Assessment of Internal Revenue Service Compliance With the Improper Payment Reporting Requirements in Fiscal Year 2014

April 27, 2015

Reference Number: 2015-40-044

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ASSESSMENT OF INTERNAL REVENUE SERVICE COMPLIANCE WITH THE IMPROPER PAYMENT REPORTING REQUIREMENTS IN FISCAL YEAR 2014

Highlights

Final Report issued on April 27, 2015

Highlights of Reference Number: 2015-40-044 to the Internal Revenue Service Chief Financial Officer.

IMPACT ON TAXPAYERS

The Improper Payments Elimination and Recovery Act (IPERA) of 2010 and subsequent legislation strengthened agency reporting requirements and redefined "significant improper payments" in Federal programs. The Office of Management and Budget has declared the Earned Income Tax Credit (EITC) Program a high-risk program that is subject to reporting in the Department of the Treasury (Treasury) Agency Financial Report. The IRS estimates that 27 percent or $17.7 billion in EITC payments were issued improperly in Fiscal Year 2014.

WHY TIGTA DID THE AUDIT

This audit was initiated because TIGTA is required to assess the IRS's compliance with the reporting requirements contained in the IPERA; Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*; and the Improper Payment Elimination and Recovery Improvement Act of 2012. The objective of this review was to determine whether the IRS complied with the annual improper payment reporting requirements for Fiscal Year 2014.

WHAT TIGTA FOUND

The IRS provided all required improper payment information to Treasury for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2014* with the exception of reporting an overall EITC improper payment rate below 10 percent. The IRS is unlikely to achieve an improper payment rate below 10 percent without expanded authorities to address identified erroneous claims.

In addition, although the IRS completed risk assessments of the 23 program fund groups identified by Treasury, the risk assessment process still does not provide a valid assessment of improper payments in IRS programs. For example, each year since Fiscal Year 2011, the IRS has continually rated the risk of improper payments associated with the Additional Child Tax Credit (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. TIGTA estimates 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.

On March 20, 2014, the Office of Management and Budget issued supplemental improper payment guidance to Treasury clarifying the requirement for annual risk assessments of all refundable tax credits. The Office of Management and Budget guidance clarified that all refundable credits, *i.e.*, the ACTC, are subject to IPERA requirements as they represent an additional outlay of funds by the Government.

TIGTA reported its concern regarding the IRS's incorrect assessment of the risk associated with the ACTC subsequent to the IRS's Fiscal Year 2014 risk assessments. TIGTA will continue to evaluate the reasonableness of the IRS's assessment of the risk of improper refundable tax credit payments when TIGTA reviews the IRS's compliance with the improper payment requirements in Fiscal Year 2015.

WHAT TIGTA RECOMMENDED

TIGTA made no recommendations in this report.

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

April 27, 2015

MEMORANDUM FOR CHIEF FINANCIAL OFFICER

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Assessment of Internal Revenue Service Compliance With the Improper Payment Reporting Requirements in Fiscal Year 2014 (Audit # 201540024)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) complied with the annual improper payment reporting requirements for Fiscal Year 2014. The Improper Payment Elimination and Recovery Act,[1] Executive Order 13520,[2] and the Improper Payment limitation and Recovery Improvement Act[3] require the Treasury Inspector General for Tax Administration (TIGTA) to review annually the IRS's compliance with these requirements. This audit is included in our Fiscal Year 2015 Annual Audit Plan and addresses the major management challenge of Fraudulent Claims and Improper Payments.

In their response to the draft report, IRS management stated that many of the payments we consider improper are merely misclassifications between the Child Tax Credit and the Additional Child Tax Credit (ACTC). It appears that the IRS is referring to instances in which audit adjustments (such as increases to income or reductions in deductions and credits) cause less of the Child Tax Credit to be refundable.[4] Nonetheless, in these instances, the ACTC was paid in error and these amounts are properly classified as improper payments. We plan to perform further analysis to isolate these instances in our assessment of the IRS's compliance with the improper payment reporting requirements in Fiscal Year 2015.

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[1] Pub. L. No. 111-204, 124 Stat. 2224.
[2] Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs* (November 20, 2009).
[3] Pub. L. No. 112-248, 126 Stat. 2390.
[4] The ACTC is the refundable portion of the Child Tax Credit.

Management's complete response to the draft report is included as Appendix VI.

