



# Audit Report



OIG-16-041

## FINANCIAL MANAGEMENT

Treasury Was Not in Compliance with IPERA for Fiscal Year 2015 Due to High Improper Payment Rate for the Earned Income Tax Credit Program

May 13, 2016

Office of  
Inspector General

Department of the Treasury

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## Abbreviations

ACTC	Additional Child Tax Credit
AOTC	American Opportunity Tax Credit
DO	Departmental Offices
EITC	Earned Income Tax Credit
EO	Executive Order
IPERA	Improper Payments Elimination and Recovery Act of 2010
IPERIA	Improper Payments Elimination and Recovery Improvement Act of 2012
IPIA	Improper Payments Information Act of 2002
IRS	Internal Revenue Service
OIG	Office of Inspector General

# Contents

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OMB	Office of Management and Budget
TIGTA	Treasury Inspector General for Tax Administration
Treasury	Department of the Treasury

*The Department of the Treasury  
Office of Inspector General*

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May 13, 2016

Brodi L. Fontenot  
Assistant Secretary for Management

This report presents the results of our audit of the Department of the Treasury's (Treasury) compliance with improper payment reporting requirements for fiscal year 2015. The objective of our audit was to assess and report on Treasury's overall compliance with requirements contained in the Improper Payments Elimination and Recovery Act of 2010 (IPERA),<sup>1</sup> enacted to help Federal agencies strengthen the framework for reducing and reporting improper payments. As part of our audit, we also assessed Treasury's compliance with additional improper payment reporting requirements set forth in Executive Order (EO) 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*, and the Improper Payments Elimination and Recovery Improvement Act of 2012 (IPERIA).<sup>2</sup> Appendix 1 provides more detail of the objective, scope, and methodology of our audit.

This report also incorporates the results of the Treasury Inspector General for Tax Administration's (TIGTA) assessment of the Internal Revenue Service's (IRS) compliance with improper payment reporting requirements in fiscal year 2015. TIGTA issued its report on April 27, 2016, which is included as appendix 2 of this report. The results of our audit, insofar as they relate to IRS, are based solely on the results of TIGTA's review.

## Results in Brief

Treasury was not in compliance with IPERA for fiscal year 2015 due to IRS not reporting an overall improper payment rate of less than 10 percent for the Earned Income Tax Credit (EITC) program. IRS estimates that 23.8 percent (\$15.6 billion) in EITC payments

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<sup>1</sup> Pub. L. No. 111-204, 124 Stat. (July 22, 2010)

<sup>2</sup> Pub. L. No. 112-248, 126 Stat. (Jan.10, 2013)

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were issued improperly in fiscal year 2015. This is the 5<sup>th</sup> consecutive year that we have determined that Treasury is noncompliant with IPERA due to IRS's EITC reporting deficiencies. We determined that Treasury was in compliance with all other IPERA, EO 13520, and IPERIA improper payment reporting requirements.

Treasury's payment recapture audit reporting needs additional improvements. That is, Treasury did not fully comply with the Office of Management and Budget's (OMB) reporting requirements for payment recapture audits. We are recommending the Assistant Secretary for Management ensure that (1) Treasury update its IPERA guidance to clarify the reporting requirements for Treasury bureaus and Departmental Offices' (DO) subcomponents (hereafter we refer to bureaus and DO subcomponents collectively as "components") payment recapture audits; and (2) the Risk and Control Group within the Office of the Deputy Chief Financial Officer strengthen its review and oversight of the data reported by components on payment recapture audits to accurately reflect the results of recapture audits.

In addition, we included as a finding in our report, TIGTA's determination that Treasury's annual risk assessment process did not provide a valid assessment of refundable credit improper payments. We are recommending that the Assistant Secretary for Management work with IRS as necessary to ensure TIGTA's recommendations related to the Additional Child Tax Credit (ACTC) and American Opportunity Tax Credit (AOTC) improper payments risk assessment processes are implemented, and appropriate action is taken to report on and reduce improper payments associated with these refundable tax credit programs.

In a written response, management agreed with our three recommendations to address the improper payments reporting deficiencies identified in our report. Management noted that it will continue to improve its annual IPERA guidance to facilitate bureaus and offices' submission of the necessary improper payments information and ensure that recaptured improper payments are disposed of in accordance with OMB Circular A-123, Appendix C requirements. Management also noted that Treasury and IRS have

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begun taking steps to improve the risk assessment related to the ACTC and AOTC.

