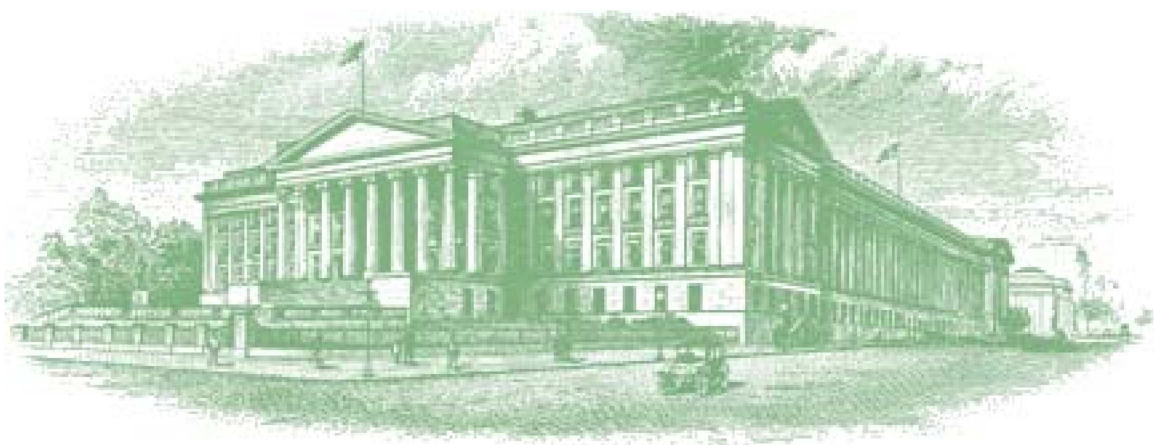
Audit Report



OIG-12-044

The Department of the Treasury Was Not in Compliance With the Improper Payments Elimination and Recovery Act for Fiscal Year 2011

March 15, 2012

Office of Inspector General

Department of the Treasury

Contents

Audit Report

Appendices

Abbreviations

AFR	Agency Financial Report
DO	Departmental Offices
EITC	Earned Income Tax Credit
IPERA	Improper Payments Elimination and Recovery Act of 2010
IPIA	Improper Payments Information Act of 2002
IRS	Internal Revenue Service
OIG	Office of Inspector General
OMB	Office of Management and Budget
RCG	Risk and Control Group
TIGTA	Treasury Inspector General for Tax Administration

This Page Intentionally Left Blank.

March 15, 2012

Daniel Tangherlini
Assistant Secretary for Management
and Chief Financial Officer

This report presents the results of our audit of the Department of the Treasury's (Treasury) compliance with Public Law 111-204, Improper Payments Elimination and Recovery Act of 2010 (IPERA). IPERA was enacted to help Federal agencies strengthen the framework for reducing and reporting improper payments. IPERA amended the Improper Payments Information Act of 2002 (IPIA) and expanded requirements for improper payment reporting and recovering overpayments across a broad range of federal programs.

We initiated this audit in accordance with IPERA, which requires the Treasury Inspector General to assess and report on Treasury's compliance with improper payment requirements.

The Treasury Inspector General for Tax Administration (TIGTA) performed a limited review of the Internal Revenue Service's (IRS) compliance with IPERA and issued its report on March 2, 2012, which is included as appendix 2 of this report. The results of our audit, insofar as they relate to the IRS, are based solely on TIGTA's report.

Results in Brief

Treasury is not in compliance with IPERA due to IRS's Earned Income Tax Credit (EITC) improper payments reporting deficiencies reported by TIGTA. Specifically, IRS has not established annual EITC improper payment reduction targets. IRS also did not report an improper payment rate of less than 10 percent for EITC.

In addition, although Treasury reported on its payment recapture audits program in its fiscal year 2011 agency financial report (AFR), it did not include certain information required by OMB

Circular No. A-136, Financial Reporting Requirements, related to payment recapture audits reporting. TIGTA reported that IRS's estimate of the EITC improper payment rate provided a reasonable estimate of overclaims, but the calculation did not include an estimate of underpayments.

We are making two recommendations in this report to address the finding related to Treasury's payment recapture audits reporting. In a written response to this report, provided as appendix 3, Treasury management agreed with our recommendations and provided its planned corrective actions.

Since we determined that Treasury was not in compliance with IPERA for fiscal year 2011, the Secretary of the Treasury is required to submit a plan to Congress describing the actions that Treasury will take to come into compliance.[1]

Background

<u>The Improper Payments Elimination and Recovery Act of 2010</u>

IPIA requires federal agencies to estimate the amount of improper payments made each year. Agencies are required to report to Congress on the causes and steps taken to reduce improper payments, and to address whether they have the information systems and other infrastructure needed to reduce improper payments. Agencies must also describe the steps taken to ensure managers are held accountable for reducing improper payments.

