TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

The Internal Revenue Service Is Not in Compliance With Executive Order 13520 to Reduce Improper Payments

August 28, 2013

Reference Number: 2013-40-084

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.

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THE INTERNAL REVENUE SERVICE IS NOT IN COMPLIANCE WITH EXECUTIVE ORDER 13520 TO REDUCE IMPROPER PAYMENTS

Highlights

Final Report issued on August 28, 2013

Highlights of Reference Number: 2013-40-084 to the Internal Revenue Service Deputy Commissioner for Operations Support.

IMPACT ON TAXPAYERS

The IRS has made little improvement in reducing improper Earned Income Tax Credit (EITC) payments since being required to report estimates of these payments to Congress. The IRS's Fiscal Year 2012 improper payment report to TIGTA indicates that EITC payments totaled nearly $62 billion. The IRS estimated that 21 to 25 percent of the EITC payments made in Fiscal Year 2012 were paid in error.

WHY TIGTA DID THE AUDIT

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

WHAT TIGTA FOUND

Executive Order 13520, signed by the President on November 20, 2009, increased Federal agencies' accountability for reducing improper payments while continuing to ensure that their programs serve and provide access to their intended beneficiaries. The IRS has taken steps to ensure access and participation by eligible individuals. The IRS estimates that the participation rate for individuals who are eligible to receive the EITC is between 78 and 80 percent.

However, the IRS is still not in compliance with the requirements of Executive Order 13520. The IRS has not established annual improper payment reduction targets as required. The IRS cited the complexity of the EITC program as well as the need to balance the reduction in improper payments while still encouraging individuals to use the credit as the two main reasons why reduction targets have not been established. IRS management stated that they recently met with the Office of Management and Budget and agreed to work together to develop supplemental measures and indicators in lieu of reduction targets. However, the IRS did not indicate when these measures would be in place.

The IRS is also not in compliance with the quarterly reporting requirement for high-dollar improper EITC payments (payments totaling more than $5,000). To determine whether the IRS reported the applicable improper payments in Tax Year 2009, TIGTA reviewed a statistically valid sample of the 60,793 Tax Year 2009 EITC claims for more than $5,000 for which the IRS examined the return and adjusted the EITC. Based on our review, TIGTA estimates that more than 10,400 of the EITC claims totaling more than $52.8 million met the criteria for the quarterly reporting to TIGTA as required by the Executive Order.

Finally, although privacy laws limit the IRS's ability to fully comply with the high-dollar EITC quarterly reporting requirement to the Council of the Inspectors General on Integrity and Efficiency, there are actions that the IRS can take to comply with the intent of the Executive Order. For example, the IRS could provide the Council with an aggregated number of EITC high-dollar payments along with the other required information.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS develop processes to identify high-dollar improper EITC payments and report the information to TIGTA and the Council as required by Executive Order 13520.

IRS management agreed with our recommendation and plans to take appropriate corrective actions.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

August 28, 2013

MEMORANDUM FOR DEPUTY COMMISSIONER FOR OPERATIONS SUPPORT

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

SUBJECT: Final Audit Report – The Internal Revenue Service Is Not in Compliance With Executive Order 13520 to Reduce Improper Payments (Audit # 201240046)

This report presents the results of our review of the Internal Revenue Service's (IRS) efforts to implement Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*.[1] Executive Order 13520 requires the Treasury Inspector General for Tax Administration to assess the IRS's compliance with the Order on an annual basis. As such, this audit is part of our Fiscal Year 2013 Annual Audit Plan and addresses the major management challenge of Fraudulent Claims and Improper Payments.

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

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

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

Table of Contents

Abbreviations

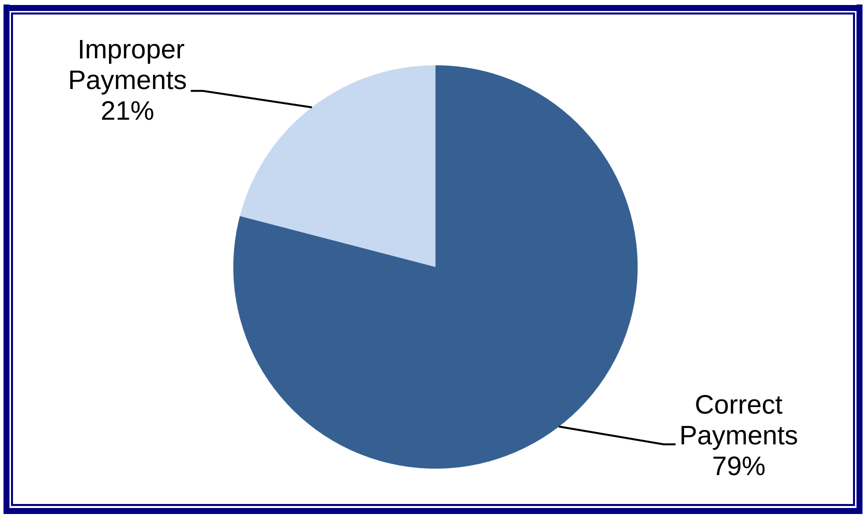
CIGIE	Council of the Inspectors General on Integrity and Efficiency
EITC	Earned Income Tax Credit
IRS	Internal Revenue Service
OMB	Office of Management and Budget
TIGTA	Treasury Inspector General for Tax Administration

Background

The Earned Income Tax Credit (EITC) is a refundable tax credit that offsets income tax owed by low-income taxpayers. Congress originally approved the EITC legislation in 1975 in part to offset the burden of Social Security taxes and to provide an incentive to work. When the credit exceeds the amount of taxes due, it generally provides a lump-sum payment in the form of a refund to those who qualify. The Internal Revenue Service (IRS) is responsible for administering the EITC. This includes providing education and outreach so that taxpayers are aware of eligibility requirements for the credit as well as establishing programs to reduce improper payment of the credit.

The Office of Management and Budget (OMB) defines an improper payment as any payment that should not have been made or that was made in an incorrect amount. Improper payments include overpayments as well as underpayments. The IRS estimated that 21 to 25 percent of the EITC payments made in Fiscal Year[1] 2012 were paid in error. Figure 1 illustrates the estimated portion of erroneous EITC payments for Fiscal Year 2012.

Figure 1: EITC Payments Made in Error in Fiscal Year 2012



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

[1] A 12-consecutive-month period ending on the last day of any month. The Federal Government's fiscal year begins on October 1 and ends on September 30.

The IRS continues to face challenges in reducing improper EITC payments

In its Fiscal Year 2012 Agency Financial Report,[2] the Department of the Treasury identified a number of factors that continue to serve as barriers to reducing improper payments in the EITC program. These include:

- Complexity of the tax law, including the need for congressional authorization of math error authority.
- Structure of the EITC.
- Confusion among eligible claimants.
- High turnover of eligible claimants.
- Unscrupulous tax return preparers.
- Fraud.

EITC eligibility rules are complicated and cause taxpayers to make errors while attempting to interpret and apply the tax laws to their individual situations. In addition, the changing population of taxpayers who claim the EITC increases the difficulty the IRS faces in improving EITC compliance. The IRS has conducted numerous studies showing how taxpayers move in and out of the EITC program. Studies show that approximately one-third of EITC claimants each year are intermittent[3] or first-time claimants. The Department of the Treasury stated that none of the six factors listed above can be considered the primary driver of EITC improper payments. The interaction among the factors makes it extremely difficult to address the credit's improper payment rate while balancing the need to ensure that eligible taxpayers receive the credit.

