The Internal Revenue Service Is Working Toward Compliance With Executive Order 13520 Reporting Requirements

December 29, 2014

Reference Number: 2015-40-009

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THE INTERNAL REVENUE SERVICE IS WORKING TOWARD COMPLIANCE WITH EXECUTIVE ORDER 13520 REPORTING REQUIREMENTS

Highlights

Final Report issued on December 29, 2014

Highlights of Reference Number: 2015-40-009 to the Internal Revenue Service Deputy Commissioner for Operations Support.

IMPACT ON TAXPAYERS

Although the IRS has reported an overall decline in the Earned Income Tax Credit (EITC) improper payment rate since Fiscal Year 2003, the amount of payments made in error has increased from $10.5 billion in Fiscal Year 2003 to $14.5 billion in Fiscal Year 2013. The IRS's Fiscal Year 2013 EITC improper payment report to TIGTA estimates that in Fiscal Year 2013, EITC claims totaled approximately $60 billion and that 24 percent of the EITC payments were paid in error.

WHY TIGTA DID THE AUDIT

This audit was initiated because Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*, requires TIGTA to assess the IRS's compliance with the Order on an annual basis. The objective of this review was to assess the IRS's compliance with the requirements contained in Executive Order 13520 for Fiscal Year 2013.

WHAT TIGTA FOUND

Executive Order 13520 increased Federal agencies' accountability for reducing improper payments while continuing to ensure that their programs serve and provide access to their intended beneficiaries. The IRS has taken steps to ensure access and participation by eligible individuals. The IRS estimates that the participation rate for individuals who are eligible to receive the EITC was nearly 80 percent for Tax Year 2010.

The IRS is not in compliance with certain requirements of Executive Order 13520 for Fiscal Year 2013. The IRS has not established annual improper payment reduction targets as required. Nonetheless, the IRS is making some progress related to its inability to comply with this requirement. The IRS has obtained approval from the Office of Management and Budget to establish and report supplemental measures in lieu of annual reduction targets.

While the IRS is currently not in compliance with the quarterly reporting requirement for high-dollar improper EITC payments (payments totaling more than $5,000) for Fiscal Year 2013, new revisions to the quarterly reporting requirements make it unlikely that the IRS would be required to report any quarterly high-dollar payments for Fiscal Years 2014 forward.

WHAT TIGTA RECOMMENDED

TIGTA made no recommendations in this report.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

December 29, 2014

MEMORANDUM FOR DEPUTY COMMISSIONER FOR OPERATIONS SUPPORT

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Is Working Toward Compliance With Executive Order 13520 Reporting Requirements (Audit # 201440019)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) complied with the requirements contained in Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*,[1] with regard to reducing improper payments in Fiscal Year 2013. Executive Order 13520 requires the Treasury Inspector General for Tax Administration to review annually the IRS's compliance with the Executive Order 13520 reporting requirements. This audit was included in our Fiscal Year 2014 Annual Audit Plan and addresses the major management challenge of Fraudulent Claims and Improper Payments.

In their response, management noted again their disagreement with information we included in the background section of this report relating to a prior review we performed which found that the IRS's risk assessments do not accurately reflect the risk associated with the Additional Child Tax Credit improper payments. As we have repeatedly reported, the risk assessment process performed by the IRS does not provide a reliable assessment of improper payments. The IRS has previously acknowledged this in its response to a prior review. Moreover, the IRS's own enforcement data clearly contradict the IRS's conclusion that the risk of improper payments in other IRS programs is low. Management's complete response to the draft report is included in Appendix VI.

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

[1] Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs* (November 20, 2009).

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Abbreviations

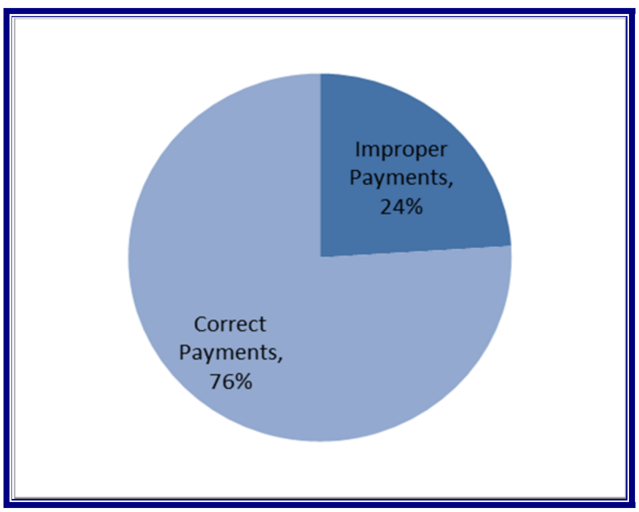
ACTC	Additional Child Tax Credit
CIGIE	Council of the Inspectors General on Integrity and Efficiency
EITC	Earned Income Tax Credit
IPERIA	Improper Payments Elimination and Recovery Improvement Act
IRS	Internal Revenue Service
OMB	Office of Management and Budget
TIGTA	Treasury Inspector General for Tax Administration

Background

The Earned Income Tax Credit (EITC) is a refundable tax credit that offsets income tax owed by low-income taxpayers. Congress originally approved the EITC legislation in 1975 in part to offset the burden of Social Security taxes and to provide an incentive to work. When the credit exceeds the amount of taxes due, it generally provides a lump-sum payment in the form of a refund to those who qualify. In the Internal Revenue Service's (IRS) Fiscal Year[1] 2013 EITC improper payment report to the Treasury Inspector General for Tax Administration (TIGTA),[2] the IRS estimated that Fiscal Year 2013 EITC claims totaled approximately $60 billion.

The IRS is responsible for administering the EITC, which includes education and outreach so that taxpayers are aware of potential eligibility requirements for the credit and programs to reduce improper payments. The Office of Management and Budget (OMB) defines an improper payment as any payment that should not have been made or that was made in an incorrect amount. Improper payments include overpayments as well as underpayments. The IRS estimated that 24 percent of the EITC payments made in Fiscal Year 2013 were paid in error. Figure 1 illustrates the estimated portion of erroneous EITC payments for Fiscal Year 2013.

Figure 1: Estimated EITC Payments Made in Error in Fiscal Year 2013



Source: IRS Report on EITC Improper Payments Executive Order 13520: Reducing Improper Payments.

