Expansion of Controls Over Refundable Credits Could Help Reduce the Billions of Dollars of Improperly Paid Claims

September 7, 2012

Reference Number: 2012-40-105

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

Redaction Legend:
2(f) = Risk Circumvention of Agency Regulation or Statute

Phone Number | 202-622-6500
E-mail Address | TIGTACommunications@tigta.treas.gov
Website | http://www.tigta.gov

EXPANSION OF CONTROLS OVER REFUNDABLE CREDITS COULD HELP REDUCE THE BILLIONS OF DOLLARS OF IMPROPERLY PAID CLAIMS

Highlights

Final Report issued on September 7, 2012

Highlights of Reference Number: 2012-40-105 to the Internal Revenue Service Deputy Commissioner for Services and Enforcement.

IMPACT ON TAXPAYERS

Refundable credits, unlike other tax credits, not only have the potential to reduce a taxpayer's tax liability to zero, but also allow the taxpayer to receive a cash payment of any remaining credit amount. This makes refundable tax credits more susceptible to fraud. Without proper controls, billions of taxpayer dollars are vulnerable to erroneous claims and fraudulent tax schemes.

WHY TIGTA DID THE AUDIT

Erroneous credits discovered after refunds are released may require more costly enforcement actions, and the likelihood of collection diminishes over time.

This audit was initiated to determine the effectiveness of the IRS's efforts to recover refundable credits disallowed during post-refund examinations and consider options the IRS could implement to decrease the issuance of erroneous refundable credits.

WHAT TIGTA FOUND

During Tax Years 2006 through 2009, taxpayers claimed almost $470 billion in refundable credits. Due to post-refund examinations, taxpayers were required to repay more than an estimated $2.3 billion in erroneous credits. By the end of December 2011, the IRS had recovered an estimated $1.3 billion, of which more than 70 percent was collected through refund offsets.

TIGTA found that taxpayers repeatedly claimed erroneous Additional Child Tax Credits (ACTC) after being disallowed the previous year. The IRS could have saved more than $108 million by reviewing claims made by taxpayers who were previously disallowed the credit.

In addition, TIGTA found that when the IRS freezes and reviews a questionable Earned Income Tax Credit (EITC) but releases a related ACTC, the ACTC will later be disallowed 67 percent of the time, and the IRS will have to employ post-refund collection methods to recover the credits. The IRS could have prevented approximately $419 million in erroneous ACTC refunds from being released had it reviewed the ACTC at the same time the EITC was being reviewed.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS implement additional controls to identify and stop erroneous claims for refundable credits before refunds are issued, including:

- Implementing an account indicator to identify taxpayers who claim erroneous refundable credits. Taxpayers with such an indicator should be required to provide documentation before their claims for refundable credits are processed and should be considered for pre-refund examinations of claims for all refundable credits. Such an indicator should be applied for a specified time period.
- Freezing and verifying claims for the ACTC on all returns for which the EITC is frozen.
- Working with the Department of the Treasury's Office of Tax Policy to seek legislation to expand the EITC due diligence requirements to include the ACTC.

IRS management agreed with TIGTA's recommendations and plans to take appropriate corrective actions. Rather than implementing an account indicator to identify taxpayers who claim erroneous refundable credits, the IRS plans to develop pre-refund examination filters to ensure historical information is available and used as selection criteria. Although this planned action is different than what TIGTA recommended, TIGTA believes that it is a viable alternative.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 7, 2012

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

FROM: Michael E. McKenney
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Expansion of Controls Over Refundable Credits Could Help Reduce the Billions of Dollars of Improperly Paid Claims (Audit # 201140045)

This report presents the results of our review to determine the effectiveness of the Internal Revenue Service's (IRS) efforts to recover refundable credits disallowed during post-refund examinations and consider options the IRS could implement to decrease the issuance of erroneous refundable credits in the future. This audit is included in our Fiscal Year 2012 Annual Audit Plan and addresses the major management challenge of Fraudulent Claims and Improper Payments.

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

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 Augusta R. Cook, Acting Assistant Inspector General for Audit (Returns Processing and Account Services), at (770) 617-6434.

Table of Contents

Abbreviations

ACTC	Additional Child Tax Credit
EITC	Earned Income Tax Credit
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration

Background

Refundable credits, unlike other tax credits, not only have the potential to reduce a taxpayer's tax liability to zero, but also allow the taxpayer to receive a cash payment of any remaining credit amount. In recent years, the number of refundable credits available to taxpayers has grown.

Two refundable credits, the Earned Income Tax Credit (EITC) and the Additional Child Tax Credit (ACTC), are designed to help working and low-income families. Some refundable credits such as the First-Time Homebuyer Credit, the American Opportunity Tax Credit, and the Adoption Credit have been offered temporarily[1] to provide incentives for specific activities, such as buying a home, obtaining a college education, and adopting a child.

Refundable tax credits can be a significant tax incentive due to their ability to increase taxpayers' refunds. However, these credits can result in a payment to individuals from the Government even if no taxes were withheld or paid, which makes refundable tax credits more susceptible to fraud. Without proper controls, billions of taxpayer dollars are vulnerable to erroneous claims and fraudulent tax schemes.

The IRS estimates that, since Fiscal Year 2003, between $99 billion and $119 billion in EITC payments have been improperly paid.

Due to their increased susceptibility to fraud and improper payments, refundable credits have received increased oversight. The reduction of improper payments is a priority of the President and Congress. The Treasury Inspector General for Tax Administration (TIGTA) and the Government Accountability Office have issued a number of reports that have addressed the Internal Revenue Service's (IRS) ability to administer these credits. The IRS estimates that it has paid between $99 billion and $119 billion in improper EITC payments alone from Fiscal Years[2] 2003 through 2011.[3] It does not have estimates for the other refundable credits.