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

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Abbreviations

ACTC	Additional Child Tax Credit
APTC	Advanced Premium Tax Credit
EITC	Earned Income Tax Credit
IPERA	Improper Payments Elimination and Recovery Act
IPERIA	Improper Payments Elimination and Recovery Improvement Act
IPIA	Improper Payments Information Act
IRS	Internal Revenue Service
NRP	National Research Program
OMB	Office of Management and Budget
PTC	Premium Tax Credit
TIGTA	Treasury Inspector General for Tax Administration

Background

The Office of Management and Budget (OMB) defines an improper payment as any payment that should not have been made, was made in an incorrect amount, or was made to an ineligible recipient. Various ways have been put forth to identify, measure, and reduce Federal improper payments, including laws specifically addressing improper payments, an Executive Order, and guidance by certain oversight agencies such as the OMB. In addition, agency Inspectors General serve a role by evaluating agency information related to improper payments.

The Improper Payments Information Act (IPIA) of 2002[1] requires Federal agencies, including the Internal Revenue Service (IRS), to estimate the amount of improper payments and report to Congress annually on the causes of and the steps taken to reduce improper payments. The IPIA also requires agencies to address whether they have the information systems and other infrastructure needed to reduce improper payments. The annual report must also describe steps the agency has taken to ensure that agency managers are held accountable for reducing improper payments. The following legislation and Executive Order clarified and expanded the IPIA requirements:

- **Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs***, signed by the President on November 20, 2009, further increases Federal agencies' accountability for reducing improper payments while continuing to ensure that Federal programs serve and provide access to their intended beneficiaries. It requires Federal agencies to provide their agency Inspector General with detailed information on efforts to identify and reduce the number of improper payments in Federal programs with the highest dollar value of improper payments.
- **Improper Payments Elimination and Recovery Act (IPERA) of 2010**,[2] enacted on July 22, 2010, amended the IPIA by strengthening agency reporting requirements and redefining "significant improper payments." For Fiscal Year[3] 2014 and beyond, significant is defined as gross annual improper payments, *i.e.*, the total amount of overpayments plus underpayments, made in the program during the fiscal year reported that a) exceeded both 1.5 percent of program outlays and $10 million of all program or activity payments or b) exceeded $100 million at any percent of program outlays.

[1] Pub. L. No. 107-300, 116 Stat. 2350.
[2] Pub. L. No. 111-204, 124 Stat. 2224.
[3] Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.

- **Improper Payments Elimination and Recovery Improvement Act (IPERIA) of 2012**,[4] enacted on January 10, 2013, 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.

On October 20, 2014, the OMB issued revisions to Circular A-123 Appendix C, *Requirements for Effective Estimation and Remediation of Improper Payments*. Circular A-123 Appendix C provides agencies and Inspectors General guidance on the implementation of the IPIA as amended by the IPERA, IPERIA, and Executive Order 13520. According to the OMB, the revised Appendix C creates a more unified, comprehensive, and less burdensome improper payment compliance framework. For example, agencies now have the flexibility to combine the various improper payment reporting requirements into one document, the Agency Financial Report. In addition, the agency Inspector General also has the flexibility to conduct one review to assess their respective agency's compliance with the various improper payment requirements.

OMB guidance on the IRS's use of supplemental measures for Earned Income Tax Credit (EITC)[5] reduction targets

According to the Department of the Treasury (Treasury), the complexity of the tax law around the EITC and the significant annual turnover within the participating population makes it difficult to set meaningful improper payment reduction targets. The OMB also recognized the challenges the IRS faces in setting EITC reduction targets. As an alternative, Treasury and the OMB have collaborated on the development of a series of EITC supplemental measures in lieu of EITC reduction targets. The OMB approved the supplemental measures on August 27, 2014, and the measures were published in the *Department of the Treasury Agency Financial Report Fiscal Year 2014* as required. The approved EITC supplemental measures are:

- The Annual Error Rate, which identifies the percentage of total EITC payments that were improper.
- The amount of Revenue Protected, which shows the total value of erroneous payments prevented or recovered through compliance activities.

[4] Pub. L. No. 112-248, 126 Stat. 2390.
[5] 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. The EITC is a refundable tax credit that offsets income tax owed by low-income taxpayers. A refundable tax credit is one that exceeds the amount of taxes due; it generally provides a lump-sum payment in the form of a refund to those who qualify.

- The amount of Revenue Protected from Paid Preparer Treatments, which shows dollars erroneously or fraudulently claimed by paid tax preparers but not paid out, or recovered, by Treasury.
- The number of Preparer Due Diligence Penalties Proposed, which reflects the effectiveness of Treasury efforts to ensure that paid tax preparers are submitting accurate, nonfraudulent EITC claims on behalf of taxpayers.

