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

April 9, 2018

Reference Number: 2018-40-032

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

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THE INTERNAL REVENUE SERVICE IS NOT IN COMPLIANCE WITH IMPROPER PAYMENT REQUIREMENTS

Highlights

Final Report issued on April 9, 2018

Highlights of Reference Number: 2018-40-032 to the Commissioner of Internal Revenue.

IMPACT ON TAXPAYERS

The Improper Payments Elimination and Recovery Act (IPERA) 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 Program a high-risk program that is subject to reporting in the Department of the Treasury Agency Financial Report. The IRS estimates that 23.9 percent ($16.2 billion) in Earned Income Tax Credit payments were issued improperly in Fiscal Year 2017.

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 IPERA; 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 the annual improper payment reporting requirements for Fiscal Year 2017.

WHAT TIGTA FOUND

The IRS provided all required Earned Income Tax Credit improper payment information for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2017.* The IRS has not reduced the overall Earned Income Tax Credit improper payment rate to less than 10 percent, but it has been approved for this exception to the 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 Earned Income Tax Credit 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 and American Opportunity Tax Credit, which results in a significant understatement of improper payments associated with refundable tax credits reported to the Office of Management and Budget and Congress. The incorrect rating allows the IRS to continue to circumvent the reporting of required information for these programs to the Department of the Treasury for inclusion in the Agency Financial Report.

The IRS has not taken actions to address more than $45.2 million in confirmed erroneous and fraudulent refundable credit claims TIGTA identified as a result of prior audits. ******2****** **********2********** **********2********** **********2********** ********2*******.

Finally, the effectiveness of traditional compliance tools to address identified erroneous claims continues to diminish. Without additional tools and authorities, billions of dollars in improper payments will be issued each year.

WHAT TIGTA RECOMMENDED

TIGTA has previously reported on the conditions discussed in this report. As such, TIGTA made no recommendations.

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

April 9, 2018

MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Is Not in Compliance With Improper Payment Requirements (Audit # 201840001)

This report presents the results of our review to determine whether the Internal Revenue Service complied with the annual improper payment reporting requirements for Fiscal Year 2017. This audit is included in our Fiscal Year 2018 Annual Audit Plan and addresses the major management challenge of Reducing Fraudulent Claims and Improper Payments.

Although we made no recommendations in this report, we did provide Internal Revenue Service management officials an opportunity to review and comment on the draft report. Management's complete response to the draft report is included as Appendix VII.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the information in the report. 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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Table of Contents

Background ..... Page 1

Results of Review ..... Page 5

- The Incorrect Risk Rating of the Additional Child Tax Credit and the American Opportunity Tax Credit Results in the Circumvention of Reporting Requirements ..... Page 5
- Assessment of Fiscal Year 2017 Compliance With Earned Income Tax Credit Improper Payment Reporting Requirements ..... Page 8
- Actions Are Not Being Taken to Address Confirmed Erroneous and Fraudulent Refundable Credit Claims ..... Page 11
- Use of Traditional Compliance Tools to Address Identified Erroneous Claims Continues to Diminish; Without Additional Tools and Authorities, Billions of Dollars in Improper Payments Will Be Issued Each Year ..... Page 15

Appendices

- Appendix I – Detailed Objective, Scope, and Methodology ..... Page 18
- Appendix II – Major Contributors to This Report ..... Page 22
- Appendix III – Report Distribution List ..... Page 23
- Appendix IV – Treasury Inspector General for Tax Administration Audit Reports on Improper Payments ..... Page 24
- Appendix V – Internal Revenue Service Programs Identified for Improper Payment Risk Assessments ..... Page 25
- Appendix VI – Methodology to Compute Potential Additional Child Tax Credit and American Opportunity Tax Credit Improper Payments ..... Page 26
- Appendix VII – Management's Response to the Draft Report ..... Page 28

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Abbreviations

ACTC	Additional Child Tax Credit
AOTC	American Opportunity Tax Credit
CTC	Child 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
SE	Self-Employment
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 2002[1] 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." For Fiscal Year[3] 2014 and beyond, significant is defined as gross annual improper payments. 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. For those high-priority programs, the IPERIA requires agencies to develop additional or

[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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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 October 20, 2014, the OMB issued revisions to Circular A-123 Appendix C, *Requirements for Effective Estimation and Remediation of Improper Payments*. 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 revised Appendix C creates a more unified, comprehensive, and less burdensome improper payment compliance framework. For example, agencies now have the flexibility to combine the various improper payment reporting requirements into one document, the Agency Financial Report.[5] In addition, the Inspectors General also have the flexibility to conduct one review to assess their respective agency's compliance with the various improper payment requirements.

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. For Fiscal Year 2017, the Department of the Treasury selected 19 IRS program fund groups. These funds were selected for assessment based on each fund groups' materiality to the IRS financial statements. Appendix V provides a list of the IRS programs identified for an improper payment risk assessment for Fiscal Year 2017. On March 20, 2014, the OMB issued additional supplemental improper payment guidance to the Department of the Treasury clarifying the requirement for annual risk assessments of all refundable tax credits. Specifically, the OMB guidance clarified that *all refundable credits* are subject to IPERA requirements because they 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 *Improper Payments Elimination and Recovery Act Risk Assessment Questionnaire* for Fiscal Year 2017 (hereafter referred to as the Risk Assessment Questionnaire) and related guidance provided by the Department of the Treasury 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 for

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

[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* (Sept. 2014); TIGTA, Ref. No. 2015-40-044, *Assessment of Internal Revenue Service Compliance With the Improper Payment Reporting Requirements in Fiscal Year 2014* (Apr. 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* (Apr. 2016).

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Fiscal Year 2016 in an attempt to provide a more accurate assessment of the risk associated with the programs the Department of the Treasury 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 Department of the Treasury 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 and 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 Department of the Treasury. For any program identified as having a high risk for improper payments, the IRS must also provide the following information for inclusion in the Department of the Treasury'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.