Both the TIGTA and the Government Accountability Office have recommended the increased use of preventive controls, stressing the importance of identifying questionable refundable credits prior to the issuance of the refund. Erroneous credits discovered after refunds are released may require more costly enforcement actions, and the likelihood of collection diminishes over time.

---

[1] Either the credit was temporary or it was only refundable temporarily.
[2] A 12-consecutive-month period ending on the last day of any month, except December. The Federal Government's fiscal year begins on October 1 and ends on September 30.
[3] Source: Department of the Treasury Performance and Accountability Reports for Fiscal Years 2003 through 2010 and the Fiscal Year 2011 Agency Financial Report.

The IRS recognizes the need to prevent erroneous refundable credits from being refunded and has implemented controls in an attempt to identify questionable claims before the refunds are issued. Examination filters have been implemented to identify potentially erroneous claims for review. For certain credits, the IRS has required supporting documentation to be attached to the tax return to verify eligibility. In some cases, by law, the IRS has been granted permission to deny the claim up front if the required supporting documentation is not received. Through the Modernized E-File system, the IRS is now able to accept portable document format attachments of supporting documentation. If the tax preparation software used by the taxpayer or his or her tax preparer does not include that functionality, tax returns must be filed on paper.

This review focused on the collectability of erroneous refundable credits once they have been refunded to the taxpayer but subsequently disallowed by either the IRS's Examination function or Criminal Investigation. We performed our analysis by "tax module," which is the portion of a taxpayer's account that relates to a specific tax return (*e.g.*, transactions and other information related to a taxpayer's Form 1040, *U.S. Individual Income Tax Return*, for Tax Year[4] 2009 would be posted to a tax module created for that tax return).[5] We identified 340 million taxpayer modules with refundable credits claimed totaling about $470 billion during Tax Years 2006 through 2009. Only 4.6 million modules (1 percent) underwent some type of direct IRS scrutiny. Because the IRS conducts a limited number of examinations each year, many additional questionable credits were allowed with no IRS scrutiny. The scope of our audit covered erroneous credits identified and disallowed by the IRS after the related refunds were issued.

This review was performed onsite at the IRS Campus[6] in Ogden, Utah, during the period August 2011 through February 2012. It included analysis of tax data located on the TIGTA Data Center Warehouse,[7] a review of taxpayer account data contained on the IRS Individual Master File,[8] and discussions and analysis of information provided by the IRS Small Business/ Self-Employed Division and the Wage and Investment Division. 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.

---

[4] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
[5] The IRS defines tax module as that part of a taxpayer's account consisting of one tax class and one tax period.
[6] The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
[7] The Data Center Warehouse is a collection of IRS databases containing various types of taxpayer account information that is maintained by the TIGTA for the purpose of analyzing data for ongoing audits.
[8] The IRS database that maintains transactions or records of individual tax accounts.

Results of Review

Many Erroneous Refundable Credits Are Never Recovered

In addition to the controls that the IRS has in place to identify and stop certain erroneous refundable credits before refunds are released, it performs reviews of tax returns after refunds are released to identify additional erroneous claims. However, a significant percentage of the credits disallowed after refunds are issued are never recovered, and much of what is recovered comes from refund offsets rather than payments made by taxpayers. Refund offsets are funds transferred from another tax module for which the taxpayer is owed a refund.[9]

We identified 1,308,540 tax modules (Tax Years 2006 through 2009) that appeared to have claims for refundable credits that were disallowed after refunds had been issued on the modules. We limited our scope to refundable credits that were disallowed by December 31, 2010, to ensure taxpayers had been given at least one year to repay the credits by the time we analyzed the modules at the end of Calendar Year 2011. From this population, we selected a statistically valid sample of 385 modules to determine how successful the IRS was in recovering these disallowed credits and ultimately reviewed 267[10] cases with post-refund disallowed refundable credits. We analyzed the modules to determine which credits were disallowed, how much was collected, what kind of payments were made, and how quickly the credits were repaid. The refundable credits sampled were:

- 62 percent ACTC.
- 35 percent EITC.[11]
- 1 percent First-Time Homebuyer Credit.
- 1 percent American Opportunity Tax Credit.

---

[9] Generally, before the IRS issues a refund, its computer system analyzes a taxpayer's entire account to ensure there are no modules for which the taxpayer has a balance due. If it finds a balance due, it automatically applies funds that would have otherwise been refunded to that balance due.

[10] From our original sample of 385, we found that credits on 111 modules were disallowed due to a pre-refund IRS examination but were included in our data because the disallowance of the credit was posted after the refund had been issued. We did not include these cases because the refund did not include the disallowed credit, and the taxpayer was not required to repay anything. In addition, we did not include the Making Work Pay Credit or the Recovery Rebate Credit in our sample because these credits were generally allowed to the population at large, without the need for significant scrutiny by the IRS. Seven modules in our sample of 385 contained only these credits.

[11] During Fiscal Years 2007 through 2009, the IRS performed more than twice as many post-refund examinations for the ACTC (774,291) than it performed on the EITC (347,777).

- 1 percent Telephone Excise Tax Refund.[12]

The total of the refundable credits disallowed on the 267 modules was $679,690. The balance owed due to the disallowed credits had been fully satisfied on 145 modules (54 percent) and had been partially satisfied on 74 modules (28 percent). The remaining 48 modules (18 percent) showed no collection activity at all. The total amount of refundable credits collected on these 267 modules as of December 31, 2011, was $390,051 (57 percent of the disallowed amounts).

Applying the results of our analysis to the 1,308,540 tax modules (Tax Years 2006 through 2009) in our population, we estimate 907,480 modules had refundable credits[13] totaling more than $2.3 billion that were disallowed after having been refunded to taxpayers. As of the end of Calendar Year 2011, we estimate the IRS collected approximately $1.3 billion (57 percent) of this $2.3 billion, leaving more than $984 million (43 percent) uncollected.