Process to identify IRS programs for improper payment risk assessment

Treasury identifies the programs that the IRS must assess for the risk of improper payments. The IRS used the Improper Payments Elimination and Recovery Risk Assessment Questionnaire for Fiscal Year 2014 (the Questionnaire) and related guidance provided by Treasury to assess the level of risk for each identified program. The Questionnaire computes a risk score for each program based on the IRS's response to the questions contained in the Questionnaire. The risk score determines whether there is a low, medium, or high risk of improper payments in a program. Treasury establishes the level of risk for a program's improper payments based on the risk score ranges and considers programs with a risk score of 0 to 11 as low risk, 12 to 28 as medium risk, and 29 and greater as high risk.

The IRS is required to forward the results and documentation for all risk assessments to the Treasury. Appendix V provides a list of the IRS programs Treasury identified for an improper payment risk assessment for Fiscal Year 2014. For any program identified as having a high risk for improper payments, the IRS must provide the following information to Treasury for inclusion in the Department's annual Agency Financial Report:

- The rate and amount of improper payments.
- The root causes of the improper payments.
- Actions taken to address the root causes.
- Annual improper payment reduction targets.
- A discussion of any limitations to the IRS's ability to reduce improper payments.

The OMB has previously declared the EITC a high-risk program; therefore, no risk assessment is required to be prepared for it. The EITC is currently the only IRS high-risk program and the only one with information included in Treasury's Agency Financial Report. The IRS estimates that 27 percent or $17.7 billion in EITC payments made in Fiscal Year 2014 were paid in error.

In addition, the OMB identifies programs that have a high priority with regard to improper payments. The EITC continues to be the only IRS program the OMB has identified as a high-priority program. As a result, the IRS is responsible for providing the Treasury Inspector General for Tax Administration (TIGTA) with the information required by the IPERIA and Executive Order 13520.

National Research Program (NRP) used to estimate EITC improper payments

The IRS uses its NRP as the primary source of data to estimate the annual EITC improper payment rate. The NRP provides the IRS with compliance information that is statistically representative of the taxpayer population. Updated estimates of taxpayer compliance are computed for each tax year.[6] The IRS uses each tax year's NRP results to update the EITC improper payment rate.

Although the NRP process results in a more current estimate of the accuracy of EITC claims than previous methods, the estimated improper payment rate for a given fiscal year is not based on current year data. Because of the time it takes to complete the annual NRP, the IRS's annual estimate of the improper payment rate is based on data that are approximately three years old. For example, EITC improper payment rates for Fiscal Year 2014 are based on information from Tax Year 2010 tax returns that were processed in Calendar Year 2011.[7] Figure 1 shows the improper payment rate formula and figures the IRS used to compute the estimated EITC improper payment rate for Fiscal Year 2014.

[6] 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.
[7] Tax Year 2010 was the most current NRP data available at the time the IRS computed the estimated Fiscal Year 2014 improper payment rate.

Figure 1: EITC Improper Payment Rate Formula and Figures Used for Fiscal Year 2014

$\dfrac{\textit{Total EITC Improper Payments – Total Claims Protected/Recovered}}{\textit{Total EITC Claims}}$
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 $18.4 billion.[8]
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 $59.7 billion.[9]

Source: TIGTA's review of IRS EITC information provided to Treasury for inclusion in the Department of the Treasury Agency Financial Report Fiscal Year 2014.

Premium Tax Credit (PTC)

The Patient Protection and Affordable Care Act[10] (hereafter referred to as the Affordable Care Act) created the Health Insurance Marketplace, also known as the Exchange. The Exchange is where individuals find information about health insurance options, purchase qualified health plans and, if eligible, obtain help paying premiums. The Affordable Care Act also created a new refundable tax credit,[11] the PTC, to assist eligible taxpayers with paying their health insurance premiums. The PTC was not included in the program fund groups selected by Treasury for which the IRS was required to complete the Questionnaire. The funds used to make Advanced PTC (APTC) payments are drawn from the PTC budget fund included in the IRS's budget and

[8] According to IRS management, $18.6 billion reported in the *Department of the Treasury Agency Financial Report Fiscal Year 2014* was the preliminary amount.
[9] 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 Treasury for inclusion in the Agency Financial Report. The estimate of EITC claims is based on a budget projection prepared by Treasury's Office of Tax Analysis. The IRS's most recent estimate is $65.2 billion.
[10] Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of the U.S. Code), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. No. 111-152, 124 Stat.1029.
[11] Refundable tax credits can be used to reduce a taxpayer's tax liability to zero. Any excess of the credit beyond the tax liability can be refunded to the taxpayers.

subsequently allocated to the Department of Health and Human Services for use in paying the APTC.

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 Headquarters in Washington, D.C., and the Wage and Investment Division, Office of Return Integrity and Compliance Services, in Atlanta, Georgia, during the period October 2014 through March 2015. 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.