The OMB has previously identified the Earned Income Tax Credit (EITC)[7] as a high-risk program and, as such, the 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 Department of the Treasury's Agency Financial Report. The IRS estimates that 23.9 percent ($16.2 billion) of EITC payments made in Fiscal Year 2017 were paid in error. The EITC continues to be the only IRS program that the OMB has identified as a high-priority program.

[7] Congress originally passed the EITC legislation in 1975 in part to offset the burden of Social Security taxes and to provide an incentive to work. The EITC is a refundable tax credit that offsets income tax owed by low-income taxpayers. Refundable tax credits can be used to reduce a taxpayer's tax liability to zero. Any excess of the credit beyond the tax liability can be refunded to the taxpayers.

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A prior TIGTA review identified that revised assessments still do not provide a valid assessment of improper payments associated with refundable tax credits

In April 2017,[8] we reported that the IRS's revised Fiscal Year 2016 Risk Assessment Questionnaire continued to provide an inaccurate assessment of improper Additional Child Tax Credit (ACTC) and American Opportunity Tax Credit (AOTC) payment risk. We found that the revised risk assessment methodology still did not include the use of available National Research Program (NRP) and IRS compliance data to quantify the erroneous payments. As such, the IRS concluded that the ACTC and AOTC present a medium risk of improper payments for Fiscal Year 2016. This was despite the IRS's own compliance data indicating that these programs have significant improper payments.

Using the IRS's own enforcement data, TIGTA estimated that the potential ACTC improper payment rate for Fiscal Year 2016 was between 22.7 percent and 27.8 percent, with potential improper payments totaling between $6.5 billion and $7.9 billion. TIGTA estimated that the potential improper payment rate for the AOTC was between 19.6 percent and 28.7 percent, with potential improper payment dollars between $900 million and $1.3 billion. The OMB defines a program as having significant improper payments when improper payments exceed both 1.5 percent of program outlays and $10 million of all program or activity payments made during the fiscal year reported or exceed $100 million at any percent of program outlays.

We again recommended the IRS revise the ACTC and AOTC improper payment risk assessment process to include a quantitative assessment using available NRP and IRS compliance data. IRS management did not agree with our recommendation and stated that the IRS developed the refundable tax credit program risk assessment framework with the Department of the Treasury and in accordance with both OMB Circular A-123 Appendix C and Treasury requirements.

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, Examination Operations, in Philadelphia, Pennsylvania, during the period September 2017 through March 2018. 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.

[8] TIGTA, Ref. No. 2017-40-030, *Revised Refundable Credit Risk Assessments Still Do Not Provide an Accurate Measure of the Risk of Improper Payments* (Apr. 2017).

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Results of Review

The Incorrect Risk Rating of the Additional Child Tax Credit and the American Opportunity Tax Credit Results in the Circumvention of Reporting Requirements

The IRS continues to incorrectly conclude that improper payments associated with the ACTC and AOTC do not have a high risk. The IRS once again erroneously rated the risk associated with these two credits as a medium risk. As we have previously reported, this rating is contrary to the IRS's own NRP and compliance data, which when analyzed shows a high risk of improper payments. As a result, the IRS is significantly understating its estimate of improper payments associated with refundable tax credits in its reports to the OMB and Congress. Further, the inaccurate risk rating also allows the IRS to circumvent the reporting of required information to the Department of the Treasury for inclusion in the Agency Financial Report. For example, for the ACTC and AOTC, 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.

In April 2017, we once again reported that the IRS's revised ACTC and AOTC risk assessment methodologies did not include an assessment of available NRP and compliance data.[9] Since Fiscal Year 2016, we have recommended that the IRS revise these methodologies to include an assessment of available NRP and compliance data. The IRS has not agreed with our recommendation. As such, similar to prior years, its Fiscal Year 2017 risk assessment still does not accurately measure ACTC and AOTC improper payment risk.

Using the IRS's own NRP and compliance data, we computed the Fiscal Year 2017 potential estimated improper payment rate for the ACTC and AOTC. Our analysis draws from the same data sources and methodology the IRS uses to compute the potential improper payment rate for the EITC[10] and is the same methodology we have used since our Fiscal Year 2013 computation.

[9] TIGTA, Ref. No. 2017-40-030, *Revised Refundable Credit Risk Assessments Still Do Not Provide an Accurate Measure of the Risk of Improper Payments* (Apr. 2017).
[10] See Appendix VI.

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This methodology has been shared with IRS management. For Fiscal Year 2017, we estimate the potential ACTC and AOTC improper payment rates as follows:

- ACTC – We estimate that 23.2 percent ($7.4 billion) of ACTC payments made during Fiscal Year 2017 were improper.[11] This includes all ACTC claims for which the IRS disallowed some portion of the ACTC regardless of whether there was a change to the Child Tax Credit (CTC).[12] We estimate that the improper payment rate for only those ACTC claims for which no reclassification to the CTC[13] occurred (*i.e.*, no adjustment was made to the CTC) is 11.3 percent, resulting in an estimated $3.6 billion in potential improper payments.[14]
- AOTC – We estimate that 28.3 percent ($1.3 billion)[15] of AOTC payments made during Fiscal Year 2017 were improper.[16]

Our computation of the potential estimated improper payments for the ACTC and AOTC show that both continue to exceed the IPERA criteria for a significant risk of improper payments and, as such, should be identified as a high-risk program. Per the OMB, any program that has gross annual improper payments that a) exceed both 1.5 percent of program outlays and $10 million of all program or activity payments or b) exceed $100 million at any percent of program outlays is considered a significant risk.