IPERA amended IPIA, redefining the previous definition of "significant improper payments" and strengthening agency reporting requirements. It also requires increased agency efforts by expanding the types of payments that should be reviewed and lowering the threshold of annual outlays that requires agencies to conduct payment recapture audit programs.

On April 14, 2011, OMB issued Revised Parts I and II to Appendix C, "Requirements for Effective Measurement and Reduction of Improper Payments," of OMB Circular No. A-123,

[1] P.L. 111-204, § 3(c)(1).

Management's Responsibility for Internal Control, on the implementation of IPERA. This guidance provided federal agencies with the required steps to follow in (1) identifying and reporting on improper payments and (2) performing and reporting on payment recapture audits.

To determine compliance with IPERA and OMB guidance, we are required to review Treasury's fiscal year 2011 AFR and any accompanying information to assess whether Treasury has:

- Published an AFR 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 31 U.S.C. §3321, 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 AFR, if required;
- Published, and has met, annual reduction targets for each program assessed to be at risk and measured for improper payments;
- 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 AFR; and
- Reported information on its efforts to recapture improper payments.

If an agency does not meet one or more of these requirements, then it is not compliant with IPERA.

Improper Payment Risk Assessment

Treasury's Risk and Control Group (RCG), a division under the Deputy Chief Financial Officer, issued *Treasury-wide Guidance for the FY 2011 Review and Risk Assessment* to all Treasury bureaus and Departmental Offices (DO) subcomponents (hereafter we refer to bureaus and DO subcomponents collectively as "components").

RCG identified the programs for which components were required to assess the risk of improper payment. Treasury components used the Improper Payments Elimination and Recovery Risk Assessment Questionnaire for FY 2011 developed by RCG to assess the level of risk for each program identified. Each component was to provide the results and documentation for all risk assessments to RCG. For any program identified as having a high risk for improper payment, the responsible component was also required to provide the following information for inclusion in the AFR:

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

For fiscal year 2011, Treasury identified the EITC, administered by IRS, as the only high risk program to be included in the AFR.

Payment Recapture Audits

IPERA requires agencies to conduct payment recapture audits (also known as recovery audits) for each program and activity that expends $1 million or more annually, if conducting such audits would be cost-effective. A payment recapture audit is a review and analysis of an agency's or program's accounting and financial records, supporting documentation, and other pertinent information supporting its payments, that is specifically designed to identify overpayments. Agencies are required to have a cost-effective program of internal control to prevent, detect, and recover overpayments.

RCG issued *Treasury-wide Guidance for the FY 2011 Payment Recapture Audits* to Treasury components. This guidance required each component to complete a worksheet providing a consistent reporting format that includes information on the component's payment recapture audits. The worksheets were to be submitted to RCG for review and the results were then consolidated and reported in the AFR.

Finding and Recommendations

Treasury Did Not Fully Report on Its Payment Recapture Audits

Treasury's fiscal year 2011 AFR did not include the following information required by OMB Circular No. A-136, Financial Reporting Requirements and OMB Circular No. A-123, Appendix C:

- Justification for the determination that certain overpayments are not collectable.
- Aging of outstanding overpayments.
- Disposition of recaptured funds.
- Overpayments recaptured outside of payment recapture audits.
- A list of programs and activities that expend more than $1 million where it was determined that conducting a payment recapture audit program would not be cost effective and the justification and analysis used in making this conclusion. It should be noted that the Treasury Executive Office for Asset Forfeiture (TEOAF) and the Bureau of the Public Debt's Office of Public Debt Accounting (OPDA) determined that a payment recapture audit of their programs would not be cost effective. However, these programs were not reported in the AFR nor were the Office of Inspector General (OIG) and OMB notified as required by OMB guidance.

Treasury consulted with OMB on how to report recapture information in its AFR when it did not have the information about the aging of outstanding overpayments, disposition of recaptured funds, and overpayments recaptured outside of payment recapture audits. OMB told them that agencies are required to report this information, if available. If the information is not available, Treasury was advised that an agency should still include the required chart, noting that the information is not available along with when it plans to report it. Based on that, Treasury disclosed in its AFR that due to the delayed release of IPERA implementation guidance, Treasury's bureaus were not able to fully implement or develop the mechanisms to acquire the additional information specified in the amended payment recapture audit guidance to complete the aging of outstanding overpayments, disposition of recaptured funds, and overpayments recaptured outside of payment recapture audits tables.