Executive Order 13520, Reducing Improper Payments and Eliminating Waste in Federal Programs,[4] increased accountability for improper payments

Executive Order 13520, in conjunction with the Improper Payments Information Act of 2002,[5] the Improper Payments Elimination and Recovery Act of 2010,[6] and the Improper Payments Elimination and Recovery Improvement Act of 2012,[7] defines Federal agencies' responsibility for identifying and reducing improper payments in Federal programs. The Executive Order, signed by the President on November 20, 2009, increased Federal agencies' accountability for reducing improper payments while continuing to ensure that their programs serve and provide

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[2] *Agency Financial Report, Department of the Treasury, Fiscal Year 2012*, issued November 15, 2013.
[3] Some taxpayers claim the EITC in one year but not the next, then file and claim the credit again at a later time.
[4] The White House, Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs* (November 20, 2009).
[5] Pub. L. 107-300.
[6] Pub. L. 111-204.
[7] Pub. L. 112-248.

access to their intended beneficiaries. The Executive Order also requires Federal agencies to provide their agency Inspector General detailed information on efforts to identify and reduce the number of improper payments in Federal programs with the highest dollar amount of improper payments. As such, the IRS is required to provide specific information regarding EITC payments to the Treasury Inspector General for Tax Administration (TIGTA) on an annual basis. The Order requires TIGTA, following receipt and review of the reported information, to assess the level of risk associated with the EITC program, determine the extent of oversight warranted, and provide the IRS Commissioner with recommendations for modifying the IRS's plan to reduce EITC improper payments.

In addition to the annual report, the Executive Order also requires Federal agencies to submit a quarterly report to the agency's Inspector General and the Council of the Inspectors General on Integrity and Efficiency (CIGIE),[8] which details specific information on high-dollar improper payments[9] identified by the agency. Agencies are required to provide this information for public release unless the information requested is protected by privacy rules or regulations.[10] Agencies with no high-dollar activity in a given quarter are not required to report for that quarter.

A prior TIGTA report[11] found that the IRS was not in compliance with Executive Order 13520

In February 2011, TIGTA reported that the IRS's methodology for computing the EITC improper payment rate provided a valid estimate of EITC overpayments. However, the IRS did not provide an estimate of EITC underpayments as required. In addition, the IRS report to TIGTA did not include annual EITC improper payment reduction targets or plans and supporting analysis for ensuring that the initiatives undertaken do not unduly burden program access and participation by eligible beneficiaries.

We recommended that the IRS establish quantifiable reduction targets along with strategies to meet those targets. We also recommended that the IRS estimate instances in which it incorrectly pays less EITC than the taxpayer claims (underpayments) in order to provide an estimate that fits the OMB definition of improper payments. The IRS agreed to evaluate the feasibility of estimating EITC underpayments. IRS management also agreed that they should establish

[8] The CIGIE was established within the executive branch by the Inspector General Act of 1978 (5 U.S.C. app. 3) as amended by the Inspector General Reform Act of 2008 (Pub. L. No. 110-409, 122 Stat. 4302 (codified in 5 U.S.C. app. 3)) to address integrity, economy, and effectiveness issues that transcend individual Government agencies and increase the professionalism and effectiveness of personnel by developing policies, standards, and approaches to aid in the establishment of a well-trained and highly skilled workforce in the offices of Inspectors General.

[9] A high-dollar overpayment is defined by the OMB as any overpayment that is in excess of 50 percent of the correct amount of the intended payments where the total payments to an individual in any quarter exceed $5,000.

[10] Agencies are to publish specific information regarding improper payments on the Internet for the public to access. The website address is http://www.paymentaccuracy.gov/.

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

quantifiable EITC reduction targets. However, IRS management indicated that they would not establish these targets until the IRS had fully implemented its Return Preparer Program[12] in September 2013.

This review was performed at the IRS Headquarters in the Office of Research, Analysis, and Statistics and in the Office of the Chief Financial Officer in Washington, D.C., during the period November 2012 through March 2013. 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.

[12] A program that pursues unscrupulous return preparers who knowingly claim excessive deductions and exemptions on returns prepared for clients. The clients may or may not have knowledge of the false claims.

Results of Review

A Significant Reduction in Earned Income Tax Credit Improper Payments Will Be Difficult to Achieve Without Alternatives to Traditional Compliance Methods

As we reported previously, despite numerous efforts, the IRS is unlikely to achieve any significant reduction in EITC improper payments. The IRS has implemented numerous processes to educate taxpayers and identify and prevent improper EITC payments.[13] For Fiscal Year 2012, the IRS reported that its efforts protected approximately $4 billion in erroneous EITC payments and identified approximately 7,000 paid tax return preparers who were not complying with EITC due diligence requirements.[14]

Although significant amounts are being protected, the IRS has made little improvement in reducing improper EITC payments as a whole since it has been required to report estimates of these payments to Congress. The IRS acknowledges that further reductions in the EITC improper payment rate will be difficult to achieve. Figure 2 presents the IRS's estimated EITC improper payments for Fiscal Years 2003 through 2012.

[13] See Appendix IV for a description of these initiatives.
[14] Due diligence requirements require paid tax return preparers to gather, verify, and maintain specific information when filing a tax return claiming the EITC.

Figure 2: EITC Improper Payments for Fiscal Years 2003 Through 2012

Fiscal Year	Minimum Improper Payments[15] Percentage	Maximum Improper Payments Percentage	Minimum Improper Payments Dollars (Billions)	Maximum Improper Payments Dollars (Billions)
2003	25%	30%	$9.5	$11.5
2004	22%	27%	$8.6	$10.7
2005	23%	28%	$9.6	$11.4
2006	23%	28%	$9.8	$11.6
2007	23%	28%	$10.4	$12.3
2008	23%	28%	$11.1	$13.1
2009	23%	28%	$11.2	$13.3
2010	24%	29%	$15.3	$18.4
2011	21%	26%	$13.7	$16.7
2012[16]	*21%*	*25%*	*$11.6*	*$13.6*
Total			$110.8	$132.6

Source: Department of the Treasury Performance and Accountability Reports for Fiscal Years 2003 through 2010 and the Fiscal Year 2011 and Fiscal Year 2012 Agency Financial Reports.

The IRS must move beyond traditional compliance methods to significantly reduce improper EITC payments

The IRS must develop alternatives to traditional compliance methods to significantly reduce EITC improper payments. Limited resources and the need to balance compliance efforts among taxpayers in all income levels limit the effectiveness of traditional compliance methods in reducing improper EITC payments. For example, in December 2008, we reported that the IRS's

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[15] For Fiscal Years 2005 through 2009, the IRS computed the minimum and maximum improper payment rates (referred to as the upper and lower bounds) using different sets of assumptions concerning the compliance of EITC claimants who fail to show up for the National Research Program audit.

[16] The estimate for FY 2012 is outdated. It was based on the assumption that a provision in the American Reinvestment and Recovery Act of 2009 (Recovery Act) (Pub. L. No. 111-5, 123 Stat. 115 (2009)) that increased the EITC for certain taxpayers would expire at the end of 2010. However, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312,124 Stat. 3299 (2010)) extended the provision through December 2012. It was later extended through December 2017 by the American Taxpayer Relief Act of 2012 (Pub. L. No. 112-240,126 Stat. 2319 (2013)).

Dependent Database[17] identified almost 600,000 potentially erroneous Tax Year 2005 EITC claims totaling $1.3 billion.[18] However, the IRS did not have the resources to address 93.7 percent of these cases with claims totaling $1.2 billion. We recommended that the IRS conduct a study to identify alternative processes that will expand its ability to effectively and efficiently identify and adjust erroneous EITC claims. The IRS agreed with our recommendation. The IRS also agreed to work with the Assistant Secretary of the Treasury for Tax Policy to obtain the authority necessary to implement alternative compliance processes.

In the IRS's Fiscal Year 2012 EITC improper payment report to TIGTA,[19] the IRS acknowledged that it cannot fully address EITC noncompliance by examining tax returns and must pursue alternatives to traditional compliance methods. The IRS's report does not indicate that it has taken any steps to identify or implement alternative compliance methods since we first made our recommendations in December 2008. As we have previously reported, if the IRS does not move beyond its traditional compliance methods, it will be unable to make any significant reduction in the estimated $11 billion to $13 billion issued each year in improper EITC payments. We are initiating an audit to review the study the IRS performed to identify alternative processes in response to our recommendation. We plan to issue a report next fiscal year.