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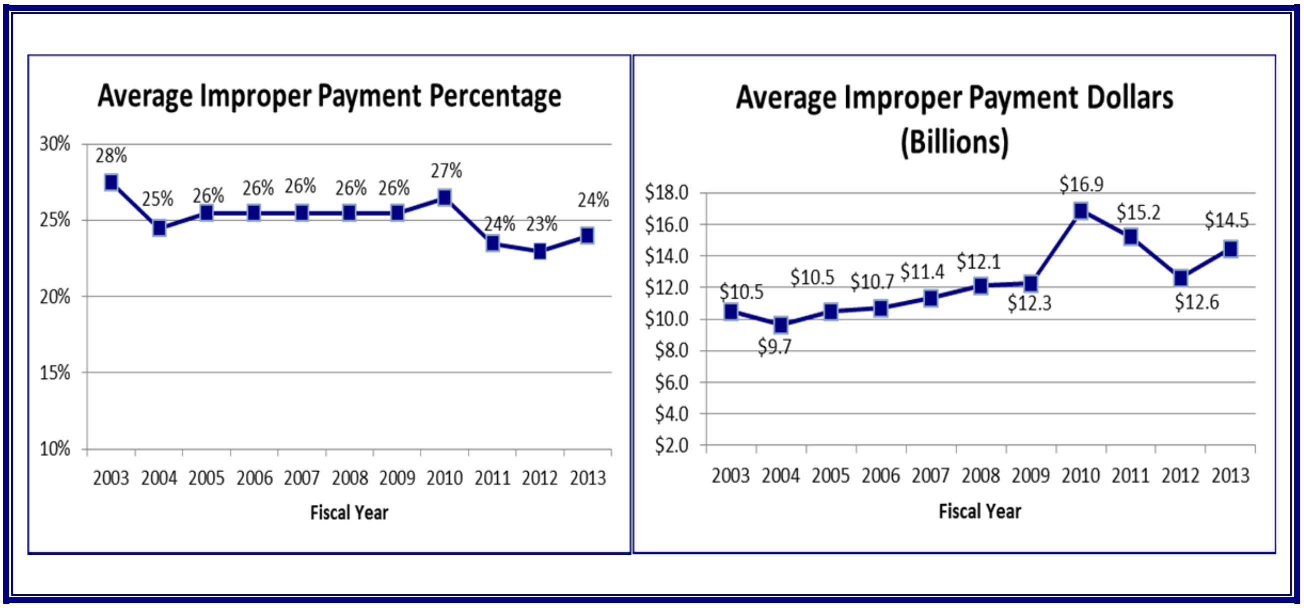
[1] Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
[2] IRS, *Report on Earned Income Tax Credit (EITC) Improper Payments Executive Order 13520: Reducing Improper Payments* (April 15, 2014).

Figure 2 presents the IRS's estimated EITC improper payments for Fiscal Year 2003 through Fiscal Year 2013.

Figure 2: Estimated EITC Improper Payments for Fiscal Years 2003 Through 2013



Source: Department of the Treasury Performance and Accountability Reports for Fiscal Years 2003 through 2011, and the Fiscal Years 2012 and 2013 Agency Financial Reports.

While the estimated EITC improper payment rate has declined since 2003, the estimated amount of payments made in error has increased from $10.5 billion in Fiscal Year 2003 to $14.5 billion in Fiscal Year 2013.

Executive Order 13520, Reducing Improper Payments and Eliminating Waste in Federal Programs,[3] increased accountability for improper payments

The Executive Order, signed by President Obama on November 20, 2009, increased Federal agencies' accountability for reducing improper payments while continuing to ensure that their programs serve and provide access to their intended beneficiaries. The Order requires the OMB Director to identify Federal programs with the highest risk of improper payments. The only OMB-identified high-priority program within the IRS is the EITC. The Order requires those Federal agencies with identified high-risk programs to provide their agency Inspector General detailed information on efforts to identify and reduce the number of improper payments in their

[3] Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs* (November 20, 2009).

respective program. As such, the IRS is required to provide specific information regarding EITC improper payments to TIGTA on an annual basis.

Following its receipt and review of the IRS's annual report, TIGTA is required to assess the level of risk associated with the EITC program, determine the extent of oversight warranted, and provide the IRS Commissioner with recommendations for modifying the IRS's plan to reduce EITC improper payments. In addition to the annual report, the Order also requires Federal agencies to submit a quarterly report to the agency's Inspector General and the Council of the Inspectors General on Integrity and Efficiency (CIGIE),[4] which details specific information on high-dollar improper payments[5] identified by the agency. Agencies are required to provide this information for public release unless the information requested is protected by privacy rules or regulations.[6] Agencies with no high-dollar activity in a given quarter are not required to report for that quarter.

The Improper Payments Elimination and Recovery Improvement Act of 2012 further expands agency improper payment requirements

The Improper Payments Elimination and Recovery Improvement Act (IPERIA) of 2012[7] further expanded agency improper payment requirements to foster greater agency accountability. Like Executive Order 13520, the IPERIA requires the OMB Director to identify a list of high-priority Federal programs. For those high-priority programs, the IPERIA requires agencies to develop additional or supplemental measures for tracking progress in reducing improper payments and submit an annual report to the Inspector General of the agency on the steps the agency has taken, and plans to take, to recover past and prevent future improper payments. The report is also required to be posted on a website accessible to the public.

The Inspector General, in turn, must submit a report that assesses the quality of the improper payment estimates and methodology used to compute the estimate for each high-priority program, review the oversight or financial controls to identify and prevent improper payments, and make recommendations to Congress on how agency plans might be modified to improve their improper payment estimates and internal controls. Final OMB guidance, issued on October 20, 2014, indicates that the IPERIA requirement to submit an annual report to the

[4] The CIGIE was established within the executive branch by the Inspector General Act of 1978 (5 U.S.C. app. 3) as amended by the Inspector General Reform Act of 2008 (Pub. L. No. 110-409, 122 Stat. 4302 (codified in 5 U.S.C. app. 3)) to address integrity, economy, and effectiveness issues that transcend individual Government agencies and increase the professionalism and effectiveness of personnel by developing policies, standards, and approaches to aid in the establishment of a well-trained and highly skilled workforce in the offices of Inspectors General.
[5] The OMB defines a high-dollar overpayment as any overpayment that is in excess of 50 percent of the correct amount of the intended payments in which the total payments to an individual in any quarter exceed $5,000.
[6] Agencies are to publish specific information regarding improper payments on the Internet for the public to access. The website address is http://www.paymentaccuracy.gov/.
[7] Pub. L. No. 112-248, 126 Stat. 2390.

Inspector General and the Inspector General's review of the report will also fulfill the annual reporting requirement under Executive Order 13520.

Prior TIGTA audits[8] found that any significant reduction in EITC improper payments will be difficult to achieve without alternatives to traditional compliance methods

Each year, we have performed reviews of IRS efforts to reduce improper EITC payments and have repeatedly reported that the IRS is unlikely to achieve any significant reduction in EITC improper payments despite the fact that it has processes that successfully identify billions of dollars in potentially erroneous EITC payments. In September 2014, we reported that significant changes in IRS compliance processes are necessary to significantly reduce EITC improper payments.[9]

Currently, the IRS can use its math error authority[10] to address erroneous EITC claims by systemically correcting mathematical or clerical errors on EITC claims or to adjust an EITC claim if a qualifying child's Social Security Number is not valid. However, the majority of potentially erroneous EITC claims that the IRS identifies do not contain the types of errors for which it has math error authority, and the number of claims the IRS can audit is limited to available resources and the need to provide a balanced compliance program. The IRS identified more than 6.6 million potentially erroneous EITC claims totaling approximately $21.6 billion in Tax Year 2011. However, the IRS was only able to address 380,719 of these potentially erroneous claims using traditional compliance methods including math error authority.

As part of its Fiscal Year 2015 budget submission, the IRS, in conjunction with the Assistant Secretary of the Treasury for Tax Policy, requested additional authority (referred to as correctable error authority) to systemically disallow a tax claim, including the EITC, when the claim is not supported by information contained in reliable Government data sources. The IRS also requested expanded authority to use the Department of Health and Human Services National Directory of New Hires database for general tax administration purposes, including data matching and verification of taxpayer claims during tax return processing.