Because payments are applied to the tax module as a whole, it is not feasible to determine a collection rate for each specific credit. However, in our analysis we applied all payments to the disallowed refundable credits first unless the payment was specifically designated for something else, such as interest or penalties. The IRS may continue to collect on these tax modules; however, the probability of collection will continue to decrease with time. The 267 tax modules had refundable credits disallowed between January 2007 and December 2010. Therefore, we had up to five years of collection data for credits reversed in Calendar Year 2007, four years of data for credits reversed in Calendar Year 2008, and so on.[14]

Assuming each credit follows a similar collectability pattern, we applied collection rates from the older tax modules to the modules for which we had only a few years worth of repayment data. Based on this application, we estimate the IRS could collect an additional $155 million, making an overall collection rate of 64 percent (leaving $829 million uncollected). This assumes that the IRS could even collect on modules that had no payment activity as of December 2011 despite the

---

[12] The refundable Adoption Credit was not included in our sample because it was not available to taxpayers until Tax Year 2010, which was outside the scope of this audit. In addition, because some refundable credits were claimed by a small number of taxpayers, not all credits were represented in our sample (*e.g.*, the Health Coverage Tax Credit, the Fuel Tax Credit, and the Credit for Prior Year Minimum Tax).
[13] Excluding Making Work Pay and Recovery Rebate Credits.
[14] These 267 modules consisted of 25 (9 percent) with credits disallowed in 2007, 59 (22 percent) with credits disallowed in 2008, 84 (31 percent) with credits disallowed in 2009, and 99 (37 percent) with credits disallowed in 2010 (percentages do not total to 100 percent due to rounding).

fact that more than 52 percent of the modules with no collection activity were at least two years old.[15]

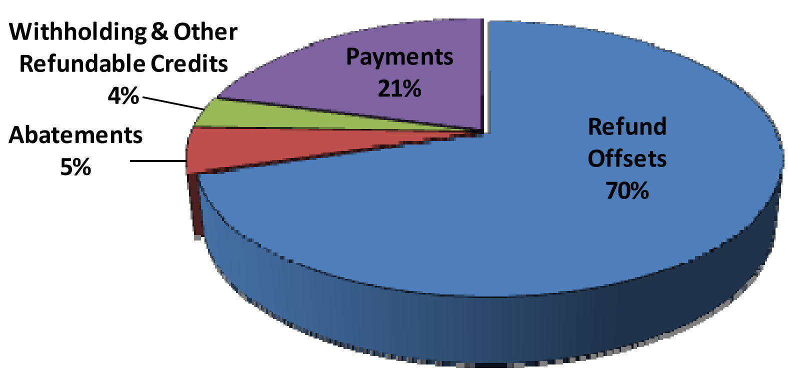
Erroneous credits are primarily recovered through refund offsets

Although the IRS recovered approximately 57 percent of the erroneous credits refunded in our sample, only 21 percent of the amounts collected came through payments received directly from taxpayers. The majority of the recovered amounts came from refund offsets.

Refund offsets do not reflect an effort made by taxpayers to repay their tax debts. Collection occurs only if taxpayers are due subsequent refunds. If taxpayers are later found to be ineligible for credits that were included in refunds that were offset, the collection situation can be compounded with additional delinquencies.

Of the total $390,051 the IRS recovered from the 267 tax modules with refunded credits, only $80,895 (21 percent) came from payments made by taxpayers. As shown in Figure 1, we found $274,429 (70 percent) came from refund offsets, $20,360 (5 percent) resulted from the abatement of part of the taxes reported on the module, and the other $14,367 (4 percent) came from adjustments stemming from additional withholding or refundable credits later claimed on amended returns.

Figure 1: Types of Repayment

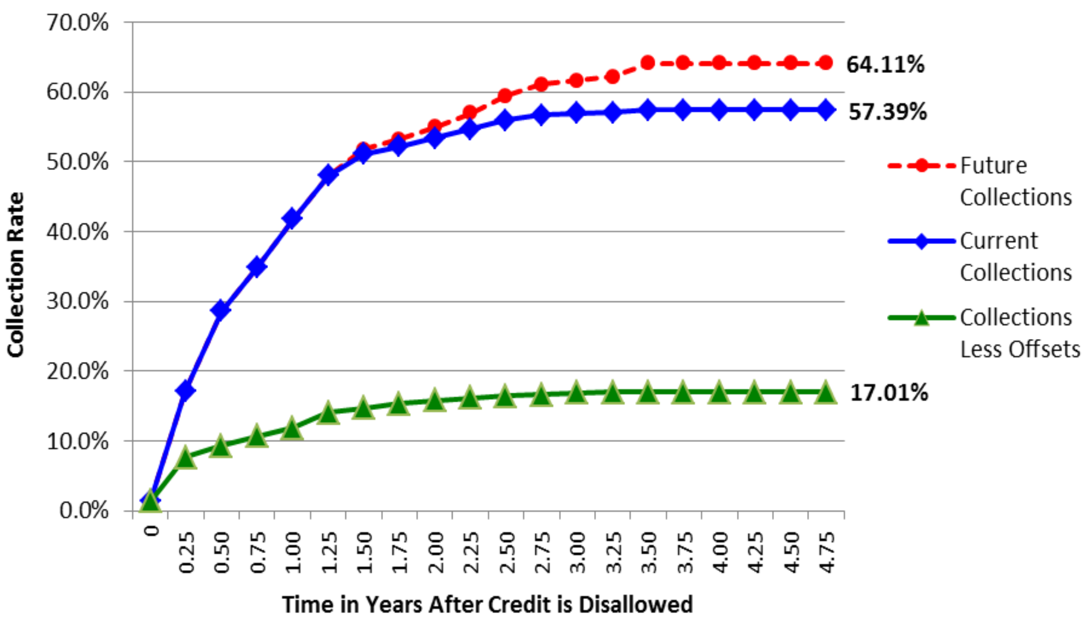


Source: TIGTA analysis of 267 taxpayer modules.

