RECOVERY ACT

Verifying Eligibility for Certain New Tax Benefits Was a Challenge for the 2010 Filing Season

September 30, 2010

Reference Number: 2010-41-128

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VERIFYING ELIGIBILITY FOR CERTAIN NEW TAX BENEFITS WAS A CHALLENGE FOR THE 2010 FILING SEASON

Highlights

Final Report issued on September 30, 2010

Highlights of Reference Number: 2010-41-128 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

One of the challenges the Internal Revenue Service (IRS) confronts each year in processing tax returns is the implementation of new tax law changes. The passage of two significant tax laws impacted the 2010 Filing Season and presented additional challenges for the IRS. As of May 28, 2010, the IRS received more than 131.7 million individual income tax returns and issued approximately 101 million refunds totaling $291.7 billion.

WHY TIGTA DID THE AUDIT

The filing season is critical for the IRS because it is during this time that most individuals file their income tax returns and contact the IRS if they have questions about specific tax laws or filing procedures. The overall objective of this review was to evaluate whether the IRS timely and accurately processed individual paper and electronically filed tax returns during the 2010 Filing Season.

WHAT TIGTA FOUND

The IRS timely processed individual tax returns during the 2010 Filing Season. However, implementing some new tax provisions presented challenges for the IRS. These challenges resulted in increased error inventories from individuals incorrectly calculating the Making Work Pay Credit and individuals not providing required documentation when claiming the First-Time Homebuyer Credit. There were nearly 23.7 million errors on tax returns through May 28, 2010, an increase of 7.1 percent in error receipts compared to the same time last year.

TIGTA identified inadequate controls and incomplete and inaccurate programming resulting in 125,762 individuals receiving nearly $111.4 million in erroneous Recovery Act-related tax benefits:

- 10,581 individuals claiming $65.6 million in erroneous Homebuyer Credits. IRS compliance efforts did not allow 2,363 of the 10,581 individuals to receive $11.3 million they claimed for the Homebuyer Credit.
- 109,665 individuals erroneously receiving $29.7 million in Making Work Pay and Government Retiree credits.
- 5,345 individuals erroneously claiming $15.6 million in plug-in vehicle credits.
- 171 individuals claiming $453,220 in erroneous Nonbusiness Energy Property credits.

TIGTA identified 2,933 individuals with more than $95.8 million in Qualified Motor Vehicle Tax deductions on Itemized Deductions (Schedule A) that exceeded the dollar amount the IRS uses to identify potentially erroneous claims. The IRS had not developed a process to identify these potentially erroneous claims on Schedule A.

WHAT TIGTA RECOMMENDED

The Commissioner, Wage and Investment Division, should:

- Develop processes to track and account for Recovery Act credits claimed on plug-in vehicle credit tax forms.
- Verify whether 8,218 individuals identified as erroneously claiming the First-Time Homebuyer Credit are entitled to claim the credit.
- Ensure computer systems are programmed to identify individuals exceeding the maximum allowable Nonbusiness Energy credits.
- Ensure programming is implemented to identify and freeze refunds of individuals claiming more than a specific dollar amount in Qualified Motor Vehicle Tax deductions on Schedule A, if the deduction is extended.

In its response to the report, the IRS agreed with each of our recommendations and plans to take corrective actions.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 30, 2010

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Verifying Eligibility for Certain New Tax Benefits Was a Challenge for the 2010 Filing Season (Audit # 201040102)

This report presents the results of our review to evaluate whether the Internal Revenue Service (IRS) timely and accurately processed individual paper and electronic tax returns during the 2010 Filing Season. This review is included in our Fiscal Year 2010 Annual Audit Plan and addresses the major management challenge of Implementing Tax Law Changes.

The American Recovery and Reinvestment Act of 2009 (Recovery Act)[1] provides separate funding to the Treasury Inspector General for Tax Administration through September 30, 2013, to be used in oversight activities of IRS programs. This audit was conducted using Recovery Act funds.

Management's complete response to the draft report is included in Appendix IX.

Copies of this report are also being sent to the IRS managers affected by the report recommendations.

Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.

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[1] Pub. L. No. 111-5, 123 Stat. 115 (2009).

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Abbreviations

e-filed; e-file(ing)	Electronically filed; electronic filing
IRS	Internal Revenue Service
MeF	Modernized e-File
SSN	Social Security Number
TIGTA	Treasury Inspector General for Tax Administration

Background

The filing season[1] is critical for the Internal Revenue Service (IRS) because it is during this time that most individuals contact the IRS if they have questions about specific tax laws or filing procedures and file their income tax returns. As of May 28, 2010, the IRS received more than 131.7 million individual tax returns. One of the challenges the IRS confronts each year in processing tax returns is the implementation of new tax law changes. Changes to the tax law have a major impact on how the IRS conducts its activities, how many resources are required, and how quickly the IRS can meet strategic goals. Before the filing season begins, the IRS must identify new tax law and administrative changes and, when necessary, revise various tax forms, instructions, and/or publications. The IRS must also reprogram its computer systems to ensure tax returns are accurately processed. Problems with tax return processing could delay tax refunds, affect the accuracy of tax accounts, and/or generate incorrect notices.

The IRS received more than 131.7 million tax returns as of May 28, 2010.

Along with the usual required updates,[2] two significant tax laws impacted the 2010 Filing Season:

- ***The American Recovery and Reinvestment Act of 2009 (Recovery Act)***,[3] enacted on February 17, 2009, includes 20 individual taxpayer provisions that will cost nearly $252 billion. Figure 1 provides a summary of the individual taxpayer provisions included in this Act.

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[1] See Appendix VIII for a glossary of terms.
[2] Each year, the tax products must be updated to reflect current tax rates, exemption amounts, and cost of living adjustments as shown in Revenue Procedures.
[3] Pub. L. No. 111-5, 123 Stat. 115 (2009).

Figure 1: Summary of Recovery Act Tax Changes for Individual Taxpayers

Recovery Act Tax Change[4]	Cost in Millions[5]	Taxpayers Impacted[6]	General Purpose
Making Work Pay Credit	$ 116,199	116.3 million	Reduce tax burden for working Americans.
Increase in Earned Income Tax Credit	$ 4,663	18.2 million	Raise low-income taxpayers above the poverty line.
Increase in Refundable Portion of Child Tax Credit	$ 14,830	15.6 million	Reduce the financial burden of raising a family.
Increase in Hope Credit[7]	$ 13,907	10.2 million	Help families pay for the costs of higher education.
Computers Allowed As Education Expense for Section 529 Education Saving Accounts	$ 6	5,000	Encourage the purchase of computers for students of higher learning.
Increase in First-Time Homebuyer Credit	$ 6,638	1 million	Encourage buying homes to stimulate the weak housing market.
The First $2,400 of Unemployment Compensation Is Nontaxable	$ 4,740	7.4 million	Reduce the tax burden of unemployed workers.
Additional Deduction for State Sales Tax and Excise Tax on Certain Motor Vehicles	$1,684	8.5 million	Encourage the purchase of cars, light trucks, motorcycles, and motor vehicles with a cost less than $49,500.
Alternative Minimum Tax Relief (Extended Nonrefundable Personal Credits and the Alternative Minimum Tax Exemption)	$69,759	26 million	Protect millions of middle-income taxpayers, who would otherwise be subject to the Alternative Minimum Tax.
Modification of Nonbusiness Energy Property Credit	$ 2,034	4.3 million	Encourage the purchase of energy efficient property designed to reduce heat loss during cold months or heat gain during warm months for use in a principal residence.
Modification of Residential Energy Efficient Property Credit	$ 268	1.67 million	Encourage the purchase of renewable sources of energy for use in a home.
Qualified Plug-In Electric Drive Motor Vehicles Credit, Certain Plug-In Electric Vehicles Credit, Conversion Kits, and Alternative Motor Vehicle Credit As a Personal Credit Against the Alternative Minimum Tax	$ 2,002	8,000	Encourage the purchase of motor vehicles (or the conversion of motor vehicles to those) that operate on clean renewable sources of energy.
Increased Exclusion for Employer Provided Commuter Transit Benefits	$ 192	Less than 8.4 million	Reduce the consumption of fossil fuels by promoting the use of more environmentally friendly commuter transit options.
Health Coverage Tax Credit (12 Sections 1899A – L)	$ 457	50,000[8]	Assist certified retirees and displaced workers with health insurance costs.
$250 Economic Recovery Payment to Certain Individuals	$ 14,225	676,000	Reduce financial burden on individuals receiving Social Security, railroad retirement, disability, or pension benefits.
$250 Special Credit for Certain Government Retirees	$ 218	696,000	Reduce tax burden on government retirees receiving a pension but not eligible for Social Security Benefits.
TOTAL ESTIMATED COST	***$251,822***		

Source: The Recovery Act and Treasury Inspector General for Tax Administration (TIGTA) analysis.