The Internal Revenue Service Is Still Not in Compliance With Executive Order 13520

Executive Order 13520 requires the IRS to provide TIGTA with an annual report detailing specific information on improper EITC payments. This report is due within 120 calendar days of the publication of the Department of the Treasury's annual Agency Financial Report. On June 14, 2010, the IRS provided the required report to TIGTA for Fiscal Year 2009. However, the IRS did not provide TIGTA with the required report for Fiscal Years 2010 or 2011. The IRS explained that, due to personnel changes, the required reports for these fiscal years were not provided to TIGTA. As such, the IRS included information for Fiscal Years 2010 and 2011 in its Fiscal Year 2012 report.

On March 14, 2013, the IRS provided the required report for Fiscal Year 2012. The Fiscal Year 2012 report included information for Fiscal Years 2010 and 2011 as the IRS indicated. However, the IRS did not include all of the information required by the Executive Order in its

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[17] A risk-based audit selection tool used by the IRS to identify tax returns for audit. The Dependent Database is made up of a collection of information databases that include birth certificate information and court documents used to establish a relationship and residency between the taxpayer and the qualifying children claimed on the tax return.
[18] TIGTA, Ref. No. 2009-40-024, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* (Dec. 2008).
[19] IRS, *Report on Earned Income Tax Credit (EITC) Improper Payments Executive Order 13520: Reducing Improper Payments* (March 14, 2013).

Fiscal Year 2012 report to TIGTA. Appendix V provides a copy of the IRS's Fiscal Year 2012 report. Figure 3 provides our assessment of the IRS's compliance with the Executive Order requirements to provide specific improper payment information to TIGTA.

Figure 3: Executive Order 13520 Reporting Requirements

Reporting Frequency	Requirement	Requirement Met?
Annually	Provide TIGTA with a report containing:	
	• Methodology for identifying and measuring EITC improper payments.	Yes
	• Plans and supporting analysis for meeting the reduction targets for EITC improper payments.	No
	• Plans and supporting analysis for ensuring that the initiatives undertaken do not unduly burden program access and participation by eligible beneficiaries.	Yes
	• Required information provided for posting to paymentaccuracy.gov website.	Yes
Quarterly	Submit to TIGTA and the CIGIE and make available to the public a report on EITC improper payments identified by the agency. The report shall describe: • Number of high-dollar improper payments made during the quarter. • The individuals or entities that received the improper payments. • Actions the IRS has taken or plans to take to recover high-dollar improper payments. • Actions the IRS intends to take to prevent improper payments from occurring in the future.	No quarterly reports have been provided to TIGTA. Disclosure laws may limit the IRS's ability to comply with CIGIE and public reporting requirements.

Source: TIGTA analysis of the IRS's Fiscal Year 2012 Executive Order 13520 report and OMB guidance issued on implementing Executive Order 13520.

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

The IRS uses its National Research Program[20] as the primary source of data to estimate the annual EITC improper payment rate. The National Research Program provides the IRS with

[20] Research conducted by the IRS to determine filing, payment, and reporting compliance by taxpayers for different types of taxes.

compliance information that is statistically representative of the taxpayer population. Updated estimates of taxpayer compliance are computed for each tax year.[21] The IRS uses each tax year's National Research Program results to update the EITC improper payment rate. Figure 4 shows the formula the IRS uses to compute the improper payment rate of EITC claims.

Figure 4: Improper EITC Payment Rate Formula

$$\frac{\textit{Total Overclaims – Total Claims Protected/Recovered}}{\textit{Total EITC Claims}}$$
Total Overclaims – The difference between the amount of the EITC claimed by the taxpayer on his or her tax return and the amount the taxpayer should have claimed.
Total Claims Protected/Recovered – The amount of EITC 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 document matching and post-refund examinations.
Total EITC Claims – The amount of the EITC claimed on all tax returns.

Source: TIGTA analysis of the IRS's Fiscal Year 2012 Executive Order 13520 report.

In February 2011, we reported that the methodology used to compute the EITC improper payment rate provides a valid estimate of the percentage and amount of EITC overpayments. However, the improper payment calculation does not include the amount of EITC underpayments. Underpayments include EITC payments made to individuals that are less than the individual was entitled to receive. The IRS's report indicated that it intends to incorporate underpayments into its estimates beginning with the Fiscal Year 2013 estimate.

The estimates for Fiscal Year 2012 EITC claims and improper payments are understated because the laws extending EITC increases were not factored into the estimates

The IRS uses an estimate for current year EITC claims because it does not know the actual amount at the time it computes the improper payment estimates. The IRS is required to submit improper payment estimates to the Department of the Treasury for inclusion in the Agency Financial Report prior to the end of each fiscal year. The estimate of EITC claims is based on a budget projection prepared by the Department of the Treasury Office of Tax Analysis. The projection is then provided to the OMB for inclusion in the OMB's published budget. The IRS uses this OMB data to estimate EITC claims for a given fiscal year.

[21] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

The IRS adjusts the estimate to account for claims that are submitted to the IRS but not paid due to processing controls. This adjusted budget projection is used to compute the amount of EITC claims paid in error. The estimated Fiscal Year 2012 EITC claim amount of $55.4 billion used to estimate EITC improper payments is significantly less than what was estimated in both Fiscal Year 2010 ($64.2 billion) and Fiscal Year 2011 ($64.7 billion). A representative from the Department of the Treasury Office of Tax Analysis, the office which developed the budget estimate, stated that the lower estimate for EITC claims is due to an assumption made when computing the 2012 budget projection. The assumption was that the Recovery Act third-child provision would no longer be in effect for claims on tax returns filed in Fiscal Year 2012. The Recovery Act increased the credit for families with three or more EITC qualifying children. This provision was to expire in December 2010.

However, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the increased credit amount through December 2012. It was later extended through December 2017 by the American Taxpayer Relief Act of 2012. Neither the Department of the Treasury nor the IRS adjusted the budget estimate to account for the extended EITC provision before using it to compute the amount of Fiscal Year 2012 EITC improper payments. As a result, the IRS's estimate of the amount of EITC paid in error in Fiscal Year 2012 is understated. The IRS informed us that it plans to adjust the Department of the Treasury's Fiscal Year 2013 budget estimate to ensure that the extended EITC provision is captured in its Fiscal Year 2013 estimate of EITC improper payments.

The IRS still has not established EITC reduction targets as required

The IRS's Fiscal Year 2012 report to TIGTA again does not include any reduction targets and the associated plans for meeting those targets as required. We also reported this issue in our February 2011 report on the IRS's compliance with Executive Order 13520 and in our review of the IRS's compliance with the Improper Payments Elimination and Recovery Act for Fiscal Year 2012.[22] In our February 2011 report, we recommended, and the IRS agreed, that reduction targets should be established. However, the IRS responded that it was in the early stages of implementing its Return Preparer Program and did not want to establish reduction targets until the program has been fully established. The IRS believed that once the program was established, it would have a good baseline from which it could develop meaningful reduction targets.

The IRS again stated in its Fiscal Year 2012 report that the regulation of tax preparers will drive increased EITC compliance, decrease fraud, and reduce the improper payment rate. However, we have expressed concern with this same assertion the IRS has made in the past because the IRS does not provide details relating to the specific reductions in improper payments as a result of tax preparer regulations nor does it provide details on when or how the IRS plans to measure

[22] 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).

the impact of tax return preparer regulations on EITC improper payments. We still have this same concern.

Moreover, it has become less likely that these new regulations will have a substantial impact. On January 18, 2013, the U.S. District Court for the District of Columbia enjoined the IRS from enforcing some of its regulatory requirements for tax return preparers. While the IRS can require tax return preparers to register with the IRS, it cannot require preparers to complete competency tests and obtain continuing education. On January 23, 2013, the IRS appealed the District Court's ruling and applied for a stay allowing the program to continue pending the outcome of the IRS's appeal. On March 27, 2013, the U.S. Court of Appeals for the District of Columbia denied the application for a stay. Therefore, the IRS's effort to regulate paid tax return preparers is on hold pending the outcome of its appeal, and it is unknown how long it will take the courts to resolve the appeal.