Use of a quantitative evaluation is needed to provide an accurate assessment of the risk of improper payments associated with the ACTC and AOTC

In response to our April 2017 report, IRS management stated that the IRS developed the refundable tax credit program risk assessment framework with the Department of the Treasury and in accordance with both OMB Circular A-123 Appendix C and Treasury implementation guideline requirements. OMB Circular A-123 Appendix C, Part I Section A,[17] requires agencies to institute a systemic method to identify programs susceptible to significant improper payments. The guidance states:

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[11] We estimate that the potential ACTC improper payment rate for Fiscal Year 2017 is between 20.9 percent and 25.5 percent and the potential improper payment dollars is between $6.7 billion and $8.1 billion.
[12] Adjustments to the ACTC may result in a corresponding adjustment to the CTC. For example, an adjustment to income may result in a taxpayer being eligible for more CTC and less ACTC than originally determined.
[13] A reclassification of the ACTC to the CTC occurs when, as a result of an audit, the IRS determines that the taxpayer could have claimed more CTC and should have claimed less ACTC.
[14] We estimate that the potential improper payment rate for cases with no reclassification to the CTC is between 9.4 percent and 13.2 percent and the potential improper payment dollars is between $3.0 billion and $4.2 billion.
[15] TIGTA's estimate of improper AOTC payments was calculated using the outlay portion reported in the Fiscal Year 2018 Federal Budget. This estimate would be greater if the calculation was completed using both tax expenditures and the outlay portion.
[16] We estimate that the potential AOTC improper payment rate for Fiscal Year 2017 is between 23.9 percent and 32.7 percent and the potential improper payment dollars is between $1.1 billion and $1.5 billion.
[17] OMB Circular A-123 Appendix C, Part I Section A, Item 9.

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This systematic method could be a quantitative evaluation based on a statistical sample or a qualitative method (e.g., a risk-assessment questionnaire).

OMB Circular A-123 does not direct agencies to use one method of assessment over another. 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. In fact, as we reported in April 2017, if the IRS used the same qualitative analysis it uses for the ACTC and the AOTC to assess the EITC, it would incorrectly rate the risk associated with the EITC as a medium risk. This would be an inaccurate risk rating because the IRS estimates that 23.9 percent ($16.2 billion) of EITC payments made in Fiscal Year 2017 were paid in error.

IRS management informed us that the IRS is developing a method to use NRP data to calculate ACTC and AOTC error rates going forward. Specifically, the IRS plans to include these error rates in the Department of the Treasury Agency Financial Report as part of its reporting on the Tax Gap.[18] However, the IRS should report these error rates under its improper payment reporting. The TIGTA developed a statistically valid methodology several years ago to estimate the ACTC and AOTC improper payment rates and amounts using NRP data and other IRS enforcement information. We have shared our methodology with the IRS.

A quantitative evaluation is also needed to accurately assess the risk of Premium Tax Credit (PTC) improper payments

In April 2016, we 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.[19] In Fiscal Year 2017, the IRS continued to use a qualitative assessment and incorrectly rated the improper payment risk associated with the PTC as medium. This is despite our reporting in March 2017 that 80,005 taxpayers potentially received $128.7 million more in the PTC than they were entitled to receive for Tax Year 2015.[20] As with the ACTC and AOTC, the IRS has developed a method to use the NRP data to calculate a PTC error rate for Tax Year 2014 tax returns (the first year for which the PTC was available). However, similar to the ACTC and AOTC, the IRS plans to use this error rate to evaluate PTC compliance as part of its Tax Gap efforts and not as a quantitative assessment of the PTC improper payment risk.

[18] The Tax Gap is the estimated difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time.
[19] 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* (Apr. 2016).
[20] TIGTA, Ref. No. 2017-43-022, *Affordable Care Act: Verification of Premium Tax Credit Claims During the 2016 Filing Season* (Mar. 2017).

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Assessment of Fiscal Year 2017 Compliance With Earned Income Tax Credit Improper Payment Reporting Requirements

As previously noted, the OMB has identified the EITC as a high-risk program, and 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 Department of the Treasury for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2017*. 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 reporting requirement. As an alternative, the Department of the Treasury 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 Department of the Treasury.
- **The Number of Preparer Due Diligence Penalties Proposed** – reflects the effectiveness of the Department of the Treasury 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 2017

Improper Payment Requirement	Source of Requirement	Provided by IRS
Conduct a program-specific risk assessment for each program or activity identified by the Department of the Treasury.	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/Department of the Treasury	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[21]

Source: TIGTA's review of IRS EITC information provided to the Department of the Treasury for inclusion in the Department of the Treasury Agency Financial Report Fiscal Year 2017.

The EITC Due Diligence Report required by the Protecting Americans from Tax Hikes Act of 2015 (PATH Act)[22] does not provide key details as to how the EITC Tax Software Field Experiment was performed

The PATH Act required the IRS to conduct a study of the effectiveness of tax return preparer due diligence requirements for claiming the EITC and provide its results to Congress no later than December 18, 2016. According to IRS management, this report was provided to Congress on April 19, 2017. The PATH Act also required the IRS to conduct a study of these requirements with regard to the CTC and AOTC and provide the results to Congress no later than December 18, 2017. As of February 27, 2018, the IRS has yet to provide the results of its study of the CTC and AOTC to Congress. IRS management informed us that the report is currently

[21] 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.

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

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undergoing review by the Department of the Treasury. The IRS was unable to provide a date the report will be issued to Congress.