Results of Review

Assessment of Internal Revenue Service Fiscal Year 2014 Compliance With Improper Payment Reporting Requirements

The IRS provided all required improper payment information to Treasury for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2014* with the exception of reporting an overall EITC improper payment rate below 10 percent. Figure 2 provides a summary of our evaluation of IRS compliance with the various improper payment requirements.

Figure 2: IRS Compliance With Improper Payment Requirements for the EITC Program for Fiscal Year 2014

Improper Payment Requirement	Source of Requirement	Provided by IRS
Conduct a program-specific risk assessment for each program or activity identified by Treasury.	IPERA	Yes
Publish an improper payment estimate for the EITC.	IPERA	Yes
Report an improper payment rate of less than 10 percent for the EITC.	IPERA	No
Provide the methodology for identifying and measuring EITC improper payments.	Executive Order	Yes
Publish annual reduction targets for the EITC and discuss progress toward meeting those targets.[12]	IPERA	Yes
Provide plans and supporting analysis for meeting the reduction targets for EITC improper payments.	Executive Order	Yes
Publish a programmatic corrective action plan for the EITC.	IPERA	Yes

[12] Supplemental measures were established in lieu of reduction targets.

Improper Payment Requirement	Source of Requirement	Provided by IRS
Report on actions the IRS intends to take to prevent future EITC improper payments.	IPERIA	Yes
Report on efforts taken or planned to recapture EITC improper payments.	IPERA IPERIA	Yes
Provide plans and supporting analysis for ensuring that the initiatives undertaken do not unduly burden program access and participation by eligible beneficiaries.	Executive Order	Yes
Provide required information for posting to paymentaccuracy.gov website.	Executive Order IPERIA	Yes
Submit quarterly reports to TIGTA and the Council of the Inspectors General on Integrity and Efficiency, and make available to the public a report on EITC improper payments identified by the agency.	Executive Order	N/A[13]

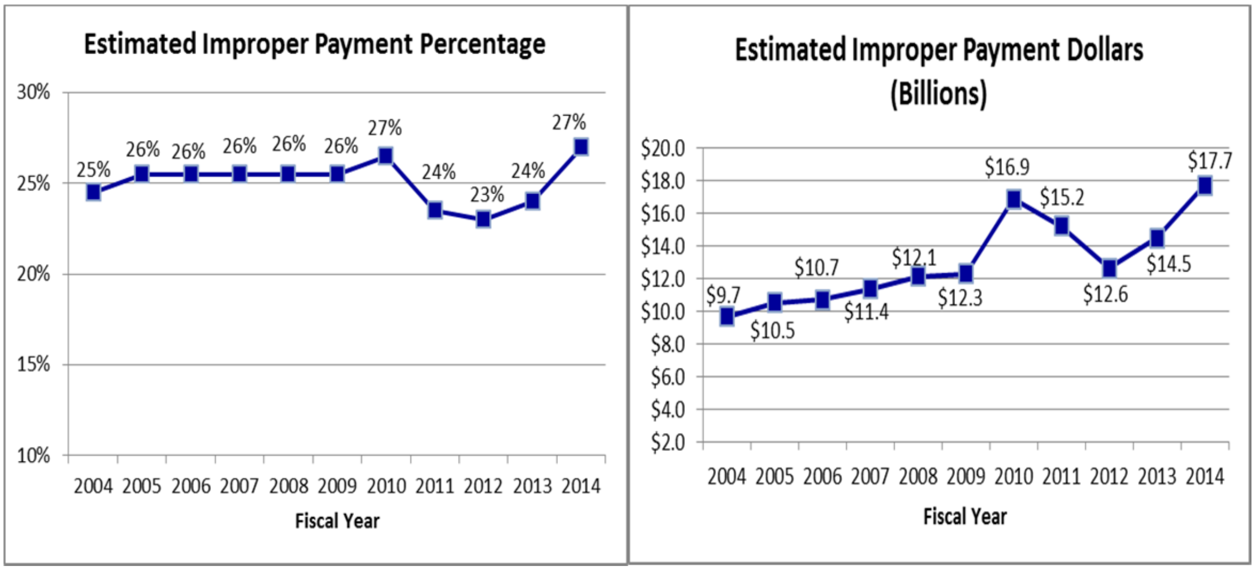
Source: TIGTA's review of IRS EITC information provided to Treasury for inclusion in the Department of the Treasury Agency Financial Report Fiscal Year 2014.

Achieving an improper payment rate below 10 percent is unlikely without expanded authorities to address identified erroneous claims

The IPERA requires agencies to report an annual improper payment rate below 10 percent. However, as shown in Figure 3, the IRS has made little improvement in reducing EITC improper payments since it has been required to provide an estimate of these payments to Congress.