Management's response is provided in appendix 3.

## Background

### Improper Payments Compliance and Reporting Requirements

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

In 2009, EO 13520 required Federal agencies to intensify their efforts to eliminate payment error, waste, fraud, and abuse in major Federal programs while continuing to ensure that these programs serve and provide access to their intended beneficiaries. It increased Federal agencies' accountability and required that Federal agencies provide their agency Inspector General with detailed information on efforts to identify and reduce the number of improper payments in Federal programs with the highest dollar value of improper payments.

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

IPERIA further expanded agency improper payment requirements to foster greater agency accountability. IPERIA requires the OMB Director to identify a list of high-priority Federal programs for greater levels of oversight and review. For those high-priority programs, IPERIA requires OMB to coordinate with agencies to establish annual targets and semi-annual or quarterly actions for

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<sup>3</sup> Pub. L. No. 107-300, 116 Stat. (Nov. 26, 2002)

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reducing improper payments. Agencies are required to submit an annual report to the Inspector General on actions (1) taken or planned to take to recover improper payments and (2) intended to take to prevent future improper payments. The report is also required to be available to the public on a central website.

For fiscal year 2015, EITC was Treasury's only OMB-identified high-priority program.

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

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

### **Treasury's Improper Payment Risk Assessment**

The Risk and Control Group issued *Treasury-Wide Guidance for the FY 2015 Implementation of Circular A-123, Appendix C, Requirements for the Effective Estimation and Remediation of Improper Payments* (Treasury's IPERA Guidance) to all components. The Risk and Control Group also provided the Treasury components with a tool—the Improper Payments Elimination and Recovery Risk Assessment Questionnaire—to assess the level of risk for each payment type, such as Federal employee payments, grants, and travel cards. After Treasury components complete and review the risk assessment, the results are provided to the Risk and Control Group. 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 Treasury's Annual Financial Report:



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

For fiscal year 2015, Treasury identified EITC as its only high risk program.

### **Payment Recapture Audits**

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

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

### **Treasury's Improper Payment Reporting**

On November 16, 2015, Treasury published and posted to its website the fiscal year 2015 Annual Financial Report. Included in that report was the required improper payments information with the following accompanying information:

- Treasury-wide assessment for all program and activities;
- improper payment dollar estimates for the EITC program;
- statistical sampling methodology used to arrive at the estimated improper payments for fiscal year 2015;

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- improper payment reduction outlook estimates for the EITC program through fiscal year 2018;
  - description of the corrective action plans for the EITC program, including the root causes and projected results;
  - overview of internal control framework for the EITC program;
  - discussion of its annual payment recapture audit efforts; and
  - results of Treasury's Do Not Pay Initiative operation.

## Audit Results

### Finding 1 Treasury Was Not in Compliance with IPERA for Fiscal Year 2015

We determined that Treasury was not in compliance with IPERA for fiscal year 2015 due to IRS not reporting an overall improper payment rate of less than 10 percent for the EITC program. IRS estimates that 23.8 percent (or \$15.6 billion) in EITC payments were issued improperly in fiscal year 2015. This is the 5th consecutive year we have determined that Treasury is not in compliance with IPERA due to IRS' EITC improper payments reporting deficiencies.

Under IPERA, Treasury was required to submit a comprehensive plan to Congress describing the actions that it is going to take to bring Treasury into compliance with IPERA. Although Treasury submitted a plan in fiscal year 2012, it only addressed deficiencies associated with its reporting on payment recapture audits, which were identified in our report on compliance with IPERA for fiscal year 2011<sup>4</sup>; the plan did not address non-compliance with IPERA due to EITC deficiencies.

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

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<sup>4</sup> *The Department of the Treasury Was Not in Compliance With the Improper Payments Elimination and Recovery Act for Fiscal Year 2011* (OIG-12-044; issued March 15, 2012)

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

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

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

However, the Act did not expand the IRS' authority to systematically correct the erroneous claims that are identified when tax returns are processed. According to TIGTA's report, without

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<sup>5</sup> Pub. L. No. 114-113, 129 Stat. 2242 (Dec. 18, 2015)

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expanded error correction authority, IRS will not be able to prevent the issuance of billions of dollars in improper EITC payments.

IRS has submitted a legislative proposal requesting correctable error authority as part of its fiscal year 2017 budget submission.