[4] The Alternative Minimum Tax relief section includes 2 provisions and the Plug-In Vehicle section includes 4 provisions for a total of 20 provisions.
[5] Estimated over 11 years (2009 through 2019) by the Joint Committee of Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the Conference Agreement for H.R. 1, the "American Recovery and Reinvestment Tax Act of 2009"* (JCX-19-09, dated February 12, 2009).
[6] Estimated by the TIGTA based on historical statistics from Tax Year 2006 and Tax Year 2009 projections.
[7] This is the American Opportunity Tax Credit.
[8] This is the number of taxpayers impacted per year.

- ***The Worker, Homeownership, and Business Assistance Act of 2009***[9] enacted on November 6, 2009, to help create jobs by providing tax cuts for homebuyers and businesses, while providing much-needed support for workers who are still struggling to find jobs.

During the 2010 Filing Season, the IRS processed individual income tax returns in four Wage and Investment Division Submission Processing sites located throughout the country.[10] All of the four sites processed paper individual income tax returns, and all but the Atlanta, Georgia, Submission Processing Site also processed electronically filed (*e-filed*) individual income tax returns.

The IRS processed individual income tax returns in four Wage and Investment Division Submission Processing sites.

Recovery Act activities require a high level of scrutiny, and taxpayer dollars spent on economic recovery must be subject to unprecedented levels of transparency and accountability. Federal agencies are required to ensure Recovery Act funds are used for authorized purposes and appropriate measures are taken to prevent fraud, waste, and abuse. As such, the Treasury Inspector General for Tax Administration is required to monitor the IRS implementation of Recovery Act provisions, and this audit was conducted to meet those requirements.

This review was performed at the Wage and Investment Division Headquarters in Atlanta, Georgia; the Submission Processing function offices in Lanham, Maryland, and Cincinnati, Ohio; and the Fresno, California; Kansas City, Missouri; and Austin, Texas, Submission Processing Sites during the period of October 2009 through July 2010. 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.

[9] Pub. L. No. 111-92, 123 Stat. 2984 (2009).
[10] Submission Processing Sites in Fresno, California; Atlanta, Georgia; Kansas City, Missouri; and Austin, Texas.

Results of Review

Individual Tax Returns Were Timely Processed

The IRS timely processed individual income tax returns during the 2010 Filing Season. Processing of tax returns was completed on schedule and refunds were issued within the required 45 calendar days of the April 15, 2010, due date.[11] Of the 131.7 million tax returns received by the IRS as of May 28, 2010, the IRS received 94.5 million (72 percent) as *e-filed*, which represents another record year for *e-filing* and exceeded IRS estimates. The increase resulted primarily from taxpayers filing online from home computers (up 7.7 percent).[12] However, use of the Free File Program continues to decrease. Individuals using the Free File Program decreased by 5.7 percent this filing season when compared to the last filing season. The IRS also saw an 11.1 percent decrease in paper-filed tax returns compared with the same time last year. As of May 28, 2010, the IRS had received more than 37.2 million paper-filed tax returns.

E-filing of individual tax returns hit another record high this year: 94.5 million e-filed tax returns were received by the IRS as of May 28, 2010.

In addition, as of May 28, 2010, the IRS issued approximately 101 million tax refunds totaling $291.7 billion. Of the 101 million tax refunds issued, direct deposits increased by 1.4 percent to almost 72 million. Figure 2 presents a summary of tax return filing statistics.

[11] Internal Revenue Code Section 6611(e) (2002).
[12] This percentage includes an 8.2 percent increase in Fillable Forms.

Figure 2: Comparative Filing Season Statistics As of May 28th

Cumulative Filing Season Data	2009 Actual	2010 Actual	Percentage Change
Individual Income Tax Returns			
Total Tax Returns Received (in thousands)	133,635	131,712	*-1.4%*
Paper Tax Returns Received (in thousands)	41,892	37,247	*-11.1%*
***E-filed* Tax Returns Received** (in thousands)	91,743	94,464	*3.0%*
Practitioner Prepared	60,221	60,502	0.5%
Home Computer	31,522	33,962	7.7%
Free File *(also included in Home Computer total)*	2,944	2,777	-5.7%
Fillable Forms *(also included in Home Computer total)*	264	286	*8.2%*
Refunds			
Total Number Issued (in thousands)	104,458	101,230	*-3.1%*
Total $ (in millions)	$279,280	$291,695	*4.5%*
Average $	$2,674	$2,882	*7.8%*
Total Number of Direct Deposits (in thousands)	70,907	71,900	*1.4%*
Total Direct Deposit $ (in millions)	$209,164	$225,410	*7.8%*

Source: IRS 2010 Weekly Filing Season Reports. Totals and percentages may not compute to those presented due to rounding.

E-filing continues to increase but Free Filing continues to decrease

The IRS continues to experience steady growth in *e-filed* tax returns. This year marks the 20th anniversary of the IRS' *e-filing* Program. Over 20 years, nearly 800 million tax returns have been *e-filed*. This year, the IRS began receiving *e-filed* tax returns on January 15, 2010. As of May 28, 2010, overall *e-file* volumes have increased 3 percent over the same period last filing season. This includes an increase of 7.7 percent in tax returns from taxpayers who *e-filed* from their home computers. The percentage of *e-filed* tax returns has increased to 72 percent of the total individual income tax returns received.

However, the number of individuals using the Free File Program decreased by 5.7 percent from this time in 2009. The traditional IRS Free File Program is a free Federal online tax preparation and *e-filing* Program for eligible taxpayers developed through a partnership between the IRS and the Free File Alliance LLC (group of private-sector tax preparation companies). The Program enables eligible individuals to use commercial tax software for free.

In addition, for the second year, the IRS and its partners offered Free File Fillable Tax Forms, which opens up the Free File Program to nearly everyone, with no income limitations. Fillable

Tax Forms allow individuals to fill out and *e-file* their tax forms at no cost. The forms are available through the Free File Program link on IRS.gov (the public IRS Internet web site). Individuals enter their tax data, perform basic math calculations, sign their tax returns electronically, print their tax returns for recordkeeping, and *e-file* their tax returns. The use of Fillable Forms totaled 286,000 an increase of 8.2 percent from 2009.

The IRS expanded its Modernized e-File (MeF) system to include individual tax returns

The IRS has used the MeF system to process business tax returns for several years. For Filing Season 2010, the IRS implemented the first phase of the MeF system to process individual tax returns. The MeF system is replacing the current IRS *e-filing* system (referred to as Legacy *e-File*) with a modernized, Internet-based *e-file* platform. When completed, the MeF system will provide a single method for filing all business and individual tax returns, forms, and schedules via the Internet. The MeF system provides real-time processing of tax returns and extensions that will improve error detection, standardize business rules, and expedite acknowledgments. The MeF system also allows for attachments in portable document format to accommodate late legislation and form changes.

The IRS implemented its first phase of MeF to process individual tax returns with a total of 694,071 tax returns processed through the MeF system as of May 28, 2010.

This first phase of the MeF system for individual income tax returns includes the U.S. Individual Income Tax Return (Form 1040), Application for Automatic Extension of Time To File U.S. Individual Income Tax Return (Form 4868), and 21 forms and schedules related to the Form 1040 for Tax Year 2009.[13] The IRS began accepting the Form 1040, Form 4868, and related forms and schedules through the MeF system for processing on February 17, 2010. The IRS estimates approximately 72 million of the individual income tax returns filed during the 2010 Filing Season would qualify for the MeF system. As of May 28, 2010, a total of 694,071 individual tax returns have been processed by the MeF system.

We completed a separate review to evaluate the first phase of the IRS' processing of individual tax returns through the MeF system.[14] The overall objective of the review was to determine whether *e-filed* individual income tax returns transmitted through the MeF system were processed timely and accurately in a manner consistent with those tax returns processed in the Legacy *e-File* system. As such, we are not including specific recommendations in this audit report.

[13] See Appendix VI for a list of the specific forms and schedules that will be processed through the MeF system.
[14] *System Errors and Lower Than Expected Tax Return Volumes Affected the Implementation of the Modernized e-File System for Individual Tax Return Processing* (Reference Number 2010-40-111, dated September 8, 2010).

Taxpayers elected to use the new savings bond option and have increased their use of the split refund option

On September 5, 2009, President Obama announced a new initiative to make it easier for more than 100 million families to save a portion or all of their tax refunds. Beginning in 2010, individuals had the ability to purchase United States Series I Savings Bonds by using Direct Deposit of Refund to More Than One Account (Form 8888) or by electing on their returns to convert their entire refund into a savings bond. As of May 28, 2010, 24,636 individuals chose to use $12.2 million of their tax refunds to purchase savings bonds and 100 individuals chose to convert their entire tax refunds of $187,880 into savings bonds.