The IRS's EITC Due Diligence Report[23] evaluates the results of the IRS's EITC Return Preparer Study and the EITC Tax Software Field Experiment.[24] The EITC Tax Software Field Experiment was performed by the Department of the Treasury to determine whether expanding the questions related to EITC eligibility would reduce EITC noncompliance without reducing participation by compliant taxpayers. This experiment involved tax return software developers asking a sample of taxpayers who self-prepared their return additional EITC due diligence questions during the 2016 Filing Season. The report states that the ongoing, multiyear EITC Return Preparer Study contributed to the effectiveness of the IRS's compliance strategy. In addition, according to the report, the EITC Tax Software Field Experiment found there was no evidence that the additional questions changed the amount of EITC individuals in the study claimed, whether the EITC was claimed at all, or whether the return triggered IRS Dependent Database filters.[25]

Our review of the IRS's study of the EITC Due Diligence Report found that the report does not provide key details as to how the EITC Tax Software Field Experiment was performed. For example, the Due Diligence report does not provide details on:

- The software providers that participated in the study. Department of the Treasury representatives stated that all tax software providers that partner with the IRS were invited to participate in the EITC Tax Software Field Experiment.
- The number of taxpayers that participated in the study and how they were selected. Department of the Treasury representatives stated that each participating provider selected their own sample of participants.

The above information is important because it can influence the results of the study. For example, additional due diligence questions may be less effective when tested by a software provider whose software already contains additional probing questions or when asked to taxpayers who have not received an EITC improper payment. To properly evaluate the impact of due diligence questions on reducing EITC improper payments, the questions needed to be asked to individuals who have incorrectly received the EITC in the past.

We requested detailed information as to the number and identity of the software providers that participated in the study as well as the number of taxpayers sampled by each participating provider and how they were selected. We will include an assessment of the EITC Tax Software

[23] *Report to Congress on the Effectiveness of Tax Return Preparer Due Diligence Requirements for Claiming the Earned Income Credit Under Section 32 of the Internal Revenue Code.*
[24] *IRS-Treasury Tax Software Field Experiment.*
[25] The Dependent Database addresses noncompliance relevant to the EITC and other tax benefits related to the dependency and residency of children.

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Field Experiment in our Fiscal Year 2019 review of compliance with improper payment reporting requirements.

Actions Are Not Being Taken to Address Confirmed Erroneous and Fraudulent Refundable Credit Claims

The IRS is not taking steps to address erroneous and fraudulent EITC and ACTC claims identified by TIGTA and the Social Security Administration (SSA). Since July 2017, we have issued three reports that identify individuals who received the EITC, the CTC/ACTC, and the AOTC and did not meet the eligibility requirements included in the PATH Act. In each of these reports, we made recommendations to the IRS to take actions needed to recover these erroneous payments:

- In July 2017, we reported that 15,744 taxpayers who filed a Tax Year 2014 return during the 2016 Filing Season received more than $34.8 million in erroneous EITC, CTC/ACTC, and AOTC because the IRS did not have the information it needed to determine if the Taxpayer Identification Number used on the tax return was issued timely.[26]
- In January 2018, we reported that individuals potentially received $637,181 in refundable tax credits and did not pay an estimated $359,127 in tax as a result of erroneous personal tax exemptions on 1,298 tax returns filed as of April 20, 2017, with an Individual Taxpayer Identification Number that should have been deactivated.[27]
- In February 2018, we reported that the IRS paid almost $9.8 million in refundable credits on 4,509 Tax Year 2013 through Tax Year 2015 tax returns processed during the 2017 Filing Season for which the Taxpayer Identification Number was not issued by the due date of the tax return.[28]

We recommended that the IRS review the 21,551 returns we identified and take the actions needed to recover the erroneous payments. IRS management agreed with our recommendations. However, as of March 12, 2018, the IRS has not taken action to recover erroneous payments associated with 21,545 (99.97 percent) of the 21,551 returns we identified. IRS management informed us that they planned to use the IRS's math error authority to adjust the tax accounts of the 21,551 taxpayers we identified to recover the erroneous payments. However, before the IRS could recover the payments, the National Taxpayer Advocate requested a formal opinion as to the IRS's authority to use its math error authority to retroactively recover erroneous credits. The

[26] 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).
[27] TIGTA, Ref. No. 2018-40-011, *Some Legal Requirements to Deactivate Individual Taxpayer Identification Numbers Have Not Been Met* (Jan. 2018).
[28] TIGTA, Ref. No. 2018-40-015, *Employer Noncompliance With Wage Reporting Requirements Significantly Reduces the Ability to Verify Refundable Tax Credit Claims Before Refunds Are Paid* (Feb. 2018).

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IRS originally sent this request to IRS Chief Counsel on September 8, 2017. We followed up with Chief Counsel on the status of the request and found that, as of February 21, 2018, it has yet to issue an opinion as to the IRS's authority to retroactively use math error authority.

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Processes have not been developed to prevent the issuance of the EITC to individuals with Social Security Numbers (SSN) that are not valid for work

In July 2017, we reported that the IRS still has 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.

The Personal Responsibility and Work Opportunity Reconciliation Act of 1996,[32] 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. For purposes of the EITC, a valid SSN is a number issued by the SSA to a U.S. citizen or to a noncitizen[33] who obtained the SSN for purposes other than to obtain a benefit partially or fully funded by the Federal Government (*e.g.*, Medicaid or food stamps).[34] These "benefit-only" SSNs are typically referred to as nonwork SSNs. In addition, a valid SSN does not include an Individual Taxpayer Identification Number, an Adoption Taxpayer Identification Number, or an IRS Number.[35] The SSA has issued almost eight million "*NOT VALID FOR EMPLOYMENT*" (nonwork) SSNs since 1972 to individuals who do not have authorization to work in the United States.