## **Finding 2      Payment Recapture Audit Reporting Needs Additional Improvements**

Treasury did not fully comply with OMB's reporting requirements for payment recapture audits. Specifically, Treasury's fiscal year 2015 Annual Financial Report contained inaccurate and incomplete information, as follow:

- OMB Circular No. A-136 Revised, *Financial Reporting Requirements* (OMB Circular No. A-136) requires that an agency's reporting of payment recapture audit efforts in the Annual Financial Report include a justification of any overpayments that have been determined not to be collectible.

Treasury's IPERA Guidance did not provide instructions to components on submitting justifications for write-offs of uncollectible improper payments. As a result, justifications were not provided for overpayments of approximately \$94,000 that were written off as uncollectible for Fiscal Service - Admin (FSA),<sup>6</sup> Departmental Offices, U.S. Mint, and the Office of D.C. Pensions.

- According to OMB Circular No. A-123, Appendix C, recaptured overpayments from expired discretionary fund accounts that were appropriated after enactment of IPERA and are not used to reimburse expenses of the agency or pay payment recapture audit contractors may be used for a financial management improvement program, the original purpose of the funds, Inspector General activities, or returned to the Treasury as miscellaneous receipts or returned to trust or special fund accounts. Each agency shall determine the actual percentage of

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<sup>6</sup> FSA is a reporting entity of the Bureau of Fiscal Service that accounts for salaries and other administrative expenses of the bureau.

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recovered overpayments used for the purposes outlined (up to the maximum amount allowed in the law and this guidance). Specifically, up to 25 percent of the recaptured funds may be used for the original purpose.

Treasury reported that recaptured overpayments of approximately \$52,200 were used for the original purpose of the funds. However, our review found that this was not the case. That is, the recaptured funds had not been used for the original purpose of the funds at the time of reporting and had been credited instead to the original expired account from which the overpayment was made.

- OMB Circular No. A-136 requires that agencies report certain information on their overpayments recaptured through payment recapture audits. The information should include a summary of how amounts recaptured in the current year have been disposed of and an aging schedule of the amount of overpayments that are outstanding. Only overpayments are reported on these tables.

The Office of Financial Stability (OFS) incorrectly included and reported the improper underpayments of \$1.24 million in the *Disposition of Funds Recaptured Through Payment Recapture Audits* table. In addition, OFS incorrectly reported the improper underpayments of \$2,500 in the *Aging of Outstanding Overpayments Identified in the Payment Recapture Audits* table. These errors were caused by misinterpretation of payment recapture audit reporting requirements.

- We also noted two computation errors in the recapture audits reporting. The recapture rate for fiscal year 2015 was incorrectly calculated and reported as 10 percent for FSA and 95 percent for Treasury in total. The correct percentages were 105 percent for FSA and 87 percent for Treasury in total.

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## **Recommendations**

We recommend the Assistant Secretary for Management ensure that:

1. Treasury update its IPERA guidance to clarify the reporting requirements for components' payment recapture audits.
2. The Risk and Control Group strengthen its review and oversight of the data reported by components on payment recapture audits to accurately reflect the results of recapture audits.

### **Management Response for Recommendations 1 and 2**

Treasury intends to reinforce and enhance the current department-wide guidance concerning disposition of recaptured improper payments. Consistent with the recommendation, Management will continue to ensure that recaptured improper payments are disposed of in accordance with OMB Circular No. A-123, Appendix C requirements. The implementation date for its corrective actions is September 30, 2016.

### **OIG Comment**

Management's response meets the intent of our recommendations.

## **Finding 3**

### **Annual Risk Assessments Underestimate the Risk of Improper Payments in IRS Tax Refund Programs**

TIGTA reported that Treasury's annual risk assessment process did not provide a valid assessment of improper tax refund payments. Although IRS performed its annual risk assessment in accordance with Treasury's IPERA guidance, TIGTA found that IRS continues to assess the risk of improper payments associated with the ACTC and AOTC as low. TIGTA's analysis shows that the estimated improper payments for both the ACTC and AOTC exceed the IPERA criteria for significant risk of improper payments. IPERA defines significant improper payments as improper payments that exceeded \$10 million during the fiscal year and 1.5 percent of program outlays, or \$100 million regardless of improper payment

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percentage of program outlays. TIGTA estimates the potential ACTC improper payments rate for fiscal year 2015 is 24.2 percent with potential improper payments totaling \$5.7 billion, and the potential AOTC improper payments rate for fiscal year 2015 is 30.7 percent with improper payments totaling \$1.8 billion.

