we addressed the IRS's administration of the Homebuyer Credit. The *Worker, Homeownership, and Business Assistance Act of 2009*<sup>24</sup> revised, extended, and expanded the Homebuyer Credit allowed by previous acts to a broader range of home purchases and added new documentation requirements. For example, residents of the same main home for at least five years may claim the Homebuyer Credit if they purchase new principal residences. In Processing Years 2009 and 2010, the IRS reported issuing Homebuyer Credits of more than \$12.3 billion and \$13.7 billion, respectively.

We recommended that the IRS require taxpayers to supply documentation with their tax return to substantiate a home purchase. IRS management initially responded that such a requirement would be burdensome for individuals and the IRS. Nonetheless, the burden of providing documentation to substantiate such a credit is no greater than the burden placed on individuals receiving payments from other Federal Government agencies and on the agencies providing those payments. For example, to receive food stamps, individuals are required to provide identification such as a driver's

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<sup>24</sup> Pub. L. No. 111-92, 123 Stat. 2984 (2009).

license, State identification, birth certificate, or alien card; proof of income; proof of amounts spent on child care; rent receipts or proof of mortgage payments; records of utility costs; and medical bills for certain household members.

The IRS also stated that it did not have math error authority to disallow the Homebuyer Credit during tax return processing even if it did ask for documentation but none was provided. The IRS initially took no steps to obtain this math error authority. After the issuance of TIGTA's first interim report on that credit,<sup>25</sup> Congress passed legislation requiring documentation for the Homebuyer Credit and providing the IRS with math error authority to disallow the credit if the documentation was not provided.<sup>26</sup> In response to our report, the IRS required taxpayers claiming the credit after November 6, 2009, to attach a copy of their Form HUD-1, *U.S. Department of Housing and Urban Development Settlement Statement*, to support their claim. The documentation requirements meant that individuals claiming the Homebuyer Credit had to file a paper tax return and could not electronically file their tax return. The IRS indicated that its current electronic filing system was not able to handle the wide variety of required and recommended supporting documents that would have to be scanned and submitted.

A significant number of erroneous claims of the Homebuyer Credits were processed prior to implementation of the documentation requirements. Overall, we estimate that at least \$485 million of the more than \$513 million in potentially erroneous claims we identified were issued with no IRS scrutiny, such as an examination or steps to validate the claim. These erroneous credits might have been denied if documentation requirements were in place.

Based on our review of the various refundable credits, we believe the IRS should require individuals to provide documentation to support eligibility for all refundable tax credits. If such documentation is required, the IRS will also need math error authority to deny refundable credits when supporting documentation is not provided.

As with the Homebuyer Credit, the IRS requires individuals claiming an Adoption Credit to file a paper tax return. However, the IRS's Modernized e-File System is replacing the IRS's existing electronic filing system with a new modernized, Internet-based system that has the capability of allowing individuals to scan and attach documents to their tax returns. The IRS first began receiving a limited number of tax returns through the Modernized e-File System in Processing Year 2010 and expects full migration in Processing Year 2012. The ability to attach supplemental information to an

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<sup>25</sup> *The Internal Revenue Service Faces Significant Challenges in Verifying Eligibility for the First-Time Homebuyer Credit* (Reference Number 2009-41-144, dated September 29, 2009).

<sup>26</sup> Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, 123 Stat. 2984 (2009).

electronic tax return will reduce the need for the IRS to require individuals to file paper tax returns.

We at TIGTA take seriously our mandate to provide independent oversight of the IRS in its administration of the Nation's tax system. I hope my discussion of refundable credits helps the Congress to ensure accountability of the IRS and assists you with your oversight duties.

Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee, thank you for the opportunity to share my views.