The IRS maintains the National Account Profile[36] file, which is compiled using data obtained from the SSA Numident Database[37] and contains Citizenship Codes that indicate the individual's citizenship status. Citizenship Code C indicates that an individual is an alien not authorized to work in the United States. Our analysis of the National Account Profile as of October 2015 found that 2.6 million SSNs have a Citizenship Code C. We contacted the SSA to confirm that the SSA Numident Database contains data showing the type of SSN issued to each individual. For example, the data would identify those individuals assigned a nonwork SSN. The SSA indicated that the Numident Database contains a field named "Evidence Code" (also referred to in SSA documentation as "Interview Code" or "IDN") that would enable the IRS to identify

[32] Pub. L. No. 104-193, 2105 Stat. 110.
[33] To be eligible for the EITC, a noncitizen generally must be a resident alien for more than half the tax year.
[34] The SSA was granted the authority to issue SSNs for the purposes of obtaining Federally funded benefits and other nonwork purposes in October 1972 with the passage of the Social Security Amendments of 1972, Pub. L. No. 92-603.
[35] A temporary number issued by the IRS.
[36] The National Account Profile is a compilation of selected entity data from various IRS Master Files. It includes Social Security Administration data and cross-reference data, making it possible to verify taxpayers who have no IRS primary Master File account. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[37] When the SSA assigns an SSN to an individual, it creates a master record of relevant information about the number holder in its Numident Database. This includes such information as the number holder's name, date of birth, place of birth, parents' names, and citizenship status.

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individuals whose SSNs were issued by the SSA as not valid for work. However, the IRS currently does not receive this field as part of the data the SSA provides to the IRS.

We recommended that the IRS evaluate the use of nonwork SSN data it currently has available for use in its systemic processes to identify potentially erroneous EITC claims. The IRS agreed with this recommendation and stated that it would analyze the available data to evaluate their usefulness in identifying fraudulent EITC claims. It should be noted that the Tax Cuts and Jobs Act, enacted in December 2017,[38] changed the requirements for the ACTC to now require a valid SSN to claim the credit.[39] As a result, the potentially erroneous claims the IRS pays as a result of ineffective processes to identify individuals with nonwork SSNs are likely to increase significantly in future years.

Use of Traditional Compliance Tools to Address Identified Erroneous Claims Continues to Diminish; Without Additional Tools and Authorities, Billions of Dollars in Improper Payments Will Be Issued Each Year

Information provided by the IRS for inclusion in the *Department of the Treasury's Agency Financial Report Fiscal Year 2017* clearly shows that the amount of EITC the IRS is protecting is declining whereas the amount of estimated EITC improper payments has increased since Fiscal Year 2015. According to IRS management, the Revenue Protected supplemental measure is defined as the cumulative erroneous EITC payments prevented and recovered through compliance activities. The reported revenue protected results from the closing of EITC examinations, closing of Automated Underreporter[40] cases, and math error adjustments. IRS management stated that the decline in volumes of returns worked and the associated dollars protected results from personnel losses in the Examination function and the Automated Underreporter Program. Figure 2 provides a comparison of IRS results for the EITC supplemental measures for Fiscal Years 2015 through 2017.

[38] Pub. L. No. 115-97.
[39] Individuals without a valid SSN may claim a credit of up to $500.
[40] Automated Underreporter cases are identified by matching information returns against data reported on individual tax returns. The Automated Underreporter system will generate proposed assessments.

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Figure 2: Comparison of Improper Payments to Revenue Protected Through Compliance Activities for Fiscal Years 2015 to 2017

Measure		Fiscal Year 2015	Fiscal Year 2016	Fiscal Year 2017
Estimated Improper Payments	Dollars	$15.6 Billion	$16.8 Billion	$16.2 Billion
Revenue Protected (through compliance activities)	Dollars	$7.3 Billion	$5.7 Billion	$4.5 Billion
	Returns	2.9 Million	1.9 Million	1.5 Million

Source: Department of the Treasury Agency Financial Report Fiscal Year 2017 (pg. 175).

As we continue to report, the IRS's use of traditional compliance tools will not provide any significant reduction in refundable credit improper payments. Without additional tools and authorities, the IRS will continue to issue billions of dollars each year in improper refundable credit payments. For example, according to the Department of the Treasury Agency Financial Report Fiscal Year 2017, approximately $1 billion (6 percent) of improper EITC payments result from income misreporting. While the PATH Act provided the IRS wage documents earlier in the filing season, it did not give the IRS authority to systemically adjust refundable credits when the income used to compute the credit is not supported by third-party income documents. The IRS must still audit each tax return to prevent or recover these unsupported refundable credits.

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 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 $1.50 to resolve an erroneous EITC claim using math error authority compared to $278 to conduct a prerefund audit.[41] 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 (referred to as correctable error 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, *Wage and Tax Statement*, from the SSA).
- The taxpayer has exceeded the lifetime limit for claiming a deduction or credit.

[41] 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.

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

Late and missing Forms W-2 reduces the ability to verify reported income at the time refundable credit claims are processed

In addition to the limitations on the IRS's authority to address identified erroneous claims, the IRS's ability to accurately verify claims is dependent on employers and third-party payers timely filing required information documents. In February 2018, we reported that some employers were noncompliant with reporting time frames for Form W-2 filing. This affected the IRS's ability to verify EITC and ACTC claims before refunds were released on February 15, 2017. For example, our analysis of tax returns with EITC and ACTC refunds released on February 15, 2017, identified 660,141 returns with refunds totaling almost $3.7 billion for which the IRS ***had no*** third-party Forms W-2. The wages reported on the 660,141 tax returns were associated with 357,335 employers. As of February 15, 2017, the IRS had not received any Forms W-2 from 319,880 (90 percent) of these 357,335 employers. In response to our analysis, IRS management noted that their ability to systemically verify income reported on the 660,141 tax returns was incomplete because employers did not submit Forms W-2. IRS management further stated that systemic income verification cannot be accurately performed for filers that report income if not all employers have reported timely.

The PATH Act requires the IRS to hold any refund that includes the EITC and the ACTC until February 15 to provide additional time to verify the income supporting these claims. To assist the IRS in verifying reported income, the PATH Act also modified the due date for filing Forms W-2 to January 31. The IRS's own assessment of employer compliance identified that only 21 percent (27,137 of 127,065) of the employers who filed Forms W-2 as of May 17, 2017, submitted their forms before February 28, 2017 (approximately two weeks after the February 15 refund release date).