We reported that expanded access to the National Directory of New Hires in conjunction with correctable error authority could have potentially allowed the IRS to prevent more than $1.7 billion in questionable EITC payments in Tax Year 2012 (based on this, we forecast that the IRS could prevent the payment of more than $8.5 billion in questionable EITC claims over the

[8] See Appendix IV for a list of these reports
[9] TIGTA, Ref. No. 2014-40-093, *Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments* (Sept. 2014).
[10] The IRS is granted math error authority in 26 U.S.C. § 6213(b). It can be used for certain purposes specified by Congress in 26 U.S.C. § 6213(g)(2) including correcting calculation errors and checking for other obvious noncompliance, such as claims above income and credit limits. If it is not specified in statute, the IRS cannot pursue assessment and collection activities without issuing a statutory notice of deficiency.

next five years).[11] However, according to IRS management, as of September 2014, the IRS has not been provided any additional authority or tools to expand its ability to prevent the issuance of improper EITC payments.

A TIGTA review found that, based on IRS data, the Additional Child Tax Credit should also be considered a program with a high risk of improper payments

IRS annual risk assessments do not accurately reflect the risk associated with Additional Child Tax Credit (ACTC) improper payments. Each year since Fiscal Year 2011, the IRS has continually rated the risk of improper payments associated with the ACTC as low. However, our review of the IRS's own enforcement data indicates that the ACTC improper payment rate is similar to that of the EITC. We estimate that the ACTC improper payment rate for Fiscal Year 2013 is between 25.2 percent and 30.5 percent, with potential ACTC improper payments totaling between \$5.9 billion and \$7.1 billion.[12]

This review was performed with information obtained from the Office of the Chief Financial Officer and the Office of Research, Analysis, and Statistics located at the IRS National Headquarters in Washington, D.C., and the Wage and Investment Division, Office of Return Integrity and Compliance Services, in Atlanta, Georgia, during the period April through September 2014. 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.

[11] The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.
[12] See TIGTA, Ref. No. 2014-40-093, *Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments* (Sept. 2014).

Results of Review

The Internal Revenue Service Continues to Be Noncompliant With Executive Order 13520 Reporting Requirements; However, Some Progress Has Been Made

Since Calendar Year 2011, we have continued to report that the IRS is not compliant with all Executive Order 13520 requirements related to establishing reduction targets and quarterly reporting of high-dollar EITC improper payments. Executive Order 13520 requires the IRS to provide TIGTA with an annual report detailing specific information on improper EITC payments. This report is due within 120 calendar days of the publication of the Department of the Treasury's Annual Agency Financial Report.[13] On April 15, 2014, the IRS provided the required report for Fiscal Year 2013.[14] Figure 3 provides our assessment of the IRS's compliance with the Executive Order requirements for Fiscal Year 2013.

Figure 3: Executive Order 13520 Reporting Requirements Fiscal Year 2013

Reporting Frequency	Requirement	Requirement Met?
Annually	Provide TIGTA with a report containing:	
	• Methodology for identifying and measuring EITC improper payments.	Yes
	• Plans and supporting analysis for meeting the reduction targets for EITC improper payments.	**No**
	• Plans and supporting analysis for ensuring that the initiatives undertaken do not unduly burden program access and participation by eligible beneficiaries.	Yes
	• Required information provided for posting to paymentaccuracy.gov website.	**No**[15]

[13] The EITC is currently the only IRS program declared as high-risk with information included in the Department of the Treasury's Agency Financial Report.
[14] Appendix V provides a copy of the IRS's Fiscal Year 2013 EITC improper payment report to TIGTA.
[15] See Figure 6, our review determined that the IRS provided all of the proper information to the Department of the Treasury for posting to the paymentaccuracy.gov website with the exception of reduction targets.

Reporting Frequency	Requirement	Requirement Met?
Quarterly	Submit to TIGTA and the CIGIE, and make available to the public a report on EITC improper payments identified by the agency.	**No**[16]

Source: TIGTA analysis of the IRS's Fiscal Year 2013 Executive Order 13520 report and OMB guidance issued on implementing Executive Order 13520.

However, the IRS continues to work towards compliance. The OMB has issued guidance to the Department of the Treasury that will enable the IRS to become compliant with Executive Order 13520 requirements to establish reduction targets and issue quarterly reports on high-dollar improper payments. Specifically, the guidance allows the IRS to use supplemental measures in lieu of reduction targets to quantify the reduction in EITC improper payments. The guidance also allows the IRS to report aggregate information on high-dollar EITC improper payments rather than detailed information which is prevented by privacy laws.

Although this guidance will enable the IRS to become compliant with Executive Order 13520, the OMB guidance was not in place during Fiscal Year 2013. As such, we continue to evaluate the IRS's compliance using those requirements prescribed in Executive Order 13520. We will evaluate the IRS's use of supplemental measures in our future annual reviews of improper payments.

The National Research Program continues to be the primary source of data to estimate the annual EITC improper payment rate

The IRS uses its National Research Program[17] as the primary source to obtain the data to estimate the annual EITC improper payment rate. The National Research Program provides the IRS with taxpayer compliance information that is statistically representative of the taxpayer population with updated estimates computed for each tax year.[18] The IRS uses the National Research Program results to annually update the EITC improper payment rate. The estimated Fiscal Year 2013 improper payment rate is based on Tax Year 2009 data.[19] Figure 4 shows the improper payment rate formula and figures the IRS used to compute the estimated EITC improper payment rate for Fiscal Year 2013.

[16] Disclosure laws may limit the IRS's ability to comply with CIGIE and public reporting requirements.
[17] Research conducted by the IRS to determine filing, payment, and reporting compliance by taxpayers for different types of taxes.
[18] 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.
[19] Tax Year 2009 was the most current National Research Program data available at the time the IRS computed the estimated Fiscal Year 2013 improper payment rate.

Figure 4: EITC Improper Payment Rate Formula and Figures Used for Fiscal Year 2013

Total EITC Improper Payments – Total Claims Protected/Recovered ***Total EITC Claims***
Total EITC Improper Payments – The difference between the amount of the EITC claimed by the taxpayer on his or her tax return and the amount the taxpayer should have claimed. This amount includes EITC overclaims and EITC underpayments. This amount totaled $16.3 billion.
Total Claims Protected/Recovered – The amount of EITC overclaims that the IRS prevents from being paid through prerefund examinations or recovers after being paid through Automated Underreporter document matching and post-refund examinations. This amount totaled $2.2 billion.
Total EITC Claims – The estimated amount of EITC claimed on all tax returns. This amount totaled $58.8 billion.[20]

Source: TIGTA analysis of the IRS's Fiscal Year 2013 Executive Order 13520 report.

An EITC provision that was extended by law was correctly included in the Fiscal Year 2013 improper payment estimate and the estimate includes underpayments

The extended EITC provision was correctly included in the IRS's Fiscal Year 2013 estimate of EITC improper payments. As we reported in August 2013, the IRS's estimate of Fiscal Year 2012 improper EITC payments was understated.[21] The Fiscal Year 2012 estimate was based on the assumption that a provision in the American Recovery and Reinvestment Act of 2009 (referred to as the Recovery Act)[22] that increased the EITC for certain taxpayers would expire at the end of Calendar Year 2010. However, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[23] extended the provision through December 2012. It was later extended through December 2017 by the American Taxpayer Relief Act of 2012.[24] The IRS's estimate did not take into account the extension of the additional EITC for families

[20] The IRS uses an estimate for current year EITC claims because it does not know the actual amount at the time it is required to submit improper payment estimates to the Department of the Treasury for inclusion in the Agency Financial Report. The estimate of EITC claims is based on a budget projection prepared by the Department of the Treasury Office of Tax Analysis. The IRS's most recent estimate is $60.3 billion.
[21] TIGTA, Ref. No. 2013-40-084, *The Internal Revenue Service Is Not in Compliance With Executive Order 13520 to Reduce Improper Payments* (Aug. 2013).
[22] Pub. L. No. 111-5, 123 Stat. 115 (2009).
[23] Pub. L. No. 111-312, 124 Stat. 3299 (2010).
[24] Pub. L. No. 112-240, 126 Stat. 2319 (2013).

with three or more children. As a result, the Fiscal Year 2012 improper payment estimate was understated.