In the meantime, the IRS continues its outreach and education efforts to EITC return preparers with the goal to educate them on the EITC, the due diligence requirements, and the new due diligence penalty. The IRS estimates that two-thirds of EITC claims are prepared with the assistance of paid tax return preparers. More than 8,500 tax return preparers received a certificate of completion for the IRS's English and Spanish interactive EITC Due Diligence training module. In addition, more than 12,000 tax return preparers attended a webinar discussing the regulation changes, and more than 10,000 tax return preparers attended EITC and due diligence presentations at the 2012 Nationwide Tax Forum.

Finally, in its Fiscal Year 2012 report, the IRS indicated that setting EITC improper payment reduction targets is one of the continuing challenges faced by the IRS. The IRS cited the complexity of the EITC program as well as the need to balance the reduction in improper payments while still encouraging eligible individuals to use the credit as the two main reasons that establishing reduction targets has been so difficult. The IRS noted that it recently met with the OMB and agreed to work together to develop supplemental measures[23] that are appropriate to gauge the impact of compliance and outreach efforts in lieu of developing error reduction targets. However, the IRS's report did not indicate when these measures would be in place.

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

The IRS continues to administer the EITC through a balanced program of education and outreach coupled with strategic programs to reduce improper payments. According to the IRS, the EITC participation rate for individuals eligible to receive the credit is between 78 and 80 percent. The IRS's report to TIGTA provides details on the specific steps it takes to ensure that all eligible individuals have access to the credit. The IRS's efforts in Fiscal Year 2012 included:

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[23] A supplemental measure should focus on higher risk areas within the high-priority program and report on root causes of errors that agencies can resolve through corrective actions.

- Holding the sixth annual EITC Awareness Day. This targeted EITC underserved populations and included targeted compliance messages.
- Conducting English and Spanish media tours reaching an audience of more than 1.8 million taxpayers.
- Holding conference calls with the print media in English and Spanish that had circulation of more than 1.4 million.
- Conducting radio interviews in both English and Spanish that reached more than 1,000 markets.

The IRS has not provided TIGTA or the CIGIE with required quarterly reports detailing high-dollar improper payments

The IRS has not provided the required quarterly reports on high-dollar improper payments (payments totaling more than $5,000) to TIGTA since Tax Year 2009. The quarterly report is to include the names of the individuals who received high-dollar improper EITC payments and the actions the IRS has taken or plans to take to recover the improper payments. Additionally, the report must list any actions the IRS intends to undertake to prevent high-dollar improper EITC payments from occurring in the future.

Prior to Tax Year 2009, the maximum allowable EITC payment was below the $5,000 reporting minimum, so it was not possible for the IRS to make a high-dollar improper EITC payment. However, the Recovery Act raised the maximum allowable EITC above $5,000 beginning in Tax Year 2009. Our February 2011 report cited this change and noted that the IRS may be required to report high-dollar improper EITC payments beginning with Tax Year 2009. Figure 5 shows the maximum allowable EITC payment based on the number of qualifying children for Tax Years 2009 through 2012.

Figure 5: Maximum EITC Payment by Tax Year and Number of Qualifying Children

Number of Qualifying Children[24]	Tax Year 2009	Tax Year 2010	Tax Year 2011	Tax Year 2012
Three or more qualifying children	$5,657	$5,666	$5,751	$5,891
Two qualifying children	$5,028	$5,036	$5,112	$5,236
One qualifying child	$3,043	$3,050	$3,094	$3,169
No qualifying children	$457	$457	$464	$475

Source: IRS.gov.

[24] A child must pass four tests to be a qualifying child for the EITC: age, relationship, residency, and joint return.

To determine if the IRS made improper high-dollar EITC payments in Tax Year 2009 that should have been reported, we analyzed a statistically valid sample of 245 of the 60,793 EITC claims of more than $5,000 for which the IRS later reduced or denied the claim. Our review showed that the IRS made 42 improper payments fitting the OMB definition of a high-dollar reportable payment. These 42 improper payments total $212,952. Based on the results of our statistically valid sample, we project that the IRS potentially made more than 10,400 such high-dollar improper EITC payments totaling more than $52.8 million during Tax Year 2009. These high-dollar improper EITC payments should have been reported to TIGTA quarterly as required by Executive Order 13520.

Internal Revenue Code Section 6103(a) prohibits the IRS from providing taxpayer identifying information, including a taxpayer's name and tax account information, to anyone who has not been granted specific authority under the Code. As a result, the IRS cannot provide the information required by the Executive Order for high-dollar improper payments to the CIGIE. However, we believe the IRS may be able to comply with the intent of the quarterly reporting requirement despite being prohibited from releasing taxpayer information to the CIGIE. For example, the IRS could provide the CIGIE with an aggregated number of EITC high-dollar payments along with the other required information. The IRS should work with the OMB to establish an alternative reporting requirement for high-dollar improper EITC payments that will allow the IRS to comply with the intent of the Executive Order.

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

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

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

Requirement	Information Provided As Required?
Name of an accountable official.	Yes
Current/historical rates and amounts of improper payments, including causes.	Yes
Current and historical rates and amounts of recovery of improper payments.	Yes
Targets for reducing as well as recovering improper payments.	No
Entities that have received the greatest amount of improper payments.[25]	N/A

Source: OMB guidance issued on implementing Executive Order 13520.

Recommendation

Recommendation 1: The Deputy Commissioner for Operations Support should develop processes to identify high-dollar improper EITC payments and report the information to TIGTA and the CIGIE as required by Executive Order 13520.

> ***Management's Response:*** The IRS agreed with this recommendation. The IRS will develop the quarterly reports on summary volumes and amounts of post-refund high-dollar EITC payment reversals that the OMB agreed meet the quarterly report requirements of Executive Order 13520. Due to the requirements of Internal Revenue Code Section 6103(a), the IRS can only provide summary data to the CIGIE.

[25] Privacy laws prohibit compliance with this requirement.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to assess the IRS's efforts to implement Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*.[1] We verified the reliability of the electronic data used in this review by scanning the data extracts for blank, incomplete, illogical, or improper data. In addition, to ensure accuracy, we traced a judgmental sample from our dataset to IRS source files by using the Integrated Data Retrieval System.[2] To accomplish our objective, we:

I. Determined whether the prior TIGTA recommendations were implemented. We met with IRS personnel from the IRS Office of the Chief Financial Officer to determine if reduction targets had been established. We also determined whether the IRS used the National Research Program[3] sample to estimate instances in which the IRS incorrectly pays less in the EITC than the taxpayer claims (underpayments).

II. Reviewed the IRS's report on EITC improper payments for Fiscal Year[4] 2012 issued to TIGTA on March 14, 2013, to determine if the IRS was in compliance with the reporting requirements of Executive Order 13520.

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

   B. Reviewed paymentaccuracy.gov to ensure that the required information was published on the website.

   C. Evaluated the IRS's efforts to ensure that eligible individuals continue to have access to the EITC. We obtained current and historical EITC participation rates and analyzed them to determine if participation has increased. We also requested information from the IRS detailing the steps it takes to encourage program access and

[1] The White House, Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs* (November 20, 2009).
[2] The IRS computer system capable of retrieving or updating stored information; it works in conjunction with taxpayer account records.
[3] The IRS National Research Program is a comprehensive effort to measure voluntary compliance through annual studies on the reporting compliance of Form 1040, *U.S. Individual Income Tax Return*, taxpayers.
[4] A 12-consecutive-month period ending on the last day of any month. The Federal Government's fiscal year begins on October 1 and ends on September 30.

analyzed this information to determine if the IRS's actions ensured that eligible individuals have access to the EITC program.