Our analysis of all tax returns claiming the EITC and the ACTC with an income reporting discrepancy[42] as of February 15, 2017, identified 850,226[43] returns that still had a discrepancy as of April 20, 2017, *i.e.*, wages reported on the tax return could not be verified to third-party reported Forms W-2. These taxpayers potentially received $2.3 billion in refunds to which they were not entitled, including $1.3 billion in EITCs and $463 million in ACTCs. We provided the IRS with our results on February 20, 2018. IRS management agreed that as of April 20, 2017, the income documents were not available. However IRS management stated that 85 percent of the missing documents were provided by employers by June 30, 2017. We are continuing to measure the timeliness of the receipt of Forms W-2 as part of our 2018 Filing Season review.

[42] An income discrepancy is the difference between the wages reported on the tax return and Forms W-2 submitted by employers.
[43] We recomputed the EITC amount, ACTC amount, and refund amount on 844,517 of the 850,226 tax returns.

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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 Year[1] 2017. 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 2017*. To accomplish our objective, we:

I. Reviewed the *Department of the Treasury Agency Financial Report Fiscal Year 2017*, published on November 15, 2017, to determine if the IRS was in compliance with the improper payment reporting requirements for Fiscal Year 2017. We compared the information contained in the Agency Financial Report to the improper payment reporting requirements outlined in the OMB Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*,[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 Department of the Treasury for posting to the paymentaccuracy.gov website.

   E. Determined if the information included in the *Department of the Treasury Agency Financial Report Fiscal Year 2017* 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.

[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] Oct. 2014.

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II. Assessed the accuracy of the IRS's computation of the EITC improper payment rate and dollar amount.

A. Determined if the IRS revised the methodology used to compute the EITC improper payment rate and dollar amount since Fiscal Year 2016.

B. Determined if the IRS revised the methodology used to compute the EITC supplemental measures for Fiscal Year 2017.

III. Evaluated the adequacy of the IRS's risk assessments for the revenue program funds identified by the Department of the Treasury.

A. Ensured that the required Risk Assessment Questionnaire was completed for each revenue program fund and identified the risk level for each.

B. Determined the potential ACTC improper payment rate for Fiscal Year 2017. We ensured that the IRS determination of improper payment risk is consistent with the potential improper payment rate. We used data from the IRS NRP 1040 Study for Tax Year 2013 and the OMB budget report and compiled the data needed to update the ACTC improper payment rate for Fiscal Year 2017.

1. Used the contract statistician to compute the potential ACTC improper payment rate using the same methodology used to compute the Fiscal Year 2016 estimated improper payment rate.

2. Using the same methodology as was used for Fiscal Year 2016, computed the total potential ACTC improper payment amount for Fiscal Year 2017.

C. Determined the potential AOTC improper payment rate for Fiscal Year 2017. We ensured that the IRS determination of improper payment risk is consistent with the potential improper payment rate. We used data from the IRS NRP 1040 Study for Tax Year 2013 and the OMB budget report and compiled the data needed to update the AOTC improper payment rate for Fiscal Year 2017.

1. Used the contract statistician to compute the potential AOTC improper payment rate using the same methodology used to compute the Fiscal Year 2016 estimated improper payment rate.

2. Using the same methodology as was used for Fiscal Year 2016, computed the total potential AOTC improper payment amount for Fiscal Year 2017.

IV. Determined if the EITC Due Diligence Report effectively met the PATH Act[6] requirements and evaluated the impact of additional EITC questions on improper payments of the EITC.

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

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VI. Performed further analysis on the 850,226 Tax Year 2016 tax returns claiming the EITC and the ACTC identified in our February 2018 audit report[7] with income and withholding that was not supported by Forms W-2, *Wage and Tax Statement*, submitted by employers. We computed the additional refund these taxpayers received.

Data Validation Methodology

During this review, we relied on data received from the IRS for the NRP on the ACTC, the AOTC, and the EITC for Tax Year 2013. We also obtained extracts from the IRS's Returns Transaction File[8] databases that were available on the TIGTA's Data Center Warehouse.[9] 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.[10] 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.

We also relied on data provided to us by the SSA. Before relying on the data, we performed an analysis to ensure the reasonableness of our data such as ranges of dollar values and tax periods. We reviewed outlier records by comparing the data fields to available data on the IRS's Integrated Data Retrieval System. In addition, we selected a random sample of the SSA data and

[7] TIGTA, Ref. No. 2018-40-015, *Employer Noncompliance With Wage Reporting Requirements Significantly Reduces the Ability to Verify Refundable Tax Credit Claims Before Refunds Are Paid* (Feb. 2018).
[8] An IRS database containing transcribed tax returns for individuals that includes most forms and schedules.
[9] A TIGTA repository of IRS data.
[10] IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

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verified that the data matched various data fields captured in the IRS's Integrated Data Retrieval System. We did not have access to the SSA internal system that generated the data, but throughout our analysis we were able to match various SSA data fields to the IRS's Returns Transaction File and Individual Master File databases and found matching information. 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.

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Appendix II

Major Contributors to This Report

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Linda M. Valentine, Senior 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

Treasury Inspector General for Tax Administration Audit Reports on Improper Payments

TIGTA, Ref. No. 2017-40-030, *Revised Refundable Credit Risk Assessments Still Do Not Provide an Accurate Measure of the Risk of Improper Payments* (Apr. 2017).

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* (Apr. 2016).

TIGTA, Ref. No. 2015-40-044, *Assessment of Internal Revenue Service Compliance With the Improper Payment Reporting Requirements in Fiscal Year 2014* (Apr. 2015).