[15] We validated our calculations by applying collection probability rates from studies conducted by the IRS and the Commercial Law League of America. The collection rates in our sample appear to follow the same collectability pattern presented in these studies, with collection declining rapidly after the first year, and virtually no collection activity after three years. According to these collectability studies, debts become practically uncollectable after three years, but the IRS could potentially collect 25 percent of debts more than a year old and 13 percent of debts more than two years old.

Collection rates are significantly affected by and dependent on refund offsets. Without refund offsets, currently, only 17 percent of the $2.3 billion dollars analyzed would have been collected. See Figure 2 for a graph of collection rates based on our samples.

Figure 2: Collection Rates Based on Samples



Source: TIGTA analysis of 267 taxpayer modules.

Inappropriate claims for refundable credits are often repaid with refunds from subsequent claims for the same refundable credits

Of the 267 modules analyzed, disallowed refundable credits were either partially or fully repaid in 219 modules. Analyzing the amounts recovered on the 219 modules where any repayments of the erroneous refund amounts had occurred, we found the following refund offsets were applied to 168 (77 percent) of the 219 modules.

- For 112 (67 percent) of 168 modules, the refund offset was the only amount recorded.
- For 71 (42 percent) of 168 modules, the same refundable credits disallowed on the modules in question were claimed on a subsequent tax return, and the resulting refunds were used to pay back the disallowed credits.

Erroneous refundable credits remain uncollected for years

On average, it took the IRS almost one year (49 weeks) from the time the original refund was issued to review and disallow the erroneous refundable credit. It took an additional 27 weeks (76 weeks from the date of the original refund), on average, for any type of payment to be made.

Most collections on the delinquent modules come as refund offsets. These are applied at the time a subsequent tax refund is generated, which is generally during the first or second quarter of the subsequent calendar year. Therefore, if the taxpayer does not consistently make payments, or fails to make any payments at all, the IRS must wait for the yearly tax season to collect any money, and a collection would be made only if the taxpayer is eligible for a refund.

For the 145 'full paid' modules, it took on average 10 months (44 weeks) from the time the credit was disallowed until it was fully repaid – or one year and nine months elapsed from the time the credit was originally released to the time the erroneous credit was fully repaid. Because of the susceptibility of these credits to fraud, and the low success rates in recovering erroneous credits once refunds have been issued, the IRS should take every reasonable step possible to identify potentially questionable credits and validate those credits before associated refunds are issued.

Additional Controls Could Prevent Unscrupulous Individuals From Repeatedly Claiming Erroneous Refundable Credits

Taxpayers who claim erroneous refundable credits often claim the same or other refundable credits in subsequent years. When the IRS examines these subsequent claims, it most often disallows them. However, it examines less than one-half of these subsequent claims.

From the 267 taxpayer modules with post-refund disallowance of refundable credits, 106 taxpayers claimed a refundable credit the next year – 86 claimed the same credit that had been disallowed. The IRS examined only 41 of the 106 modules with claimed refundable credits, and examined less than one-half (34 of 86) of the modules in which taxpayers claimed the exact same credits in the following year.[16]

Of the 41 IRS examinations where taxpayers took any refundable credit in the following year, 37 (90 percent) resulted in disallowance of the subsequent credit or credits claimed. When the subsequently claimed credit was the same credit that was disallowed, 91 percent (31 of 34) were disallowed based on the subsequent examination.

We found similar results when reviewing disallowed credits that were being repaid by refund offsets resulting from the same credits claimed in subsequent years (but which may or may not have been claimed the very next year). Of 71 such cases, the IRS did not examine

[16] In six of the 34 cases, the IRS examined only one of two refundable credits that were previously claimed.

62 (87 percent) of the subsequently claimed credits. However, it disallowed eight (89 percent) of the nine subsequently claimed credits that it did examine.

*****************************2(f)**************************************
********************************2(f)*****************. According to the IRS, most refundable credits are available only for a limited time ***************2(f)*************
***************************2(f)**********************. In addition, the IRS stated that the eligibility requirements for credits may change from year to year and, therefore, a subsequent claim of the same credit may not necessarily be questionable. However, examination results indicate that taxpayers who are not compliant with one refundable credit are often noncompliant with other refundable credits, regardless of the credits' eligibility requirements or the length of time the credits are available.

Certain recurring credits, such as the ACTC, warrant additional pre-refund scrutiny

When a refundable credit is designed to be available for multiple tax years and eligibility requirements are substantially the same for each year, increased audit consideration may be warranted for taxpayers who make ineligible claims one year and subsequently claim the same credit the following year. Credits such as the EITC, the ACTC, the American Opportunity Tax Credit, the Fuel Tax Credit, and the Health Coverage Tax Credit are available for multiple years and the Federal Government could benefit from controls to identify taxpayers who repeatedly file erroneous claims for these credits.

The IRS has developed several controls in an attempt to address repeated erroneous claims for the EITC. It may ban a taxpayer from receiving the EITC for up to 10 years if that taxpayer knowingly, recklessly, or fraudulently claimed the credit. An indicator is placed on the account to prevent the taxpayer from receiving the EITC if the credit is claimed while the ban is in effect. In order to claim the EITC in later years, the taxpayer must certify eligibility by submitting Form 8862, *Information To Claim Earned Income Credit After Disallowance*.

The ACTC is a refundable credit that generally maintains the same eligibility requirements and is available for multiple years. However, the IRS does not have similar controls in place to track taxpayers who repeatedly make ineligible ACTC claims.