D. Determined whether the IRS had a quarterly reporting requirement. We used the TIGTA Data Center Warehouse and identified 60,793 Tax Year 2009 EITC claims of more than $5,000 for which the IRS reduced or denied the claim. We validated the data by matching a judgmental sample to the IRS's Integrated Data Retrieval System to ensure that the data were consistent and complete.

   1. Reviewed a statistically valid sample of 245 of the 60,793 Tax Year 2009 EITC claims of more than $5,000. Our sample size was determined based on a confidence level of 95 percent, an expected rate of occurrence of 20 percent, and a precision of ± 5 percent. A statistical sample was taken because we wanted to estimate the number of returns with high-dollar improper EITC payments in Tax Year 2009. We determined that the IRS made high-dollar improper payments in 42 of the 245 tax returns we reviewed, with payments totaling $212,952.

   2. Projected the results of our statistically valid sample of 245 Tax Year 2009 tax returns to the population. We estimated that the IRS made 10,421 high-dollar improper EITC payments totaling $52.8 million in Tax Year 2009.

E. Analyzed the Department of the Treasury's Fiscal Year 2012 Agency Financial Report and the IRS's March 14, 2013, EITC improper payment report to TIGTA and assessed the level of risk and oversight warranted. We interviewed IRS personnel to determine what has been done to reduce improper EITC payments and obtained current and historical rates for improper EITC payments to determine if the IRS had made improvements.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: controls in place to ensure that the IRS is compliant with Executive Order 13520. We evaluated these controls by analyzing the IRS's Fiscal Year 2012 report on EITC improper payments. In addition, we reviewed a statistically valid sample of high-dollar improper EITC payments made in Tax Year 2009.

Appendix II

Major Contributors to This Report

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Appendix III

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- Chief Financial Officer CFO
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Appendix IV

Efforts Undertaken to Reduce Improper Earned Income Tax Credit Payments

The IRS's Fiscal Year[1] 2012 report to TIGTA[2] details the tools the IRS has in place to verify EITC claims and prevent or recover improper EITC payments. The IRS has two primary tools that it uses to identify improper EITC payments before the EITC refund is paid – math error and prerefund examinations. The IRS also uses document matching and post-refund examinations to identify and recover improper EITC payments that have already been issued to taxpayers.

- ***Math Error*** **–** An automated process that allows the IRS to systemically deny an EITC claim when certain conditions exist, *e.g.*, clerical errors and invalid Taxpayer Identification Numbers. Math error checks are performed while tax returns are being processed and before refunds are sent to taxpayers. According to the IRS, it protects $320 million in erroneous EITC refunds annually as a result of math error authority.
- ***Prerefund Examinations*** – Prerefund examinations are conducted to determine the validity of the EITC claim before the EITC refund is issued. The IRS uses complex filters to identify potentially erroneous EITC claims and select EITC tax returns for examination. Once a tax return is selected for examination, the IRS places a hold on the EITC portion of the taxpayer's refund until it can make a determination as to the validity of the EITC claim. The IRS continues to process the tax return without the EITC and issues the non-EITC portion of the tax refund to the taxpayer. According to the IRS, 70 percent of the 500,000 EITC examinations the IRS conducts each year are prerefund examinations. These examinations protected approximately $1.6 billion in EITC refunds in Fiscal Year 2012.
- ***Document Matching*** – The IRS's Automated Underreporter program matches income claimed on tax returns to income reported by third parties to identify instances in which EITC claimants underreport income. At a predetermined level of income, the amount of the EITC that an individual is eligible for decreases as the individual's income increases. Therefore, taxpayers have an incentive to underreport income to increase the amount of the EITC they are eligible for. When differences in claimed and reported income are discovered, the IRS adjusts the taxpayer's income, recalculates the EITC, and pursues

[1] A 12-consecutive-month period ending on the last day of any month. The Federal Government's fiscal year begins on October 1 and ends on September 30.
[2] As required by Executive Order 13520. The IRS issued the report to TIGTA on March 14, 2013.

recovery of the amount of the EITC paid in error. The IRS protected $1.6 billion in EITC claims in Fiscal Year 2012 as a result of document matching.

- ***Post-refund Examinations*** – Post-refund examinations occur after the tax return is processed and a refund has been issued. Similar to prerefund examinations, the IRS evaluates the validity of a taxpayer's EITC claim. If it is determined that the EITC claim is not valid, the IRS will calculate the amount of the EITC refund issued in error and make an assessment to the taxpayer's account for that amount. These examinations protected approximately $0.5 billion in EITC refunds in Fiscal Year 2012.
- ***Paid Tax Return Preparer Compliance Initiatives*** – The IRS estimates that approximately two-thirds of all EITC claims were filed with the assistance of paid tax return preparers. The IRS has developed an outreach program to educate and assist tax return preparers in preparing correct EITC claims. The IRS has also developed programs to address tax return preparers who repeatedly file erroneous EITC claims. As a result of these programs, the IRS was able to address the noncompliance of more than 7,000 tax return preparers during Fiscal Year 2012. One program identified 1,500 tax return preparers who prepared 660,000 tax returns and protected more than $183 million in EITC payments.

Figure 1 details the revenue the IRS protected or expects to protect as a result of its efforts to reduce improper EITC payments.

Figure 1: EITC Revenue Protected for Fiscal Years 2007 Through 2013

	Enforcement Revenue Protected (Dollars in Billions)							
	Fiscal Year 2007	Fiscal Year 2008	Fiscal Year 2009	Fiscal Year 2010	Fiscal Year 2011[3]	Fiscal Year 2012[4]	Fiscal Year 2013[5]	Fiscal Years 2007–2013 Totals
Exam Closures	1.49	2.00	2.15	1.97	2.04	2.05	2.05	13.75
Math Error Notices	0.41	0.44	0.40	0.41	0.35	0.32	0.28	2.61
Document Matching	1.29	1.23	1.17	1.43	1.32	1.55	1.55	9.54
Amended Returns	–	0.07	0.07	0.06	0.04	0.04	0.04	0.32
Total	**3.19**	**3.74**	**3.79**	**3.87**	**3.75**	**3.96**	**3.92**	**26.22**

Source: The IRS's Fiscal Year 2012 Agency Financial Report.

[3] Restated actual.
[4] Preliminary estimates.
[5] Estimated based on Fiscal Year 2012 preliminary data.

Appendix V

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

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

DEPUTY COMMISSIONER

March 14, 2013

The Honorable J. Russell George
Treasury Inspector General for Tax Administration
Department of the Treasury
1125 15th Street, NW
Washington, DC 20005

Dear Mr. George:

I am writing in response to the reporting requirements in Section 2(a)(i) of Executive Order 13520: Reducing Improper Payments (Executive Order), and Appendix C, Part III to the Office of Management and Budget (OMB) Circular A-123, Requirements for Effective Measurement and Remediation of Improper Payments. The Earned Income Tax Credit (EITC) has been designated a high-priority program by OMB. For Tax Year 2011, over 27 million taxpayers received nearly $62 billion in EITC, making the credit one of the largest tax credits in the United States. The EITC is often credited with successful poverty reduction.

This updated report provides specific information on our current methodology for measuring the EITC improper payment rate, surmised root causes for improper claims, and current and planned actions to mitigate improper payments.

The Internal Revenue Service (IRS) continues to administer the EITC through a balanced program of education and outreach so that taxpayers are aware of potential eligibility for the credit coupled with strategic programs addressed at taxpayers and preparers to reduce improper payments. The EITC has a 78-80 percent participation rate. The estimated improper payment rate for Fiscal Year 2012 is 22.8 percent ($13 billion).

The IRS continues to improve and expand its existing compliance treatments to stop erroneous EITC payments. The IRS has also continued implementation of its plan to register return preparers and create enforcement tools that impact the paid return preparer community more broadly, although some of these efforts are on hold pending recent litigation. The IRS continues to believe that the new regulation of tax return preparers will help drive increased EITC compliance, decrease fraud, and reduce improper payments. The IRS is aggressively pursuing improper payments through other preparer efforts including undercover shopping visits, preparer visits, and by enjoining egregious return preparers. Additionally, the IRS has expanded its traditional treatments

2

of EITC preparers to test a new real-time component and additional treatments to identify what treatments are effective for specific preparer segments.