Regarding EOAF and OPDA's programs for which it was determined that a payment recapture audit program would not be cost effective, Treasury deemed the programs to be low risk and immaterial and therefore did not notify OMB and the OIG nor disclose these programs in the AFR. The implementing guidance, however, does not provide for an agency determination as to the materiality threshold for notifying OMB and the OIG and inclusion in the AFR; rather, it is required for all programs and activities that expend more than $1 million.

Treasury stated in its AFR that it was developing an updated plan to ensure implementation of the payment recapture audit portion of IPERA no later than the end of fiscal year 2013. We believe that Treasury should accelerate its efforts to comply with IPERA for fiscal year 2012.

Recommendations

We recommend that the Assistant Secretary for Management and Chief Financial Officer:

1. Ensure that components submit required payment recapture audits information to RCG for inclusion in the AFR.

2. Notify OMB and the OIG of any programs and activities that expend more than $1 million where a cost effective payment recapture audit program is not able to be performed and include these programs and activities in the AFR with the justification and analysis used to make this conclusion.

Management Response

Management agreed with our recommendations. Treasury plans to update its annual IPERA guidance to ensure compliance with required disclosures and notifications.

OIG Comment

The actions planned by Treasury satisfy the intent of the recommendations.

* * * * * *

We appreciate the courtesies and cooperation extended to our staff during this audit. Should you have any questions, you may contact me at (202) 927-5400, or Joel A. Grover, Deputy Assistant Inspector General for Financial Management and Information Technology Audits at (202) 927-5768. Major contributors to this report are listed in appendix 4.

/s/
Marla A. Freedman
Assistant Inspector General for Audit

The objective of our audit was to determine Treasury's compliance with IPERA, OMB Circular No. A-123, Appendix C, Requirements for Effective Measurement and Remediation of Improper Payments and OMB Circular No. A-136, Financial Reporting Requirements. Our scope did not include the review of programs and activities administered by IRS. TIGTA is responsible for the audit of IRS's compliance with IPERA. TIGTA's scope was limited to an assessment of EITC information that IRS provided for inclusion in Treasury's AFR. EITC was the only program identified by the IRS for improper payment reporting.

To accomplish our objective, we reviewed applicable laws, OMB Guidance, and Treasury-wide Guidance related to IPERA; interviewed key DO and component personnel; and performed testing of Treasury's risk assessment and payment recapture audits. We reviewed Treasury's fiscal year 2011 AFR to determine if Treasury complied with the reporting requirements of IPERA. We conducted our fieldwork in Washington, DC from January to March 2012.

To review Treasury's risk assessment process, we randomly selected a sample of 27 of the 68 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, except for one of the programs in our sample, we reviewed the program risk assessments and conducted interviews of personnel involved in their preparation and review.

To review the payment recapture audit program we randomly selected a sample of 13 of the 18 non-IRS components. To determine the reasonableness and accuracy of the information reported, and compliance with the applicable guidance for the sample, we reviewed the components' submissions and conducted interviews with component personnel, as well as reviewed supporting documentation.

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 All Improper Payments Elimination and Recovery Act Requirements

March 2, 2012

Reference Number: 2012-40-028

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.

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

HIGHLIGHTS

THE INTERNAL REVENUE SERVICE IS NOT IN COMPLIANCE WITH ALL IMPROPER PAYMENTS ELIMINATION AND RECOVERY ACT REQUIREMENTS

Highlights

Final Report issued on March 2, 2012

Highlights of Reference Number: 2012-40-028 to the Internal Revenue Service Chief Financial Officer.

IMPACT ON TAXPAYERS

The Improper Payments Elimination and Recovery Act of 2010 increased agency accountability for reducing improper payments in Federal programs. The only program the IRS has identified for improper payment reporting is the Earned Income Tax Credit (EITC) Program. The IRS estimates that 21 to 26 percent of EITC payments were issued improperly in Fiscal Year 2011. This equates to $13.7 billion to $16.7 billion in EITC improper payments.

WHY TIGTA DID THE AUDIT

This audit was initiated because the Improper Payments Elimination and Recovery Act of 2010 requires the TIGTA to assess the IRS's compliance with improper payment requirements. The objective of this review was to assess the IRS's compliance with the Improper Payments Elimination and Recovery Act of 2010. The scope of this review was limited to an assessment of EITC information the IRS provided for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2011*.