[13] The recently issued OMB guidance 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, the IRS would not be required to report any quarterly high-dollar payments for Fiscal Year 2014 forward.

Figure 3: Estimated EITC Improper Payments for Fiscal Years 2004 Through 2014



Source: Department of the Treasury Performance and Accountability Reports for Fiscal Years 2004 through 2011, and the Fiscal Years 2012 through 2014 Agency Financial Reports.

In September 2014, we reported that the IRS continues to report significant improper EITC payments each year.[14] Compliance resources are limited, and additional alternatives to traditional compliance methods have not been developed. Consequently, the IRS does not address the majority of potentially erroneous EITC claims. This is despite the fact that the IRS has processes that successfully identify billions of dollars in potentially erroneous EITC payments.

Currently, under the Internal Revenue Code, the IRS can use its math error authority[15] to address erroneous EITC claims by systemically correcting mathematical or clerical errors on EITC claims, such as correcting entries made on the wrong line on the tax return or mathematical errors in computing income or the EITC. In addition, the IRS can use math error authority to adjust an EITC claim if a qualifying child's Social Security Number is not valid. However, the

[14] 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).
[15] 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.

majority of potentially erroneous EITC claims the IRS identifies do not contain the types of errors for which it has math error authority. For example, the IRS identified approximately 6.5 million potentially erroneous EITC claims totaling approximately $21.9 billion in Tax Year 2012 for which it does not have math error authority. In Tax Year 2012, the IRS used math error authority to identify and systemically correct only 241,975 (.009 or less than 1 percent) of approximately 27.3 million EITC claims. The 241,975 returns claimed EITCs totaling $299 million.

While the IRS has the authority to audit potentially erroneous EITC claims for which it does not have math error authority, doing so is more costly than the math error process. The IRS estimates that it costs $1.50 to resolve an erroneous EITC claim using math error authority compared to $278 to conduct a prerefund audit. In addition, the number of potentially erroneous EITC claims the IRS can audit is further reduced by its need to allocate its limited resources among the various segments of taxpayer noncompliance to provide a balanced tax enforcement program. As a result, billions of dollars in potentially erroneous EITC claims go unaddressed each year.

National Directory of New Hires wage and employment data along with correctable error authority could significantly reduce improper payments

Legislation would be needed to enable the IRS to systemically disallow a tax claim when information contained in reliable Government data sources does not support the claim. The IRS, in conjunction with the Assistant Secretary of the Treasury for Tax Policy, has put forth a legislative proposal requesting this additional authority (hereafter referred to as correctable error authority). According to the IRS, reliable Government data sources include information obtained from the Social Security Administration, the Department of Health and Human Services, the Federal Bureau of Prisons, and the States' Departments of Corrections. The IRS requested correctable error authority as part of its Fiscal Year 2016 budget submission. However, as of February 2015, the IRS had not been provided any additional authority or tools to expand its ability to prevent the issuance of improper EITC payments.

The IRS is granted the authority to use the National Directory of New Hires to verify EITC claims. However, the IRS does not have the authority to systemically disallow an EITC claim that is not supported by data included in the National Directory of New Hires. Expanded authority to make corrections to tax returns when data obtained from the Department of Health and Human Services indicate the taxpayer's refundable credit claims are not valid would significantly reduce improper payments. For example, the information could be used at the time tax returns are filed to identify those individuals who claim the EITC based on wages that do not appear to be valid. Our review of Tax Year 2012 tax returns identified more than $1.7 billion in potentially erroneous EITCs claimed on tax returns with no third-party Forms W-2, *Wage and Tax Statement*, received by the IRS supporting the wages reported.

Annual Risk Assessments Continue to Underestimate the Risk of Improper Payments in Internal Revenue Service Programs

Our review continues to find that although the IRS completed the risk assessments of the required funds, the risk assessment process does not provide a valid assessment of improper tax refund payments. The EITC remains the only revenue program fund to be considered a high risk for improper payments despite numerous indicators that other refundable tax credits, *i.e.*, the Additional Child Tax Credit (ACTC), also potentially result in significant improper payments.

During the course of this review, we were provided with documentation showing that risk assessments were performed for each of the programs that Treasury required the IRS to assess. Treasury selected 23 IRS program fund groups for review for Fiscal Year 2014 – five administrative program funds and 18 revenue program funds.[16] These funds were selected for assessment based on each fund groups' materiality to the IRS financial statements.