IRS is currently re-evaluating the improper payment risk assessment process for ACTC program.

### **Recommendation**

In its report, TIGTA recommended to that IRS ensure that (1) the revised ACTC improper payment risk assessment process includes a quantitative assessment for ACTC improper payment risk using available enforcement data and (2) the results of the AOTC improper payment risk assessment accurately reflect the high risk associated with AOTC payments. Completion of the AOTC improper payment risk assessment should include a quantitative assessment of AOTC improper payment risk using available enforcement data. IRS agreed with TIGTA's recommendations.

We recommend the Assistant Secretary for Management work with IRS as necessary to ensure TIGTA's recommendations related to the ACTC and AOTC improper payments risk assessment processes are implemented, and appropriate action is taken to report on and reduce improper payments associated with these refundable tax credit programs.

### **Management Response**

Treasury and IRS began taking steps to improve the risk assessment related to ACTC and AOTC programs. The implementation date is November 15, 2016.

### **OIG Comment**

Management's commitment to take steps to improve the risk assessment meets the intent of our recommendation.

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

/s/

James Hodge  
Director, Financial Statement and Procurement Audits



The overall objective our audit was to determine whether the Department of the Treasury (Treasury) complied with the improper payment reporting requirements for fiscal year 2015. We assessed Treasury's compliance with the reporting requirements set forth in the Improper Payments Elimination and Recovery Act of 2010 (IPERA); Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*; and the Improper Payment Elimination and Recovery Improvement Act of 2012. Our audit scope did not include the review of programs and activities administered by the Internal Revenue Service (IRS). The Treasury Inspector General for Tax Administration (TIGTA) is responsible for the audit of IRS' compliance with improper payment reporting requirements. TIGTA's scope included an assessment of the Earned Income Tax Credit information that IRS provided for inclusion in Treasury's fiscal year 2015 Agency Financial Report and a review of IRS' progress on previous recommendations.

To accomplish our objective, we reviewed applicable laws, regulations, guidance issued by the Office of Management and Budget (OMB), and *Treasury-wide Guidance for the FY 2015 Implementation of Effective Estimation and Remediation of Improper Payments*; reviewed Treasury's fiscal year 2015 Annual Financial Report; interviewed Departmental Offices and component entities' personnel; and performed testing of Treasury's risk assessments and payment recapture audit programs.

To determine compliance with IPERA and OMB guidance, we reviewed the fiscal year 2015 Annual Financial Report and any accompanying information to assess whether Treasury had:

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

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

To assess Treasury's risk assessment process, we randomly selected a sample of 10 of 60 non-IRS programs identified by Treasury for risk assessment. To determine the reasonableness and accuracy of the information reported and compliance with the applicable guidance for the sample, we reviewed the program risk assessments and conducted interviews of personnel involved in their preparation and review.

To assess Treasury's payment recapture audit program, we selected the entire population of 20 reporting entities due to our prior year audit finding on Treasury's recapture audit.<sup>7</sup> To determine the reasonableness and accuracy of the information reported, and compliance with the applicable guidance, we reviewed the components' submissions and conducted interviews with component personnel, as well as reviewed supporting documentation.

We conducted our fieldwork in Washington, DC, from February 2016 to May 2016.

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.

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<sup>7</sup> *Treasury's Improper Payment Reporting Needs Improvement* (OIG-15-033; issued May 15, 2015)

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**TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION**



***Without Expanded Error Correction Authority,  
Billions of Dollars in Identified Potentially  
Erroneous Earned Income Credit Claims Will  
Continue to Go Unaddressed Each Year***

April 27, 2016

Reference Number: 2016-40-036

This report remains the property of the Treasury Inspector General for Tax Administration (TIGTA) and may not be disseminated beyond the Internal Revenue Service without the permission of TIGTA.

This report may contain confidential return information protected from disclosure pursuant to I.R.C. § 6103(a). Such information may be disclosed only to Department of the Treasury employees who have a need to know this information in connection with their official tax administration duties.

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**Phone Number / 202-622-6500**

**E-mail Address / [TIGTACommunications@tigta.treas.gov](mailto:TIGTACommunications@tigta.treas.gov)**

**Website / <http://www.treasury.gov/tigta>**



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Treasury Inspector General for Tax Administration  
P.O. Box 589  
Ben Franklin Station  
Washington, D.C. 20044-0589

Information you provide is confidential and you may remain anonymous.