In addition, Fiscal Year 2013 is the first time the IRS's improper payment estimate includes EITC underpayments. The *Department of the Treasury Agency Financial Report Fiscal Year 2013* states that underpayments increased the overall improper payment rate by less than 0.05 percent.

The IRS is working toward compliance with the requirement to establish EITC reduction targets

The IRS's Fiscal Year 2013 EITC improper payment report to TIGTA still does not include reduction targets and the associated plans for meeting those targets, as required. The IRS stated in its Fiscal Year 2013 EITC improper payment report that setting reduction targets continues to be a challenge for many reasons, including limited resources that affect the number of potentially erroneous EITC claims that the IRS can audit. The IRS recognized that its past and current efforts have not significantly affected the improper payment rate. The IRS stated that its focus is on identifying ways to deter, discourage, or deny EITC overclaims. The IRS also expects to explore options to make EITC eligibility easier for taxpayers and tax return preparers to establish and for the IRS to validate.

As we reported earlier, on August 27, 2014, the OMB approved the IRS's supplemental measures for assessing the reduction in EITC improper payments. The IRS anticipates reporting these measures in the Department of the Treasury Annual Financial Report beginning with Fiscal Year 2014.

The IRS continues to take steps to ensure access and participation by eligible individuals

The IRS continues to administer the EITC through a balanced program of education and outreach coupled with strategic programs to reduce improper payments. According to the IRS, the EITC participation rate for individuals eligible to receive the credit was nearly 80 percent for Tax Year 2010.[25] The IRS's Fiscal Year 2013 EITC improper payment report to TIGTA provides details on the specific steps it takes to ensure that all eligible individuals have access to the credit. The IRS's efforts in Fiscal Year 2013 included:

- Holding the seventh annual EITC Awareness Day. This targeted EITC underserved populations and included targeted compliance messages.
- Holding more than 200 events in both English and Spanish.

[25] Tax Year 2010 is the most recent year in which the IRS has the EITC participation rate.

- Contacting more than one million individuals through Spanish print media and web and radio conference calls.
- Initiating social media communications that reached an audience of more than 1.4 million.

Recent revised high-dollar improper payment amounts make it unlikely that the IRS will have a related reporting requirement in the future

Although the IRS has not provided required quarterly reports on high-dollar improper payments (payments totaling more than $5,000) to TIGTA or the CIGIE, it is implementing corrective actions (in response to a prior TIGTA review) to move towards compliance with this requirement. In August 2013, we reported that the IRS potentially made high-dollar EITC improper payments totaling more than $52.8 million during Tax Year 2009. These high-dollar improper EITC payments should have been reported to TIGTA quarterly as required by Executive Order 13520. We also noted that, while Internal Revenue Code Section 6103(a) prohibits the IRS from providing taxpayer-identifying information to the CIGIE, the IRS could fulfill the intent of the Executive Order by reporting aggregate high-dollar EITC payment information.

We recommended that the IRS develop processes to identify high-dollar improper EITC payments as required by Executive Order 13520. The IRS agreed to develop and issue quarterly reports on summary volumes and amounts of high-dollar EITC improper payments. However, on October 20, 2014, the OMB issued revised improper payment requirements effective for Fiscal Year 2014 forward which raised the dollar threshold for which agencies are required to report quarterly high-dollar improper payments from $5,000 per individual to $25,000 per individual. Because the maximum EITC an individual can receive is well below the revised $25,000 threshold, it is unlikely the IRS would be required to report any quarterly high-dollar payments for Fiscal Years 2014 forward.

Required information was sent for posting to the paymentaccuracy.gov website

Executive Order 13520 also requires agencies to publish specific information on the Internet about improper payments made under high-priority programs. A website titled paymentaccuracy.gov was created to provide the general public with access to the information. The IRS is required to provide specific information but is not responsible for maintaining and updating this website. The Department of the Treasury is responsible for updating information on this website. Our review determined that the IRS provided all of the proper information to the Department of the Treasury with the exception of reduction targets as previously discussed. Figure 6 contains the results of our review.

Figure 6: Information Required to Be Published on paymentaccuracy.gov

Requirement	Information Provided As Required?
Name of an accountable official.	Yes
Current/historical rates and amounts of improper payments, including causes.	Yes
Current and historical rates and amounts of recovery of improper payments.	Yes
Targets for reducing as well as recovering improper payments.	No
Entities that have received the greatest amount of improper payments.[26]	N/A

Source: OMB guidance issued on implementing Executive Order 13520.

[26] Disclosure laws prohibit compliance with this requirement.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS complied with the requirements contained in Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs,*[1] with regard to reducing improper payments in Fiscal Year[2] 2013. To accomplish our objective, we:

I. Evaluated the IRS's progress in implementing prior audit recommendations.

   A. Reviewed the March 2014 OMB guidance to the Department of the Treasury and the IRS with regard to the assessment and reporting of tax refunds for the purposes of complying with Executive Order 13520.

   B. Determined the IRS's progress with establishing supplemental measures for use in evaluating the incremental reduction in EITC improper payments.

   C. Determined the methodology used to estimate EITC underpayments.

   D. Determined the IRS's progress with developing processes to identify high-dollar improper EITC payments and reporting the information to TIGTA and the CIGIE as required by Executive Order 13520.

II. Reviewed the IRS's report on EITC improper payments for Fiscal Year 2013 issued to TIGTA on April 15, 2014,[3] to determine if the IRS was in compliance with the reporting requirements of Executive Order 13520.

   A. Reviewed the information that the IRS provided to the Department of the Treasury for posting to the paymentaccuracy.gov website.

   B. Determined whether the IRS included its methodology for identifying and measuring EITC improper payments, plans and supporting analysis for meeting the reduction targets for improper EITC payments, and plans and supporting analysis for ensuring that the initiatives undertaken to reduce improper payments do not unduly burden program access and participation by eligible beneficiaries.

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[1] Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs* (November 20, 2009).

[2] Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.

[3] IRS, *Report on Earned Income Tax Credit (EITC) Improper Payments Executive Order 13520: Reducing Improper Payments* (April 15, 2014).

C. Obtained current and historical rates for improper EITC payments to determine if the IRS had made any improvement.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: controls in place to ensure that the IRS met the reporting requirements established in Executive Order 13520. We tested these controls by analyzing the IRS's Fiscal Year 2013 report to TIGTA on EITC improper payments.

Appendix II

Major Contributors to This Report

Russell P. Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services)
Deann L. Baiza, Director
Roy E. Thompson, Audit Manager
Jane G. Lee, Lead Auditor
Nikole L. Smith, Auditor

Appendix III

Report Distribution List

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Appendix IV

Treasury Inspector General for Tax Administration Audit Reports on Improper Payments

TIGTA, Ref. No. 2014-40-093, *Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments* (Sept. 2014).

TIGTA, Ref. No. 2014-40-027, *The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply With the Improper Payments Elimination and Recovery Act* (Mar. 2014).