One of the continuing challenges faced by the IRS has been the difficulty in setting EITC improper payment reduction targets due to many influencing factors including the credit complexity and the need to balance the reduction in improper payments with encouragement of eligible taxpayers to claim the credit. The IRS recently met with OMB and agreed that we would work together to develop supplemental measures and indicators in lieu of reduction targets. These steps will allow us to be in compliance with the Executive Order. The IRS will continue to report our compliance and outreach activities which impact improper payments.

If you have any questions, please contact me or a member of your staff may contact my Assistant Deputy, Kathleen E. Walters, at (202) 622-5036.

Sincerely,

Beth Tucker

Beth Tucker
Deputy Commissioner for
Operations Support

Enclosure

ENCLOSURE

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

BACKGROUND

For Tax Year (TY) 2011, over 27 million taxpayers received nearly $62 billion in EITC, making the credit one of the largest tax credits in the United States. Each year, about 6 million individuals - half of them children - are lifted above the poverty level as a result of the EITC. For TY 2013, the maximum EITC available is $5,891 for a married couple with three qualifying children. The maximum EITC available in TY 2008 was approximately $4,800 for a married couple with two qualifying children.

The EITC estimated participation rate for Fiscal Year (FY) 2012 was 78-80 percent. The estimated improper payment rate was 22.8 percent ($13 billion). The estimated percentage is based on taxpayer compliance behavior as measured by the TY 2008 National Research Program (NRP) Individual Income Tax Reporting Compliance study.

Addressing EITC improper payments has been an ongoing effort for the IRS, primarily through an aggressive compliance program. Recent efforts have focused on paid return preparers, who prepare about two-thirds of EITC returns and are believed to impact improper payments. The IRS believes the implementation of new registration requirements, as well as the use of compliance tools, for all paid return preparers will have an impact on improper payments, although data are not yet available to permit proper estimation of the effects of this effort. Additionally, the action of the United States District Court for the District of Columbia in January 2013, to enjoin the IRS from enforcing the new testing and education requirements, will delay implementation and the IRS's ability to measure its effect.

IMPROPER PAYMENTS ESTIMATION METHODOLOGY

I. Introduction

EITC improper payments consist of the erroneous amounts of EITC paid out to taxpayers that are not later recovered or corrected by the IRS.[1] A current fiscal year estimate of improper payments is obtained by first estimating an improper payment rate from the most recent year for which individual-income-tax reporting compliance data are available from the IRS National Research Program (NRP); for FY 2012, this is TY 2008. The estimated rate is then multiplied by an estimate of total EITC claims for the current fiscal year in order to obtain an estimate of current improper payments.

This general methodology has been in place since the first improper payment reporting in FY 2005, but there have been some improvements to certain aspects of this methodology, particularly since FY 2009. First, the IRS now reports a single point

[1] These improper payments include both EITC amounts that are refunded to taxpayers and EITC amounts that offset or reduce tax liability.

estimate of the improper payment rate with a confidence interval, rather than having two separate estimates based on two different assumptions. Second, there is no longer a separate adjustment to account for the expected effects of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) because taxpayer compliance data that post-dates the legislation has become available. Third, the current estimate of total EITC claims – which is multiplied by the rate to obtain current improper payments – is no longer taken directly from the budget projections of EITC outlays and expenditures from the Department of the Treasury's (Treasury) Office of Tax Analysis. An adjustment is now made to account for the slight difference between amounts actually paid out and the initial claims made by taxpayers; the latter is more appropriate because it better corresponds to the denominator used for the improper payment rate.

Finally, although not implemented for the most recent FY 2012 estimate, and therefore not described in this document, the IRS intends to incorporate underpayments into its estimates beginning with the FY 2013 estimate.

The following sections provide additional details on the improper payment estimation.

II. The Improper Payment Rate

The improper payment rate is constructed as follows, which makes explicit the terms on the right-hand side that need to be estimated:

$$\textit{EITC Improper Payment Rate} = \frac{\textit{EITC Overclaims} - \textit{EITC Overclaims Recovered}}{\textit{Total EITC Claims on all Returns}}$$

A. Estimating EITC Overclaims and Total EITC Claims

The only way to know the actual amount of invalid EITC claims would be to audit all of the approximately 27 million claimants. This is not feasible; however, the NRP conducts annual studies on the reporting compliance of Form 1040 taxpayers. Embedded in these annual studies is a sample of EITC claimants large enough to estimate the amount of overclaims with 3 percent precision and 90 percent confidence, approximately 2,300 taxpayers. This is the data source used to estimate the amount of EITC overclaims, defined as the difference between the EITC amounts claimed by taxpayers on their returns and the amount taxpayers should have claimed, as determined by the NRP examination. For TY 2008, the most recent data available, the overclaim amount is estimated to be $13.5 billion.

The IRS also uses the NRP sample to estimate the total amount of EITC claims. The amount of the taxpayer's original claim is captured during data processing; however, this field is not edited and therefore can have transcription errors in it. Rather than try to

3

edit the entire population of claimants, the IRS chose to use the NRP sample, edit those returns, and use them to estimate the total amount of claims. For TY 2008, approximately $50 billion was claimed for EITC.

B. Estimating Amount of EITC Overclaims Recovered

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

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

Some EITC overclaims are identified and recovered through AUR activities. The AUR system allows the IRS to detect misreported and underreported income by comparing documents provided by third-parties with corresponding income information reported by the taxpayer. AUR information is captured in IRS Enforcement Revenue Information System (ERIS) data, which tracks assessments and collections from IRS enforcement-related activities. The estimate of the amount of overclaims recovered through AUR reflects amounts IRS has collected or expects to collect on TY 2008 EITC overpayments that were identified by AUR. This estimate was based on actual AUR results shown in ERIS data through February 2012, increased slightly to account for estimated assessments and collections made after February 2012 on TY 2008 returns. These figures are based on IRS operations applied to all EITC claims, not just NRP sample returns.

EITC overclaims also are prevented and recovered through examination activities. Many examinations of EITC claims are conducted pre-refund. This means that the EITC claim is not paid, but rather is held by the IRS pending the outcome of the examination. For these cases, the EITC amount is paid only if the examination determination supports the taxpayer's claim in full or in part. Other EITC examinations are conducted after the credit is paid, i.e., post-refund. For these cases, should the IRS reduce or deny the EITC claim, the IRS must recover the amount that was previously paid. The amount of EITC overclaims that were not paid due to pre-refund examinations and the amount that was recovered through post-refund examinations were based on actual amounts either not paid or recovered as shown in ERIS data. The ERIS data through February 2012 were adjusted slightly to account for assessments and collections made after February 2012 on TY 2008 returns. A total of $2.1 billion of improper payments is expected to be recovered through enforcement activities for TY 2008.

C. Calculating the Improper Payment Rate

Plugging the amounts described above into the equation for the improper payment rate yields a point estimate of 22.8 percent. The associated 90 percent confidence interval is 21.0 percent to 24.6 percent.

D. Revision in Methodology since FY 2009: Moving to a single point estimate

In all IRS compliance studies, uncertainty arises when taxpayers do not respond to the notice for audit. In some cases, the reason for nonresponse is identifiable, such as when the IRS is not able to locate the taxpayer or when the taxpayer lives in a disaster area; in other cases, the reason for nonresponse is not known but for whatever reason, the taxpayer was unable or unwilling to participate in the audit. In the past, IRS dealt with this nonresponse by making two alternative assumptions about the true compliance of these taxpayers. The lower-bound estimate assumed that these taxpayers had the same compliance behavior as others who were similar (i.e., in the same sample strata). The upper-bound estimate assumed that the exam outcome correctly reflected the taxpayers' compliance – which in most cases meant the full amount of the claim was an overclaim.