In addition, individuals can still elect to have their Federal income tax refunds split and electronically deposited in up to three accounts (e.g., checking, savings, or Individual Retirement Arrangement) and may have up to three different United States financial institutions, including banks, brokerage firms, or credit unions. Form 8888 must also be prepared for this option. As of May 28, 2010, 567,255 individuals chose to split their tax refunds of $2.5 billion between 2 or 3 different accounts. The number of individuals using the split tax refund option increased 49 percent over the same time period in 2009, and the total amount of tax refunds increased by 59 percent.

Individuals Took Advantage of New and Expanded Credits and Deductions

Both the Recovery Act and the Worker, Homeownership, and Business Assistance Act legislation contain provisions to assist individual taxpayers:

- The Recovery Act provisions provide tax relief to working or retired Americans and their families including refundable tax credits, a sales tax deduction on motor vehicles, Alternative Minimum Tax relief for middle-income taxpayers, a reduction in taxable unemployment compensation, a payment for Social Security recipients, a credit for Government retirees, tax credits that promote investing in renewable sources of energy, and changes to the Health Coverage Tax Credit.
- The Worker, Homeownership, and Business Assistance Act of 2009 provisions help create jobs by providing tax cuts for homebuyers and businesses, while providing much-needed support for workers who are still struggling to find jobs. The legislation also extends and expands the First-Time Homebuyer Credit (Homebuyer Credit) along with adding anti-fraud measures. The credit of $8,000 is extended for homes purchased or under contract by April 30, 2010. In addition, a smaller credit of up to $6,500 is available to taxpayers who have lived in their homes for at least 5 years and wish to purchase a new home. The new law extends a similar credit until May 2011 for members of the uniformed services whose duty takes them overseas.

Figure 3 provides the number of individuals and dollar amounts claimed for some of the new and/or expanded credits/deductions as of May 28, 2010.

Figure 3: Individuals Claiming New and/or Expanded Tax Credits/Deductions

	Claims for the Credits Through May 28, 2010	
Recovery Act Credit	**Number of Taxpayers**	**Dollar Amount**
Making Work Pay Credit and Special Credit for Government Retirees	89.8 million	$53.3 billion
American Opportunity Tax Credit	8.3 million	$7.1 billion
First-Time Homebuyer Credit	1.05 million[15]	$7.4 billion
Additional Deduction for State Sales Tax and Excise Tax on the Purchase of a Qualified Motor Vehicle	4.1 million[16]	$8.4 billion
Extension and Modification of Credit for Nonbusiness Energy Property and Modification of Credit for Residential Energy Efficient Property	6.2 million	$5.2 billion
Plug-In Vehicle Credits	16,874	$75.3 million*

Source: TIGTA analysis of 2010 Filing Season tax return volumes through May 28, 2010.
**These amounts represent only those that were claimed on an e-filed tax return. Claims for these credits cannot be identified on paper tax returns.*

However, our testing identified that the IRS is unable to completely track and account for some new credits claimed for individual tax provisions because processes have not been implemented to capture information from the following tax forms included with paper-filed tax returns:

- Electric plug-in vehicle credits on Qualified Plug-in Electric and Electric Vehicle Credit (Form 8834).
- Alternative Motor Vehicle Credit (Form 8910).
- Qualified Plug-in Electric Drive Motor Vehicle Credit (Form 8936).

As such, the IRS is not able to identify the number of individuals claiming the credits and the amount of credits claimed. We alerted IRS management of their inability to track and account for these Recovery Act funds. We recommended that the IRS implement Special Processing

[15] Tax returns claiming the First-Time Homebuyer Credit between February 16, 2010, and May 28, 2010.
[16] The Additional Deduction for State Sales Tax and Excise Tax on the Purchase of a Qualified Motor Vehicle can be claimed on either the Itemized Deductions (Form 1040, Schedule A) or the Standard Deduction for Certain Filers (Form 1040, Schedule L). The amounts identified on Schedule L are IRS computed amounts based on transcribed data. The amounts identified on Schedule A were the amounts claimed by the taxpayer.

Code programming to enable the IRS to track and account for these credits filed on paper tax returns. Special Processing Codes are entered on tax returns with certain conditions to alert the computer to a special condition or computation.

The IRS agreed that it needs the ability to provide transparent reporting of Recovery Act-related credits and responded that existing and newly created processes will allow it to report on the use of these credits. Programming was to be implemented to add Special Processing Codes to enable the IRS to track and account for funds allocated as part of tax provisions included in the Recovery Act for individuals claiming Electric Vehicle Credits on paper-filed tax returns. The implementation date for the programming was originally February 18, 2010, but was delayed to March 2, 2010. The IRS subsequently informed us that they decided to delay identifying and tracking these credits until the beginning of the 2011 Filing Season.

Recommendation

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Develop processes to track and account for Recovery Act credits claimed on Forms 8834, 8910, and 8936.

> ***Management's Response:*** IRS management agreed with this recommendation. They submitted a Unified Work Request on August 3, 2010, to create Error Resolution System input-only fields that will enable the IRS to capture the data needed to track and account for Recovery Act credits claimed on Forms 8834, 8910, and 8936. Since the requested action will be subject to funding and resource prioritization by Modernization and Information Technology Services, submission of the Unified Work Request will complete the corrective action.

Implementing Recovery Act and Worker, Homeownership, and Business Assistance Provisions Presented Challenges

The IRS recognized the difficulty taxpayers had in claiming new credits and/or deductions. In an attempt to reduce this difficulty, the IRS created new forms, schedules, and/or instructions. Implementing legislation for the 2010 Filing Season required the IRS to update many tax products and perform extensive programming in an effort to ensure tax returns would be processed accurately. We identified 71 tax products (33 tax forms, 12 instructions, and 26 publications) requiring updates due to legislation and determined 59 of them had been updated clearly and accurately. Of the remaining 12 tax products, 9 were incorrect, 2 had inconsistencies identified after we had notified the IRS,[17] and 1 was unavailable for review during the filing season.[18] See Appendix VII for more information about the specific issues we raised relative to tax products and the IRS actions taken as of May 28, 2010, to address these concerns.

Furthermore, of the significant new or expanded credits/deductions we reviewed, the IRS correctly implemented programming/processes to accurately process tax returns with the following credits:

- Temporary increase in the Earned Income Tax Credit – The Earned Income Tax Credit percentage for families with 3 or more qualifying children was correctly increased to 45 percent of earned income. In addition, the increased threshold phase-out amounts were correctly implemented.
- Temporary increase in the refundable portion of the Child Tax Credit – The formula for computing the refundable child credit was correctly changed. The formula was modified to apply to 15 percent of earned income in excess of $3,000 instead of the previous $8,500 earned income amount.
- The American Opportunity Tax Credit – Controls were correctly implemented to ensure:
    - The $2,500 maximum credit per student was not exceeded.
    - The $1,000 maximum refundable credit per student was not exceeded.
    - The credit was properly reduced when the Modified Adjusted Gross Income was between $80,000 and $90,000 ($160,000 and $180,000 for married filing jointly).
    - The credit was properly denied when the Modified Adjusted Gross Income exceeded $90,000 ($180,000 for married filing jointly).
- Clarification of the Uniform Definition of a Child in relation to returns claiming the Child Tax Credit, Additional Child Tax Credit, or Earned Income Tax Credit – Controls were implemented to ensure a child must generally be younger than the person claiming the child and the Child Tax Credit may be claimed only for a child for whom an exemption is claimed.

However, some new tax provisions presented challenges for the IRS. Problems implementing these provisions resulted in increased error inventories from individuals incorrectly calculating the Making Work Pay Credit and individuals not providing required documentation when claiming the Homebuyer Credit. Prior to the start of the filing season, the IRS recognized the difficulty individuals would have in calculating the Making Work Pay Credit and complying

[17] On November 17, 2009, we notified the IRS of our concerns regarding the nine tax products that contained inconsistencies, were incomplete, and/or were inaccurate. These two tax products were identified subsequent to this notification.
[18] This tax product subsequently became available, was reviewed, and was found to have been correctly updated.

with the Homebuyer Credit documentation requirements. In an attempt to alleviate confusion and errors, the IRS developed and executed an aggressive outreach campaign. For example:

- The IRS sent reminders to tax professionals that the amount on Line 10 of the Making Work Pay and Government Retiree Credits (Schedule M), which asks if the individual or their spouse (if filing jointly) received an Economic Recovery Payment in 2009, must match the Economic Recovery Payment received by the taxpayer in 2009. If individuals cannot recall if they received this payment, they were advised to contact the respective agency to confirm whether they received the payment before resubmitting their tax returns claiming the Making Work Pay and Government Retiree Credits. However, to date, more than 1 million *e-filed* tax returns have been rejected and this issue is included in the top 5 errors on paper tax returns.
- The IRS provided a lookup tool, "Did I Receive an Economic Recovery Payment?" which gives individuals an easy way to determine if they received the one-time Economic Recovery Payment. The Internet application became available March 17, 2010, on IRS.gov. In addition, individuals can call a toll-free telephone number to access the telephone application.
- The IRS conducted an extensive communications campaign focusing on key Recovery Act provisions, including more than three dozen news releases and fact sheets and two dozen plain language tax tips for the public and tax professionals covering the Homebuyer Credit, Making Work Pay Credit, Energy, and Education credits.
- The IRS created 10 Recovery Act videos on YouTube in English, Spanish, and American Sign Language along with podcasts on IRS.gov and iTunes. Sixteen radio Public Service Announcements were produced in English and six in Spanish. Recovery Act flyers and posters were created in six languages (English, Spanish, Chinese, Korean, Russian and Vietnamese) and some publications were provided in multiple languages that covered the Recovery Act in general as well as the Homebuyer Credit and Making Work Pay Credit.