WHAT TIGTA FOUND

The methodology the IRS uses to estimate the EITC improper payment rate results in a reasonable estimate of EITC overclaims. However, the IRS did not comply with all of the improper payment requirements included in the Improper Payments Elimination and Recovery Act.

The Department of the Treasury identifies the programs for which the IRS must assess the risk of improper payments. The IRS compiles the required information and forwards it to the Department of the Treasury for inclusion in the Department's agency financial report.

Our analysis of the information the IRS provided to the Department of the Treasury showed that the IRS is not in compliance with all Improper Payments Elimination and Recovery Act requirements. The IRS has not established annual EITC improper payment reduction targets and has not computed a gross estimate of EITC improper payments as the estimate does not include underpayments. An underpayment results when an EITC payment is made in an amount less than what an individual is entitled to receive.

The IRS has plans in place to establish EITC reduction targets and is exploring the feasibility of computing an improper payment estimate for EITC underpayments.

WHAT TIGTA RECOMMENDED

TIGTA made no recommendations in this report.

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

March 2, 2012

MEMORANDUM FOR THE CHIEF FINANCIAL OFFICER

Michael E McKenney

FROM: *(for)* Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements (Audit # 201240011)

This report represents the results of our review to assess the Internal Revenue Service's (IRS) compliance with the Improper Payments Elimination and Recovery Act (IPERA) of 2010.[1] The IPERA requires the Treasury Inspector General for Tax Administration to review annually the IRS's compliance with the IPERA reporting requirements. This audit is included in the Treasury Inspector General for Tax Administration's Fiscal Year 2012 Annual Audit Plan and addresses the major management challenge of Fraudulent Claims and Improper Payments.

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

Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.

[1] Pub. L. 111-204.

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

Table of Contents

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

Abbreviations

EITC	Earned Income Tax Credit
FY	Fiscal Year
IPERA	Improper Payments Elimination and Recovery Act of 2010
IRS	Internal Revenue Service
NRP	National Research Program
TIGTA	Treasury Inspector General for Tax Administration

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

Background

The Improper Payment Information Act of 2002[1] requires Federal agencies, including the Internal Revenue Service (IRS), to estimate the amount of improper payments made each year. The agencies must report to Congress on the causes and the steps taken to reduce improper payments and address whether they have the information systems and other infrastructure needed to reduce improper payments. Agencies must also describe the steps taken to ensure managers are held accountable for reducing improper payments.

Executive Order 13520 further increases Federal Agency accountability in reducing improper payments

Executive Order 13520, signed by President Obama on November 20, 2009, further increases Federal agencies' accountability for reducing improper payments while continuing to ensure Federal programs serve and provide access to their intended beneficiaries. The Order 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 value of improper payments. The Secretary of the Treasury is required to provide specific information regarding Earned Income Tax Credit (EITC) improper payments to the Office of Management and Budget and the Treasury Inspector General for Tax Administration (TIGTA). The Executive Order requires the TIGTA 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.

The Improper Payments Elimination and Recovery Act of 2010 amends the Improper Payments Act of 2002

On July 22, 2010, President Obama signed into law the Improper Payments Elimination and Recovery Act of 2010[2] (IPERA). The IPERA amends the Improper Payments Information Act of 2002 by redefining the definition of "significant improper payments" and strengthening agency reporting requirements. The IPERA requires the TIGTA to review annually the IRS's compliance with the IPERA reporting requirements. The TIGTA report is due within 120 days of the issuance of the Department of the Treasury agency financial report.

IPERA process to identify IRS programs for improper payment risk assessment

The Department of the Treasury identified the programs for which the IRS must assess the risk of improper payments. The IRS uses an Improper Payments Elimination and Recovery Risk

[1] Pub. L. No. 107-300, 116 Stat. 2350.
[2] Pub. L. 111-204.

Page 1

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

Assessment Questionnaire for Fiscal Year (FY)[3] 2011 (the Questionnaire) developed by the Department of the Treasury to assess the level of risk within each of the identified programs. The Questionnaire assigns a risk score to each program based on the IRS's response to the questionnaire. The level of risk for improper payments for the program is then based on risk score ranges established by the Department of the Treasury. For example, the Department of the Treasury considers programs with a risk score of 0 to 11 as low risk, 12 to 28 as medium risk, and 29 and greater as high risk. The IRS is required to forward the results and documentation for all risk assessments to the Department of the Treasury. Appendix IV provides a list of the IRS programs the Department of the Treasury identified for an improper payment risk assessment.