From the 267 modules with post-refund disallowed credits, 228 taxpayers were disallowed the ACTC. Of these, 60 taxpayers (26 percent) claimed the ACTC the next year. Only 21 (35 percent) of the 60 ACTC claims were examined by the IRS, the majority of which were selected because of a questionable EITC claim.[17] We reviewed the 21 returns for which the IRS chose to review the ACTC in conjunction with another tax issue and found all 21 ACTC claims

[17] Fourteen cases were selected because the return met EITC examination criteria. The other seven were selected for various other reasons (such as items found on Schedules A and C), none of which specifically identified the ACTC as the cause of the examination.

were disallowed or reduced.[18] All but two were initially refunded to the taxpayer and subsequently disallowed, therefore, requiring repayment of the credit through the collection process.

The remaining 39 (65 percent) of 60 repeat ACTC credits were not examined *****2(f)******
**************************************2(f)**********************************
*************************************2(f)************************************
2(f). From these 39 cases, we found five for which the IRS examined and disallowed an EITC claim because the taxpayer could not establish eligibility for a qualifying child. However, the IRS did not examine the ACTC claim on the same return, even though the absence of a qualifying child may indicate the taxpayer was also ineligible for the ACTC.

The total ACTC subsequently claimed by the 60 taxpayers in our sample was $63,171. The total ACTC for the 21 examined cases was $26,267, of which $22,779 (87 percent) was disallowed. Based on these results, we estimate more than $125 million of potentially erroneous claims for the ACTC were refunded without adequate scrutiny during Tax Years 2006 through 2009, of which more than $108 million were improper.

Techniques used to apply pre-refund freezes to the EITC could be expanded

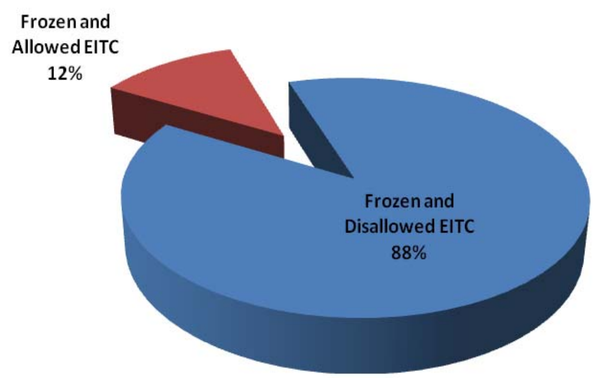
One method the IRS uses to limit erroneous EITC claims involves freezing the EITC portion of the refunds until taxpayers' qualifications for the EITC can be verified. For example, if a taxpayer is due a $1,200 refund based on his or her individual income tax return, $1,000 of which is the EITC, the IRS would send him or her $200 and freeze the $1,000 EITC. The IRS would then review the EITC to determine if the taxpayer is eligible. If the IRS confirms the taxpayer is eligible for the EITC, the IRS sends the taxpayer the remaining $1,000. This method has also been used on other refundable credits, such as the First-Time Homebuyer Credit and the Adoption Credit.

The disadvantage to freezing credits to provide time to determine their validity is that refunds associated with credits legitimately claimed by taxpayers can be delayed. The IRS has undergone criticism for delaying refunds. However, refundable credits generally represent payments from the Federal Government, rather than the return of overwithheld or overpaid taxes. As such, the recipients of these payments should undergo the same scrutiny and verification as recipients of Federal benefits paid outside the tax system.

The IRS does not freeze the EITC that every taxpayer claims, only those that meet certain criteria identified when tax returns are filed. As shown in Figure 3, in Tax Years 2006 through 2009, the IRS froze EITC claims totaling $3,651,155,911, of which $3,222,186,516, or 88 percent, were ultimately determined to be erroneous and were disallowed.

[18] Eighteen ACTC claims were fully reversed and three were reduced in amount.

**Figure 3: $3,651,155,911 in Frozen EITC Claims
Tax Years 2006 Through 2009**



Source: The TIGTA's Data Center Warehouse and SAS queries.

We identified 680,068 tax returns from Tax Years 2006 through 2009 that had a freeze on the refunds and claims for at least two refundable credits. We took a statistically valid sample of 384 tax returns to determine if the process used to freeze the EITC could be expanded to any other refundable credits. Utilizing information from IRS computer systems, we determined that 365 of the returns in our sample had a frozen EITC, and 332 of the returns had a frozen EITC and an ACTC claim. In 221 (67 percent) of the cases, the frozen EITC was disallowed while the ACTC was initially allowed and sent to the taxpayer, then later disallowed. In these cases, the IRS had to attempt to recover the amounts it already sent to the taxpayers for the erroneous ACTC claims. Based on our sample, we determined that for Tax Years 2006 through 2009, had the IRS frozen and verified the ACTC each time it did so for the EITC, it could have saved approximately $419 million in erroneous ACTC claims from being refunded to taxpayers.

Expanding the due diligence requirements to the ACTC could reduce erroneous claims for the ACTC

The eligibility rules for refundable credits can be complex and taxpayers often use the services of paid preparers when filing their tax returns. In our analysis, 207 (78 percent) of the 267 modules with disallowed refundable credits were for tax returns prepared by paid preparers.

The IRS stated in May 2011 that more than 60 percent of EITC returns are prepared by paid preparers. Paid preparers who file EITC returns are required to complete Form 8867, *Paid Preparer's Earned Income Credit Checklist*, detailing the due diligence they performed while preparing EITC claims. The checklist aids preparers in validating that the taxpayer for whom the return is prepared does qualify for the EITC. Beginning with Tax Year 2011, preparers can be penalized up to $500 if this checklist is not attached to a return.

Erroneous ACTC claims are often found in conjunction with erroneous EITC claims. According to the IRS, 65 percent of examined EITC returns affect the ACTC. The EITC and ACTC contain similar eligibility requirements. For example, each credit has income limits, and each credit typically involves a qualifying child (the EITC can be claimed without any qualifying children, albeit for a limited amount). Given the strong correlation between the ACTC and EITC, and that the two credits are often claimed together, it would be beneficial if legislation were passed to expand the due diligence requirements and penalties to include the ACTC.