In addition, the IRS developed computer programming to check each tax return and identify individuals that qualified for the Making Work Pay Credit but did not claim the credit on their tax returns. Through May 28, 2010, the IRS provided Making Work Pay credits to 1,654,801 individuals who were entitled to the credit but had not claimed the credit on their tax returns.

Despite these efforts, there were nearly 23.7 million errors on tax returns through May 28, 2010, an increase of 7.1 percent in error receipts compared to the same time last year. The increase in error inventories resulted primarily from individuals incorrectly calculating the Making Work Pay Credit and/or not providing required documentation when claiming the Homebuyer Credit. In addition to the increased error inventories, our review identified inadequate controls and incomplete and inaccurate programming resulting in 125,762 individuals receiving nearly $111.4 million in erroneous Recovery Act-related tax benefits. Figure 4 provides a summary of erroneous tax benefits identified during the filing season.

Figure 4: Summary of Erroneous and/or Excess Tax Benefits Identified

Recovery Act Credit	Erroneous and/or Excess Tax Benefits Claimed Through May 28, 2010 — Number of Taxpayers	Dollar Amount
First-Time Homebuyer Credit	10,581[19]	$65.6 million
Making Work Pay Credit and Special Credit for Government Retirees	109,665	$29.7 million
Plug-In Vehicle Credits	5,345*	$15.6 million
Extension and Modification of Credit for Nonbusiness Energy Property and Modification of Credit for Residential Energy Efficient Property	171*	$453,220

Source: TIGTA analysis of 2010 Filing Season tax return volumes through May 28, 2010.
**These amounts represent only those that were claimed on an e-filed tax return. Claims for these credits cannot be identified on paper tax returns.*

Erroneous First-Time Homebuyer Credits Were Claimed by Individuals With Ineligible Home Purchase Dates

As of May 28, 2010, we identified 10,581 individuals claiming $65.6 million in Homebuyer Credits which appear to be erroneous:

- **Ineligible past purchase date:** 8,734 individuals claimed $52.6 million in erroneous Homebuyer Credits as long-time residents with a purchase date prior to November 6, 2009. Of these 8,734 individuals, subsequent IRS compliance efforts did not allow 2,180 individuals to receive $10.4 million they claimed for the Homebuyer Credit. To qualify for this Credit, the law specifies that these individuals must complete the purchase of their new home after November 6, 2009. The IRS did not establish controls to identify individuals who erroneously claim the Homebuyer Credit as long-time residents with incorrect purchase dates.

  On April 5, 2010, we alerted the IRS to this condition. We recommended the IRS immediately revise its tax return processing programs to identify these tax returns. IRS management agreed with our recommendation and issued an alert to its examiners on April 9, 2010, instructing them to disallow the Homebuyer Credit for individuals claiming

[19] This includes only originally filed Tax Year 2009 tax returns claiming the First-Time Homebuyer Credit between February 16, 2010, and May 28, 2010.

the Credit as long-time residents for homes purchased before November 7, 2009. Although this alert was issued, we continue to identify individuals allowed to erroneously claim the Homebuyer Credit as a long-time resident with home purchase dates prior to November 6, 2009.

- **Ineligible future purchase date:** 1,847 individuals claimed $13 million in erroneous Homebuyer Credits for a home with a purchase date subsequent to the filing date of the tax return. Of these 1,847 individuals, subsequent IRS compliance efforts did not allow 183 individuals to receive $965,656 they claimed for the Homebuyer Credit. To qualify for the Homebuyer Credit, individuals must complete the purchase of their new home before claiming the credit. The IRS did not establish controls to identify individuals who claimed the Homebuyer Credit for future home purchase dates.

Processes are ensuring individuals provide required documentation and meet the minimum age requirement in support of Homebuyer Credit claims

Previous TIGTA reviews[20] identified:

- The IRS did not request that individuals attach some form of documentation to tax returns to verify eligibility before the Homebuyer Credit was allowed. In a memorandum dated November 25, 2008, we recommended that the IRS ensure information on each line of the First-Time Homebuyer Credit (Form 5405) be transcribed for paper tax returns and that the information from Form 5405 be used to validate claims for the First-Time Homebuyer Credit. We also recommended the IRS require individuals to attach documentation to substantiate a home purchase and verify eligibility for the Credit. The IRS disagreed with both recommendations.
- 582 individuals under 18 years of age claimed almost $4 million in First-Time Homebuyer Credits. The youngest individuals were 4 years old. Contract law generally exempts children under the age of 18 from being bound by the terms of a contract. Therefore, it is unlikely that these individuals would have entered into an arms-length transaction for the purchase of a home.

Subsequent to our raising the above concerns, the Worker, Homeownership, and Business Assistance Act included important measures to combat tax fraud and protect responsible homebuyers, including setting a minimum age for home purchases and requiring documentary proof of the purchase in order to receive the credit. Our review of more than 1 million tax returns with claims for the Homebuyer Credit as of May 28, 2010, identified no individuals under the age of 18 erroneously received the Homebuyer Credit. In addition, we selected a sample of 69 tax returns for individuals claiming the Homebuyer Credit in which required

[20] See Appendix V for a list of completed, ongoing, or planned audits relating to areas reported on in this report.

documentation was not provided by the individual to support their claim. Of the 69 returns sampled:

- 65 (94.2 percent) returns – the IRS had corresponded with the individual to request required documentation. IRS management decided to suspend processing of tax returns submitted without supporting statements and to correspond with these individuals before denying the credit with its math error authority. Although this decision slowed the processing of some tax returns, it benefited individuals by providing them with the opportunity to submit the required documentation to receive their Homebuyer Credit.
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Recommendations

The Commissioner, Wage and Investment Division, should

Recommendation 2: Verify whether the 6,554 individuals who TIGTA identified as claiming the Homebuyer Credit as long-time residents for homes purchased prior to November 6, 2009, are entitled to claim the Credit. In addition, develop a process to identify other individuals allowed to erroneously claim the Homebuyer Credit as long-time residents subsequent to the end of our testing on May 28, 2010.

> **Management's Response:** IRS management agreed with this recommendation. The IRS will use third-party public property records to verify that the 6,554 individuals the TIGTA identified as claiming the Homebuyer Credit as long-time residents for homes purchased prior to November 6, 2009, are entitled to claim the Credit. The IRS will use this same process to verify the actual purchase date for other individuals who erroneously claimed the Homebuyer Credit as long-time residents.

Recommendation 3: Verify whether the 1,664 individuals who TIGTA identified as claiming the Homebuyer Credit for future purchase dates are entitled to claim the Credit. In addition, develop a process to identify other individuals allowed to erroneously claim the Homebuyer Credit with future purchase dates subsequent to the end of our testing on May 28, 2010.

> **Management's Response:** IRS management agreed with this recommendation. The IRS will use third-party public property records to verify that the 1,664 individuals TIGTA identified as claiming the Homebuyer Credit for future purchase dates are entitled to claim the Credit. The IRS will use this same process to verify the actual purchase date

of other individuals who erroneously claimed the Homebuyer Credit for future purchase dates.

Incorrect Programming Resulted in the Issuance of Erroneous Making Work Pay and Government Retiree Credits

As of May 28, 2010, we identified that the IRS erroneously issued Making Work Pay and Government Retiree Credits to 109,665 individuals totaling $29.7 million. The IRS developed programming to systemically compute the Making Work Pay and Government Retiree Credits on tax returns on which the individual appears eligible for the credits. However, errors in this programming resulted in the issuance of the erroneous credits.

Individuals without a valid Social Security Number erroneously received the Making Work Pay Credit

Prior to the IRS correcting its computer programming, we identified 38,446 individuals (as of February 26, 2010) that erroneously received the Making Work Pay Credit. These individuals did not have a valid Social Security Number (SSN) and therefore did not qualify for the credit. Tax examiners successfully denied the Credit for 405,065 (91 percent) of the tax returns filed without a valid SSN. However, for the remaining 38,446 (9 percent), tax examiners failed to correctly disallow the credit, which resulted in individuals incorrectly receiving $15.2 million in erroneous Making Work Pay Credits.