On March 20, 2014, the OMB issued supplemental improper payment guidance to Treasury clarifying the requirement for annual risk assessments of all refundable tax credits. Specifically, the OMB guidance clarified that *all refundable credits* are subject to IPERA requirements as they represent an additional outlay of funds by the Government. However, as we reported in September 2014,[17] risk assessments do not accurately reflect the risk associated with other refundable credit improper payments. For example, Treasury has selected the ACTC as one of the revenue program funds for which the IRS must perform a risk assessment to assess the level of improper payment risk. Treasury selected the ACTC based on its materiality to the IRS's financial statements.

Although the IRS has conducted the annual risk assessment of the ACTC as required by Treasury, each year since Fiscal Year 2011, the IRS has continually rated the risk of improper payments associated with the ACTC as low. The methodology that the IRS uses to conduct the risk assessment continues to provide an inaccurate assessment of the risk of ACTC improper payments. As we reported in our September 2014 report, 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. The OMB defines a program as having significant improper payments when improper payments exceed both 1.5 percent of program outlays and $10 million of all program or activity payments made during the fiscal year reported or exceed $100 million at any percent of program outlays.

[16] See Appendix V. Note: The EITC Program has been declared a high-risk program for improper payments by the OMB; therefore, no formal risk assessment is required for it.
[17] 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).

In our September 2014 report, we recommended the IRS ensure that the results of the ACTC improper payment risk assessment accurately reflect the high risk associated with ACTC payments and provide a reliable estimate of improper payments and that the assessment should include an evaluation of available NRP and enforcement data when determining the overall risk of improper payments. The IRS disagreed with this recommendation. IRS management stated that the Improper Payment Risk Assessment is completed for the ACTC following the guidance of Treasury and the OMB. The IRS stated that the Questionnaire and scoring methodology reflect operational risks associated with administration of the credit. The IRS further stated that it already considers enforcement data and overall risks associated with administration of the ACTC by its inclusion in the Tax Gap[18] estimate. Notwithstanding the IRS's assertion, the risk associated with ACTC payments is not reflected in the IRS's report on improper payments. This is a concern because the IRS's own enforcement data show that the risk of improper payments associated with the ACTC is similar to that of the EITC – high risk.

We reported our concern regarding the IRS's incorrect assessment of the risk associated with the ACTC after the IRS had conducted its Fiscal Year 2014 risk assessments. We will continue to assess the IRS's compliance on the reporting of improper payments relating to refundable credits when we review the IRS's Fiscal Year 2015 risk assessment rankings. In particular, we will evaluate whether IRS management uses its own enforcement data to accurately reflect the high risk associated with ACTC payments and provide a reliable estimate of improper payments.

The Questionnaire still does not include questions to adequately address specific risks commonly associated with verifying refundable credit claims

In January 2013,[19] we reported that the design of the Questionnaire does not provide an adequate assessment of the risk associated with tax refunds. For example, the Questionnaire contains questions that do not apply to the IRS's revenue program funds. Yet a "yes" or "no" answer to these questions is required. Depending on the response to these questions, the program's risk score can be affected. In addition, questions pertaining to other areas of potential risk in tax administration were not included in the Questionnaire. For example, the Questionnaire does not ask if the IRS has the information it needs to validate a taxpayer's claim for a tax refund at the time the tax return is filed and the tax refund is paid.

In response to our report, the IRS met with Treasury to revise the Questionnaire for revenue funds. Treasury modified the Questionnaire to allow a response of "not applicable" for the questions that do not apply to the IRS's revenue program funds and added a section called Compliance Plan. This section asks if there is an approved compliance plan that identifies the

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[18] The Tax Gap is the estimated difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time.
[19] TIGTA, Ref. No. 2013-40-015, *Improper Payments Elimination and Recovery Act Risk Assessments of Revenue Programs Are Unreliable* (Jan. 2013).

applicable filing, reporting, and payment risks. The section also asks if the compliance plan indicates that pre-processing and/or post-processing filters will be utilized. Treasury also deleted 11 questions from the Questionnaire and added eight new questions. However, the new questions still do not address whether the IRS has the information it needs to validate taxpayer claims at the time the tax return is filed and the refund is paid. The remaining questions are relatively unchanged.

Our review of the revised Questionnaire found that changes are needed to ensure that the Questionnaire provides a valid assessment of the risk of improper tax refund payments. The revised Questionnaire still does not address the risk associated with the IRS not having information it needs to validate a taxpayer's claim for a tax refund at the time the tax return is filed and the tax refund is paid. The IRS continues to inappropriately conclude that tax refund programs for which it conducts a risk assessment have a low risk of improper payments. As a result, the IRS continues to underestimate the risk of improper tax refund payments.