For any program identified as having a high risk for improper payments, the IRS must provide the following information to the Department of the Treasury for inclusion in the Department's agency financial report:

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

During the course of this review, we were provided with documentation showing risk assessments were performed for each of the programs that the Department of the Treasury required the IRS to assess. The EITC is the only high-risk program the IRS has identified and the only program with information included in the agency financial report.

The IRS uses results from its National Research Program (NRP) to compute the improper payment estimate for the EITC

The IRS used results from its NRP to estimate the FY 2011 EITC improper payment rate. The NRP data are used to estimate the total EITC overclaims and total EITC claims. IRS management indicated that the NRP is the primary source of data the IRS uses to estimate taxpayer EITC behavior for the purpose of estimating the improper payment rate. The NRP provides the IRS with compliance information that is statistically representative of the taxpayer population.

In 2007, the IRS began the process of updating its NRP data by reviewing a stratified, randomly selected sample of individual tax returns. The IRS will use each year's NRP results to update the improper payment rate. Although the updated NRP process will result in a more current estimate

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

Page 2

of the accuracy of EITC claims, the estimated improper payment rate for a given fiscal year will not be based on current year data. Because of the time it takes to complete the annual NRP, the IRS's annual estimate will be based on data that are approximately three years old. For example, improper payment estimates for FY 2011 are based on Tax Year[4] 2007 tax returns.

The scope of this review was limited to an assessment of EITC information the IRS provided for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2011* as this was the only high-risk program identified by the IRS. The next phase of our review will assess the accuracy and sufficiency of the IRS's preparation of the Improper Payments Elimination and Recovery Risk Assessment Questionnaire for those programs that were not identified as having a high risk for improper payments.

This review was performed at the IRS Headquarters in Washington, D.C., in the Office of Research, Analysis, and Statistics and in the Office of the Chief Financial Officer during the period November 2011 through February 2012. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

Results of Review

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

Our review determined that the IRS did not provide all required IPERA information to the Department of the Treasury for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2011.* Figure 1 provides a summary of our evaluation of IRS compliance with the IPERA.

Figure 1: IRS Compliance With Improper Payment Requirements for the Earned Income Tax Credit Program[5]

IPERA Requirement	Provided by the IRS
Conduct a program-specific risk assessment for each program or activity that conforms with Section 3321 of Title 31 U.S.C.	Yes[6]
Publish an improper payment estimate for the EITC.	Yes
Publish a programmatic corrective action plan for the EITC.	Yes
Describe the steps taken to ensure the agency managers and programs are held accountable for eliminating and reducing improper payments.	Yes
Publish annual reduction targets for the EITC and discuss progress toward meeting those targets.	No
Report an improper payment rate of less than 10 percent for the EITC.	No
Report on efforts to recapture EITC improper payments.	Yes

Source: The 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 2011 issued November 15, 2011.

According to the IPERA, agencies that are not in compliance with the requirements in Figure 1 must submit a plan to Congress describing the actions that the agency will take to become compliant.

[5] The scope of this assessment was limited to an evaluation of the completeness of the improper payment information provided by the IRS to the Department of the Treasury.
[6] During the course of this review, we were provided with documentation showing risk assessments were performed for each of the programs the Department of the Treasury required the IRS to assess. The next phase of our review will assess the accuracy and sufficiency of the performance of these risk assessments.

Page 4

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

Noncompliance with IPERA reporting requirements increases the risk that the IRS will not significantly reduce EITC improper payments

As we previously reported, the IRS has made little improvement in reducing EITC improper payments since being required to report estimates of these payments to Congress in 2002.[7] The IRS acknowledges that further reductions in the EITC error rate will be difficult to achieve. Figure 2 presents the IRS's estimated EITC improper payments for FY 2003 through FY 2011.

Figure 2: EITC Improper Payments for Fiscal Years 2003 to 2011

Fiscal Year	Minimum Improper Payments[8] 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

Source: Department of the Treasury Performance and Accountability Reports for FY 2003 through FY 2010 and the FY 2011 Agency Financial Report.

Although the IRS reported a slightly lower EITC improper payment rate for FY 2011, IRS management informed us that the decrease in the FY 2011 improper payment rate cannot necessarily be attributed to a reduction in the amount of EITC improper payments. A number of factors can cause the improper payment rate and resulting dollar estimate to fluctuate from year to year. For example, the IRS changed the way it estimates EITC improper payments since it first began reporting the estimate in FY 2003. Prior to FY 2010, the IRS computed a range for the EITC improper payment rate using two basic assumptions.

[7] 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* pp. 3–4 (Feb. 2011).
[8] For FY 2005 through FY 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 NRP audit.