## HIGHLIGHTS

**WITHOUT EXPANDED ERROR  
CORRECTION AUTHORITY, BILLIONS  
OF DOLLARS IN IDENTIFIED  
POTENTIALLY ERRONEOUS EARNED  
INCOME CREDIT CLAIMS WILL  
CONTINUE TO GO UNADDRESSED  
EACH YEAR**

### Highlights

Final Report issued on April 27, 2016

Highlights of Reference Number: 2016-40-036  
to the Internal Revenue Service Chief Financial  
Officer.

#### IMPACT ON TAXPAYERS

The Improper Payments Elimination and Recovery Act (IPERA) of 2010 and subsequent legislation strengthened agency reporting requirements and redefined "significant improper payments" in Federal programs. The Office of Management and Budget has declared the Earned Income Tax Credit (EITC) Program a high-risk program that is subject to reporting in the Department of the Treasury (Treasury) Agency Financial Report. The IRS estimates that 23.8 percent (\$15.6 billion) of EITC payments were issued improperly in Fiscal Year 2015.

#### WHY TIGTA DID THE AUDIT

This audit was initiated because TIGTA is required to assess the IRS's compliance with the reporting requirements contained in the IPERA; Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*; and the Improper Payment Elimination and Recovery Improvement Act of 2012. The objective of this review was to determine whether the IRS complied with the annual improper payment reporting requirements for Fiscal Year 2015.

#### WHAT TIGTA FOUND

The IRS provided all required improper payment information to Treasury for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2015* with the continued

exception of not reporting an overall EITC improper payment rate of less than 10 percent.

The Consolidated Appropriations Act of 2016 provides the IRS with additional tools to reduce EITC improper payments. However, it did not expand the IRS's authority to systemically correct the erroneous claims it identifies. Without this authority, the IRS continues to be unable to address the majority of potentially erroneous EITC claims it identifies. The IRS can audit potentially erroneous EITC claims; however, the number of claims the IRS can audit is limited by resources. As a result, billions of dollars in potentially erroneous EITC claims go unaddressed each year.

In addition, although the IRS completed risk assessments of the 22 program fund groups identified by the Treasury, the risk assessment process still does not provide a valid assessment of refundable credit improper payments. The IRS continued to rate the risk of improper payments associated with the Additional Child Tax Credit and the American Opportunity Tax Credit in Fiscal Year 2015 as low.

However, based on the IRS's own enforcement data, TIGTA estimates that the potential Additional Child Tax Credit improper payment rate for Fiscal Year 2015 is 24.2 percent, with potential improper payments totaling \$5.7 billion, and estimates that the potential American Opportunity Tax Credit improper payment rate for Fiscal Year 2015 is 30.7 percent, with potential improper payments totaling \$1.8 billion.

#### WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS ensure that the revised Additional Child Tax Credit improper payment risk assessment process includes a quantitative assessment. TIGTA also recommended that the IRS ensure that the results of the American Opportunity Tax Credit Improper Payment risk assessment accurately reflect the high risk associated with American Opportunity Tax Credit payments. The IRS agreed with the recommendations.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

April 27, 2016

**MEMORANDUM FOR CHIEF FINANCIAL OFFICER**

A handwritten signature in blue ink that reads "Michael E. McKenney".

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

**SUBJECT:** Final Audit Report – Without Expanded Error Correction Authority,  
Billions of Dollars in Identified Potentially Erroneous Earned Income  
Credit Claims Will Continue to Go Unaddressed Each Year  
(Audit # 201640001)

This report presents the results of our review to determine whether the Internal Revenue Service complied with the annual improper payment reporting requirements for Fiscal Year 2015. This audit is included in our Fiscal Year 2016 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 in Appendix VI.

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



***Without Expanded Error Correction Authority, Billions of Dollars in Identified Potentially Erroneous Earned Income Credit Claims Will Continue to Go Unaddressed Each Year***

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***Without Expanded Error Correction Authority, Billions of Dollars in Identified Potentially Erroneous Earned Income Credit Claims Will Continue to Go Unaddressed Each Year***

### ***Abbreviations***

ACTC	Additional Child Tax Credit
AOTC	American Opportunity Tax Credit
APTC	Advance Premium Tax Credit
CTC	Child Tax Credit
EITC	Earned Income Tax Credit
FFRDC	Federally Funded Research and Development Center
IPERA	Improper Payments Elimination and Recovery Act
IPERIA	Improper Payments Elimination and Recovery Improvement Act
IPIA	Improper Payments Information Act
IRS	Internal Revenue Service
NRP	National Research Program
OMB	Office of Management and Budget
PTC	Premium Tax Credit
TIGTA	Treasury Inspector General for Tax Administration