The Structure of the Premium Tax Credit Increases the Complexity of Assessing and Reporting Improper Payments

An agency is usually responsible for complying with the improper payment requirements for payments made from the agency's appropriated funds. Because the funds to make APTC and PTC payments were appropriated to the IRS, it would follow that the IRS will be responsible for assessing the risk of PTC improper payments and complying with the other improper payment requirements. However, the IRS is not solely responsible for administering the PTC. The Department of Health and Human Services Centers for Medicare and Medicaid Services oversees implementation of certain Affordable Care Act provisions related to the Exchanges. The Exchanges have sole responsibility for determining if an individual is eligible to purchase health insurance through the Exchange as well as determining the amount of the APTC they are eligible to receive.

Once the Exchange determines the amount of the APTC an individual is entitled to receive, an individual then elects the actual amount to be sent to his or her insurer on a monthly basis. Individuals can elect to send all, a portion, or none of the APTC to which they are entitled. Once an individual selects his or her insurance coverage and determines the amount of the APTC to be sent to his or her insurer, the insurer submits the information to the Centers for Medicare and Medicaid Services which then sends a request to Treasury's Bureau of the Fiscal Service to issue monthly APTC payments to the individual's insurance provider.

The IRS is responsible for determining the amount of the PTC a taxpayer is entitled to receive. The Affordable Care Act requires all individuals for whom APTC payments were made to an insurer to file a tax return to reconcile the APTC with the actual PTC they are entitled to receive based on the income and family size reported on their tax return.

Because the IRS and the Department of Health and Human Services are responsible for the administration of the PTC, improper PTC payments can result from weaknesses in either agency's programs. As a result, the IRS cannot effectively assess the risk of PTC improper payments, estimate the improper payment rate and dollars, or establish corrective actions to address the causes of and reduce improper PTC payments.

The Department of Health and Human Services began making APTC payments in January 2014 to insurance companies for individuals who purchased insurance covering Calendar Year 2014 through a Health Insurance Exchange. According to IRS management, the OMB established an interagency working group to collaboratively work together to ensure that there is an assessment of risk for improper payments across all payments made from the PTC account. The IRS along with the Department of Health and Human Services Centers for Medicare and Medicaid Services and Treasury are part of the working group. We will evaluate the IRS's improper payment reporting on the PTC in our future annual reviews.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS complied with the annual improper payment reporting requirements for Fiscal Year[1] 2014. This review evaluated the IRS's compliance with the reporting requirements contained in the IPERA of 2010;[2] Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*;[3] and the IPERIA of 2012.[4] The scope of this review included an assessment of the information that the IRS provided for inclusion in the *Department of the Treasury (Treasury) Agency Financial Report Fiscal Year 2014* and a review of the IRS's progress on previous recommendations. To accomplish our objective, we:

I. Determined if conditions identified in prior TIGTA audits still exist. We reviewed Treasury's Joint Audit Management Enterprise System reports, discussed the IRS's corrective actions with management, and determined if the previous recommendations and goals had been implemented.

   A. Determined the methodology used to develop supplemental measures to be used in lieu of EITC improper payment reduction targets.

   B. Determined if improvements have been made to the IPERA risk assessment process.

II. Reviewed the *Department of the Treasury Agency Financial Report Fiscal Year 2014* published on November 17, 2014, to determine if the IRS was in compliance with the improper payment reporting requirements for Fiscal Year 2014. We compared the information contained in the Agency Financial Report to the improper payment reporting requirements outlined in the OMB Circular A-123, *Management's Responsibility for Internal Control*, guidance on improper payment reporting.

   A. Determined if the IRS was in compliance with IPERA reporting elements.

   B. Determined if the IRS was in compliance with IPERIA reporting elements.

   C. Determined if the IRS was in compliance with Executive Order 13520 reporting elements.

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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] Pub. L. No. 111-204, 124 Stat. 2224.
[3] Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs* (November 20, 2009).
[4] Pub. L. No. 112-248, 126 Stat. 2390.

D. Reviewed the information that the IRS provided to Treasury for posting to the paymentaccuracy.gov website.

E. Evaluated the accuracy and reasonableness of the IRS's estimate of the EITC improper payment rate. We also evaluated the IRS computations of the overall EITC improper payment rate and associated dollar projections to verify they were accurate.

III. Determined how PTC improper payments are to be accounted for under improper payment legislation. We obtained support for decisions made by the OMB with regard to how the risk of PTC improper payments should to be evaluated.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: controls in place to ensure that the IRS met the annual improper payment reporting requirements established in the IPERA, Executive Order 13520, and the IPERIA. We tested these controls by reviewing and analyzing relevant documents, data, and calculations related to the preparation of EITC improper payment estimate information.