It should be noted that 36,026 of these individuals did not claim the Making Work Pay Credit. For these individuals, IRS programs incorrectly computed the credit without taking into account that the individual did not have the required valid SSN. The IRS computes the amount of the Making Work Pay Credit for every Tax Year 2009 tax return processed. Tax returns for which the IRS' computation of the Making Work Pay Credit differs from the taxpayer's are sent to the Error Resolution function for tax examiner review. For the tax returns with a discrepancy, tax examiners are required to review the tax returns and disallow the credit for those individuals who file without a valid SSN. The Recovery Act provides that in order to be eligible for the Making Work Pay Credit an individual must provide a valid SSN. In the case of tax returns filed as married filing jointly, at least one of the individuals filing the tax return must provide an SSN.[21]

On February 5, 2010, we alerted the IRS of the fact that individuals without a valid SSN were erroneously receiving the Making Work Pay Credit. We recommended that the IRS immediately revise its tax return processing programs to not compute an amount for the Making Work Pay Credit for individuals who do not have a valid SSN. IRS management responded that the issue could be resolved through a programming change and the change was scheduled to be

[21] For purposes of this section of the Recovery Act, the SSN does not include a Taxpayer Identification Number issued by the IRS.

implemented on February 25, 2010. We determined this programming change was made and subsequent to the change we no longer identified erroneous Making Work Pay Credits to individuals without a valid SSN.

Individuals receiving a Government Retiree Credit are erroneously receiving excess credits

As of May 28, 2010, we identified 71,219 individuals who erroneously received $14.5 million in excess Making Work Pay and Government Retiree Credits because IRS computer programs were incorrectly computing the Making Work Pay and Government Retiree Credits. Programming was not correctly computing the credit for individuals who indicated eligibility to receive the $250 Government Retiree Credit and who also received a $250 Economic Recovery Payment.

The Recovery Act provided for a special credit for certain Government retirees. If an individual received a pension or annuity from a Government entity for work not covered by Social Security, he or she is entitled to the $250 Government Retiree Credit. If the individual also had income from wages or other earned income, he or she may also be entitled to the Making Work Pay Credit. In both situations, the Making Work Pay Credit is reduced if an individual received the Economic Recovery Payment.[22] These credits are calculated and reported using the Schedule M. The IRS tax return processing system computes the Making Work Pay and Government Retiree Credits on tax returns using formulas based on several factors.[23] Tax returns for which the IRS' computation for these credits differs from the taxpayers are sent to the Error Resolution function for tax examiner review.

On February 19, 2010, we alerted the IRS of this condition and recommended that the IRS immediately revise its tax return processing programs to correctly compute the Making Work Pay and Government Retiree Credits on tax returns with a Special Processing Code "M." Special Processing Code "M" is entered on tax returns when Line 11 on Schedule M has either a dollar amount or the "Yes" box is checked indicating the taxpayer received a pension or annuity from a Government entity for work not covered by Social Security. IRS management responded that manual procedures for tax examiners to correct this condition were issued. In addition, a correction to the programming was requested and the programming was to be completed by April 1, 2010. However, we continued to identify erroneous claims after the planned programming correction and determined the programming change was not implemented until April 23, 2010.

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[22] Economic Recovery Payments were sent to taxpayers that received Social Security benefits, Supplemental Security Income benefits, Railroad Retirement benefits, or Veterans Affairs disability compensation or pension benefits.

[23] Factors include wages, self-employment income, Adjusted Gross Income, Economic Recovery Payment indicators, and Special Processing Codes.

Inadequate Controls Resulted in Erroneous Plug-In Vehicle Credits

As of May 28, 2010, we identified 5,345 individuals erroneously claiming $15.6 million in plug-in vehicle credits:

- 1,180 individuals claiming $2.1 million in erroneous credits for vehicles with vehicle years that did not qualify. These individuals claimed electric plug-in vehicle credits on Form 8834 and Form 8936 and reported a vehicle with a year earlier than 2009. The law requires that vehicles must be new to qualify for these credits.
- 257 individuals claiming $559,942 in erroneous credits for vehicles that did not have qualifying in-service dates. These individuals claimed electric plug-in vehicle credits on Form 8834 and Form 8910 and reported vehicles with an in-service date earlier than February 17, 2009. The law requires vehicles have in-service dates after February 17, 2009. Individuals also claimed credits on Form 8936 and reported vehicles with in-service dates earlier than January 1, 2009. The law requires vehicles have in-service dates after December 31, 2008.
- 3,908 individuals claiming $13 million in erroneous credits that do not qualify based on the make of the vehicle. The law specifies that the make of the vehicles must qualify. These individuals claimed electric plug-in vehicle credits on Form 8834 and Form 8936 and reported vehicle makes that were not included on the approved list of vehicles for the Form 8834 and Form 8936 tax credits. The IRS provides a list of vehicle manufacturers, makes, and models that qualify for the tax credits claimed on Form 8834 and Form 8936 on IRS.gov. The Form 8910 does not require a specific vehicle manufacturer, make, or model as it is a conversion.

We alerted IRS management to the above conditions on February 10, 2010. Based on our alert, the IRS implemented five new error reject codes on March 29, 2010, to reject *e-filed* tax returns with a vehicle year and/or in-service date that do not meet the tax provision requirements for the plug-in vehicle credits. In addition, instructions were issued to tax examiners to enter a Computer Condition Code on paper tax returns with disqualifying in-service dates and the credit will be denied.

However, the IRS did not agree to verify the make of the vehicle during tax return processing because this would require IRS employees to review the forms for several hundred different types of qualifying vehicles. It would also have a significant impact on the number of tax returns that could be reviewed per hour. The IRS also believes this issue is best handled after the tax return has been processed, and a Compliance Strategy being developed for Recovery Act provisions will include tests in Fiscal Year 2011 for this issue.

We are performing a separate review[24] to further assess the IRS' ability to identify and prevent erroneous Plug-in and Alternative Motor Vehicle Credits. As such, we are not including specific recommendations or outcome measures in this report.

Incomplete Programming Resulted in Erroneous Nonbusiness Energy Property Credits

As of May 28, 2010, we identified 171 individuals claiming $453,220 in erroneous nonbusiness energy property credits. Controls allowed these individuals to claim a credit that exceeded the maximum allowable amount for the Nonbusiness Energy Property Credit based on their filing status and multiple residence indicators.

- For all filing statuses reporting only one primary residence, the maximum allowable credit is $1,500.
- For married individuals filing jointly reporting more than one primary residence, the maximum allowable credit is $3,000.

Our review identified that the IRS planned to implement an *e-file* reject code to prevent claims for more than the allowable maximum credit amounts of $1,500 for single filers or $3,000 for married filing jointly filers. However, the programming was not implemented. We notified the IRS in an email alert on April 15, 2010, that as of April 2, 2010, we had identified 123 individuals that erroneously received $315,055 in Nonbusiness Energy Property Credits. We recommended that the IRS implement the *e-file* reject code to prevent claims for more than the allowable maximum credit amounts. The IRS responded that programming had been requested on April 23, 2010, to implement a new error reject code to prevent claims for more than the allowable maximum credit amounts. The initial programming implementation date was scheduled for May 14, 2010, but was extended to June 24, 2010.

We were not able to analyze paper tax returns to identify erroneous claims. Although the IRS can track and account for the credits on the Residential Energy Credits (Form 5695) claimed on *e-filed* tax returns, accurate tracking and accounting for these credits on paper-filed tax returns is more difficult. On paper-filed tax returns, these credits are included on a line on the Form 1040 with two additional tax credits. The IRS has programming in place to identify tax returns with any amount claimed on this line. Tax examiners then review the returns and move the amounts into appropriate fields. The Form 5695 has two credits, the Nonbusiness Energy Property Credit and the Residential Energy Efficient Property Credit. The IRS moves the amounts for these two credits into one field, Residential Energy Credits. Combining the two credits into one total on paper tax returns impairs the IRS' ability to accurately report the number of claims and the

[24] *Electric Plug-In Vehicle and Alternative Motor Vehicle Credit Claims* (Audit # 201040131).

respective amounts paid for the Nonbusiness Energy Property Credit and the Residential Energy Efficient Property Credit.

We plan to conduct a separate review to further assess IRS' ability to identify and prevent erroneous Residential Energy Property Credits.[25]

Recommendation

The Commissioner, Wage and Investment Division, should:

Recommendation 4: Ensure that the computer systems are programmed to identify individual claims exceeding the maximum allowable Nonbusiness Energy credit amounts. This should include programming to reject *e-filed* returns with this condition.

> ***Management's Response:*** IRS management agreed with this recommendation. A Special Processing Code will be entered on paper tax returns to identify individual claims within the maximum allowable Nonbusiness Energy Credit amount. Because the Nonbusiness Energy Credit is included on a line with two other credits, the return will fall out to the Error Resolution System for review if the combined credits claimed exceed the allowable amount and the Special Processing Code is not present. The IRS will use math error authority to reduce any excessive Nonbusiness Energy Credit claimed to the maximum allowable amount.
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> A Unified Work Request was submitted on August 4, 2010, for programming to reject e-filed returns where individual claims for the Nonbusiness Energy Credit exceeded the maximum allowable amount. Since the requested action will be subject to funding and resource prioritization by Modernization and Information Technology Services, submission of the Unified Work Request will complete the corrective action.