Increased documentation for refundable credits should be required of noncompliant taxpayers

Requiring documentation to support a claim for credits has often been an effective control for the IRS. However, the IRS has been reluctant to utilize this control method because it believes it is burdensome to tax administration and taxpayers, precludes taxpayers from filing electronically, and requires math error authority to administer properly.

A recent example is the First-Time Homebuyer Credit. Because of the vulnerability of this credit to fraud, the TIGTA recommended that the IRS require taxpayers to attach documentation to their tax returns to substantiate a home purchase and verify eligibility for the credit. IRS management initially responded that a requirement to supply documentation during the processing of the tax return would be burdensome for both the taxpayer and the IRS. Even if the recommended documentation was not provided, the IRS did not have math error authority to disallow the credit during processing. The IRS also noted that requiring documentation would preclude many taxpayers from electronic filing.

The current annual estimate of the improper payments for the EITC alone is greater than the entire budget of the IRS.

Because improper claims associated with this credit proved to be significant, Congress passed legislation requiring documentation to substantiate this credit and providing the IRS with math error authority to disallow the credit if documentation was not provided. Subsequent to the implementation of these controls, the erroneous claims identified by the IRS declined dramatically. For claims processed prior to the documentation requirements (Processing Year[19] 2009), the IRS's pre-refund audits of these claims resulted in a disallowance rate of 75 percent. However, after the documentation requirements were implemented, this disallowance rate fell to 17.5 percent and for most of the subsequent processing year remained below 13 percent.

Although a requirement to provide documentation for every refundable credit claimed would increase burden on taxpayers and increase IRS's administrative costs, requiring no documentation increases the chances of fraud and is not commensurate with the requirements of other Federal Government programs. The current annual estimate of the improper payments for the EITC alone is greater than the entire budget of the IRS.

[19] The calendar year in which the tax return or document is processed by the IRS.

At a minimum, the IRS should require documentation from taxpayers or tax preparers who have in the past abused refundable credits. For example, to help address compliance problems with the EITC, Congress passed legislation requiring taxpayers who had the EITC denied during examinations to prove eligibility before receiving the EITC again. The accounts of these taxpayers are notated with a specific indicator to identify them as being required to prove their eligibility. We believe similar controls should be explored for taxpayers who abuse any refundable credits.

Recommendations

The Deputy Commissioner for Services and Enforcement should:

Recommendation 1: Implement an account indicator to identify taxpayers who claim erroneous refundable credits. Taxpayers with such an indicator should be required to provide documentation before their claims for refundable credits are processed and should be considered for pre-refund examinations of claims for all refundable credits. Such an indicator should apply for a specified time period.

> ***Management's Response:*** IRS management agreed that a taxpayer's prior history of claiming erroneous refundable credits should be a factor in considering whether to issue a refund for the current year. Rather than utilizing an account indicator, the IRS will develop pre-refund examination filters to ensure historical data are available and used as a selection criteria. It is the IRS's intent to implement such filters for the upcoming filing season.
>
> ***Office of Audit Comment:*** The IRS's planned action is different than what the TIGTA recommended but we believe their planned action is a viable alternative.

Recommendation 2: Freeze and verify claims for the ACTC on all returns for which the EITC is frozen.

> ***Management's Response:*** IRS management agreed that freezing the ACTC along with the EITC on tax returns selected for pre-refund examination may prevent the payment of claims that may subsequently be found to be improper. The IRS is exploring options in this area.

Legislative Recommendation

Recommendation 3: The Deputy Commissioner for Services and Enforcement should work with the Department of the Treasury's Office of Tax Policy to seek legislation to expand the EITC due diligence requirements and penalties to include the ACTC.

> ***Management's Response:*** IRS management agreed with this recommendation. The IRS will work with the Department of the Treasury's Office of Tax Policy regarding the

potential need for legislation to expand the EITC due diligence requirements and penalties to include the ACTC.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine the effectiveness of IRS's efforts to recover refundable credits disallowed during post-refund examinations and consider options the IRS could implement to decrease the issuance of erroneous refundable credits in the future. To accomplish this objective, we:

I. Determined the effectiveness of the IRS's efforts to recover refunds issued for erroneous claims for refundable credits.

   A. Computer identified erroneous claims for refundable credits that were disallowed after refunds were issued and reassessed to the taxpayer using a Data Center Warehouse extract of the IRS Individual Master File[1] for Tax Years[2] 2006 through 2009. We compared the disallowed credit amount to the amount recovered over time. We ensured the validity and reliability of the data by comparing the first 50 records of our extract to tax information on the Integrated Data Retrieval System.[3]

      1. Determined the number and amount of refundable credits issued.

      2. Determined the number and amount of claims reversed due to IRS examinations.

      3. Determined the number of claims reversed where no refund amount was recaptured. Overall, we computed the amount and percentage of erroneous refunds recovered.

         a. Computer identified 1,308,540 tax modules with refundable credits that were disallowed after refunds were issued between January 1, 2007, and December 31, 2010. Each of these modules had refundable credits disallowed

---

[1] The IRS database that maintains transactions or records of individual tax accounts.
[2] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
[3] The IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

by either the IRS's Examination function or Criminal Investigation. From this population, we analyzed a statistically valid sample of 385 modules.[4]

B. Analyzed the type of repayments (payments, offsets, or abatements) and identified any instances where taxpayers may have repeatedly claimed erroneous credits and repaid prior examination assessments using those credits.

C. Identified any applicable demographic trends in which refundable credits are erroneously claimed and not recovered, *i.e.*, paid preparers.

II. Determined what controls are available and/or used by the IRS to identify and disallow erroneous refundable credits and determined whether new controls should be implemented to reduce erroneous claims.

