Audit Report

OIG-18-045

FINANCIAL MANAGEMENT

Treasury Did Not Comply with the IPERA Requirements for Fiscal Year 2017

May 14, 2018

Office of Inspector General

Department of the Treasury

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Contents

Appendices

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Abbreviations

ACTC	Additional Child Tax Credit
AOTC	American Opportunity Tax Credit
CTC	Child Tax Credit
EITC	Earned Income Tax Credit
EO	Executive Order
IPERA	Improper Payments Elimination and Recovery Act of 2010
IPERIA	Improper Payments Elimination and Recovery Improvement Act of 2012
IPIA	Improper Payments Information Act of 2002
IRS	Internal Revenue Service
NRP	National Research Program
OIG	Office of Inspector General
OMB	Office of Management and Budget
PATH	Protecting Americans from Tax Hikes Act of 2015
PTC	Premium Tax Credit
SSN	Social Security Number
TIGTA	Treasury Inspector General for Tax Administration
Treasury	Department of the Treasury

May 14, 2018

David F. Eisner
Assistant Secretary for Management

This report presents the results of our audit of the Department of the Treasury's (Treasury) compliance with improper payment reporting requirements for fiscal year 2017. The objective of our audit was to assess and report on Treasury's overall compliance with requirements contained in the Improper Payments Elimination and Recovery Act of 2010 (IPERA),[1] enacted to help Federal agencies strengthen the framework for reducing and reporting improper payments. As part of our audit, we also assessed Treasury's compliance with additional improper payment reporting requirements set forth in Executive Order (EO) 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*, and the Improper Payments Elimination and Recovery Improvement Act of 2012 (IPERIA).[2] Appendix 1 provides more detail of the objective, scope, and methodology of our audit.

This report also summarizes the results of the Treasury Inspector General for Tax Administration's (TIGTA) assessment of the Internal Revenue Service's (IRS) compliance with improper payment reporting requirements in fiscal year 2017. This summarization includes the IRS management response to TIGTA's audit findings. TIGTA issued its report on April 9, 2018, which is included as appendix 2 of this report.

Results in Brief

Treasury was not in compliance with IPERA for fiscal year 2017 due to IRS not reducing the overall Earned Income Tax Credit (EITC) improper payment rate to less than 10 percent of the program payments. IRS estimates that 23.94 percent

[1] Pub. L. No. 111-204, 124 Stat. (July 22, 2010)
[2] Pub. L. No. 112-248, 126 Stat. (January10, 2013)

($16.2 billion) of EITC payments were issued improperly in fiscal year 2017. This is the 7th consecutive year that we have determined that Treasury is noncompliant with IPERA due to IRS's EITC reporting deficiencies. We determined that Treasury was in compliance with all other IPERA, EO 13520, and IPERIA improper payment reporting requirements.

We also reviewed Treasury's risk assessment process and recapture audit programs to determine the accuracy and reasonableness of Treasury improper payments reporting and found no matters of concern. In addition, we determined that Treasury complied with the requirement to publish its Agency Financial Report (AFR) and any accompanying material required by the Office of Management and Budget (OMB) on its website for fiscal year 2017, and posted required improper payment information to the paymentaccuracy.gov website.

In a written response, management noted that it strives to improve IPERA compliance and reporting processes and will continue to collaborate with the IRS and OMB to identify a more effective process for reporting compliance information for refundable credit programs. Additionally, management noted that it will continue incorporating information on the refundable credit programs in the Department's AFR as part of a broader discussion on tax gap, tax burden, and refundable tax credit compliance.

Treasury management's response is provided in appendix 3.

We also summarized TIGTA's audit results in this report. TIGTA determined that IRS continues to incorrectly rate the improper payment risk associated with the Additional Child Tax Credit (ACTC) and American Opportunity Tax Credit (AOTC) which results in a significant understatement of improper payments. IRS's ACTC and AOTC were erroneously identified as medium risk programs instead of as high risk programs. The incorrect rating results in the exclusion of required reporting by the IRS in the AFR. In addition, TIGTA determined that a quantitative evaluation is needed to provide an accurate assessment of the risk of improper payments associated with the ACTC, AOTC, and Premium Tax Credit (PTC). IRS management informed TIGTA that it is developing a method to use National Research Program (NRP) data to calculate ACTC and AOTC error rates going forward.

The IRS has also not taken actions to address more than $45.2 million in confirmed erroneous and fraudulent refundable claims identified by TIGTA. Additionally, IRS noted that processes have not been developed to prevent the issuance of the EITC to individuals with Social Security Numbers (SSN) that are not valid for work.

Finally, TIGTA evaluated traditional compliance tools that are being used to address identified erroneous claims and reported that without additional tools and authorities, the IRS will continue to issue billions of dollars each year in improper refundable credit payments including EITC.

TIGTA's report and the IRS management response are provided in appendix 2.

Background

Improper Payments Compliance and Reporting Requirements

Under the Improper Payments Information Act of 2002 (IPIA),[3] Federal agencies were required to review and identify programs and activities susceptible to improper payments on an annual basis and report estimates of improper payments to Congress along with actions to reduce estimated improper payments that exceeded $10 million.

In 2009, EO 13520 required Federal agencies to intensify their efforts to eliminate payment error, waste, fraud, and abuse in major Federal programs while continuing to ensure that these programs serve and provide access to their intended beneficiaries. It increased Federal agencies' accountability and required that Federal agencies 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.

[3] Pub. L. No. 107-300, 116 Stat. (November 26, 2002)

Following EO 13520, IPERA amended IPIA, strengthening agencies' program reviews and reporting requirements. IPERA expanded the types of payments to be reviewed and established the requirement for agencies to conduct recovery audits if cost-effective. IPERA also required Inspectors General to report on their respective agencies' compliance with IPERA each fiscal year.

IPERIA further expanded agency improper payment requirements to foster greater agency accountability. IPERIA requires the OMB Director to identify a list of high priority Federal programs for greater levels of oversight and review. For those high priority programs, IPERIA requires OMB to coordinate with agencies to establish annual targets and semi-annual or quarterly actions for reducing improper payments. Agencies are required to submit an annual report to the Inspector General on actions (1) taken or planned to recover improper payments and (2) intended to prevent future improper payments. The report is also required to be available to the public on a central website.

For fiscal year 2017, EITC was Treasury's only OMB-identified high priority program.

In accordance with IPERIA and EO 13520, Offices of Inspector General (OIG) are required to review and report on their respective agencies' OMB-designated high priority programs, if any. Specifically, OIGs are to review management's assessment of the level of risk, the quality of the improper payment estimates and methodology, and the oversight and financial controls in place to identify and prevent improper payments. Recommendations, if any, are to be provided for modifying agency plans related to its high priority programs to include improvements for determining and estimating improper payments.

In Memorandum 15-02 dated October 20, 2014, OMB issued revisions to OMB Circular No. A-123, Appendix C, to provide agencies guidance on implementing all improper payment compliance and reporting requirements.