Page 5

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

- The IRS computed the maximum improper payment rate using the assumption that the EITC claims of individuals who did not respond to the IRS notice of audit were incorrect, thus resulting in an overpayment.
- The IRS computed the minimum improper payment rate using an overpayment amount for those taxpayers who did not respond to the notice of audit. This overpayment amount was computed using the assumption that the audit results for taxpayers who did not responded to the notice of audit were the same as those who did respond.

In FY 2010, continuing to use data gathered annually through the NRP, the IRS began using a new methodology for computing the improper payment amount. The annual sample along with the new methodology allows the IRS to calculate a point estimate for the improper payment amount with three percent precision and a 90 percent confidence rate as required by the IPERA. This new methodology accounts for the taxpayers who do not respond to the notification of audit through the application of sophisticated statistical formulas and techniques rather than the previous assumptions that were used.

In addition, legislative changes to the EITC and changes in the economy also directly impact the number and amount of EITC claims filed each year. The estimated improper payment rate and resulting dollar estimate will increase or decrease as the number of EITC claims received in a given tax year increases or decreases.

Quantifiable targets to reduce EITC improper payments were not established as required by the IPERA

Of continued concern is the IRS's noncompliance in establishing required quantifiable targets to reduce EITC improper payments. In our February 2011 report, the IRS agreed with our recommendation to establish EITC improper payment reduction targets.[9] In their response, IRS management stated that the IRS's return preparer initiative is its most promising avenue to substantially reduce erroneous EITC payments. Management noted that the IRS was in the first year of a three-year ramp-up of this initiative and indicated that the IRS will have a baseline against which it can set meaningful reduction targets after the program is fully established. However, the IRS did not provide details on when or how it plans to measure the impact of the tax return preparer strategy on EITC improper payments.

As we noted in our previous report, the IRS had just begun implementing the tax return preparer strategy and did not anticipate the strategy would be fully implemented until 2014. According to information contained in the *Department of the Treasury Agency Financial Report Fiscal Year 2011*, the IRS estimates it will pay an additional $35 billion to $43 billion in improper EITC payments in FYs 2012 through 2014. Without targets to reduce EITC improper payments as

[9] 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* pp. 6–8 and 10 (Feb. 2011).

Page 6

required by the IPERA, there is a lack of accountability for the IRS to eliminate payment error, waste, fraud, and abuse.

The Estimate of the Earned Income Tax Credit Improper Payment Rate Provides a Reasonable Estimate of Overclaims

The methodology used to compute the FY 2011 EITC improper payment rate provides a reasonable estimate of the percentage and amount of EITC overpayments. The formula used by the IRS to compute the EITC improper payment rate is shown in Figure 3.

Figure 3: EITC Improper Payment Rate Formula

Total Overclaims – Total Claims Protected/Recovered *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 the IRS prevents (protects) in EITC overclaims through various activities including math error processing and pre-refund examinations. This data element also includes the amount the IRS recovers in overclaims that were erroneously paid. Recovery activities include Automated Underreporter examinations and post-refund examinations.
Total EITC Claims – the amount of EITC claimed on all tax returns.

Source: IRS Improper Payment Estimates for the Earned Income Tax Credit: Methodology for the Fiscal Years 2011–2014 Update dated July 2011.

The IRS uses the results of audits conducted as part of the NRP to estimate the EITC improper payment rate. The IRS Office of Research, Analysis, and Statistics determined the EITC sample size and selected a statistically valid sample of 2,219 tax returns with EITC claims filed during Tax Year 2007. The IRS Examination function conducted detailed audits of the sampled tax returns. The Office of Research, Analysis, and Statistics then used the results of the audits to estimate the EITC overclaims, EITC claims recovered, and total EITC claims for the formula in Figure 3.

Our analysis of these estimates shows that the IRS accurately reflects the results of the audits that were conducted for the purpose of estimating the EITC improper payment rate. In addition, our statistician independently verified that the NRP sample size is sufficient to measure the statistical reliability of results. The statistician also concluded that the related formulas and calculations were accurate and consistent and that a multiyear strategy is an acceptable approach to conduct the study. Finally, the statistician concluded that the formula used to compute the EITC overpayment rate will provide a reasonable estimate of EITC overpayments.

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

However, as we have previously reported, the EITC improper payment calculation does not include an estimate of EITC underpayments. Underpayments include EITC payments made to individuals that are less than the individual is entitled to receive. By not including EITC underpayments in the estimate of EITC improper payments, the IRS could be understating the rate and/or dollar value of improper payments being made. The IRS disclosed in the *FY 2011 Agency Financial Report* that it did not include EITC underpayments in its estimate of EITC improper payments. The report states that underpayments were not included because they "do not appear with sufficient frequency in the statistically valid test data to have a measurable effect on the estimate."