TIGTA, Ref. No. 2015-40-009, *The Internal Revenue Service Is Working Toward Compliance With Executive Order 13520 Reporting Requirements* (Dec. 2014).

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* (Sept. 2014).

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).

TIGTA, Ref. No. 2013-40-084, *The Internal Revenue Service Is Not in Compliance With Executive Order 13520 to Reduce Improper Payments* (Aug. 2013).

TIGTA, Ref. No. 2013-40-024, *The Internal Revenue Service Was Not in Compliance With All Requirements of the Improper Payments Elimination and Recovery Act for Fiscal Year 2012* (Feb. 2013).

TIGTA, Ref. No. 2012-40-028, *The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements* (Mar. 2012).

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

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Appendix V

Internal Revenue Service Programs Identified for Improper Payment Risk Assessments

The following IRS programs were identified by the Department of the Treasury for improper payment risk assessments for Fiscal Year 2017.

IRS Program	Type of Program	Level of Risk Identified
Refund Collection	Revenue	Low
Refund Collection – Interest	Revenue	Low
Headquarters Disbursement Earned Income Credit[1]	Revenue	High
Additional Child Tax Credit	Revenue	Medium
Alternative Minimum Tax – Corporations	Revenue	Low
American Opportunity Tax Credit	Revenue	Medium
Build America Bond and Recovery Zone Bond	Administrative	Low
Qualified Zone Academy Bonds	Administrative	Low
Qualified School Construction Bonds	Administrative	Low
New Clean Renewable Energy Bonds	Administrative	Low
Qualified Energy Conservation Bonds	Administrative	Low
Premium Tax Credit	Revenue	Medium
Health Coverage Tax Credit	Revenue	Low
Small Business Insurance Tax Credit	Administrative	Low
Informant Reimbursement	Revenue	Low
Taxpayer Services	Administrative	Low
Examination and Appeals	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.

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Appendix VI

Methodology to Compute Potential Additional Child Tax Credit and American Opportunity Tax Credit Improper Payments

To compute the potential estimated improper rate for the ACTC and AOTC, we used the same data sources and methodologies to the extent possible that the IRS uses to estimate the EITC improper payment rate. For example, we used the results of the IRS's NRP 1040 Study for Tax Year 2013, which is the same study the IRS used to estimate the Fiscal Year 2017 EITC improper payment rate. In addition, we computed the estimated amount of potential ACTC and AOTC improper payments by applying our estimate of the potential improper payment rate to the OMB budget estimates that are consistent with the budget estimates used by the IRS to compute Fiscal Year 2017 EITC improper payments.

Methodology Used to Compute the Potential ACTC and AOTC Improper Payment Rate for Fiscal Year 2017

Potential Improper Payment Rate	**=**	***Improper Payments – Overclaims Recovered / Total Claims***

Improper Payments – The difference between the amount of the ACTC or AOTC 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 2013. This amount includes overclaims and underpayments. This amount totaled $6.7 billion for the ACTC and $2.4 billion for the AOTC.

Overclaims Recovered – The amount of ACTC or AOTC 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[1] document matching and post-refund examinations.

ACTC Overclaims Recovered – This amount was estimated by applying the ratio of EITC overclaims recovered to EITC improper payments from the IRS's Fiscal Year 2017 EITC improper payment rate calculation. Using the EITC overclaims recovered ratio of 11.7 percent, we estimated the ACTC overclaims recovered to total $778.8 million.[2]

AOTC Overclaims Recovered – We used data provided by the IRS for the amount recovered through prerefund examinations or recovered through Automated Underreporter document matching and post-refund examinations. AOTC overclaims recovered total $94.5 million.

[1] Automated Underreporter cases are identified by matching information returns against data reported on individual tax returns. The Automated Underreporter system will generate proposed assessments.
[2] Numbers may not add up due to rounding.

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Total Claims – The amount of the ACTC or AOTC claimed on all tax returns based on the NRP results for Tax Year 2013. This amount totaled $25.4 billion for the ACTC and $8.3 billion for the AOTC.

Potential Improper Payment Dollars	**=**	***Estimated Claims*[3] *X Potential Improper Payment Rate***

Estimated Fiscal Year 2017 Improper Payment Dollars – This amount was computed by multiplying the estimated Improper Payment Rate by the estimate of total claims for that year.

ACTC – The estimate of ACTC Fiscal Year 2017 improper payments is $7.4 billion.

AOTC – The estimate of AOTC Fiscal Year 2017 improper payments is $1.3 billion.

Source: TIGTA analysis of Tax Year 2013 1040 NRP ACTC and AOTC data and the IRS's calculation of the Fiscal Year 2017 EITC improper payment rate.

[3] Estimated claims are determined after upward adjustments are made to estimates of tax expenditures and outlays in the Fiscal Year 2018 Federal Budget. For the ACTC, the estimated total claims were $31.9 billion. For AOTC, the estimated claims totaled $4.5 billion and included only the outlay portions reported in the Fiscal Year 2018 Federal Budget.

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Appendix VII

Management's Response to the Draft Report

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

CHIEF FINANCIAL OFFICER

April 2, 2018

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Ursula S. Gillis
Chief Financial Officer

SUBJECT: Response to Draft Audit Report – The Internal Revenue Service is Not in Compliance with Improper Payment Requirements (Audit #201840001)

Thank you for the opportunity to review and comment on your draft audit report entitled, *The Internal Revenue Service is Not in Compliance with Improper Payment Requirements*. Administering the refundable tax credits (RTCs) – 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) – represents a significant challenge for the IRS due to the nature of tax credits and the lack of information that is necessary for complete verification of taxpayer eligibility and claims at the time a return is filed. The RTCs each have numerous eligibility rules that contribute to the challenge of administering these credits. The rules differ for each credit and often require 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. The IRS also lacks 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. Moreover, as you noted in your report, we are limited in our ability to use existing statutory authority to make pre-refund changes or corrections to taxpayer returns, and we do not have sufficient resources to increase staffing to expand the use of our existing compliance tools to reduce RTC overclaims significantly or to increase recoveries.