Treasury's Improper Payment Risk Assessment

Treasury issued *Fiscal Year 2017 Treasury Implementation Guide for OMB Circular A-123 Appendix C: Requirements for Effective Estimation and Remediation of Improper Payments* (Treasury's IPERA Guidance) to all components. Treasury also provided all components a tool—the IPERA Risk Assessment Questionnaire for FY 2017—to assess the level of risk for each payment type, such as Federal employee payments including payroll, contract payments, benefits, grants, and travel cards. The IPERA Risk Assessment Questionnaire must be applied to each payment type within each Fund Group.[4] Using component responses, the Risk Assessment Questionnaire computes a per-program risk score which determines the risk assessment rating of low, medium, or high.

After each component completes and reviews its risk assessment, the results are provided to Treasury. For programs at medium risk for incurring significant improper payments, the component is required to conduct an internal control review. For any program identified as having a high risk for improper payment, the responsible component is also required to provide the following information for inclusion in Treasury's AFR:

- estimates of improper payments,
- root causes of improper payments,
- corrective action plan to reduce improper payments,
- status of internal controls over improper payments, and
- annual improper payments reduction outlook.

For fiscal year 2017, Treasury identified EITC as its only high risk program. The risks of improper payments for AOTC, ACTC and PTC were rated as medium.

Payment Recapture Audits

IPERA requires agencies to conduct recovery audits (also referred to as payment recapture audits) to prevent, detect, and recover overpayments, if conducting such audits would be cost-effective,

[4] A Fund Group is a set of activities recognized as a program within the component.

for each program and activity that expends $1 million or more annually. A payment recapture audit is a review and analysis of an agency's or program's accounting and financial records, and other pertinent information supporting its payments that is specifically designed to identify overpayments.

Treasury's IPERA Guidance requires each component to complete and submit a worksheet providing a consistent reporting format that includes information on the results of the component's payment recapture audits. The worksheets are submitted to Treasury for review and the data are consolidated and reported in the AFR.

Treasury's Improper Payment Reporting

On November 15, 2017, Treasury published its fiscal year 2017 AFR and subsequently posted it to its website. Included in that report was the required improper payments information with the following accompanying information:

- Treasury-wide assessment and results;
- improper payment estimates for the EITC program;
- statistical sampling methodology used to arrive at the estimated improper payments for fiscal year 2017;
- summary discussing the supplemental measures for the EITC program;
- IRS's strategy of identifying and reducing EITC refund claims in fiscal year 2017;
- description of the corrective action plans for the EITC program, including the root causes and projected result for fiscal year 2018;
- description of barriers, which limit the IRS's corrective actions in reducing improper payments in the EITC program;
- discussion of annual payment recapture audit efforts; and
- results of Treasury's Do Not Pay Initiative operation.

Treasury OIG Audit Results

According to OMB Circular A-123, an agency is required to meet six specific requirements to be compliant with IPERA. The six requirements are (1) publishing an AFR; (2) conducting a risk assessment; (3) publishing an improper payment estimate; (4) publishing corrective action plans; (5) publishing and meeting reduction targets; and (6) reporting a gross improper payment rate of less than 10 percent. We found that Treasury did not comply with IPERA for fiscal year 2017 because the IRS reported a gross improper payment rate of more than 10 percent for the EITC program. Specifically, the IRS reported an EITC improper payment rate of 23.94 percent (or $16.2 billion). We discuss this further in our Finding below. Treasury did comply with the other five IPERA requirements as outlined in Table 1.

Table 1: **Treasury's Compliance with IPERA Requirements**

Improper Payment Criteria	**Compliance**
Publish an AFR	Yes
Conduct risk assessment	Yes
Publish an improper payment estimate	Yes
Publish corrective action plans	Yes
Publish and meet reduction targets	Yes
Report a gross improper payment rate of less than 10 percent	No

Source: OIG's and TIGTA's review of the Department of the Treasury Agency Financial Report for Fiscal Year 2017

We also reviewed Treasury's risk assessment process and recapture audit programs to determine the accuracy and reasonableness of Treasury improper payments reporting and found no matters of concern. We noted that Treasury (1) included the required improper payment disclosures in the AFR; (2) performed risk assessments using required criteria defined by OMB Circular A-123; and (3) conformed to OMB guidance for payment recapture audits. In addition, we determined that Treasury complied with the requirement to post required improper payment information to the paymentaccuracy.gov website.

Treasury Was Not in Compliance with IPERA for Fiscal Year 2017

We determined that Treasury was not in compliance with IPERA for fiscal year 2017 due to IRS not reducing the overall improper payment rate for the EITC program to less than 10 percent. IRS estimates that 23.9 percent (or $16.2 billion) in EITC payments were issued improperly in fiscal year 2017. IPERA requires a gross improper payment rate of less than 10 percent for each program and activity for which an improper payment estimate was obtained and published in the AFR. This is the 7th consecutive year we have determined that Treasury is not in compliance with IPERA due to IRS's EITC improper payments reporting deficiencies.

On June 15, 2015, Treasury notified Congress of several proposed statutory changes to reduce the improper payment rate of the EITC program. As part of its notification, Treasury informed Congress that the Administration's fiscal year 2016 budget includes proposals that are intended to help improve EITC compliance by:

- Accelerating due dates for filing information returns, including Form W-2, *Wage and Tax Statement* (W-2), to facilitate early detection of income misreporting and fraud, including identity theft. This would allow the IRS to identify erroneous EITC claims and stop the refunds before they are paid;
- Regulating tax return preparers, which would help reduce erroneous EITC claims by weeding out unscrupulous and incompetent preparers;
- Providing more flexible correctable error authority, which would help the IRS to deny certain erroneous claims, including erroneous EITC claims, before refunds are paid;
- Increasing civil and criminal penalties for tax-related identity theft, which would prevent some erroneous EITC claims; and
- Simplifying the rules for claiming the EITC for taxpayers who reside with a child that they do not claim as a dependent,

which would reduce taxpayer burden and improve EITC compliance.

Congress passed the Consolidated Appropriations Act of 2016, which became law on December 18, 2015.[5] The law provides the IRS with additional tools to reduce EITC improper payments. The provisions include:

- Effective for tax returns filed after December 18, 2015, individuals (primary, secondary, and dependent) must have a valid SSN issued on or before the due date of the tax return to be eligible to claim the EITC.
- Beginning in January 2017, employers and third-parties were required to file W-2s, and report on employee income by January 31 each year. These forms were previously due no later than March 31 (February 28 for paper filed forms) each year. The Act also prohibits the IRS from issuing tax refunds prior to February 15 when the tax return includes the EITC.

However, the Act did not expand the IRS's authority to systematically correct the erroneous claims that are identified when tax returns are processed. According to TIGTA, without expanded error correction authority, IRS will not be able to prevent the issuance of billions of dollars in improper EITC payments.

IRS has submitted a legislative proposal requesting correctable error authority as part of its fiscal year 2019 budget submission. However, as of April 2018, the law does not provide this authority.

Treasury Inspector General for Tax Administration Audit Results

The following are excerpts from TIGTA's fiscal year 2017 IPERA audit report. As TIGTA has previously reported on the conditions discussed in its report, no recommendations were made.

[5] Pub. L. No. 114-113, 129 Stat. 2242 (December 18, 2015)

Finding 1 The Incorrect Risk Rating of the Additional Child Tax Credit (ACTC) and the American Opportunity Tax Credit (AOTC) Results in the Circumvention of Reporting Requirements

TIGTA reported that IRS continues to incorrectly conclude improper payments associated with ACTC and AOTC credits do not have a high risk. The IRS once again erroneously rated the risk associated with these two credits as medium which is contrary to the IRS's own NRP and compliance data, which when analyzed shows a high risk of improper payments. As a result, the IRS is significantly understating its estimate of improper payments associated with refundable tax credits in its reports to the OMB and Congress. Furthermore, the inaccurate risk rating results in the exclusion of required reporting by the IRS in the AFR.