A. Identified various refundable credits available to taxpayers over the last five years and any applicable legislative requirements requiring the taxpayer to prove eligibility.

B. Reviewed documented IRS procedures (Internal Revenue Manual, desk procedures, Functional Specification Packages, *etc.*) designed to identify and stop questionable refundable credits before the refund is released.

C. Identified any documentation required of the taxpayer to prove eligibility for each credit and determined whether the IRS has math error authority to disallow any of the credits if proper documentation is not provided. Also, we determined the status of the IRS's ability to accept additional documentation on electronic returns.

D. Studied previous TIGTA reports on refundable credits and determined whether documentation was required to prove eligibility and whether the IRS utilized math error authority for claims without supporting documentation.

E. Determined whether the IRS freezes only the applicable questionable credit and releases the remaining refund.

1. Computer identified 680,068 modules from the IRS Master File[5] that had an examination freeze and at least two claimed refundable credits during Tax Years 2006 through 2009. From this population, we analyzed a statistically valid

---

[4] The statistical sample size was selected by using a 95 percent confidence level, a ±5 percent precision, and a 50 percent expected error rate. From our original sample of 385, we found that credits on 111 modules were disallowed due to a pre-refund IRS examination but were included in our data because the disallowance of the credit was posted after the refund had been issued. We did not include these cases because the refund did not include the disallowed credit, and the taxpayer was not required to repay anything. In addition, we did not include the Making Work Pay Credit or the Recovery Rebate Credit in our sample because these credits were generally allowed to the population at large, without the need for significant scrutiny by the IRS. Seven modules in our sample of 385 contained only these credits.

[5] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

sample of 384 modules.[6] The population was validated for accuracy and reliability by comparing the statistically valid sample to tax information on the Integrated Data Retrieval System.

F. Evaluated controls in place to track known unscrupulous taxpayers, such as the EITC indicator on taxpayer accounts banned from taking the credit, and determined whether a similar approach might be utilized for other refundable credits.

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: IRS Examination and Collection functions' policies, procedures, and practices for identifying, examining, and collecting on accounts with potentially erroneous refundable credit claims. We evaluated these controls by interviewing IRS management, reviewing documentation, and analyzing IRS data for taxpayers who claimed erroneous refundable credits.

[6] The statistical sample size was selected by using a 95 percent confidence level, a ±5 percent precision, and a 50 percent expected error rate.

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)
Augusta R. Cook, Acting Assistant Inspector General for Audit (Returns Processing and Account Services)
Kyle R. Andersen, Director
Bill R. Russell, Audit Manager
Laura Paulsen, Lead Auditor
Patricia A. Jackson, Senior Auditor
Levi J. Dickson, Auditor
Lance J. Welling, Auditor
Joseph L. Katz, Ph.D., Contractor, Statistical Sampling Consultant

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Wage and Investment Division SE:W
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Services and Operations, Wage and Investment Division SE:W
Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS
Director, Collection-Field, Small Business/Self-Employed Division SE:S:C
Director, Compliance, Wage and Investment Division SE:W:CP
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, Return Integrity and Correspondence Services SE:W:RICS
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM
Director, Filing and Payment Compliance, Wage and Investment Division SE:W:CP:FPC
Director, Reporting Compliance, Wage and Investment Division SE:W:CP:RC
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:
    Commissioner, Small Business/Self-Employed Division SE:S
    Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PEI
Assistant Secretary of the Treasury for Tax Policy

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.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $108,768,565 in questionable ACTC claims issued during Tax Years[1] 2006 through 2009 (see page 8).

Methodology Used to Measure the Reported Benefit:

We obtained from the IRS Individual Master File[2] a computer extract of 1,308,540 tax modules (Tax Years 2006 through 2009) with refundable credits that were disallowed post-refund between January 1, 2007, and December 31, 2010. Each of these modules had refundable credits disallowed by either the IRS's Examination function or Criminal Investigation. We reviewed a statistically valid sample of 385 of the modules to determine which refundable credits were disallowed after the issuance of the refund and also determine which taxpayers claimed the same refundable credits the year following the disallowance.

Of the 385 modules, we found 60 taxpayers with a disallowed ACTC in one year who claimed the ACTC the very next year. The IRS reviewed 21 of these taxpayer claims but released the other 39 without any scrutiny. The IRS disallowed or reduced in amount all 21 examined ACTC claims.

The total of the ACTC subsequently claimed by the 60 taxpayers in our sample was $63,171. The total ACTC for the 21 examined cases was $26,267, of which $22,779 (86.7210 percent) was disallowed.

We determined the 39 claims that received no IRS scrutiny totaled $36,904 and divided by the sample size of 385, resulting in a sample average of $95.85. By multiplying $95.85 by the population of 1,308,540, we projected the IRS released $125,423,559[3] in potentially erroneous ACTC claims during Tax Years 2006 through 2009. We multiplied the .867210 disallowance

[1] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
[2] The IRS database that maintains transactions or records of individual tax accounts.
[3] Our projection is based on a 95 percent confidence level and a precision (range) of ± $42,133,788 ($83,289,771-$167,557,347).

rate of the 21 examined claims by the $125,423,559 and estimated that $108,768,565[4] of ACTC claims were likely erroneous but released without scrutiny.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; $418,969,493 in erroneous ACTC claims that could have been saved on tax modules with a frozen EITC if the ACTC had also been frozen (see page 8).

Methodology Used to Measure the Reported Benefit:

Our review identified $418,969,493 in erroneous ACTC claims that the IRS paid out. These erroneous claims were on tax modules for Tax Years 2006 through 2009 that had a frozen EITC claim that was ultimately disallowed. If the ACTC had been frozen as well, these funds would not have gone out and the IRS would not be responsible for trying to recapture the erroneous ACTC claims.