While this approach provided adequate bounds, it did not provide a single point estimate with the confidence level and precision required by the Improper Payments Information Act (IPIA). Beginning in FY 2010, the IRS corrected this by estimating and reporting a single point estimate for improper payments. The new approach relies on more sophisticated interpretations of behavioral assumptions. Rather than simply applying the average compliance behavior within strata to nonrespondents, more taxpayer characteristics associated with noncompliance are used to project overclaim behavior to the nonrespondents. One method of doing this is to impute overclaims for all nonresponse. This is a statistical technique commonly used to fill in, or impute, missing values based on other information in a given dataset. Another method is to exclude the nonresponse cases and to reweight the remaining sample members using enhanced "raked" sample weights that depend on many more characteristics than those used to determine sample strata.

E. Revision in Methodology since FY 2009: Eliminating the EGTRRA adjustments

Enacted in 2001, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) was expected to influence taxpayer behavior in a number of ways, among them increased claims and improved compliance for EITC claimants.[2] Since the prior improper payment rate estimates were derived from pre-EGTRRA taxpayer behavior

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[2] For example, EGTRRA implemented a uniform definition of a "qualifying child" and simplified the rule for determining which taxpayer was eligible to claim the qualifying child in cases where the child was a qualifying child of more than one person (the Adjusted Gross Income tiebreaker rule). The simpler rules were expected to enhance compliance by reducing the number of claims arising from misinterpretation of the tax law and to increase claims by those who were deterred by its complexity.

(TY 2001), the estimates were adjusted to reflect the predicted impact of the EITC-related EGTRRA provisions. In the FY 2010 update, these adjustments became no longer necessary since the newer NRP data beginning in TY 2006 should inherently capture taxpayer responses to EGTRRA.

III. EITC Improper Payment Estimates for FY 2010-2012

The final step of estimating EITC improper payments involves multiplying the improper payment rate for each fiscal year by the corresponding EITC claims for the year. These latter estimates are obtained by taking budget projections of EITC outlays and expenditures from the Department of the Treasury's Office of Tax Analysis and making slight upward adjustments to account for the slight difference between amounts actually paid out and the initial EITC claims made by taxpayers on their filed returns. This difference arises because some of the original claims are never actually disbursed to taxpayers, being disallowed through math-error processing or revenue protected by pre-refund examinations, although these are offset to some extent by new EITC claims made on amended returns. EITC claims are more appropriate here than amounts actually paid out because they correspond to the denominator of the improper payment rate. Information from prior years was used to determine the appropriate adjustment factor.

Applying this adjustment factor to the budget estimates of EITC to obtain total claims represents a small revision to the methodology that IRS began implementing in FY 2010.

This yields the estimates for EITC improper payments shown in the table below. Although this discussion has so far reported the figures that apply for the most recent estimate, FY 2012, estimates of improper payments for FY 2010 and FY 2011 are also presented.

Fiscal Year	**2010**	**2011**	**2012**
Estimates of Total EITC Claims	$64.2	$64.7	$55.4
EITC Improper Payment Rate	**26.3%**	**23.5%**	**22.8%**
Lower bound of 90% Confidence Interval	23.9%	21.2%	21.0%
Upper bound of 90% Confidence Interval	28.7%	25.8%	24.6%
Total Improper Payments	**$16.9**	**$15.2**	**$12.6**
Lower bound of 90% Confidence Interval	$15.3	$13.7	$11.6
Upper bound of 90% Confidence Interval	$18.4	$16.7	$13.6

EXISTING IRS ACTIONS TO REDUCE IMPROPER PAYMENTS

EITC eligibility is determined through a complex set of determinations regarding income levels, residency, and relationships of qualifying children to the taxpayer. Unlike social benefit programs, EITC is claimed voluntarily through the filing of a tax return, without upfront eligibility determinations through a caseworker. Administration costs continue to be less than 1 percent of payments delivered. This is quite different from non-tax benefits programs in which administrative costs related to determining eligibility can range as high as 20 percent of program expenditures.

The IRS continues to explore the root causes of EITC improper payments. The surmised root causes outlined below are based on the most recent detailed compliance study from TY 1999 and updated FY 2012 estimates of improper payments computed using TY 2001 NRP compliance study data, which contained less detail. The tax law changes enacted by the EGTRRA were not in effect for 1999. These law changes will be reflected in the new 3-year rolling NRP compliance study, which started with TY 2006. Information that matches that reviewed in the TY 1999 study is available in the new 3-year study, currently in the review process. We will revisit our hypothesis on root causes when the study is available. The following discusses the currently surmised root causes of EITC improper payments.

I. Issues with EITC Statutory Framework

The root causes for improper payments are a combination of intentional and inadvertent errors by both taxpayers and practitioners and can be grouped as follows:

Authentication - It is estimated that 75 percent or $9.45 billion in improper payments are from authentication errors. They include errors associated with the inability to authenticate qualifying child eligibility requirements, mainly relationship and residency requirements, filing status, when married couples file as single or head of household, and eligibility in nontraditional and complex living situations. Authentication is completed on a portion of this error category during pre-refund examinations.

Verification - It is estimated that 25 percent or $3.15 billion in improper payments are from verification errors. These errors relate to improper income reporting which allows claimants to fall within the EITC income limitations and qualify for EITC. The errors include both underreporting and overreporting of income by both wage earners and taxpayers who report that they are self-employed.

Income reported through information returns such as Forms W-2, Forms 1099, etc., which can be used for verification of some income, becomes available only after tax returns are processed. Under law, the IRS must process income tax returns within 45 days of receipt or pay interest to taxpayers.

II. Existing Program to Prevent Improper Payments

The continuing IRS strategy with respect to EITC improper payments is to intervene early to ensure compliance with the rules. Thus, the IRS has extensive outreach and education to taxpayers and preparers so that they are aware of the legal requirements for EITC eligibility. Efforts also include improved examination selection processes and data matching using third-party data, reducing taxpayer burden while increasing revenue protected. Most recently, the IRS has begun to concentrate more on regulating the preparer community.

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

Math Error: This refers to an automated process in which the IRS identifies math or other statistical irregularities and automatically prepares an adjusted return for a taxpayer. These upfront, systemic processing checks protect $320 million in EITC refund claims annually.

Document Matching: This process involves comparing income information provided by the taxpayer with matching information, e.g., Form W-2 and Form 1099, from employers to identify discrepancies. This post-refund process protected $1.6 billion in EITC refund claims in FY 2012. The IRS conducted almost 1 million of these reviews, in addition to 500,000 audits.

Examinations: The IRS identifies tax returns and amended returns for examination and holds the EITC portion of the refund until an audit can be conducted. Of the approximate 500,000 audits conducted by the IRS annually, 70 percent are conducted before the EITC portion of the refund is released. These examinations are selected using an effective risk-based audit selection model that result in over a 90 percent change rate. Examinations protected almost $2.1 billion in EITC refund claims in FY 2012.

EITC taxpayers are disproportionally subjected to audit, and they are twice as likely to be audited as other individual taxpayers. For FY 2011, EITC audits were 31 percent of all individual audits. The IRS recognizes that it cannot fully address EITC noncompliance by simply auditing returns and must pursue alternatives to traditional compliance efforts. Significant expansion of EITC enforcement activities would come at the expense of other tax administration priorities and result in an unbalanced program focusing disproportionately on the working poor.

Other programs include the following:

- **Data Transcription**: The transcription of applicable income-related information and the Schedule EIC, *Earned Income Credit*, during the initial processing of the tax

8

return, provides data electronically to support automated income matching and various analysis and risk-based scoring processes.

- **Wage Verification**: The IRS uses complex rules and algorithms to identify potential false wages reported on EITC tax returns. Social Security Numbers on these returns are matched to wage information on the U.S. Department of Health and Human Services National Database of New Hires and other verification data to determine the legitimacy of the income.