TIGTA also reported that the IRS's revised ACTC and AOTC risk assessment methodologies did not include an assessment of available NRP and compliance data. Using the IRS's own NRP and compliance data, TIGTA computed the fiscal year 2017 potential estimated improper payment rate as 23.2 percent ($7.4 billion) for the ACTC and 28.3 percent ($1.3 billion) for the AOTC. Both continue to exceed the IPERA criteria for a significant risk of improper payments and, as such, should be identified as high risk programs.

In addition, the use of a quantitative evaluation is needed to provide an accurate assessment of the risk of improper payments associated with the ACTC and AOTC. TIGTA's evaluation of IRS's improper payment risk assessment methodology has continually shown that the IRS's repeated use of qualitative evaluation does not provide an accurate assessment of the risk of improper payments. IRS management informed TIGTA that the IRS is developing a method to use NRP data to calculate ACTC and AOTC error rates going forward. Specifically, the IRS plans to include these error rates in the Treasury AFR as part of its reporting on the Tax Gap.[6] However, TIGTA believes the IRS should report these error rates under its improper payment reporting.

[6] 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.

Furthermore, a quantitative evaluation is also needed to accurately assess the risk of the PTC. In April 2016, TIGTA reported that the IRS's methodology to assess the PTC did not include a quantitative assessment and, as such, its assessment of an improper payment risk associated with the PTC is unreliable. In fiscal year 2017, the IRS continued to use a qualitative assessment and incorrectly rated the improper payment risk associated with the PTC as medium despite TIGTA's reporting in March 2017 that 80,005 taxpayers potentially received $128.7 million more in PTC than they were entitled to receive for Tax Year 2015. As with the ACTC and AOTC, the IRS has developed a method to use the NRP data to calculate a PTC error rate for Tax Year 2014 tax returns (the first year for which the PTC was available). However, similar to the ACTC and AOTC, the IRS plans to use this error rate to evaluate PTC compliance as part of its Tax Gap efforts and not as a quantitative assessment of the PTC improper payment risk.

Finding 2 Assessment of Fiscal Year 2017 Compliance with Earned Income Tax Credit (EITC) Improper Payment Reporting Requirements

TIGTA reported that the IRS has not reduced the overall EITC improper payment rate to less than 10 percent, but it has been approved for this exception to the reporting requirement. As an alternative, the Department of the Treasury and the OMB collaborated on the development of a series of EITC supplemental measures for use in lieu of reduction targets. The supplemental measures are:

- The Annual Error Rate – identifies the percentage of total EITC payments that were improper.
- The Amount of Revenue Protected – shows the total value of erroneous payments prevented or recovered through compliance activities.
- The Amount of Revenue Protected From Paid Preparer Treatments – shows dollars erroneously or fraudulently claimed by paid tax preparers but not paid out, or recovered by Treasury

- The Number of Preparer Due Diligence Penalties Proposed – reflects the effectiveness of the Treasury's efforts to ensure that paid tax preparers are submitting accurate, non-fraudulent EITC claims on behalf of taxpayers

In addition, the EITC Due Diligence Report required by the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) does not provide key details as to how the EITC Tax Software Field Experiment was performed. The PATH Act required the IRS to conduct a study of the effectiveness of tax return preparer due diligence requirements for claiming EITC and provide its results to Congress no later than December 18, 2016. According to IRS management, this report was provided to Congress on April 19, 2017. The PATH Act also required the IRS to conduct a study of these requirements with regard to the Child Tax Credit (CTC) and AOTC and provide the results to Congress no later than December 18, 2017. As of February 27, 2018, the IRS has yet to provide the results of its study of the CTC and AOTC to Congress. IRS management informed us that the report is currently undergoing Treasury's review. The IRS was unable to provide a date the report will be issued to Congress.

The IRS's EITC Due Diligence Report evaluates the results of the IRS's EITC Return Preparer Study and the EITC Tax Software Field Experiment. However, TIGTA's review of the IRS's study of the EITC Due Diligence Report found that it does not provide key details as to how the EITC Tax Software Field Experiment was performed. TIGTA requested (and had yet to receive as of the date of their report) detailed information as to the number and identity of the software providers that participated in the study as well as the number of taxpayers sampled by each participating provider and how they were selected.

Finding 3 Actions Are Not Being Taken to Address Confirmed Erroneous and Fraudulent Refundable Credit Claims

TIGTA reported that the IRS is not taking steps to address erroneous and fraudulent EITC and ACTC claims identified by TIGTA and the Social Security Administration (SSA). Since July 2017, TIGTA has issued three reports that identify individuals who received the EITC, the CTC/ACTC, and the AOTC and did not meet the eligibility requirements included in the PATH Act. TIGTA recommended the IRS review the 21,551 returns identified and take actions needed to recover the erroneous payments. However, as of March 12, 2018, the IRS has not taken action.

TIGTA reported that the IRS still has not established processes to prevent individuals who have a nonwork SSN from receiving the EITC. As a result, 49,310 individuals who are not authorized to work in the United States received almost $117.7 million in potentially erroneous EITCs in Tax Year 2014.

Finding 4 Use of Traditional Compliance Tools to Address Identified Erroneous Claims Continues to Diminish – Without Additional Tools and Authorities, Billions in Improper Payments Will Be Issued Each Year

TIGTA reported that information provided by the IRS for inclusion in Treasury's fiscal year 2017 AFR clearly shows the amount of EITC the IRS is protecting is declining whereas the amount of estimated EITC improper payments has increased since fiscal year 2015.

TIGTA continues to report that the IRS's use of traditional compliance tools will not provide any significant reduction in refundable credit improper payments. Without additional tools and authorities, the IRS will continue to issue billions of dollars each year in improper refundable credit payments.

TIGTA also reported that in addition to the limitations on the IRS's authority to address identified erroneous claims, the IRS's ability to accurately verify claims is dependent on employers and third-party payers timely filing required information documents. In response, the IRS noted that their ability to systematically verify income reported on tax returns was incomplete because employers did not submit Forms W-2 and systemic income verification cannot be accurately performed for filers that report income if not all employers have reported timely.

TIGTA’s report and the IRS management response are provided in appendix 2 of this report.

* * * * * *

We appreciate the courtesy and cooperation extended to our staff during this audit. Should you have any questions, you may contact me at (202) 927-0009, or Catherine Yi, Audit Manager, at (202) 927-5591. Major contributors to this report are listed in appendix 4.

/s/
James Hodge
Director, Financial Audits

The overall objective of our audit was to determine whether the Department of the Treasury (Treasury) complied with the improper payment reporting requirements for fiscal year 2017. We assessed Treasury's compliance with the reporting requirements set forth in the Improper Payments Elimination and Recovery Act of 2010 (IPERA); Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*; and the Improper Payment Elimination and Recovery Improvement Act of 2012 (IPERIA). Our audit scope did not include the review of programs and activities administered by the Internal Revenue Service (IRS). The Treasury Inspector General for Tax Administration (TIGTA) is responsible for the audit of IRS's compliance with improper payment reporting requirements. TIGTA's scope included an assessment of the Earned Income Tax Credit information that IRS provided for inclusion in Treasury's fiscal year 2017 Agency Financial Report and a review of IRS's progress on previous recommendations.