In our prior review, we recommended that the Deputy Commissioner for Operations Support use the NRP sample to estimate instances in which the IRS incorrectly pays less in the EITC than the taxpayer claims (underpayments). IRS management agreed in concept with this recommendation and will explore whether using the NRP sample is possible and practical. IRS management indicated that underpayments happen so infrequently in the NRP sample that the IRS may be unable to use NRP audit results to construct a statistically valid estimate of a population total.

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to to assess the IRS's compliance with the IPERA.[1] The IPERA requires the TIGTA to review annually the IRS's compliance with the IPERA reporting requirements.

The scope of this review was limited to an assessment of the information the IRS provided for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2011*. The next phase of our review will assess the accuracy and sufficiency of the IRS's improper payment risk assessment and evaluation process.

To accomplish our objective, we:

I. Determined if the *Department of the Treasury Agency Financial Report Fiscal Year 2011* complied with the IPERA reporting requirements. We compared the information contained in the agency financial report to the IPERA reporting requirements outlined in Office of Management and Budget Circular A-123, *Management's Responsibility for Internal Control*, guidance on improper payment reporting. We also compared the information provided by the IRS to the Department of the Treasury to the information contained in the agency financial report to ensure the information was accurately reflected in the report. In addition, we reviewed prior TIGTA audit reports on the IRS's compliance with improper payment reporting requirements.

II. Evaluated the accuracy and reasonableness of the IRS's estimate of the EITC improper payment rate. We assessed the statistical validity of the methodology the IRS used to estimate the EITC overclaims and total EITC claims used to compute the EITC improper payment rate. We also compared the EITC overclaims provided by the Office of Research, Analysis, and Statistics for the statistically valid sample of 2,219 EITC claims to the EITC overclaim amounts on the IRS Master File[2] to ensure the data used by the IRS to compute the EITC overclaim rate was valid. In addition, we reviewed prior TIGTA audit reports on the validity of the IRS's sample selection and design for the NRP.

[1] Pub. L. 111-204.
[2] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

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 the IRS met the reporting requirements established in the IPERA.

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)
Russell P. Martin, Director
Deann L. Baiza, Audit Manager
Karen C. Fulte, Senior Auditor
Sandra L. Hinton, Senior Auditor
Lawrence R. Smith, Senior Auditor
Evan A. Close, Auditor
Joseph L. Katz, Ph.D., Contractor, Statistical Sampling Consultant

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Operations Support OS
Deputy Commissioner for Services and Enforcement SE
Assistant Deputy Commissioner for Operations Support OS
Assistant Deputy Commissioner for Services and Enforcement SE
Commissioner, Wage and Investment Division SE:W
Director, Office of Research, Analysis, and Statistics RAS
Deputy Director, Office of Research, Analysis, and Statistics RAS
Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division SE:W:ETARC
Director, Earned Income Tax Credit, Wage and Investment Division SE:W:ETARC:E
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:
    Chief Financial Officer
    Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PEI

Page 12

Appendix IV

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 FY 2011.

IRS Program	Type of Program	Level of Risk Identified
Refund Collection	Revenue	Low
Stimulus Disbursements	Revenue	Low
Earned Income Tax Credit Disbursements	Revenue	High
Child Tax Credit Payments	Revenue	Low
Health Care Credit Payments	Revenue	Low
Alternative Minimum Tax Credit Refunds	Revenue	Low
Home Buyers Credit Refunds	Revenue	Low
Corporation Refunds	Revenue	Low
Recovery Act Payments	Revenue	Low
Grants for Investments in Qualified Theraputic Projects in Lieu of Tax	Revenue	Low
Informant Reimbursement	Revenue	Low
Affordable Health Care Program	Administrative	Low
Recovery Act Administrative Expenses	Administrative	Low
Taxpayer Services	Administrative	Low
Tax Law Enforcement	Administrative	Low
Operations Support	Administrative	Low
Information Technology Investments/ Business Systems Modernization	Administrative	Low
Health Insurance Tax Credit	Administrative	Low
Federal Tax Lien Revolving Fund	Administrative	Low

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

IRS Program	Type of Program	Level of Risk Identified
Special Fund User Fees	Administrative	Low
Private Collection Agent Program	Administrative	Low
Department of Transportation Federal Highway Administration Allocation Account	Administrative	Low

The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements

Appendix V

Management's Response to the Draft Report

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

CHIEF FINANCIAL OFFICER

RECEIVED
FEB 28 2012

February 28, 2012

MEMORANDUM FOR MICHAEL R. PHILLIPS
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 All Improper Payments Elimination and Recovery Act Requirements (Audit # 201240011)

Thank you for the opportunity to review and respond to the draft report titled, "The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements" (Audit # 201240011).