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

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

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

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

Appendix V

Internal Revenue Service Report to the Treasury Inspector General for Tax Administration

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

DEPUTY COMMISSIONER

April 15, 2014

MEMORANDUM FOR J. RUSSELL GEORGE
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: P. Sherry
Peggy Sherry
Deputy Commissioner for Operations Support

SUBJECT: Reporting Requirements in Section 2(a)(i) of Executive Order 13520

I am writing in response to the reporting requirements in Section 2(a)(i) of Executive Order 13520: Reducing Improper Payments (Executive Order), and Appendix C, Part III to the Office of Management and Budget (OMB) Circular A-123, Requirements for Effective Measurement and Remediation of Improper Payments. The OMB has designated the Earned Income Tax Credit (EITC) a high-priority program. For Tax Year (TY) 2012, over 27 million taxpayers received more than $63 billion in EITC, making it one of the largest tax credits in the United States that is also often credited with successful poverty reduction.

This updated report provides specific information on the Internal Revenue Service's (IRS) current methodology for measuring the EITC improper payment rate, surmised root causes for improper claims, and current and planned actions to mitigate improper payments.

The IRS continues to administer the EITC through a balanced program of education and outreach so that taxpayers are aware of potential eligibility for the credit coupled with strategic programs addressed at taxpayers and preparers to reduce improper payments. The EITC has a nearly 80 percent participation rate. The estimated improper payment rate for Fiscal Year (FY) 2013 is 24 percent ($14.5 billion).

The IRS continues to improve and expand its existing compliance treatments to stop erroneous EITC payments and its efforts to improve return preparer EITC competence. An adverse judicial decision[1], however, has caused the IRS to reconsider how best to achieve its objective of improved preparer competence and compliance, including

1. The U.S. District Court for the District of Columbia ruled that the IRS lacked statutory authority to impose requirements for competency testing and continuing education on return preparers. The U.S. Court of Appeals for the District of Columbia Circuit upheld the lower court's decision on February 11, 2014 [Loving v. IRS, 917 F. Supp. 2d 67 (D.D.C. 2013), aff'd 742 F.3d 1013 (D.C. Cir. 2014)]

interim efforts toward that objective while pursuing critically important legislation to clearly define the IRS' authority for regulating preparers. The IRS believes that regulation of tax return preparers will improve overall preparer education, decrease fraud, and subsequently reduce improper payments. The IRS is also aggressively pursuing improper payments through other preparer compliance efforts including undercover shopping visits, preparer visits, and by enjoining egregious return preparers. Additionally, the IRS has expanded its EITC Return Preparer Strategy to include a new just-in-time component, contacting preparers of erroneous EITC claims upon submission to the IRS. By applying various methods of preparer intervention, IRS will be able to identify which are most effective for reducing erroneous claims from specific preparer segments.

Setting EITC improper payment reduction targets continues to be a challenge for many reasons: e.g., the IRS is generally unable to remove the credit without conducting an audit but because of the high error rate, can only audit a fraction of the potential erroneous claims it identifies. The IRS must also balance the reduction in improper payments with encouragement of eligible taxpayers to claim the credit. Over years of EITC administration, the IRS has refined its tax administration tools with impressive results for those we can afford to touch, but those efforts have not significantly affected the improper payment rate. The IRS is therefore currently reflecting on its many past and current efforts and exploring other new possibilities. Our focus is on identifying ways to deter, discourage or deny EITC overclaims by those submitting or enabling them. We expect to explore a broad range of possibilities to make EITC eligibility easier to establish for taxpayers, and those who serve them, and easier to validate eligibility for the tax administrator.

The IRS is further collaborating with OMB and agreed that we would work together to develop supplemental measures and indicators in lieu of reduction targets. We are also working with OMB to create a quarterly high-dollar overpayment report that meets the intent of Executive Order 13520. These steps will allow us to be in compliance with the Executive Order. The IRS will continue to report its compliance and outreach activities that impact improper payments.

If you have any questions, please contact me or a member of your staff may contact Greg Kane, Deputy Chief Financial Officer, at (202) 317-6400.

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Report on Earned Income Tax Credit (EITC) Improper Payments
Executive Order 13520: Reducing Improper Payments

BACKGROUND

The Earned Income Tax Credit (EITC) is a refundable tax credit for low and moderate-income workers. For Tax Year (TY) 2012, over 27 million taxpayers received more than $63 billion in EITC, making it one of the largest tax credits in the United States. It is also often credited with successful poverty reduction. For TY 2013, the maximum EITC available is $6,044 for a married couple with three qualifying children.

Although the EITC is credited with lifting millions out of poverty, the program also experiences substantial erroneous claims. Based on the latest estimates from Research, Analysis & Statistics (RAS) for FY 2013, the EITC erroneous payment rate is 24 percent – roughly $14.5 billion. Addressing EITC improper payments has been an ongoing effort for the IRS. We currently manage a robust compliance program to combat EITC erroneous payments. In fact, in FY 2013, 34 percent of all individual audits conducted by the IRS were selected on the basis of the EITC claim. Due to its comprehensive EITC compliance programs, the IRS successfully protected almost $4 billion in revenue.

Despite these efforts, there is more we can do. The IRS will continue to find ways to maximize results with limited resources and use data driven analyses to help identify new approaches to positively impact the two potentially conflicting EITC goals of reducing error and increasing participation.

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IMPROPER PAYMENTS ESTIMATES FOR THE EARNED INCOME TAX CREDIT: METHODOLOGY FOR FISCAL YEAR 2013

I. Introduction

The Improper Payments Elimination and Recovery Act of 2010 (IPERA, Public Law 111-204), defines programs as being "susceptible to significant improper payments" if the program has improper payments exceeding both 2.5 percent of total program payments and $10 million. Since the EITC falls under this definition, the IRS provides statistically valid annual estimates of the amount of improper payments to OMB as part of the Act.

In order to estimate the amount of improper payments, the IRS first estimates the absolute amount of EITC overclaims and underpayments. Next, the amount of payments recovered through enforcement activities is subtracted to get the estimated net improper payment amount. In order to apply this to other years, a rate is developed by dividing the net amount of improper payments by the total amount of claims. This rate can then be applied to future years to develop an estimate of the improper payments for the respective years. The following describes the methodology used to derive the estimate of improper payments for FY 2013 and the future year projections through FY 2016, shown in the table below. The change in this year's estimate compared to prior years is not statistically significant. This means we cannot conclude that the actual population improper payment rate has changed. In fact, this year's estimate of 24.0 percent is consistent with the average rate over the three prior years of 24.2 percent.

FY 2013-2016 EITC IPERA Improper Payments Estimates ($ billions)

Fiscal Year	**2013**	**2014**	**2015**	**2016**
Estimates of Total EITC Claims	$60.3	$58.3	$60.0	$61.1
EITC Improper Payment Rate	**24.0%**	**24.0%**	**24.0%**	**24.0%**
Lower bound of 90% Confidence Interval	22.1%	22.1%	22.1%	22.1%
Upper bound of 90% Confidence Interval	25.9%	25.9%	25.9%	25.9%
Total Improper Payments	$14.5	$14.0	$14.4	$14.7
Lower bound of 90% Confidence Interval	$13.3	$12.9	$13.3	$13.5
Upper bound of 90% Confidence Interval	$15.6	$15.1	$15.6	$15.9

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II. EITC Improper Payment Estimates for FY 2013 – FY 2016

The improper payments estimates for FY 2013 through FY 2016 were developed by multiplying an improper payment rate for each fiscal year by the total estimated EITC claims for the corresponding fiscal year. It is assumed that the National Research Program (NRP)-based TY 2009 improper payments rate is applicable for each of these years. The rate used was derived as follows:

$$\text{EITC Improper Payment Rate} = \frac{\text{Absolute Amount of EITC Overclaims and Underpayments} - \text{Amount of EITC Overclaims Recovered}}{\text{Amount of Total EITC Claimed on all Returns}}$$

To obtain projections of total EITC claims, upward adjustments were made to estimates of EITC tax expenditures and outlays in the FY 2014 federal budget. This was done for two types of adjustments. The first adjustment reflects that these amounts likely understate the amount of the EITC initially claimed on filed tax returns. This is because some of the original claims are never actually disbursed to taxpayers, being disallowed through math error processing or revenue protected by pre-refund audits, although these are offset to some extent by new EITC claims made on amended returns. The relationship between estimates of EITC claims and estimates of expenditures and outlays in prior years was used to determine the appropriate adjustment factor.