To accomplish our objective, we reviewed applicable laws, regulations, guidance issued by the Office of Management and Budget (OMB), and *Treasury-wide Guidance for the FY 2017 Implementation of Effective Estimation and Remediation of Improper Payments*; reviewed Treasury's fiscal year 2017 Annual Financial Report; interviewed Departmental Offices and component entities' personnel; and performed testing of Treasury's risk assessments and payment recapture audit programs.

To determine compliance with IPERA and OMB guidance, we reviewed the fiscal year 2017 Annual Financial Report and any accompanying information to assess whether Treasury had:

- published an Annual Financial Report for the most recent fiscal year and posted that report and any accompanying materials required by OMB on Treasury's website;
- conducted a program specific risk assessment for each program or activity that conforms with IPERIA, if required;
- published improper payment estimates for all programs and activities identified as susceptible to significant improper payments under its risk assessment, if required;
- published programmatic corrective action plans in the Annual Financial Report, if required;

- published, and is meeting, annual reduction targets for each program assessed to be at risk and estimated for improper payments, if required and applicable; and
- reported a gross improper payment rate of less than 10 percent for each program and activity for which an improper payment estimate was obtained and published in the Annual Financial Report.

To assess Treasury's risk assessment process, we randomly selected a statistical sample of 13 of 55 non-IRS programs identified by Treasury for risk assessment. To determine the reasonableness and accuracy of the information reported and compliance with the applicable guidance for the sample, we reviewed the program risk assessments and supporting documentation. We conducted interviews of Treasury personnel involved in the risk assessment and review process. We also provided the 13 selected components with an OIG questionnaire and used their responses to evaluate their risk assessment methodologies.

To assess Treasury's payment recapture audit program, we selected the entire population of 21 reporting entities due to our prior year audit finding on Treasury's recapture audit.[7] To determine the reasonableness and accuracy of the information reported, and compliance with the applicable guidance, we reviewed the components' submissions of the payment recapture audit results along with its supporting documentation and determined if the component (1) employed an internal control program to prevent, detect and recover overpayments; (2) considered all programs that expend $1 million or more annually; (3) prepared and submitted justifications for those programs that did not complete a payment recapture audit; (4) completed and submitted Payment Recapture Audit Results worksheets; and (5) disposed of recovered funds in accordance with OMB guidance. In order to make this determination, we also obtained evidence through the components' responses to our questionnaires and our interviews with Treasury personnel.

[7] *Treasury Did Not Comply with the IPERA Requirements for Fiscal Year 2016 Due to the Earned Income Tax Credit Program* (OIG-17-043; issued May 12, 2017)

We conducted our fieldwork in Washington, DC, from February 2018 to May 2018.

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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

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

April 9, 2018

Reference Number: 2018-40-032

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

Redaction Legend:
2 = Law Enforcement Techniques/ Procedures and Guidelines for Law Enforcement Investigations or Prosecutions

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

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Or Write:
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P.O. Box 589
Ben Franklin Station
Washington, D.C. 20044-0589

Information you provide is confidential and you may remain anonymous.

HIGHLIGHTS

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

Highlights

Final Report issued on April 9, 2018

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

IMPACT ON TAXPAYERS

The Improper Payments Elimination and Recovery Act (IPERA) of 2010 and subsequent legislation strengthened agency reporting requirements and redefined "significant improper payments" in Federal programs. The Office of Management and Budget has declared the Earned Income Tax Credit Program a high-risk program that is subject to reporting in the Department of the Treasury Agency Financial Report. The IRS estimates that 23.9 percent ($16.2 billion) in Earned Income Tax Credit payments were issued improperly in Fiscal Year 2017.

WHY TIGTA DID THE AUDIT

This audit was initiated because TIGTA is required to assess the IRS's compliance with the reporting requirements contained in the IPERA; Executive Order 13520, *Reducing Improper Payments*; and the Improper Payment Elimination and Recovery Improvement Act of 2012. The objective of this review was to determine whether the IRS complied with the annual improper payment reporting requirements for Fiscal Year 2017.

WHAT TIGTA FOUND

The IRS provided all required Earned Income Tax Credit improper payment information for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2017.* The IRS has not reduced the overall Earned Income Tax Credit improper payment rate to less than 10 percent, but it has been approved for this exception to the reporting requirement. As an alternative, the Department of the Treasury and the Office of Management and Budget collaborated on the development of a series of Earned Income Tax Credit supplemental measures for use in lieu of reduction targets.

The IRS continues to incorrectly rate the improper payment risk associated with the Additional Child Tax Credit and American Opportunity Tax Credit, which results in a significant understatement of improper payments associated with refundable tax credits reported to the Office of Management and Budget and Congress. The incorrect rating allows the IRS to continue to circumvent the reporting of required information for these programs to the Department of the Treasury for inclusion in the Agency Financial Report.

The IRS has not taken actions to address more than $45.2 million in confirmed erroneous and fraudulent refundable credit claims TIGTA identified as a result of prior audits. ******2******
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Finally, the effectiveness of traditional compliance tools to address identified erroneous claims continues to diminish. Without additional tools and authorities, billions of dollars in improper payments will be issued each year.

WHAT TIGTA RECOMMENDED

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

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

April 9, 2018

MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

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

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

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

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

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

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IPIA	Improper Payments Information Act
IRS	Internal Revenue Service
NRP	National Research Program
OMB	Office of Management and Budget
PATH Act	Protecting Americans from Tax Hikes Act of 2015
PTC	Premium Tax Credit
SE	Self-Employment
SSA	Social Security Administration
SSN	Social Security Number
TIGTA	Treasury Inspector General for Tax Administration

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

Background

The Office of Management and Budget (OMB) defines an improper payment as any payment that should not have been made, was made in an incorrect amount, or was made to an ineligible recipient. Agency Inspectors General have responsibility for evaluating agency information related to improper payments. The Improper Payments Information Act (IPIA) of 2002[1] requires Federal agencies, including the Internal Revenue Service (IRS), to estimate the amount of improper payments and report to Congress annually on the causes of and the steps taken to reduce improper payments. The IPIA also requires agencies to address whether they have the information systems and other infrastructure needed to reduce improper payments. The annual report must also describe steps the agency has taken to ensure that agency managers are held accountable for reducing improper payments. The following legislation and Executive Order clarified and expanded the IPIA requirements:

- **Executive Order 13520, *Reducing Improper Payments*** – signed by the President on November 20, 2009, it increased Federal agencies' accountability for reducing improper payments while continuing to ensure that Federal programs serve and provide access to intended beneficiaries. It requires Federal agencies to provide agency Inspectors General with detailed information on efforts to identify and reduce the number of improper payments in Federal programs with the highest dollar value of improper payments.