Individuals Received Excessive Qualified Motor Vehicle Tax Deductions

As of May 28, 2010, we identified 2,933 individuals with more than $95.8 million in Qualified Motor Vehicle Tax deductions on Form 1040, Itemized Deductions (Schedule A), that exceeded the dollar amount which the IRS uses to identify a potentially erroneous claim. The Qualified Motor Vehicle Tax deduction can be claimed on either Schedule A or Standard Deduction for Certain Filers (Schedule L). The amount of the deduction is limited to the tax paid on the first $49,500 of the purchase price of the qualified motor vehicle.

The IRS implemented controls to identify and freeze the refund for individuals claiming a Qualified Motor Vehicle Tax deduction in excess of a specific dollar amount on a Schedule L.

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[25] *Residential Energy Credits* (Audit # 201040109).

Once the freeze is applied, the tax return is sent to an examiner to determine if the claim is legitimate. Similar controls, however, were not implemented to identify excessive Qualified Motor Vehicle Tax deductions claimed on Schedule A.

We alerted IRS management on April 20, 2010, of this condition and recommended that the IRS implement controls similar to those implemented for Schedule L to identify excessive Qualified Motor Vehicle Tax deductions claimed on Schedule A. IRS management agreed with the recommendation and will request a programming change to implement controls, similar to those for Schedule L, to identify excessive Qualified Motor Vehicle Tax deductions claimed on Schedule A for Tax Year 2009 tax returns, since the deduction expired on December 31, 2009.

Recommendation

If the Qualified Motor Vehicle Tax deduction is extended, the Commissioner, Wage and Investment Division, should:

Recommendation 5: Ensure programming is implemented to identify and freeze refunds of individuals claiming more than a specific dollar amount in Qualified Motor Vehicle Tax deductions on Schedule A. This programming should mirror the programming already in place for potentially excessive Qualified Motor Vehicle Tax deductions on Schedule L. In addition, examiners should review the 2,933 individuals who TIGTA identified as claiming the Qualified Motor Vehicle Tax deduction on Schedule A that exceeded a specific dollar amount to ensure these individuals qualify for the deduction.

> ***Management's Response:*** IRS management agreed with this recommendation. They submitted two Unified Work Requests on August 3, 2010, and August 11, 2010, to implement programming to identify and freeze refunds of individuals claiming over a specific dollar amount in Qualified Motor Vehicle Tax deductions on Schedule A, Itemized Deductions. Since the requested action will be subject to funding and resource prioritization by Modernization and Information Technology Services, submission of the Unified Work Request will complete the corrective action.
>
> The Director, Compliance, Wage and Investment Division, will coordinate with the Director, Campus Compliance, Small Business/Self Employment Division, to ensure these cases are reviewed. Cases warranting examination will be selected for audit.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate whether the IRS timely and accurately processed individual paper and electronic tax returns during the 2010 Filing Season.[1] To accomplish our objective, we:

I. Identified new tax legislation and administrative changes for the 2010 Filing Season that will have the greatest potential affect on individual taxpayers.

   A. Reviewed tax forms, instructions, and publications to determine whether they were accurately updated with the changes.

   B. Reviewed tax return processing procedures and change documentation to determine whether adequate controls were included to accurately process the new tax provisions during tax return processing.

II. Determined whether the IRS correctly implemented new tax legislation and administrative changes that affected the processing of individual tax returns during the 2010 Filing Season. We used computer analysis of 100 percent of the Tax Year 2009 individual income tax returns processed nationally on the Individual Return Transaction File between January 1 and May 28, 2010,[2] to identify returns affected by recent tax legislation and administrative changes and determined whether they were processed correctly. We electronically identified:

   1. 89,824,023 tax returns processed claiming the Making Work Pay and Government Retiree Credits (Schedule M) through May 28, 2010.

   2. 8,261,467 tax returns processed claiming $7,076,432,821 in refundable American Opportunity Tax Credits on Education Credits (Form 8863) through May 28, 2010.

   3. 4,079,167 tax returns processed with $8,427,765,863 in Additional Deductions for State Sales Tax and Excise Tax On the Purchase of Qualified Motor Vehicles on

[1] See Appendix VIII for a glossary of terms
[2] To assess the reliability of computer-processed data, programmers in the TIGTA Office of Information Services validated the data that were extracted, and we verified the data with appropriate documentation. Judgmental samples were selected and reviewed to ensure that the amounts presented were supported by external sources. As appropriate, data in the selected data records were compared to the physical tax returns to verify that the amounts were supported.

Itemized Deductions (Schedule A) and Standard Deduction for Certain Filers (Schedule L) through May 28, 2010.

4. 16,874 *e-filed* tax returns processed with electric plug-in vehicle credits on Qualified Plug-in Electric and Electric Vehicle Credit (Form 8834), Alternative Motor Vehicle Credit (Form 8910), and Qualified Plug-in Electric Drive Motor Vehicle Credit (Form 8936) through May 28, 2010.
5. 1,049,550 tax returns processed with a First-Time Homebuyer Credit and Repayment of the Credit (Form 5405) through May 28, 2010. In addition, we selected a judgmental sample of 122 tax returns from the Fresno, California; Kansas City, Missouri; and Austin, Texas, Submission Processing Sites to determine if they were accurately processed when they had supporting documentation or did not have supporting documentation. We used judgmental sampling to ensure that the original returns could be quickly obtained to evaluate the accuracy of processing.

III. Determined whether the IRS monitoring systems indicated that individual returns were being processed accurately and in a timely manner.

A. Monitored various Submission Processing site production reports, inventory reports, and return error inventories between January 15 and May 28, 2010, for key indicators of return processing and compared the statistics to those for the 2009 Filing Season.

B. Monitored the IRS Program Completion Date reports from April 26 through May 17, 2010, to determine whether the Submission Processing sites processed all refund returns in a timely manner.

C. Monitored Error Resolution System inventories (for delays or capacity problems).

D. Monitored weekly 2010 Filing Season Wage and Investment Division Production meetings between January 21 and June 3, 2010, and monitored the IRS Submission Processing function web site to identify potentially significant issues.

IV. Determined whether the IRS had corrected problems identified in the 2009 Filing Seasons. From returns processed by the Submission Processing sites between January 1 and May 28, 2010, we electronically identified Tax Year 2009 returns that met specific criteria.

A. Identified through May 28, 2010, 1,049,550 tax returns claiming the First-Time Homebuyer Credit on First-Time Homebuyer Credit and Repayment of the Credit (Form 5405). We electronically analyzed these returns to determine whether they were properly processed with respect to the previously identified problems.

IV. Monitored issues of stakeholder interest.

A. Determined whether taxpayers were using the new savings bond option for direct purchase of savings bonds with tax refunds.

B. Determined whether taxpayers have significantly increased the use of the split refund option for depositing their refund.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the processes for planning, organizing, directing, and controlling program operations for the 2010 Filing Season. We also evaluated the controls that are incorporated directly into computer applications to help ensure the validity, completeness, and accuracy of transactions and data during application processing of tax returns for the 2010 Filing Season.

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner C
Office of the Deputy Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Wage and Investment Division SE:W
Director, Business Modernization Office, Wage and Investment Division SE:W:BMO
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Customer Assistance, Relationships, and Education, Wage and Investment Division SE:W:CAR
Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division SE:W:ETARC
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM
Director, Field Assistance, Wage and Investment Division SE:W:CAR:FA
Director, Joint Operations Center, Wage and Investment Division SE:W:CAS:JOC
Director, Stakeholder Partnership, Education, and Communications, Wage and Investment Division SE:W:CAR:SPEC
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
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Chief Counsel CC
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Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

For all of the outcomes listed in this appendix, we conducted computer analyses of Tax Year 2009 individual income tax returns.[1] The returns were processed by the IRS Submission Processing sites between January 1, 2010, and May 28, 2010, and were posted to the Individual Master File. We developed specific criteria to identify returns affected by the new tax law changes covered in this review. We used further computer analysis and auditor evaluation of return data to determine if the IRS accurately processed individual tax returns during the 2010 Filing Season.

Type and Value of Outcome Measure:

- Cost Savings (Funds Put to Better Use) – Potential; 6,554 individuals claiming $42.2 million in erroneous Homebuyer Credits (see page 12).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 6,554 individuals claiming $42.2 million in Homebuyer Credits when their tax returns were processed. These individuals filed a tax return claiming the Homebuyer Credit as a long-time resident with a purchase date prior to November 6, 2009.

Type and Value of Outcome Measure:

- Cost Savings (Funds Put to Better Use) – Potential; 1,664 individuals claiming $12 million in erroneous Homebuyer Credits (see page 12).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 1,664 individuals claiming $12 million in Homebuyer Credits when their tax returns were processed. These individuals filed a tax return claiming a Homebuyer Credit for a home which had not yet been purchased, but reportedly would be in the future.