We are pleased with your acknowledgement that the methodology used to compute the FY 2011 EITC improper payment rate provides a reasonable estimate of the percentage and amount of EITC overpayments. Furthermore, consistent with your recommendation in the report titled, "Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year" (Report # 2011-40-023 issued February 7, 2011), we are continuing to implement our return preparer initiative aimed at substantially reducing erroneous EITC payments. As previously noted, FY 2011 was the first year of a three-year ramp-up of this initiative and we expect to have a baseline against which we can set meaningful reduction targets after the program is fully established by FY 2014.

If you have any questions, please contact Peter Rose, Associate Chief Financial Officer, Corporate Planning and Internal Control, at (202) 622-4508.

Page 15

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

March 14, 2012

MEMORANDUM FOR MARLA A. FREEMAN
ASSISTANT INSPECTOR GENERAL FOR AUDIT

FROM: Dan Tangherlini
Assistant Secretary for Management
and Chief Financial Officer

SUBJECT: Management Response to Draft Report – The Department of the Treasury Was Not in Compliance with the Improper Payments Elimination and Recovery Act (IPERA) for Fiscal Year (FY) 2011

I have reviewed the subject draft report and appreciate the opportunity to respond. Treasury recognizes the importance of achieving full compliance with IPERA, including compliance with the government-wide implementing guidance issued by the Office of Management and Budget (OMB) in Memorandum M-11-16, *Issuance of Revised Parts I and II to Appendix C of OMB Circular A-123*, and OMB Circular A-136, *Financial Reporting Requirements*. In FY 2011, as we implemented IPERA, we were able to build upon the strong foundation provided by an established and rigorous Improper Payments and Recovery Audits program. During FY 2012, we will continue to work toward full compliance with IPERA.

Attached please find our planned corrective actions in response to your recommendations. If you have any questions, please let me know, or your staff may contact Harold Barnshaw, Director, Risk and Control Group (RCG), at (202) 622-9331.

Attachment

Attachment

Recommendation 1: Ensure that components submit required payment recapture audits information to the RCG for inclusion in the agency financial report (AFR).

Corrective Action 1-1: We agree with this recommendation. RCG will update Treasury's annual IPERA guidance to include specific deliverables related to the IPERA compliance requirements.

Implementation Date: May 31, 2012

Responsible Official: Deputy Chief Financial Officer

Corrective Action 1-2: RCG will hold a briefing with the bureaus/offices to review and discuss the updated requirements for full compliance with IPERA.

Implementation Date: May 31, 2012

Responsible Official: Deputy Chief Financial Officer

Recommendation 2: Notify OMB and the OIG of any programs and activities that expend more than $1 million where a cost effective payment recapture audit program is not able to be performed and include these programs and activities in the AFR with the justification and analysis used to make this conclusion.

Corrective Action 2-1: We agree with this recommendation. RCG will hold a briefing with the bureaus/offices to review and discuss the compliance and supporting documentation requirements for those programs for which a cost effective payment recapture audit program cannot be performed.

Implementation Date: May 31, 2012

Responsible Official: Deputy Chief Financial Officer

Corrective Action 2-2: RCG will include in its IPERA guidance a new action to compile a list of the bureau/office programs and activities that expend more than $1 million and for which the performance of payment recapture audits would not be cost effective. Treasury will provide the list of these programs and activities to OMB and OIG, and separately publish the list, along with justification and analysis, in the AFR.

Implementation Date: November 30, 2012

Responsible Officer: Deputy Chief Financial Officer

Joel A. Grover, Deputy Assistant Inspector General for Financial Management and Information Technology Audit
Michael Fitzgerald, Director, Financial Audit
Catherine Yi, Audit Manager
Shiela Michel, Audit Manager
Myung Han, Audit Manager
Rufus Etienne, Auditor-in-Charge
Kenneth Harness, Senior Auditor
Robert Hong, Auditor
Angelo Arpaia, Referencer

The Department of the Treasury

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

Office of Management and Budget

Controller, Office of Federal Financial Management
OIG Budget Examiner

United States Senate

Chairman and Ranking Member
Committee on Homeland Security and Governmental Affairs

U.S. House of Representative

Chairman and Ranking Member
Committee on Oversight and Government Reform

U.S. Government Accountability Office

Comptroller General of the United States