- **Improper Payments Elimination and Recovery Act (IPERA) of 2010**[2] – enacted on July 22, 2010, it amended the IPIA by strengthening agency reporting requirements and redefining "significant improper payments." For Fiscal Year[3] 2014 and beyond, significant is defined as gross annual improper payments. The gross annual improper payments is the total amount of overpayments plus underpayments made in the program during the fiscal year reported that a) exceeded both 1.5 percent of program outlays and $10 million of all program or activity payments or b) exceeded $100 million at any percent of program outlays.

- **Improper Payments Elimination and Recovery Improvement Act (IPERIA) of 2012**[4] – enacted on January 10, 2013, it further expanded agency improper payment requirements to foster greater agency accountability. Like Executive Order 13520, the IPERIA requires the OMB Director to identify a list of high-priority Federal programs. For those high-priority programs, the IPERIA requires agencies to develop additional or

[1] Pub. L. No. 107-300, 116 Stat. 2350.
[2] Pub. L. No. 111-204, 124 Stat. 2224.
[3] Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
[4] Pub. L. No. 112-248, 126 Stat. 2390.

supplemental measures for tracking progress in reducing improper payments and submit an annual report to the Inspector General of the agency on the steps the agency has taken and plans to take to recover past and prevent future improper payments. The report is also required to be posted on a website accessible to the public.

On October 20, 2014, the OMB issued revisions to Circular A-123 Appendix C, *Requirements for Effective Estimation and Remediation of Improper Payments*. Circular A-123 Appendix C provides agencies and Inspectors General with guidance on the implementation of the IPIA as amended by the IPERA, IPERIA, and Executive Order 13520. According to the OMB, the revised Appendix C creates a more unified, comprehensive, and less burdensome improper payment compliance framework. For example, agencies now have the flexibility to combine the various improper payment reporting requirements into one document, the Agency Financial Report.[5] In addition, the Inspectors General also have the flexibility to conduct one review to assess their respective agency's compliance with the various improper payment requirements.

Process to identify IRS programs for improper payment risk assessment

The Department of the Treasury identifies the programs that the IRS must assess for the risk of improper payments. For Fiscal Year 2017, the Department of the Treasury selected 19 IRS program fund groups. These funds were selected for assessment based on each fund groups' materiality to the IRS financial statements. Appendix V provides a list of the IRS programs identified for an improper payment risk assessment for Fiscal Year 2017. On March 20, 2014, the OMB issued additional supplemental improper payment guidance to the Department of the Treasury clarifying the requirement for annual risk assessments of all refundable tax credits. Specifically, the OMB guidance clarified that *all refundable credits* are subject to IPERA requirements because they represent an additional outlay of funds by the Government. Nonrefundable tax credits reduce an individual's tax liability and represent an offset of excess taxes that were already paid to the Government. Therefore, nonrefundable tax credits do not result in an additional budget outlay.

The IRS used the *Improper Payments Elimination and Recovery Act Risk Assessment Questionnaire* for Fiscal Year 2017 (hereafter referred to as the Risk Assessment Questionnaire) and related guidance provided by the Department of the Treasury to assess the level of risk for each identified program. In response to concerns raised in prior Treasury Inspector General for

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

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Tax Administration (TIGTA) reports,[6] the Risk Assessment Questionnaire was updated for Fiscal Year 2016 in an attempt to provide a more accurate assessment of the risk associated with the programs the Department of the Treasury identified.
The Risk Assessment Questionnaire computes a risk score for each program based on the IRS's response to the questions it contains. The risk score determines whether there is a low, medium, or high risk of improper payments in a program. The Department of the Treasury establishes the level of risk for a program's improper payments. Based on the risk score, different actions are required by agencies:

- *Low-risk program* – A risk score of 0 to 28 requires agencies to monitor those programs annually through the risk assessment.
- *Medium-risk program* – A risk score of 29 to 44 requires agencies to review payment controls for improvement opportunities.
- *High-risk program* – A risk score of 45 and geater requires agencies to establish a corrective action plan.

The IRS is required to forward the results and documentation supporting the risk assessments performed to the Department of the Treasury. For any program identified as having a high risk for improper payments, the IRS must also provide the following information for inclusion in the Department of the Treasury's annual Agency Financial Report:

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

The OMB has previously identified the Earned Income Tax Credit (EITC)[7] as a high-risk program and, as such, the annual risk assessment is not required to be performed. The EITC is

[6] TIGTA, Ref. No. 2014-40-093, *Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments* (Sept. 2014); TIGTA, Ref. No. 2015-40-044, *Assessment of Internal Revenue Service Compliance With the Improper Payment Reporting Requirements in Fiscal Year 2014* (Apr. 2015); and TIGTA, Ref. No. 2016-40-036, *Without Expanded Error Correction Authority, Billions of Dollars in Identified Potentially Erroneous Earned Income Credit Claims Will Continue to Go Unaddressed Each Year* (Apr. 2016).
[7] Congress originally passed the EITC legislation in 1975 in part to offset the burden of Social Security taxes and to provide an incentive to work. The EITC is a refundable tax credit that offsets income tax owed by low-income

currently the only IRS high-risk program and the only program with information included in the Department of the Treasury's Agency Financial Report. The IRS estimates that 23.9 percent ($16.2 billion) of EITC payments made in Fiscal Year 2017 were paid in error. The EITC continues to be the only IRS program that the OMB has identified as a high-priority program.

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

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

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

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

This review was performed with information obtained from the Office of the Chief Financial Officer and the Office of Research, Applied Analytics, and Statistics located at the IRS Headquarters in Washington, D.C., and the Small Business/Self-Employed Division, Examination Operations, in Philadelphia, Pennsylvania, during the period September 2017 through March 2018. In addition to assessing the IRS's compliance with the improper payment reporting requirements, we also evaluated the effectiveness of the IRS's use of select tools to

taxpayers. Refundable tax credits can be used to reduce a taxpayer's tax liability to zero. Any excess of the credit beyond the tax liability can be refunded to the taxpayers.

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

prevent and recover erroneous refundable credit payments. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Results of Review

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

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

- The rate and amount of improper payments.
- The causes of improper payments and the agency's plans to address them.
- Reduction targets.
- Limitations to the agency's ability to reduce improper payments, including legislative limitations.

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

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

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

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

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

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

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

In response to our April 2017 report, IRS management stated that the IRS developed the refundable tax credit program risk assessment framework with the Department of the Treasury and in accordance with both OMB Circular A-123 Appendix C and Treasury implementation guideline requirements. OMB Circular A-123 Appendix C, Part I Section A,[17] requires agencies

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

to institute a systemic method to identify programs susceptible to significant improper payments. The guidance states:

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

OMB Circular A-123 does not direct agencies to use one method of assessment over another. Rather, the guidance provides agencies an example of the methods that could be used to evaluate risk. Our evaluation of the IRS's improper payment risk assessment methodology has continually shown that the IRS's repeated use of a qualitative evaluation does not provide an accurate assessment of the risk of improper payments. In fact, as we reported in April 2017, if the IRS used the same qualitative analysis it uses for the ACTC and the AOTC to assess the EITC, it would incorrectly rate the risk associated with the EITC as a medium risk. This would be an inaccurate risk rating because the IRS estimates that 23.9 percent ($16.2 billion) of EITC payments made in Fiscal Year 2017 were paid in error.