[1] See Appendix VIII for a glossary of terms.

Type and Value of Outcome Measure:

- Cost Savings (Funds Put to Better Use) – Potential; 38,446 individuals that erroneously received $15.2 million in Making Work Pay Credits (see page 15).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 38,446 individuals that erroneously received $15.2 million in Making Work Pay Credits because they did not have a valid SSN.

Type and Value of Outcome Measure:

- Cost Savings (Funds Put to Better Use) – Potential; 71,219 individuals who erroneously received $14.5 million in excess Making Work Pay and Government Retiree Credits (see page 15).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 71,219 individuals who erroneously received $14.5 million in excess Making Work Pay and Government Retiree Credits because the IRS programming was not correctly computing the credit for individuals who indicated eligibility to receive the $250 Government Retiree Credit and who also received a $250 Economic Recovery Payment.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; 171 individuals claiming $453,220 in erroneous nonbusiness energy property credits (see page 17).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 171 individuals claiming $453,220 in erroneous nonbusiness energy property credits because an *e-file* reject code was not implemented to prevent claims for more than the allowable maximum credit amounts of $1,500 for single filers or $3,000 for married individuals filing jointly reporting more than one primary residence.

Appendix V

List of Related Treasury Inspector General for Tax Administration Reviews Completed, Ongoing, or Planned

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)

Audit Objective: Determine whether the IRS has controls in place that effectively identify erroneous claims for the First-Time Homebuyer Credit.

Additional Steps Are Needed to Prevent and Recover Erroneous Claims for the First-Time Homebuyer Credit (Reference Number 2010-41-069, dated June 17, 2010)

Audit Objective: Determine whether the IRS has controls in place that effectively identify erroneous claims for the First-Time Homebuyer Credit.

System Errors and Lower Than Expected Tax Return Volumes Affected the Implementation of the Modernized e-File System for Individual Tax Return Processing (Reference Number 2010-40-111, dated September 8, 2010)

Audit Objective: Determine whether *e-filed* individual income tax returns transmitted through the MeF system are processed timely and accurately in a manner consistent with those tax returns processed in the Legacy *e-File* system.

A Comprehensive Strategy Is Being Developed to Identify Individuals With First-Time Homebuyer Credit Repayment Requirements (Reference Number 2010-41-086, dated August 16, 2010)

Audit Objective: Determine whether the IRS has developed effective strategies to administer the First-Time Homebuyer Credit, recapture the Credit from taxpayers when appropriate, and prevent improper Credits.

Processing of Amended Returns Claiming the First-Time Homebuyer Credit (Audit Number 201040140)

Audit Objective: To determine whether the IRS has controls in place to ensure claims for the First-Time Homebuyer Credit claimed on amended income tax returns are appropriately processed.

First-Time Homebuyer Credit (Erroneous Claims) Phase 3 (Audit Number 201040141)

Audit Objective: To determine whether the IRS has controls in place that effectively identify erroneous claims for the First-Time Homebuyer Credit.

Electric Plug-In Vehicle and Alternative Motor Vehicle Credit Claims (Audit Number 201040131)

Audit Objective: Assess the effectiveness of the IRS' processes to identify and prevent erroneous claims for the Electric Plug-In Vehicle Credit and Alternative Motor Vehicles.

Deductions Associated With the Purchase of Qualified Motor Vehicles (Audit Number 201040108)

Audit Objective: Assess the effectiveness of the IRS' process to identify erroneous Qualified Motor Vehicle deductions.

Residential Energy Credits (Audit Number 201040109)

Audit Objective: Assess the effectiveness of the IRS' process to identify erroneous Residential Energy Credits.

Process to Ensure Repayment of the First-Time Homebuyer Credit (Audit Number 201040107)

Audit Objective: Assess the IRS' efforts to ensure accurate and timely repayment of the First-Time Homebuyer Credit.

Appendix VI

List of Tax Forms and Schedules Processed Through Modernized e-File

Form 1040 – U.S. Individual Income Tax Return

Schedule A – Itemized Deductions

Schedule B – Interest and Ordinary Dividends

Schedule C – Profit or Loss From Business

Schedule D – Capital Gains and Losses

Schedule E – Supplemental Income and Loss

Schedule EIC – Earned Income Credit

Schedule M – Making Work Pay and Government Retiree Credits

Schedule R – Credit for the Elderly or the Disabled

Schedule SE – Self-Employment Tax

Form 1099-R – Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

Form 2106 – Employee Business Expenses

Form 2210 – Underpayment of Estimated Tax by Individuals, Estates, and Trusts

Form 2441 – Child and Dependent Care Expenses

Form 4562 – Depreciation and Amortization (Including Information on Listed Property)

Form 4868 – Application for Automatic Extension of Time To File U.S. Individual Income Tax Return

Form 8283 – Noncash Charitable Contributions

Form 8812 – Additional Child Tax Credit

Form 8829 – Expenses for Business Use of Your Home

Form 8863 – Education Credits (American Opportunity, Hope, and Lifetime Learning Credits)

Form 8880 – Credit for Qualified Retirement Savings Contributions

Form 8888 – Direct Deposit of Refund to More Than One Account

Form W-2 – Wage and Tax Statement

Appendix VII

List of Tax Products Reviewed

Tax Products	Description of Exception Issue	Actions the IRS Agreed to Take	IRS Actions Taken
Draft Residential Energy Credits (Form 5695)	The information provided on Page 3 of the General Instructions under "Joint Occupancy" conflicted with the instructions on Page 5 for Line 6.	Update the final version with the recommended changes.	The IRS updated the instructions on Page 5 to eliminate the conflict with the instructions on Page 3.
Instructions for Draft Alternative Motor Vehicle Credit (Form 8910) and Draft Qualified Plug-in Electric Drive Motor Vehicle Credit (Form 8936) including the instructions	The instructions for these two draft forms referred taxpayers to an Internal Revenue Code section for the definition of a qualified plug-in vehicle rather than simply providing the taxpayer with the definition of a qualified plug-in electric drive motor vehicle as a four-wheeled vehicle.	Add text to Form 8910 to point out that alternative motor vehicles must have four wheels and to review the other requirements in the Internal Revenue Code to ensure they are adequately covered in the instructions.	The Instructions for the final Form 8910 and the instructions in the Final Form 8936 were both updated to define a qualified plug-in electric drive motor vehicle as a four-wheeled vehicle.
Draft Qualified Plug-in Electric and Electric Vehicle Credit (Form 8834), Draft Alternative Motor Vehicle Credit (Form 8910), and Draft Qualified Plug-in Electric Drive Motor Vehicle Credit (Form 8936) including the instructions	These three draft forms did not include a calculation step or Caution on the front of the form that informed or prevented taxpayers from claiming a double benefit for the same vehicle on more than one of these forms.	Place Cautions at the top of the 2009 Forms 8834, 8910, and 8936 similar to the Cautions used on Alcohol and Cellulosic Biofuels Credits (Form 6478) and Biodiesel and Renewable Diesel Fuels Credits (Form 8864).	The Final Forms 8834, 8910, and 8936 were not updated to include the Caution. The IRS stated the Caution would be added to these Forms in 2010.
Highlights of 2008 Tax Changes (Publication 553) (June 2009)	Under "2009 Changes" for "New plug-in electric drive motor vehicle credit" it states, "Has a gross vehicle weight rating of less than 14,000 pounds." Less than 14,000 pounds is correct for Tax Year 2010. For Tax Year 2009, the gross vehicle weight rating may be more than 26,000 pounds.	Review the tax products and articles on IRS.gov that refer to the gross vehicle weight rating to ensure they are corrected and changed as needed and post a What's Hot topic on IRS.gov.	Publication 553 (June 2009 version) was updated on IRS.gov to correct the inaccuracy.
Instructions for U.S. Individual Income Tax Return (Form 1040) and Instructions for U.S. Individual Income Tax Return (Form 1040A)	In the brief section on the Refundable Education Credit (the American Opportunity Tax Credit) filers are referred back to an earlier section on the Education Credit where no information on this credit is provided. A reference to the Education Credits (American Opportunity, Hope, and Lifetime Learning Credits) (Form 8863) and instructions where the American Opportunity Tax Credit is fully addressed would be more helpful.	Consider updating the 2010 versions of these two tax products because the 2009 versions had already gone to print.	The TIGTA will follow up on this issue during our tax product review for the 2011 Filing Season.

Tax Products	Description of Exception Issue	Actions the IRS Agreed to Take	IRS Actions Taken
Instructions for Form 1040 and for Form 1040A and Making Work Pay and Government Retiree Credits (Schedule M)	These three tax products do not inform the taxpayer that an SSN is required to be eligible to claim the Making Work Pay Credit and Government Retiree Credit.	Consider updating the 2010 versions of these three tax products because the 2009 versions had already gone to print.	The TIGTA will follow up on this issue during our tax product review for the 2011 Filing Season.