The second adjustment reflects that projected EITC claims published in the FY 2014 budget assumed the third child EITC provisions would expire after TY 2012. With the passage of the American Taxpayer Relief Act of 2012, the third child EITC provisions were extended through TY 2017. The adjustments made to the FY 2014 budget are based on prior year increases in total EITC claims resulting from the third child EITC provisions.

The final step of estimating EITC improper payments for FY 2013 involves multiplying the improper payment rate by the estimate of total claims for that year. This yields the estimate for EITC improper payments for FY 2013 shown in the table. In order to provide projections through FY 2016, the same improper payment rate is applied to future year projections of total claims.

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III. Estimating the Absolute Amount of the EITC Overclaims and Underpayments, and Total EITC Claims

The only way to know the actual amount of invalid EITC claims would be to audit all of the approximately 27 million claimants. This is clearly not feasible; however, through the NRP, the IRS conducts annual studies on the reporting compliance of Form 1040 taxpayers. Embedded in these annual studies is a sample of EITC claimants large enough to estimate the improper payment percentage with plus or minus 2.5 percent precision and 90 percent confidence, approximately 2,400 taxpayers. This is the data source used to estimate the absolute amount of EITC overclaims and underpayments. EITC overclaims are defined as the difference between the EITC amount claimed by the taxpayer on his or her return and the amount the taxpayer should have claimed, as determined by the NRP audits. EITC underpayments are defined as the amount of the EITC disallowed by the IRS in processing that should have been allowed, as determined by the NRP audits. For TY 2009 (the most recent data available), the absolute overclaim and underpayment amount is estimated to be $16.3 billion. This year is the first year in which the estimate includes underpayments in the improper payment calculation. The underpayments increase the overall improper payment rate by less than 0.05 percentage points.

The IRS also uses the NRP sample to estimate the total amount of EITC claims. The amount of the taxpayers' original claims is captured during data processing. Rather than try to edit the entire population of claimants, the IRS chose to use the NRP sample, edit those returns, and use them to estimate the total amount of claims. For TY 2009, approximately $58.8 billion was claimed for the EITC.

IV. Estimating Amount of EITC Overclaims Recovered

The IRS, through various administrative activities, prevents the payment of some EITC overclaims and recovers some overclaims that were paid. This occurs primarily through math error processing, information document matching in the Automated Underreporter (AUR) Program, and the audit of returns.

Math error processing involves computerized checks for mathematical and clerical errors during standard tax return processing. This generally involves checks for arithmetic mistakes and errors in reading tax and EITC tables, but also includes checks for valid taxpayer identification numbers. Since this is done during processing, the claim on a return with a math error is never paid and is therefore not part of the overpayment estimation.

Some EITC overclaims are identified and recovered through Automated Underreporter (AUR) activities. The AUR program allows the IRS to detect misreported and underreported income by comparing documents provided by third-parties with corresponding income information reported by the taxpayer. AUR information is captured in the IRS Enforcement Revenue Information System (ERIS) database, which tracks assessments and collections from IRS enforcement-related activities. The estimate of the amount of overclaims recovered through the AUR reflects amounts the IRS has collected or expects to collect on TY 2009 EITC overpayments that were identified through the AUR Program. This estimate was based on actual AUR results shown in the ERIS data through December 2012, increased slightly to account for estimated assessments

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and collections made after December 2012 on TY 2009 returns. These figures are based on IRS operations applied to all EITC claims, not just NRP sample returns.

EITC overclaims are also prevented and recovered through audit activities. Many audits of EITC claims are conducted pre-refund. This means that the EITC claim is not paid, but rather is held by the IRS pending the outcome of the audit. For these cases, the EITC amount is paid only if the audit determination supports the taxpayer's claim in full or in part. Other EITC audits are conducted after the credit is paid, i.e., post-refund. For these cases, should the IRS reduce or deny the EITC claim, the IRS must recover the amount that was previously paid. The amount of EITC overclaims that was not paid due to pre-refund audits and the amount that was recovered through post-refund audits were based on actual amounts either not paid or recovered as shown in ERIS data. The ERIS data through December 2012 were adjusted slightly to account for assessments and collections made after December 2012 on TY 2009 returns. A total of $2.2 billion of improper payments was recovered through enforcement activities for TY 2009.

CONTINUING CHALLENGES TO ADDRESS EITC IMPROPER PAYMENTS

Complicated Eligibility Criteria: The EITC eligibility rules are complicated and in some cases cause taxpayers and practitioners to make errors while attempting to interpret and apply the tax laws to a taxpayer's individual situation. These errors include those associated with the difficulty of determining who is a qualified child – principally with respect to relationship and residency requirements. Errors also include determining filing status (i.e., where a married couple file as single or head of household, and eligibility in non-traditional and complex living situations).

The eligibility criteria for the EITC and their application to specific fact patterns can be especially problematic in light of the population of eligible taxpayers. Low income taxpayers may not have experience in making legal determinations under the tax laws. The complexity of the EITC is likely a factor in the use of paid preparers. Taxpayers often rely on return preparers to assist them in determining eligibility for the credit.

Other errors in the EITC payments relate to improper income reporting, which allows claimants to fall within the EITC income limitations and qualify for the EITC. These errors include both underreporting and over-reporting of income by both wage earners and taxpayers who report being self-employed.

Shifting Population of Those Who Are Eligible: The population of taxpayers who claim the EITC is estimated to change by a third each year for varying reasons, increasing the difficulty the IRS faces in improving EITC compliance. The ever-changing EITC population reduces the effectiveness of the IRS education, outreach, and enforcement efforts.

Nature of the Credit: The EITC is a refundable credit which means it has value regardless of tax liability. The IRS has found that refundable credits of significant amounts attract fraud and fraudulent preparers.

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Increasing Participation and Addressing Improper Payments: Although participation rate is not directly related to improper payments, it is a measure that ensures balanced administration because efforts to address improper payments could have a negative impact on participation by eligible taxpayers. Based on the most recent estimates, the EITC participation rate for TY 2010 was nearly 80 percent.

EXISTING IRS ACTIONS TO REDUCE IMPROPER PAYMENTS

I. Root Causes of EITC Error

The root causes for improper payments are a combination of intentional and inadvertent errors by both taxpayers and practitioners.

The root causes described are based on the most recent detailed EITC Compliance Study covering TYs 2006 through 2008. This updated study indicates that many aspects of EITC compliance are qualitatively unchanged from the 1999 Compliance Study. The IRS plans to use the updated study data to further explore and understand the nature of the errors to formulate future actions.