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

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

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

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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. 2016-40-036, *Without Expanded Error Correction Authority, Billions of Dollars in Identified Potentially Erroneous Earned Income Credit Claims Will Continue to Go Unaddressed Each Year* (Apr. 2016).
[20] TIGTA, Ref. No. 2017-43-022, *Affordable Care Act: Verification of Premium Tax Credit Claims During the 2016 Filing Season* (Mar. 2017).

the ACTC and AOTC, the IRS plans to use this error rate to evaluate PTC compliance as part of its Tax Gap efforts and not as a quantitative assessment of the PTC improper payment risk.

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

As previously noted, the OMB has identified the EITC as a high-risk program, and as such the IRS is required to report annually on its efforts to reduce EITC improper payments. Our review confirmed that the IRS provided all required EITC improper payment information to the Department of the Treasury for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2017*. The IRS has not reduced the overall EITC improper payment rate to less than 10 percent; however, it has been approved for this exception to the reporting requirement. As an alternative, the Department of the Treasury and the OMB collaborated on the development of a series of EITC supplemental measures for use in lieu of reduction targets. The OMB approved these supplemental measures on August 27, 2014, and the measures were published in the *Department of the Treasury Agency Financial Report Fiscal Year 2014* as required. The supplemental measures are:

- **The Annual Error Rate** – identifies the percentage of total EITC payments that were improper.
- **The Amount of Revenue Protected** – shows the total value of erroneous payments prevented or recovered through compliance activities.
- **The Amount of Revenue Protected From Paid Preparer Treatments** – shows dollars erroneously or fraudulently claimed by paid tax preparers but not paid out or recovered by the Department of the Treasury.
- **The Number of Preparer Due Diligence Penalties Proposed** – reflects the effectiveness of the Department of the Treasury efforts to ensure that paid tax preparers are submitting accurate, nonfraudulent EITC claims on behalf of taxpayers.

Figure 1 provides a summary of our evaluation of IRS compliance with the various improper payment reporting requirements, including the reporting of supplemental measures.

Figure 1: IRS Compliance With Improper Payment Requirements for the EITC Program for Fiscal Year 2017

Improper Payment Requirement	Source of Requirement	Provided by IRS
Conduct a program-specific risk assessment for each program or activity identified by the Department of the Treasury.	IPERA	Yes
Publish an improper payment estimate for the EITC.	IPERA	Yes

Improper Payment Requirement	Source of Requirement	Provided by IRS
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 EITC improper payment supplemental measures in lieu of annual reduction targets for the EITC.	OMB/Department of the Treasury	Yes
Provide plans and supporting analysis for meeting the reduction targets for EITC improper payments.	Executive Order	Yes
Publish a programmatic corrective action plan for the EITC.	IPERA	Yes
Report on actions the IRS intends to take to prevent future EITC improper payments.	IPERIA	Yes
Report on efforts taken or planned to recapture EITC improper payments.	IPERA / IPERIA	Yes
Provide plans and supporting analysis for ensuring that the initiatives undertaken do not unduly burden program access and participation by eligible beneficiaries.	Executive Order	Yes
Provide required EITC information for posting to the paymentaccuracy.gov website.	Executive Order / IPERIA	Yes
Submit quarterly reports to TIGTA and the Council of the Inspectors General on Integrity and Efficiency and make available to the public a report on EITC improper payments identified by the agency.	Executive Order	N/A[21]

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

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

The PATH Act required the IRS to conduct a study of the effectiveness of tax return preparer due diligence requirements for claiming the EITC and provide its results to Congress no later than

[21] Effective for Fiscal Year 2014 forward, the dollar threshold for which agencies are required to report quarterly high-dollar improper payments is $25,000 per individual. Because the maximum EITC an individual can receive is well below the $25,000 threshold, the IRS would not be required to report any quarterly high-dollar payments for Fiscal Year 2014 forward.
[22] Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, 129 Stat. 2242 (2015).

December 18, 2016. According to IRS management, this report was provided to Congress on April 19, 2017. The PATH Act also required the IRS to conduct a study of these requirements with regard to the CTC and AOTC and provide the results to Congress no later than December 18, 2017. As of February 27, 2018, the IRS has yet to provide the results of its study of the CTC and AOTC to Congress. IRS management informed us that the report is currently undergoing review by the Department of the Treasury. The IRS was unable to provide a date the report will be issued to Congress.

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

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

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

The above information is important because it can influence the results of the study. For example, additional due diligence questions may be less effective when tested by a software

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

provider whose software already contains additional probing questions or when asked to taxpayers who have not received an EITC improper payment. To properly evaluate the impact of due diligence questions on reducing EITC improper payments, the questions needed to be asked to individuals who have incorrectly received the EITC in the past.

We requested detailed information as to the number and identity of the software providers that participated in the study as well as the number of taxpayers sampled by each participating provider and how they were selected. We will include an assessment of the EITC Tax Software Field Experiment in our Fiscal Year 2019 review of compliance with improper payment reporting requirements.

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

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

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

[26] TIGTA, Ref. No. 2017-40-042, *Processes Do Not Maximize the Use of Third-Party Income Documents to Identify Potentially Improper Refundable Credit Claims* (July 2017).
[27] TIGTA, Ref. No. 2018-40-011, *Some Legal Requirements to Deactivate Individual Taxpayer Identification Numbers Have Not Been Met* (Jan. 2018).

2017 Filing Season for which the Taxpayer Identification Number was not issued by the due date of the tax return.[28]

We recommended that the IRS review the 21,551 returns we identified and take the actions needed to recover the erroneous payments. IRS management agreed with our recommendations. However, as of March 12, 2018, the IRS has not taken action to recover erroneous payments associated with 21,545 (99.97 percent) of the 21,551 returns we identified. IRS management informed us that they planned to use the IRS's math error authority to adjust the tax accounts of the 21,551 taxpayers we identified to recover the erroneous payments. However, before the IRS could recover the payments, the National Taxpayer Advocate requested a formal opinion as to the IRS's authority to use its math error authority to retroactively recover erroneous credits. The IRS originally sent this request to IRS Chief Counsel on September 8, 2017. We followed up with Chief Counsel on the status of the request and found that, as of February 21, 2018, it has yet to issue an opinion as to the IRS's authority to retroactively use math error authority.

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[28] TIGTA, Ref. No. 2018-40-015, *Employer Noncompliance With Wage Reporting Requirements Significantly Reduces the Ability to Verify Refundable Tax Credit Claims Before Refunds Are Paid* (Feb. 2018).
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The Internal Revenue Service Is Not in Compliance With Improper Payment Requirements

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31 The IRS has the authority to ban taxpayers from claiming the EITC for two years or 10 years. The PATH Act expanded this authority to include the CTC/ACTC and AOTC.

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

In July 2017, we reported that the IRS still has not established processes to prevent individuals who have a "nonwork" SSN from receiving the EITC. As a result, 49,310 individuals who are not authorized to work in the United States received almost $117.7 million in potentially erroneous EITCs in Tax Year 2014.