To identify the $418,969,493, we reviewed a statistical sample of 384 taxpayer modules, drawn from a population of 680,068. The population consisted of modules that had a frozen refund indicator and at least two refundable credits claimed. We found that in 332 (86.46 percent) of the 384 cases, the modules had a frozen EITC and an ACTC claim. In 221 (66.57 percent) of the 332 cases, the EITC was frozen and ultimately disallowed and the ACTC was initially allowed and sent to the taxpayer, only to be subsequently disallowed. In these cases, the IRS had to attempt to recapture the amounts it already sent to the taxpayers for the erroneous ACTC claims.

We determined the 221 erroneous ACTC claims in our sample totaled $236,570.14, divided by the sample size of 384, resulting in a sample average of $616.07. By multiplying $616.07 by the population of 680,068, we projected that the IRS could have saved $418,969,493[5] had the ACTC been frozen along with the EITC.

---

[4] Our projection is based on a 95 percent confidence level and a precision (range) of ± $36,538,842 ($72,229,723-$145,307,407).

[5] Our projection is based on a 95 percent confidence level and a precision (range) of ± $36,688,787 ($382,280,706-$455,658,280).

Appendix V

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

COMMISSIONER
WAGE AND INVESTMENT DIVISION

August 16, 2012

RECEIVED
AUG 16 2012

MEMORANDUM FOR MICHAEL E. MCKENNEY
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Peggy Bogadi *Peggy Bogadi*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Expansion of Controls Over Refundable Credits Could Help Reduce the Billions of Dollars of Improperly Paid Claims (Audit # 201140045)

The IRS is committed to combating refund fraud in the tax system. The IRS receives and processes more than 140 million individual income tax returns annually. Each of these returns is screened through IRS fraud detection systems to identify those with the highest probability of error and flag them for additional scrutiny. IRS filters and screens are continually improved and refined and we have taken steps related to the issues identified in the report.

In some situations, the IRS has statutory authority, commonly referred to as Math Error Authority (MEA), to correct return errors and provide notices to taxpayers of increases in tax and/or decreases in allowable credits. As noted in the report, Congress extended the scope of MEA in the past to include specific documentation requirements regarding the Earned Income Tax Credit (EITC) and the First-Time Homebuyer Credit. When questionable return information does not fall within the limited scope of MEA, the IRS must rely on deficiency procedures to resolve any outstanding questions regarding the accuracy of claims made on the tax return.

Tax returns with questionable claims for refundable credits that do not fall within the scope of MEA, must be prioritized within the work to be performed by the compliance functions. We agree that additional scrutiny should be considered for returns of taxpayers who improperly claim refundable credits for past years. However, we would caution that erroneous claims include much more than intentional non-compliance, and in many cases a taxpayer that is found to be ineligible one year may be eligible the next – particularly where there are numerous eligibility criteria. It should also be noted that under present law, following deficiency procedures would be necessary in order to stop payment of a refund. As noted in the report, authority was granted which provides for banning taxpayers from receiving the EITC for up to 10 years if they knowingly, recklessly, or fraudulently make erroneous claims. When taxpayers make subsequent EITC claims during the period they are banned and do not recertify their eligibility by submitting Form 8862, *Information to Claim Earned Income Credit After Disallowance*, the IRS must use deficiency procedures to address the improperly claimed EITC. The IRS has elevated the need for MEA in addressing repeat erroneous EITC claims, and we will explore pursing application of that treatment to other refundable credits when appropriate.

As noted, we are in the process of refining the filter process to address many of the issues raised in the report. Our experience with the EITC indicates that the filtering process applied during initial return processing results in a better selection of claims to be referred for pre-refund examination when compared with relying solely on the presence or absence of the EITC ban indicator.

Attached are our comments on your recommendations. If you have any questions, please contact me, or a member of your staff may contact Jodi L. Patterson, Director, Return Integrity and Correspondence Services, Wage and Investment Division, at (202) 283-7673.

Attachment

Attachment

RECOMMENDATIONS

The Deputy Commissioner for Services and Enforcement should:

RECOMMENDATION 1
Implement an account indicator to identify taxpayers who claim erroneous refundable credits. Taxpayers with such an indicator should be required to provide documentation before their claims for refundable credits are processed and should be considered for pre-refund examinations of claims for all refundable credits. Such an indicator should apply for a specified time period.

CORRECTIVE ACTION
We agree that a taxpayer's prior history of claiming erroneous refundable credits should be a factor in considering whether to issue a refund for the current year. Rather than utilizing an account indicator, we will develop pre-refund examination filters to ensure historical data is available and used as a selection criteria. We believe this is the most flexible and cost-effective means of considering prior year erroneous refund experience. It is our intent to implement such filters for the coming filing season.

IMPLEMENTATION DATE
January 15, 2013

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

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

RECOMMENDATION 2
Freeze and verify claims for the ACTC on all returns for which the EITC is frozen.

CORRECTIVE ACTION
We agree that freezing the Additional Child Tax Credit (ACTC) along with EITC on returns selected for pre-refund examination may prevent the payment of claims that may subsequently be found to be improper. The IRS is exploring options in this area.

IMPLEMENTATION DATE
January 15, 2013

RESPONSIBLE OFFICIAL
Director, Reporting Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.

LEGISLATIVE RECOMMENDATION

RECOMMENDATION 3

Work with the Department of the Treasury's Office of Tax Policy to seek legislation to expand the EITC due diligence requirements and penalties to include the ACTC.

CORRECTIVE ACTION

We agree to continue to work with the Department of the Treasury's Office of Tax Policy regarding the potential need for legislation to expand the Earned Income Tax Credit due diligence requirements and penalties to include the ACTC.

IMPLEMENTATION DATE

Implemented and Ongoing

RESPONSIBLE OFFICIAL

Director, Earned Income Tax Credit, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.