Appendix II

Major Contributors to This Report

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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. 2015-40-009, *The Internal Revenue Service Is Working Toward Compliance With Executive Order 13520 Reporting Requirements* (Dec. 2014).

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

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

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

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

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

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

Appendix V

Internal Revenue Service Programs Identified for Improper Payment Risk Assessments

The following IRS programs were identified by the Department of the Treasury for improper payment risk assessments for Fiscal Year 2014.

IRS Program	Type of Program	Level of Risk Identified
Affordable Health Care Program	Administrative	Low
Business Systems Modernization	Administrative	Low
Information Systems	Administrative	Low
Tax Law Enforcement	Administrative	Low
Taxpayer Services	Administrative	Low
Adoption Credit	Revenue	Low
Alternative Minimum Tax Credit Refunds	Revenue	Low
American Opportunity Credit	Revenue	Low
Build America Bonds	Revenue	Low
Child (Tax) Credit Payments	Revenue	Low
Consolidated Omnibus Budget Reconciliation Act Credit	Revenue	Low
Corporation Tax Credit Refunds	Revenue	Low
EITC Disbursements[1]	Revenue	High
Health Care Credit Payments	Revenue	Low
Home Buyers Credit Refunds	Revenue	Low
Informant Reimbursement	Revenue	Low
New Clean Renewable Energy Bonds	Revenue	Low
Qualified Energy Conservation Bond	Revenue	Low
Qualified Zone Academy Bonds	Revenue	Low

[1] The EITC Program has been declared a high-risk program for improper payments by the OMB; therefore, no formal risk assessment is required for it.

IRS Program	Type of Program	Level of Risk Identified
Qualified School Construction Bonds	Revenue	Low
Refund Collection	Revenue	Low
Refund Collection – Interest	Revenue	Low
Small Business Health Insurance Tax Credit	Revenue	Low

Source: IRS Office of the Chief Financial Officer.

Appendix VI

Management's Response to the Draft Report

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

CHIEF FINANCIAL OFFICER

April 20, 2015

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Robin L. Canady
Chief Financial Officer Robin L. Canady

SUBJECT: Assessment of Internal Revenue Service Compliance With the Improper Payment Reporting Requirements in Fiscal Year 2014 (Audit #201540024)

We have reviewed your draft audit report titled, "Assessment of Internal Revenue Service Compliance With the Improper Payment Reporting Requirements in Fiscal Year 2014." I was pleased that the report acknowledges the challenges the IRS faces in administering the Earned Income Tax Credit (EITC) program. Your audit correctly recognizes that many of the EITC program's improper payments are related to the legislatively-driven structure of the program, which the IRS lacks the statutory authority to correct. I also appreciate your acknowledgement of the many mitigating efforts the IRS has undertaken with respect to the program despite this constraint. The IRS continues to work with the Department of the Treasury to develop and propose legislative changes that would improve our ability to ensure taxpayer compliance with EITC program requirements and reduce improper payments.

In the report, IRS efforts related to assessing the risk of improper payments for the Affordable Care Act (ACA) Premium Tax Credit (PTC) program are mischaracterized. Your statement that the IRS cannot effectively assess the risk of PTC improper payments, estimate the improper payment rate and dollars, or establish corrective actions to address the causes of and reduce improper PTC payments would be correct if done alone, but the IRS is working jointly with the Centers for Medicare and Medicaid Services (CMS), the Department of Health and Human Services (HHS), the Department of the Treasury and the Office of Management and Budget (OMB) on an interagency effort to develop the definition of an improper payment with respect to the ACA Advance Premium Tax Credit (APTC) and PTC programs as well as develop plans for assessing risks. CMS is currently sharing with IRS its Statement of Work for completing work during FY 2015 and the IRS has committed to use its existing Risk Assessment

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Questionnaire, using a similar methodology to the other refundable tax credit programs, to determine areas that might affect payment accuracy, even though IRS is not required to do a risk assessment in FY 2015 since payments of PTC refunds have just begun. The IRS is modifying the qualitative risk assessment to address the specifics of this program.

Finally, I am concerned with TIGTA's characterization of the Additional Child Tax Credit (ACTC) program based on its analysis of IRS data. As the IRS responded in the formal report, many of the payments TIGTA considers "improper" are merely misclassifications between CTC and ACTC, and not true improper payments. The underlying CTC/ACTC data from the National Research Program are sound, but by focusing only on the ACTC, TIGTA is obtaining results that are incomplete and misleading. Our respective staffs have discussed this issue several times and it appears that we have fundamentally different perspectives on this issue.

If you have any questions, please contact me at (202) 317-6400, or a member of your staff may contact John Pekarik, Associate Chief Financial Officer for Corporate Planning and Internal Control, at (202) 803-9151.