The Personal Responsibility and Work Opportunity Reconciliation Act of 1996,[32] enacted August 22, 1996, requires individuals claiming the EITC to have a valid-for-work SSN and authorizes the IRS to deny claims to those individuals who file using an invalid SSN. The taxpayer, spouse (if married filing jointly), and each qualifying child must have a valid SSN to be eligible to claim the EITC. For purposes of the EITC, a valid SSN is a number issued by the SSA to a U.S. citizen or to a noncitizen[33] who obtained the SSN for purposes other than to obtain a benefit partially or fully funded by the Federal Government (*e.g.*, Medicaid or food stamps).[34] These "benefit-only" SSNs are typically referred to as nonwork SSNs. In addition, a valid SSN does not include an Individual Taxpayer Identification Number, an Adoption Taxpayer Identification Number, or an IRS Number.[35] The SSA has issued almost eight million "*NOT*

[32] Pub. L. No. 104-193, 2105 Stat. 110.
[33] To be eligible for the EITC, a noncitizen generally must be a resident alien for more than half the tax year.
[34] The SSA was granted the authority to issue SSNs for the purposes of obtaining Federally funded benefits and other nonwork purposes in October 1972 with the passage of the Social Security Amendments of 1972, Pub. L. No. 92-603.
[35] A temporary number issued by the IRS.

VALID FOR EMPLOYMENT" (nonwork) SSNs since 1972 to individuals who do not have authorization to work in the United States.

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

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

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

Information provided by the IRS for inclusion in the *Department of the Treasury's Agency Financial Report Fiscal Year 2017* clearly shows that the amount of ***EITC the IRS is protecting is declining whereas the amount of estimated EITC improper payments***

[36] The National Account Profile is a compilation of selected entity data from various IRS Master Files. It includes Social Security Administration data and cross-reference data, making it possible to verify taxpayers who have no IRS primary Master File account. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[37] When the SSA assigns an SSN to an individual, it creates a master record of relevant information about the number holder in its Numident Database. This includes such information as the number holder's name, date of birth, place of birth, parents' names, and citizenship status.
[38] Pub. L. No. 115-97.
[39] Individuals without a valid SSN may claim a credit of up to $500.

has increased since Fiscal Year 2015. According to IRS management, the Revenue Protected supplemental measure is defined as the cumulative erroneous EITC payments prevented and recovered through compliance activities. The reported revenue protected results from the closing of EITC examinations, closing of Automated Underreporter[40] cases, and math error adjustments. IRS management stated that the decline in volumes of returns worked and the associated dollars protected results from personnel losses in the Examination function and the Automated Underreporter Program. Figure 2 provides a comparison of IRS results for the EITC supplemental measures for Fiscal Years 2015 through 2017.

[40] Automated Underreporter cases are identified by matching information returns against data reported on individual tax returns. The Automated Underreporter system will generate proposed assessments.

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

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

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

As we continue to report, the IRS's use of traditional compliance tools will not provide any significant reduction in refundable credit improper payments. Without additional tools and authorities, the IRS will continue to issue billions of dollars each year in improper refundable credit payments. For example, according to the Department of the Treasury Agency Financial Report Fiscal Year 2017, approximately $1 billion (6 percent) of improper EITC payments result from income misreporting. While the PATH Act provided the IRS wage documents earlier in the filing season, it did not give the IRS authority to systemically adjust refundable credits when the income used to compute the credit is not supported by third-party income documents. The IRS must still audit each tax return to prevent or recover these unsupported refundable credits. Currently, under the Internal Revenue Code, the IRS can use its math error authority to address erroneous EITC claims by systemically correcting mathematical or clerical errors such as correcting entries made on the wrong line on the tax return or mathematical errors in computing income or the EITC. The IRS must conduct an audit to address potentially erroneous refundable credit claims for which it does not have math error authority. The IRS estimated that it costs $1.50 to resolve an erroneous EITC claim using math error authority compared to $278 to conduct a prerefund audit.[41] However, the majority of potentially erroneous EITC claims the IRS identifies do not contain the types of errors for which it has math error authority.

The IRS has repeatedly requested additional authority (referred to as correctable error authority) that would allow it to correct tax returns during processing when:

- The information provided by the taxpayer does not match the information contained in Government databases (*e.g.*, income information reported on the tax return does not match Form W-2, *Wage and Tax Statement*, from the SSA).
- The taxpayer has exceeded the lifetime limit for claiming a deduction or credit.

[41] Cost to use math error authority as of June 25, 2014, as provided by the IRS. The IRS provided the cost of a prerefund audit based on Fiscal Year 2010 financial data.

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

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

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

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

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

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

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS complied with the annual improper payment reporting requirements for Fiscal Year[1] 2017. This review evaluated the IRS's compliance with the reporting requirements contained in the IPERA of 2010;[2] Executive Order 13520, *Reducing Improper Payments*;[3] and the IPERIA of 2012.[4] The scope of this review included an assessment of the information that the IRS provided for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2017*. To accomplish our objective, we:

I. Reviewed the *Department of the Treasury Agency Financial Report Fiscal Year 2017*, published on November 15, 2017, to determine if the IRS was in compliance with the improper payment reporting requirements for Fiscal Year 2017. We compared the information contained in the Agency Financial Report to the improper payment reporting requirements outlined in the OMB Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*,[5] guidance on improper payment reporting.

   A. Determined if the IRS was in compliance with IPERA reporting requirements.
   B. Determined if the IRS was in compliance with IPERIA reporting requirements.
   C. Determined if the IRS was in compliance with Executive Order 13520 reporting requirements.
   D. Reviewed information that the IRS provided to the Department of the Treasury for posting to the paymentaccuracy.gov website.
   E. Determined if the information included in the *Department of the Treasury Agency Financial Report Fiscal Year 2017* relative to EITC improper payments accurately reflects the underlying information from the IRS and was posted to paymentaccuracy.gov or other Internet locations as required.

[1] Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
[2] Pub. L. No. 111-204, 124 Stat. 2224.
[3] Executive Order 13520, *Reducing Improper Payments* (November 20, 2009).
[4] Pub. L. No. 112-248, 126 Stat. 2390.
[5] Oct. 2014.

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

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

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

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

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

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

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

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

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

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

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

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

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

Data Validation Methodology

During this review, we relied on data received from the IRS for the NRP on the ACTC, the AOTC, and the EITC for Tax Year 2013. We also obtained extracts from the IRS's Returns Transaction File[8] databases that were available on the TIGTA's Data Center Warehouse.[9] Before relying on the data, we ensured that each file contained the specific data elements we requested. In addition, we selected random samples of each extract and verified that the data in

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[6] Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, 129 Stat. 2242 (2015).
[7] TIGTA, Ref. No. 2018-40-015, *Employer Noncompliance With Wage Reporting Requirements Significantly Reduces the Ability to Verify Refundable Tax Credit Claims Before Refunds Are Paid* (Feb. 2018).
[8] An IRS database containing transcribed tax returns for individuals that includes most forms and schedules.
[9] A TIGTA repository of IRS data.

the extracts were the same as the data captured in the IRS's Integrated Data Retrieval System.[10] We also performed an analysis to ensure the validity and reasonableness of our data such as ranges of dollar values, transaction dates, and tax periods. Based on the results of our testing, we believe that the data used in our review were reliable.

We also relied on data provided to us by the SSA. Before relying on the data, we performed an analysis to ensure the reasonableness of our data such as ranges of dollar values and tax periods. We reviewed outlier records by comparing the data fields to available data on the IRS's Integrated Data Retrieval System. In addition, we selected a random sample of the SSA data and verified that the data matched various data fields captured in the IRS's Integrated Data Retrieval System. We did not have access to the SSA internal system that generated the data, but throughout our analysis we were able to match various SSA data fields to the IRS's Returns Transaction File and Individual Master File databases and found matching information. Based on the results of our testing, we believe that the data used in our review were reliable.