Qualifying child errors continue to account for the highest dollar amount of overclaims. Income misreporting, particularly of self-employment income, accounts for the second highest amount of overclaim dollars. Filing status errors are the third largest contributor to overclaim dollars. One notable change since the 1999 Compliance Study is that tiebreaker rules are no longer a major source of overclaims due to provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). EGTRRA simplified the income concepts used in determining the credit and relaxed the tiebreaker rules, allowing eligible taxpayers with the same qualifying child to decide amongst themselves who would claim the child.

The root causes fall into the following two categories:

Authentication - It is estimated that 70 percent or $10.15 billion in improper payments are from authentication errors. They include errors associated with the inability to authenticate qualifying child eligibility requirements, mainly relationship and residency requirements; filing status, when married couples file as single or head of household; and eligibility in nontraditional and complex living situations. Authentication is completed on a portion of this error category during pre-refund audits.

Verification - It is estimated that 30 percent or $4.35 billion in improper payments are from verification errors. These errors relate to improper income reporting which allows claimants to fall within the EITC income limitations and qualify for the EITC. The errors include both under-reporting and over-reporting of income by both wage earners and taxpayers who report that they are self-employed.

Income reported through information returns (such as Forms W-2, Forms 1099), which can be used for verification of some income, are currently not available to the IRS before most tax returns are submitted and processed. Under law, the IRS must process income tax returns within

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45 days of the return due date or pay interest to taxpayers. Delaying refunds to perform income verification could result in the IRS having to pay interest on those determined to be valid.

II. Expanded Efforts to Combat Fraud and Identity Theft

The IRS has expanded its efforts to stop fraudulent EITC returns from processing. Our upfront efforts prevent the fraudulent refunds from becoming part of improper payments. IRS identity theft filters selected over 217,000 returns, preventing almost $500 million in EITC refunds in calendar year 2013.

The IRS is especially committed to improving our multi-faceted approaches to stop fraudulent refundable EITC claims and strives to operate in such a way that returns are screened out at the earliest possible stage. Tax returns are processed through our Electronic Fraud Detection System, designed to identify schemes and suspicious patterns. For returns identified as questionable, the refunds are frozen and are reviewed by a team of employees before refunds are released. In addition, the IRS secures advance wage information from some large employers, which is used to screen questionable claims during processing as part of our Questionable Refund Program. In calendar year 2013, in addition to returns stopped for identity theft, the IRS detected and stopped 358,000 questionable EITC returns claiming almost $1 billion.

We will continue these efforts and expand and enhance the number and quality of our identity theft and questionable refund screening filters. The IRS Criminal Investigation (CI) function increased its focus on EITC fraud. Publicity associated with these efforts is used to deter future EITC fraud. In FY 2012 and 2013, the IRS secured 168 and 344 EITC indictments with 150 and 265 convictions, respectively. We also secured 62 and 84 return preparer indictments and secured convictions of 60 and 66, respectively.

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III. Existing Programs to Prevent Improper Payments

EITC Taxpayer Outreach
The IRS EITC strategy is to intervene early to ensure compliance with the rules. Thus, the IRS will continue extensive outreach and education to taxpayers so that they are aware of the legal requirements for EITC eligibility and can apply the law accurately.

The IRS conducted its annual EITC marketing campaign, including the seventh annual EITC Awareness Day, which targeted EITC underserved populations and included tailored compliance messages. The English and Spanish satellite media tours reached an audience of over 1.8 million taxpayers, the print media conference calls in English and Spanish reached over 1.4 million in circulation, and the radio interviews in English and Spanish covered over 1,000 affiliate markets.

EITC Enforcement Program
The IRS EITC-focused enforcement programs currently protect almost $4 billion annually. The following programs contribute to the broader strategy of identifying errors as early in the process as possible:

Math Error: This refers to an automated process in which the IRS identifies math or other statistical irregularities and automatically prepares an adjusted return for a taxpayer filing on paper and generally rejects electronic returns. These upfront, systemic processing checks on paper returns protect $320 million in EITC refund claims annually. On electronic returns, in FY 2013, the IRS identified 1.75 million math errors of which taxpayers corrected 1.38 million when re-filing electronic returns. The IRS currently has limited legislative authority to use this process. A proposal in the Green Book, accompanying the FY 2015 budget submission, if passed into law, would allow us to adjust an EITC overclaim and reduce the refund by the adjusted EITC amount, based on a reliable government data source matched against a submitted tax return.

Document Matching: This process involves comparing income information provided by the taxpayer with matching information (e.g., Form W-2 and Form 1099) from employers to identify discrepancies. This post-refund process protected $1.4 billion in EITC claims in FY 2013. The IRS adjusted over 900,000 EITC returns in FY 2013 (over and above 500,000 correspondence audits).

Audits: The IRS identifies tax returns and amended returns for audit and holds the EITC portion of the refund until an audit can be conducted. Of the approximately 500,000 audits conducted by the IRS annually, 70 percent are conducted before the EITC portion of the refund is paid. These audits are selected using an effective risk-based audit selection model that results in over a 90 percent change rate. Audits protect almost $2.1 billion in erroneous EITC claims annually. The IRS identifies many more potential overclaims that are not audited because of its finite resources and authorities.

Because of the refundable nature of the credit, the high error rate, and the high dollar amount associated with the credit, EITC claims are twice as likely to be audited as other individual taxpayer returns. For FY 2013, EITC audits comprised 34 percent of all individual return audits; that is about four percent of all EITC claims. The IRS recognizes that it cannot fully address

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EITC noncompliance by simply auditing returns and must pursue alternatives to traditional compliance efforts. Significant expansion of EITC enforcement activities would come at the expense of other tax administration priorities and result in an unbalanced program focusing disproportionately on the working poor.

Soft Notice: The IRS uses soft notices as a low cost alternative to audits. They help educate taxpayers on their compliance responsibilities and are an inexpensive means to recover improper payments. In FY 2013, the IRS sent over 110,000 letters to alert taxpayers that an exemption or qualifying child for the EITC claimed on their returns had also been claimed by another person.

Two- and Ten-Year Bans - IRC §32(k) authorizes the IRS to ban taxpayers from claiming the EITC for two years if the IRS determines during an audit that they claimed the credit improperly due to reckless or intentional disregard of rules and regulations or for ten years if due to fraud. When a two- or ten-year ban is proposed, deficiency procedures are followed and taxpayers are provided their full appeal rights. As of January 1, 2013, there were over 67,000 two-year bans and 745 ten-year bans on taxpayer accounts.

RETURN PREPARER FOCUS FOR REDUCING IMPROPER PAYMENTS

Paid return preparers assisted in the preparation of 57% of all EITC claims in TY 2012. Because evidence suggests that unscrupulous preparers and preparers not demonstrating basic competency or exercising due diligence contribute to overall improper EITC claims, the IRS has expanded its efforts to address preparers in recent years.

In December 2009, the IRS announced its plan to register return preparers and create enforcement tools that impact the paid return preparer community more broadly. The IRS program sought to establish standards for the tax preparer community in order to enhance protections and services for taxpayers, increase confidence in the tax system, and assure greater compliance with the tax laws. In January 2013, the U.S. District Court for the District of Columbia, in a case called Loving v. IRS, enjoined the IRS from enforcing some of the regulatory requirements, finding that the IRS lacked the requisite statutory authority to regulate tax return preparers by requiring testing and continuing education. This decision was upheld by the U.S. Court of Appeals for the D.C. Circuit on February 11, 2014. The injunction and court proceedings delayed the IRS' implementation of planned preparer regulation and its ability to measure the impact on noncompliance. The IRS, however, continued registering preparers and issuing Preparer Tax Identification Numbers (PTINs), as the Loving litigation had no impact on this aspect of the preparer program.