Appendix VIII

Glossary of Terms

Adjusted Gross Income	Calculated after certain adjustments are made but before standard or itemized deductions and personal exemptions are subtracted.
Earned Income Tax Credit	A refundable Federal tax credit for low-income working individuals and families.
Error Resolution System	Responsible for correcting taxpayer and return preparer errors, as well as errors made during IRS processing of tax returns.
Filing Season	The period from January 1 through April 15 when most individual income tax returns are filed.
Free File Program	A free Federal tax preparation and electronic filing program for eligible taxpayers developed through a partnership between the IRS and the Free File Alliance LLC. The Alliance is a group of private-sector tax software companies.
Individual Master File	The IRS database that maintains transactions or records of individual tax accounts.
Individual Return Transaction File	Contains data transcribed from initial input of the original individual tax returns during return processing.
Making Work Pay Credit	A refundable tax credit of 6.2 percent of wages. The maximum credit is $400 for individuals and $800 for married couples.
Master File	The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
Modernized e-File	This system provides real-time processing of tax returns and extensions that will improve error detection, standardize business rules, and expedite acknowledgments. The system also allows taxpayers to attach documents to their tax return.
Modified Adjusted Gross Income	Calculated without regard to certain deductions or exclusions, unlike Adjusted Gross Income.

Submission Processing Site	The data processing arm of the IRS. The sites process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
Tax Year	The 12-month period for which tax is calculated. For most individual taxpayers, the tax year is synonymous with the calendar year.

Appendix IX

Management's Response to the Draft Report

COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

RECEIVED
SEP 17 2010
BY: PAB

SEP 16 2010

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard Byrd, Jr.
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Verifying Eligibility for Certain New Tax Benefits Was a Challenge for the 2010 Filing Season (Audit # 201040102)

We have reviewed the subject draft report and appreciate your acknowledgement of our delivery of another successful Filing Season in 2010. This achievement is especially significant in light of the challenges resulting from the economic downturn and enactment of legislation, such as the American Reinvestment and Recovery Act of 2009 and the Worker, Homeownership, and Business Assistance Act of 2009. The IRS aligned resources to meet the increased demand for services, increased taxpayer access to assistance, reviewed processes to improve efficiency, and delivered modernized systems to help taxpayers meet their obligations.

As of July 24, 2010, over 133 million individual tax returns were processed with more than 104 million refunds issued. Over 95 million of these returns were filed electronically, which is a 2.96 percent increase over last year. The Customer Account Data Engine processed 41 million of the 133 million tax returns, meeting daily processing timeframes. This is a 2.9 percent increase over last year. As you noted in your report, the processing of tax returns was completed on schedule.

Despite the timing of new tax law provisions, we successfully modified computer programming, and implemented procedural changes and revisions to the tax forms, with no significant delays. Additional filters and procedures were put into place for the First Time Homebuyer Credit to prevent erroneous refunds, and the Electronic Tax Administration and Refundable Credit organization partnered with private industry to expand Free File and Free File Fillable Forms to provide more forms coverage and eligibility to more taxpayers.

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We did have higher than usual error inventories as you state in your report. Much of this increase resulted from the decision to apply the Making Work Pay Credit to eligible taxpayers even if it is not claimed on their tax return. As of July 24, 2010, IRS verified and allowed the Making Work Pay Credit to over 4.5 million taxpayers. As your report states, we took immediate action to correct issues that arose during the filing season. In addition, we are taking enforcement actions to recover amounts that may be owed.

We reviewed the outcome measures identified in Appendix IV and agree with your assessment. Attached are our comments to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Peter J. Stipek, Director, Customer Accounts Services, Wage and Investment Division, at (404) 338-8910.

Attachment

Attachment

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 1: Develop processes to track and account for Recovery Act credits claimed on Forms 8834, 8910, and 8936.

CORRECTIVE ACTION
We agree with this recommendation. We submitted a Unified Work Request (UWR) on August 3, 2010, to create Error Resolution System (ERS) input-only fields that will enable the IRS to capture the data needed to track and account for Recovery Act credits claimed on Forms 8834, 8910, and 8936. Since the requested action will be subject to funding and resource prioritization by Modernization and Information Technology Services (MITS), submission of the UWR will complete the corrective action.

IMPLEMENTATION DATE
August 3, 2010

RESPONSIBLE OFFICIAL
Director, Submission Processing, Customer Account Services, Wage and Investment Division

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

RECOMMENDATION 2: Verify whether the 6,554 individuals who TIGTA identified as claiming the Homebuyer Credit as long-time residents for homes purchased prior to November 6, 2009, are entitled to claim the Credit. In addition, develop a process to identify other individuals allowed to erroneously claim the Homebuyer Credit as long-time residents subsequent to the end of our testing on May 28, 2010.

CORRECTIVE ACTION
We agree with this recommendation. We will use third-party public property records to verify that the 6,554 individuals the Treasury Inspector General for Tax Administration (TIGTA) identified as claiming the Homebuyer Credit as long-time residents for homes purchased prior to November 6, 2009, are entitled to claim the credit. We will use this same process to verify the actual purchase date of other individuals who erroneously claimed the Homebuyer Credit as long-time residents.

IMPLEMENTATION DATE
January 15, 2011

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RESPONSIBLE OFFICIAL
Director, Earned Income Tax Credit, Electronic Tax Administration and Refundable Credits, Wage and Investment Division
Director, Accounts Management, Customer Account Services, Wage and Investment Division

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

RECOMMENDATION 3: Verify whether the 1,664 individuals who TIGTA identified as claiming the Homebuyer Credit for future purchase dates are entitled to claim the Credit. In addition, develop a process to identify other individuals allowed to erroneously claim the Homebuyer Credit with future purchase dates subsequent to the end of our testing on May 28, 2010.

CORRECTIVE ACTION
We agree with this recommendation. We will use third-party public property records to verify that the 1,664 individuals TIGTA identified as claiming the Homebuyer Credit for future purchase dates are entitled to claim the credit. We will use this same process to verify the actual purchase date of other individuals who erroneously claimed the Homebuyer Credit for future purchase dates.

IMPLEMENTATION DATE
January 15, 2011

RESPONSIBLE OFFICIAL
Director, Earned Income Tax Credit, Electronic Tax Administration and Refundable Credits, Wage and Investment Division
Director, Accounts Management, Customer Account Services, Wage and Investment Division

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

RECOMMENDATION 4: Ensure that the computer systems are programmed to identify individual claims exceeding the maximum allowable Nonbusiness Energy credit amounts. This should include programming to reject *e-filed* returns with this condition.

CORRECTIVE ACTION
We agree with this recommendation. A Special Processing Code (SPC) will be entered on paper tax returns to identify individual claims within the maximum allowable Nonbusiness Energy Credit amount. Because the Nonbusiness Energy Credit is included on a line with two other credits, the return will fall out to ERS for review if the combined credits claimed exceed the allowable amount and the SPC is not present. We will use math error authority to reduce any excessive Nonbusiness Energy Credit claimed to the maximum allowable amount.

We submitted a UWR on August 4, 2010, for programming to reject e-filed returns where individual claims for the Nonbusiness Energy Credit exceeded the maximum allowable amount. Since the requested action will be subject to funding and resource prioritization by MITS, submission of the UWR will complete the corrective action.

IMPLEMENTATION DATE
February 15, 2011, for paper returns
August 4, 2010, for electronic returns programming

RESPONSIBLE OFFICIAL
Director, Submission Processing, Customer Account Services, Wage and Investment Division

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

RECOMMENDATION 5: Ensure programming is implemented to identify and freeze refunds of individuals claiming more than a specific dollar amount in Qualified Motor Vehicle Tax deductions on Schedule A. This programming should mirror the programming already in place for potentially excessive Qualified Motor Vehicle Tax deductions on Schedule L. In addition, examiners should review the 2,933 individuals who TIGTA identified as claiming the Qualified Motor Vehicle Tax deduction on Schedule A that exceeded a specific dollar amount to ensure these individuals qualify for the deduction.

CORRECTIVE ACTION
We agree with this recommendation. We submitted two UWRs, on August 3, 2010, and August 11, 2010, to implement programming to identify and freeze refunds of individuals claiming over a specific dollar amount in Qualified Motor Vehicle Tax deductions on Schedule A, *Itemized Deductions*. Since the requested action will be subject to funding and resource prioritization by MITS, submission of the UWR will complete the corrective action.

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The Director, Compliance, Wage and Investment Division, will coordinate with the Director, Campus Compliance, Small Business/Self Employed Division, to ensure these cases are reviewed. Cases warranting examination will be selected for audit.

IMPLEMENTATION DATE
July 15, 2011, for review
August 11, 2010, for programming

RESPONSIBLE OFFICIALS
Director, Compliance, Wage and Investment Division
Director, Campus Compliance Services, Small Business/Self Employed Division

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