Internal controls methodology

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

[10] IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

Appendix II

Major Contributors to This Report

Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services)
Deann L. Baiza, Director
Kathleen A. Hughes, Audit Manager
Ngan B. Tang, Lead Auditor
Linda M. Valentine, Senior Auditor
Laura P. Haws, Information Technology Specialist (Data Analytics)

Appendix III

Report Distribution List

Chief Financial Officer
Deputy Commissioner for Operations Support
Deputy Commissioner for Services and Enforcement
Commissioner, Wage and Investment Division
Chief, Research, Applied Analytics, and Statistics
Director, Office of Legislative Affairs
Director, Office of Program Evaluation and Risk Analysis
Director, Return Integrity and Compliance Services, Wage and Investment Division
Director, Office of Audit Coordination

Appendix IV

Treasury Inspector General for Tax Administration Audit Reports on Improper Payments

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

TIGTA, Ref. No. 2016-40-036, *Without Expanded Error Correction Authority, Billions of Dollars in Identified Potentially Erroneous Earned Income Credit Claims Will Continue to Go Unaddressed Each Year* (Apr. 2016).

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

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

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

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

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

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

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

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

Appendix V

Internal Revenue Service Programs Identified for Improper Payment Risk Assessments

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

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

Source: IRS Office of the Chief Financial Officer.

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

Appendix VI

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

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

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

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

Improper Payments – The difference between the amount of the ACTC or AOTC claimed by the taxpayer on his or her tax return and the amount the taxpayer should have claimed based on NRP results for Tax Year 2013. This amount includes overclaims and underpayments. This amount totaled $6.7 billion for the ACTC and $2.4 billion for the AOTC.

Overclaims Recovered – The amount of ACTC or AOTC overclaims that the IRS prevents from being paid through activities such as math error processing and prerefund examinations or recovers after being paid through Automated Underreporter[1] document matching and post-refund examinations.

ACTC Overclaims Recovered – This amount was estimated by applying the ratio of EITC overclaims recovered to EITC improper payments from the IRS's Fiscal Year 2017 EITC

[1] Automated Underreporter cases are identified by matching information returns against data reported on individual tax returns. The Automated Underreporter system will generate proposed assessments.

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

improper payment rate calculation. Using the EITC overclaims recovered ratio of 11.7 percent, we estimated the ACTC overclaims recovered to total $778.8 million.[2]

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

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

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

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

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

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

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

[2] Numbers may not add up due to rounding.
[3] Estimated claims are determined after upward adjustments are made to estimates of tax expenditures and outlays in the Fiscal Year 2018 Federal Budget. For the ACTC, the estimated total claims were $31.9 billion. For AOTC, the estimated claims totaled $4.5 billion and included only the outlay portions reported in the Fiscal Year 2018 Federal Budget.

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

Appendix VII

Management's Response to the Draft Report

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

CHIEF FINANCIAL OFFICER

April 2, 2018

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Ursula S. Gillis
Chief Financial Officer

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

Thank you for the opportunity to review and comment on your draft audit report entitled, *The Internal Revenue Service is Not in Compliance with Improper Payment Requirements*. Administering the refundable tax credits (RTCs) – including the Earned Income Tax Credit (EITC), the American Opportunity Tax Credit (AOTC), the Additional Child Tax Credit (ACTC), and the Premium Tax Credit (PTC) component of the Affordable Care Act (ACA) – represents a significant challenge for the IRS due to the nature of tax credits and the lack of information that is necessary for complete verification of taxpayer eligibility and claims at the time a return is filed. The RTCs each have numerous eligibility rules that contribute to the challenge of administering these credits. The rules differ for each credit and often require taxpayers to sort through complicated family relationships and residency arrangements to determine eligibility. This complexity contributes to the relatively high overclaim rates for these credits. The IRS also lacks third-party information that we could use to verify eligibility for the RTCs since the information needed may not be available when returns are processed, may be unreliable, or may not exist. Moreover, as you noted in your report, we are limited in our ability to use existing statutory authority to make pre-refund changes or corrections to taxpayer returns, and we do not have sufficient resources to increase staffing to expand the use of our existing compliance tools to reduce RTC overclaims significantly or to increase recoveries.

We believe – and our risk assessments continue to show – that RTC overclaims are not rooted in internal control weaknesses, financial management deficiencies or reporting failures, but instead result from the eligibility rules and the statutory construction of the credits. We periodically develop tax gap estimates and undertake other compliance studies that provide estimates of noncompliance including a recently completed ACTC compliance study, with another study on AOTC nearing completion. The IRS reported that the overclaim rate for the Child Tax Credit (CTC) – the refundable portion of ACTC

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

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

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

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

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

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

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

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

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

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

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

Assistant Secretary

May 11, 2018

**MEMORANDUM FOR DIRECTOR JAMES HODGE
FINANCIAL STATEMENT AND PROCUREMENT AUDITS,
OFFICE OF INSPECTOR GENERAL**

FROM: David F. Eisner
Assistant Secretary for Management

SUBJECT: Audit of Treasury's Compliance with the Improper Payment Reporting Requirements for Fiscal Year (FY) 2017

We have reviewed the draft audit report on Treasury's improper payment reporting for FY 2017 and appreciate the opportunity to respond. We recognize the importance of achieving full compliance with the Improper Payment Elimination and Recovery Act (IPERA), which includes complying with the Office of Management and Budget (OMB) Memorandum M-15-02, Appendix C to Circular A-123, *Requirements for Effective Estimation and Remediation of Improper Payments*, and OMB Circular A-136, *Financial Reporting Requirements*.

Your audit concluded that Treasury did not comply with the IPERA requirement for FY 2017 as the improper payment rate for the Earned Income Tax Credit (EITC) is greater than 10 percent, as reported by the Treasury Inspector General for Tax Administration (TIGTA). We appreciate your acknowledgement that Treasury was in compliance with all other IPERA requirements. We continually strive to improve our IPERA compliance and reporting processes.

The risk assessments for refundable tax credit programs show that improper payments from refundable credits are not rooted in internal weaknesses, financial management deficiencies, or financial reporting failures, but instead, from inherent aspects of delivering these benefits through the tax system, as well as how Congress structured the program, and IRS' lack of available tools to verify data or correct identified issues.

We will continue to collaborate with the IRS and OMB to identify a more effective process for reporting compliance information for refundable credit programs. Additionally, we will continue incorporating information on the refundable credit programs in the Department's Agency Financial Report as part of a broader discussion on tax gap, tax burden, and refundable tax credit compliance.

If you have any questions, please let us know, or you may contact Carole Banks, Deputy Chief Financial Officer, at (202) 622-0818.

Catherine Yi, Audit Manager
Shiela Michel, Audit Manager
R. Nikki Akinyeye, Auditor-in-Charge
Rufus Etienne, Auditor
Rebecca Berry, Auditor
Kevin Guishard, Referencer

The Department of the Treasury

Secretary of the Treasury
Counselor to the Secretary
Assistant Secretary for Management
Deputy Chief Financial Officer
Director, Risk and Control Group

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gulfcoastrestorationhotline@oig.treas.gov

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