NEW APPROACH--RETURN PREPARER FOCUS FOR REDUCING IMPROPER PAYMENTS

In January 2010, the IRS announced a plan to register return preparers and create enforcement tools that impact the paid return preparer community more broadly. The regulation of tax return preparers is being implemented in order to drive increased EITC compliance, decrease fraud, and impact the level of improper payments. Paid return preparers assist in the preparation of approximately two-thirds of all EITC claims. Evidence suggests that unscrupulous preparers contribute to overall improper EITC claims.

The IRS program establishes standards for the tax preparer community in order to enhance protections and services for taxpayers, increase confidence in the tax system, and result in greater compliance with the tax laws. As part of the program, the IRS started implementation of a number of activities over the last several years, including:

- Requiring all signing paid preparers to register with the IRS and obtain a unique preparer identification number (PTIN);
- Applying compliance checks to some preparers;
- Requiring competency tests for all paid return preparers who are not attorneys or Certified Public Accountants in good standing;
- Requiring ongoing continuing professional education for all paid preparers; and
- Extending the ethical rules in Treasury Department Circular 230 to all paid preparers, which will allow the IRS to suspend or otherwise discipline preparers who engage in unethical or disreputable conduct.

On January 18, 2013, the U.S. District Court for the District of Columbia enjoined the IRS from enforcing some of the regulatory requirements. Although the IRS can require that tax preparers register with the IRS to get a PTIN and can charge fees for this requirement, the IRS may not require competency testing and continuing education under the injunction. The Justice Department has filed a motion with the Appeals Court requesting a stay of the permanent injunction imposed on the IRS return preparer program as it appeals the ruling of the U.S. District Court. The injunction and court proceedings will obviously delay IRS's implementation of planned preparer regulation and its ability to measure its impact on noncompliance.

As part of the EITC-focused paid return preparer effort, separate from the initiative described above, the IRS developed a risk-based scoring and selection system to identify preparers for several enforcement treatment streams based on a preparer's level of egregiousness, including:

- **Due Diligence Visits:** Field examiners audit EITC preparers to verify they are meeting their due diligence requirements and assess penalties as warranted. The penalty rate for FY 2012 was almost 90 percent.
- **Knock and Talk Visits:** This integrated approach consists of Criminal Investigation (CI) agents and examiners visiting EITC preparers to educate them on EITC laws and due diligence requirements. During FY 2012, 100 Knock and Talk Visits were conducted.
- **Focused Injunctions:** This initiative utilizes the results of previous IRS compliance actions to enable an efficient injunction process to prevent egregious preparers from filing future returns. Nine full injunctions and three partial injunctions have been granted to date.
- **Notices:** The IRS sends notices to segments of preparers, including first-time paid preparers and low and medium risk preparers, to educate them on their due diligence responsibilities and the consequences of noncompliance.
- **Undercover Shopping:** The IRS continues it efforts around EITC paid preparers, including undercover shopping by CI agents and preparer investigations.

The IRS worked with Treasury on the proposal to increase the preparer EITC due diligence penalty and expanded preparer EITC due diligence requirements. On October 21, 2011, the United States-Korea Free Trade Agreement Implementation Act, Public Law 112-41, increased the preparer due diligence penalty in IRC §6695(g) from $100 to $500 starting with TY 2012 returns. The penalty had not been adjusted since it was introduced in 1977. In December 2011, revised Treasury Regulations §1.6695-2 were issued that require paid preparers to attach the due diligence checklist, previously retained in their records, to their client returns starting with TY 2011 returns. The regulations also required preparers to retain client records on which they had relied to make an EITC eligibility determination. The expanded regulations and increased penalty will help ensure that preparers comply with their EITC due diligence requirements.

In FY 2012, the IRS expanded traditional treatments to incorporate a real-time component and additional treatments. The objective of the real-time preparer treatment is to reduce the risk of EITC erroneous refunds by focusing efforts on noncompliant return preparers before and during the early filing season. Under the Real-Time Preparer Pilot, IRS selected 1,500 preparers, responsible for almost 660,000 returns, for real-time monitoring and intervention through letters and phone calls. These activities protected $183.4 million in EITC with Child Tax Credit and Additional Child Tax Credit also protected $45 million. Furthermore, more than 400 Real-Time Due Diligence Visits closed with a penalty rate of 86 percent and almost 10,300 ($5.2 million) in penalties.

In FY 2012, the IRS sent warning notices of noncompliance to approximately 5,000 EITC preparers who did not attach the due diligence checklist to client EITC returns, as required in the updated regulations. The letter informed them of their failure to meet the requirement and potential consequences of the increased penalty of $500 per return.

The IRS continued outreach and education efforts to EITC return preparers with the goal to educate them on EITC, the new due diligence requirements, and increased due diligence penalty. Over 8,500 preparers received a certificate of completion for the English and Spanish interactive EITC Due Diligence Training module. The IRS also conducted a webinar, with attendance of over 12,000, to inform the preparer community of the regulation changes. Additionally, more than 10,000 preparers attended EITC and due diligence presentations at the 2012 Nationwide Tax Forums.

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

Pending the results of litigation on regulation of return preparers, and full implementation of preparer regulation, the IRS still intends to analyze its impact on EITC improper payments.

NEXT STEPS

The IRS will continue to review root causes of EITC improper payments. As part of this work, the IRS will use results from the new compliance study and will continue its aggressive enforcement program and return preparer focus. Additionally, the IRS will work with the Office of Management Budget to develop supplemental measures that are appropriate for gauging the impact of the compliance and outreach efforts in lieu of developing error reduction targets.

Appendix VI

Management's Response to the Draft Report

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

CHIEF FINANCIAL OFFICER

July 17, 2013

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

FROM: Pamela J. LaRue
Chief Financial Officer

SUBJECT: Draft Audit Report –The Internal Revenue Service Is Not in Compliance With Executive Order 13520 to Reduce Improper Payments (Audit # 201240046)

Thank you for the opportunity to review and respond to the draft report titled, "The Internal Revenue Service Is Not in Compliance With Executive Order 13520 to Reduce Improper Payments." We appreciate the acknowledgement that the IRS, while not currently in compliance with the requirements of Executive Order (EO) 13520, is working with the Office of Management and Budget (OMB) to develop supplemental measures in lieu of reduction targets.

The IRS met with OMB on July 12, 2013, to discuss proposed supplemental measures. We will continue to work with them to finalize these measures and to obtain written concurrence that the IRS is meeting reporting expectations under EO 13520 in conjunction with the Improper Payments Information Act of 2002, the Improper Payments Elimination and Recovery Act of 2010, and the Improper Payments Elimination and Recovery Improvement Act of 2012.

We agree with the report recommendation that the IRS should develop a process to identify and report on high-dollar improper Earned Income Tax Credit (EITC) payments and report the information to TIGTA and the Council of Inspectors General on Integrity and Efficiency (CIGIE) as required by EO 13520. Our proposed corrective action to this recommendation, which OMB concurred with at the July 12 meeting, is detailed in the attachment.

If you have any questions, please contact Peter Rose, Associate Chief Financial Officer, Corporate Planning and Internal Control, at (202) 435-6422.

Attachment

Attachment

RECOMMENDATION 1
The Deputy Commissioner for Operations Support should develop processes to identify high-dollar improper EITC payments and report the information to TIGTA and the CIGIE as required by Executive Order 13520.

CORRECTIVE ACTION
The IRS agrees with this recommendation. The IRS will develop the quarterly reports on summary volumes and amounts of post-refund high-dollar Earned Income Tax Credit (EITC) payment reversals that the Office of Management and Budget agreed meet the quarterly reporting requirements of Executive Order 13520. Due to the requirements of Internal Revenue Code Section 6103(a), the IRS can only provide summary data to the Council of Inspectors General on Integrity and Efficiency (CIGIE).

IMPLEMENTATION DATE
September 30, 2014

RESPONSIBLE OFFICIAL
Chief Financial Officer

CORRECTIVE ACTION MONITORING PLAN
N/A