The IRS continues to believe that the regulation of tax return preparers will help drive increased EITC compliance, decrease fraud, and reduce improper payments. The Loving decision, however, has caused the IRS to reconsider how best to achieve its objective of improved preparer competence and compliance. This includes interim IRS efforts toward that objective and the simultaneous pursuit of critically important legislation to clearly define the IRS' authority for regulating preparers.

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The IRS is also aggressively pursuing improper payments through other preparer efforts including undercover shopping visits, preparer visits, and by enjoining egregious return preparers. Additionally, the IRS has expanded its traditional treatments of EITC preparers to include a new just-in-time component and other treatments to identify which are most effective for specific preparer segments.

The IRC §6695(g) EITC due diligence penalty increased from $100 to $500 in 2011, with FY 2013 being the second year that return preparers were subjected to this increased penalty and required to comply with expanded Treasury Regulations §1.6695 -2. As part of their due diligence, these regulations require paid preparers to attach the due diligence checklist, previously retained in their records, to their client returns and require preparers to retain client records on which they relied to make an EITC eligibility determination. For TY 2012, the IRS expanded the Form 8867, *Paid Preparer's Earned Income Credit Checklist,* for preparers to list the relied upon records.

Prior to the 2013 filing season, the IRS sent warning notices of noncompliance to approximately 5,000 EITC preparers who did not attach the Form 8867 to 2011 tax returns, as required in the updated due diligence regulations. The letter informed them of their failure to meet the requirement and potential consequences. The IRS is in the process of asserting penalties on approximately 800 preparers who remained noncompliant with 2012 returns. Additionally, as a result of the IRS' collaboration with software developers, most companies did program their TY 2012 professional tax preparation software to automatically transmit Form 8867. As a result, the IRS received less than one percent of paid preparer electronic returns without the required form attached.

The IRS has also continued with its EITC-focused paid return preparer effort, separate from the Servicewide preparer initiative described above. This includes continued outreach and compliance actions to address preparer EITC due diligence noncompliance using existing treatments and continued testing of new preparer treatments and approaches. The objective is to reduce the risk of EITC erroneous refunds by focusing efforts on noncompliant return preparers before and during the early filing season.

In FY 2013, the IRS expanded the number of noncompliant preparers treated to 10,000 with its existing treatments and tests of new progressive combinations of treatments. Treatments included just-in-time pre-filing season letters, educational visits, client return audits, and preparer due diligence audits. The filing season treatments included letters, phone calls, client return audits, and preparer audits. For example:

- **Pre-Filing Season and Filing Season Notices:** The IRS sends compliance and warning notices to preparers to educate them on their due diligence responsibilities and the consequences of noncompliance.
- **Due Diligence Visits (DDVs):** Field examiners audit EITC preparers to verify they are meeting their due diligence requirements and assert penalties as warranted. In FY 2013, examiners completed 540 pre-filing season DDVs with a penalty rate of 86 percent and over $14.9 million in proposed in penalties; 300 filing season DDVs with a penalty rate of 81 percent and almost $2.9 million in penalties; and over $200,000 in proposed penalties on 27

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filing season DDVs as a follow-up for continuing noncompliant preparers who received an educational visit.

- **Knock and Talk Visits:** This integrated approach consists of CI agents and auditors visiting EITC preparers to educate them on EITC laws and due diligence requirements. During FY 2013, 109 Knock and Talk Visits were conducted.
- **EITC Due Diligence Injunctions:** This initiative builds on the results of previous IRS compliance actions to support injunctive actions to prevent egregious preparers from filing future returns. For FY 2013, the IRS obtained four civil injunctions with a revenue impact of $15.4 million.
- **Undercover Shopping:** The IRS continues its efforts around EITC paid preparers, including undercover shopping by CI agents and preparer investigations.

Preliminary analysis of the FY 2013 strategy revealed that in addition to the penalties and injunction revenues protected above, the treatments protected over $500 million dollars (EITC and Child Tax Credit).

In conjunction with our compliance efforts, the IRS continued outreach and education efforts to EITC return preparers with the goal to educate them on the EITC due diligence requirements. Over 14,500 preparers received a certificate of completion for the English and Spanish web-based interactive EITC Due Diligence Training modules offered by the IRS. Additionally, more than 4,000 preparers attended the EITC due diligence presentation and 5,400 attended the child-related tax benefits presentation at the 2013 Nationwide Tax Forums.

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Next Steps

The IRS will continue to review root causes of EITC improper payments. As part of this work, the IRS will use results from the new EITC Compliance Study (TY 2006 – 2008) and will continue its aggressive enforcement program and return preparer focus.

The IRS is also assessing its many past and current efforts as well as exploring new possibilities, including methods to simplify the EITC eligibility requirements, making it easier to claim and process, to finding more efficient ways to distinguish valid claims from overclaims. Over years of EITC administration evolution, the IRS has refined its tax administration tools with impressive results for those we can afford to touch through our finite resources and authorities. Even those extensive and effective tax administration treatments applied to the EITC submissions, over time, have not been enough to significantly affect the EITC improper payment rate.

Our goal is to find additional ways to be able to deter, discourage or deny overclaims through a variety of administrative means, such as math error authority for arithmetic and validity errors. It will include reaching out to others who likewise may have made strides in benefits administration and learn how we may be able to partner or leverage their claim validation experience in some manner. The outreach will also include looking for additional reliable data sources that could be used to exercise a correctible error authority, as proposed in the Green Book accompanying the FY 2015 budget submission. The new authority, if passed into law, and a reliable government data source matched against a submitted tax return, if found and justified, would allow us to adjust an EITC overclaim upon submission and reduce the refund by the adjusted EITC amount. We will use what we learn through these efforts to improve our education and assistance activities to deter and discourage those submitting or enabling EITC overclaims.

Appendix VI

Management's Response to the Draft Report

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

CHIEF FINANCIAL OFFICER

December 12, 2014

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Robin L. Canady
Chief Financial Officer

Robin L. Canady

SUBJECT: Draft Audit Report – The Internal Revenue Service Is Working Toward Compliance With Executive Order 13520 Reporting Requirements (Audit #201440019)

I am writing in response to the subject report on the actions the Internal Revenue Service (IRS) has taken toward becoming compliant with Executive Order (EO) 13520 reporting requirements. The Earned Income Tax Credit (EITC) is the Treasury Department's only high risk program and poses numerous challenges with respect to improper payments and reporting.

Your report acknowledges the IRS received agreements from the Office of Management and Budget (OMB) on reporting supplemental measures and for quarterly high-dollar payment reporting to bring the IRS into further compliance with EO 13520 reporting requirements. As your report acknowledges OMB updated guidance on improper payment reporting requirements under EO 13520 on October 20, 2014, that were retroactive through fiscal year 2014. As you noted, the upward revision to the dollar threshold resulted in the IRS not being required to report on high-dollar payments for FY 2014 and beyond. Your report also acknowledges that OMB approved a set of supplemental measures, and these measures were reported in the FY 2014 Treasury Agency Financial Report (AFR) for the first time this year, and will be posted for public review at the PaymentAccuracy.gov web site.

As we reported in our response to your performance audit on the Additional Child Tax Credit (ACTC), the IRS disagrees with your assertion that our risk assessments do not accurately reflect the risk associated with the ACTC payments and TIGTA's potential outcome measure estimates.

Please contact me at (202) 317-6400 or John Pekarik, Associate Chief Financial Officer for Corporate Planning and Internal Control, at (202) 803-9151 if you have any questions.