We believe – and our risk assessments continue to show – 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 periodically develop tax gap estimates and undertake other compliance studies that provide estimates of noncompliance including a recently completed ACTC compliance study, with another study on AOTC nearing completion. The IRS reported that the overclaim rate for the Child Tax Credit (CTC) – the refundable portion of ACTC

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– was about $6.2 billion (13 percent) annually between tax years 2006 and 2008, and about $10.5 billion (20 percent) annually between tax years 2009 and 2011. This information is found on page 139 of the FY 2017 Treasury Agency Financial Report (AFR). We will include the AOTC study in the FY 2018 AFR. We acknowledge your concerns about our reporting of the dollars at issue and, in the interest of greater transparency, we will discuss the overclaim rates for the RTCs in the FY 2018 AFR.

The IRS uses its National Research Program (NRP) to analyze the sources of noncompliance in general and RTC overclaims in particular. These studies give us insight that helps focus our compliance programs. For example, we reported in the FY 2017 AFR that 94 percent of EITC overclaims result from our inability to authenticate eligibility information such as qualifying child requirements, residency, filing status and other issues. Another six percent result from program design limitations such as missing third-party verification information. We use this information to improve our filters and compliance programs each year, update our detection tools to improve accuracy and reduce taxpayer burden, and reject millions of returns claiming RTCs for missing forms, incorrect social security numbers, and other reasons.

We continue to have concerns about the characterization of overclaims of refundable tax credits as improper payments based on the definition included in the Improper Payments Elimination and Recovery Act (IPERA) and related legislation. We support the general intent behind IPERA and agree that federal entities must take steps to design and implement effective controls that safeguard government resources. We conducted 19 separate risk assessments last year to evaluate the controls over these IRS accounts, with most results indicating a low risk of susceptibility to improper payments. However, if the purpose of IPERA is to reduce the number and value of government payments that should not have been made, then the RTCs will fail every time because we simply do not have the information to verify or block claims before refunds are paid, and only have the resources to pursue a fraction of potential overclaims. We have engaged the Office of Management and Budget (OMB) in discussions about how to address the RTCs; however, these discussions have not resulted in any decisions to date.

The IRS disagrees with your characterization of Treasury's qualitative risk assessment approach as an attempt to circumvent IPERA reporting requirements. While we agree that the dollar values are significant, basing our evaluation and reporting on the strict framework of IPERA will not solve the problem. That is why we continue to conduct compliance studies and other analyses to evaluate RTC overclaims in the context of the tax gap and the overall framework of tax administration. Notwithstanding our differing views, however, we strongly believe in assessing and reporting on all aspects of tax compliance, which is why we include RTCs as components of tax gap analysis and reporting.

The IRS will need help to reduce RTC overclaims significantly. We appreciate the initial steps Congress has taken with the *Protecting Americans from Tax Hikes (PATH) Act of*

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2015, but it is still premature to measure the full effect of this legislation on RTC compliance and we believe that the PATH Act itself will be insufficient. We continue to believe that additional third party reporting requirements and correctible error authority are essential to being able to reduce RTC overclaims significantly. To that end, Treasury has submitted legislative proposals each year in its annual budget that would modify tax administration processes or the IRS's authority, helping us address this problem. The proposals submitted with the FY 2019 President's Budget included an expansion of the IRS's correctible error authority in cases where (1) the information provided by the taxpayer does not match the information contained in government databases; (2) the taxpayer has exceeded the lifetime limit for claiming a deduction or credit; or (3) the taxpayer has failed to include with his or her return certain documentation required by statute. A second proposal would grant the IRS the authority to require minimum standards for an estimated 400,000 paid tax return preparers currently without credentials, helping to reduce the number of incompetent and dishonest preparers filing erroneous and fraudulent returns.

Regardless of whether Congress provides the additional authorities, the IRS continues to evaluate its current compliance tools and develop new strategies for reducing refundable tax credit overclaims. As required by the PATH Act, we prepared a report for Congress detailing the effectiveness of tax return preparer due diligence requirements for claiming the CTC under section 24 of the Internal Revenue Code of 1986, and AOTC under section 25A(i). Our report discusses Treasury's and IRS's efforts to improve CTC and AOTC compliance and reduce CTC and AOTC improper payments through return preparer due diligence enforcement efforts. (Treasury has cleared the report and 0MB is reviewing it.) We also are taking steps to address erroneous and fraudulent EITC and ACTC claims identified by TIGTA and the Social Security Administration (SSA). For example, we created a new Letter 6015, *Retroactive Claim Notice (PATH),* to address the retroactive claim cases using math error authority. The letter includes a toll-free number and encourages taxpayers to call if they have any questions about the notice or the adjustment. We also conducted a test of letters and adjustments as part of the process to ensure the procedures worked as designed, and are preparing to adjust the affected returns once final approval is received from Chief Counsel.

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The IRS also recognizes that we have opportunities to improve compliance in instances where, through error or deliberate misrepresentation, taxpayers are making claims to credits to which they are not entitled. Non-work social security numbers (SSNs) are one area where we are taking steps to make improvements. We have found that the information available from SSA is not always current; for example, when a non-citizen is issued an SSN and later becomes a citizen, his/her SSN will not change and the SSA database may not be updated. However, in the case of non-work SSNs, we are initiating a pilot program that will send notices to EITC claimants with SSNs that are potentially not valid for work, asking them to provide documentation that their status has changed such that they became eligible for the credit. If the taxpayer cannot provide the documentation or fails to respond to the notice, the IRS will disallow the credit.

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.

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