***Without Expanded Error Correction Authority, Billions of Dollars in Identified Potentially Erroneous Earned Income Credit Claims Will Continue to Go Unaddressed Each Year***

## ***Background***

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

- **Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs***, signed by the President on November 20, 2009, further increases Federal agencies' accountability for reducing improper payments while continuing to ensure that Federal programs serve and provide access to their intended beneficiaries. It requires Federal agencies to provide their agency Inspector General with detailed information on efforts to identify and reduce the number of improper payments in Federal programs with the highest dollar value of improper payments.
- **Improper Payments Elimination and Recovery Act (IPERA) of 2010**,<sup>2</sup> enacted on July 22, 2010, amended the IPIA by strengthening agency reporting requirements and redefining "significant improper payments." For Fiscal Year<sup>3</sup> 2014 and beyond, significant is defined as gross annual improper payments, *i.e.*, the total amount of overpayments plus underpayments made in the program during the fiscal year reported that a) exceeded both 1.5 percent of program outlays and \$10 million of all program or activity payments or b) exceeded \$100 million at any percent of program outlays.
- **Improper Payments Elimination and Recovery Improvement Act (IPERIA) of 2012**,<sup>4</sup> enacted on January 10, 2013, further expanded agency improper payment requirements to foster greater agency accountability. Like Executive Order 13520, the IPERIA requires the OMB Director to identify a list of high-priority Federal programs. For those high-priority programs, the IPERIA requires agencies to develop additional or

<sup>1</sup> Pub. L. No. 107-300, 116 Stat. 2350.

<sup>2</sup> Pub. L. No. 111-204, 124 Stat. 2224.

<sup>3</sup> Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.

<sup>4</sup> Pub. L. No. 112-248, 126 Stat. 2390.



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

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

**OMB guidance on the IRS's use of supplemental measures for Earned Income Tax Credit (EITC)<sup>5</sup> reduction targets**

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

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

<sup>5</sup> Congress originally passed the EITC legislation in 1975 in part to offset the burden of Social Security taxes and to provide an incentive to work. The EITC is a refundable tax credit that offsets income tax owed by low-income taxpayers. Refundable tax credits can be used to reduce a taxpayer's tax liability to zero. Any excess of the credit beyond the tax liability can be refunded to the taxpayers.



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**Process to identify IRS programs for improper payment risk assessment**

The Treasury identifies the programs that the IRS must assess for the risk of improper payments. The Treasury selected 22 IRS program fund groups for review for Fiscal Year 2015 – six administrative funds and 16 revenue funds. These funds were selected for assessment based on each fund groups' materiality to the IRS financial statements. Appendix V provides a list of the IRS programs the Treasury identified for an improper payment risk assessment for Fiscal Year 2015.

The IRS used the Improper Payments Elimination and Recovery Risk Assessment Questionnaire for Fiscal Year 2015 (the Risk Assessment Questionnaire) and related guidance provided by the Treasury to assess the level of risk for each identified program. The Questionnaire computes a risk score for each program based on the IRS's response to the questions it contains. The risk score determines whether there is a low, medium, or high risk of improper payments in a program. The Treasury establishes the level of risk for a program's improper payments based on the risk score ranges and considers programs with a risk score of 0 to 11 as low risk, 12 to 28 as medium risk, and 29 and greater as high risk.

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

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

The OMB has previously declared the EITC a high-risk program; therefore, no risk assessment is required to be prepared for it. The EITC is currently the only IRS high-risk program and the only one with information included in the Treasury's Agency Financial Report. The IRS estimates that 23.8 percent (\$15.6 billion) of EITC payments made in Fiscal Year 2015 were paid in error. In addition, the OMB identifies programs that have a high priority with regard to improper payments. The EITC continues to be the only IRS program that the OMB has identified as a high-priority program.



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**Prior Treasury Inspector General for Tax Administration (TIGTA) reviews identified that annual risk assessments do not accurately reflect the risks associated with refundable credits**

Our prior reviews found that although the IRS completed the risk assessments of the required funds, the risk assessment process does not provide a valid assessment of improper payments associated with refundable credits. The EITC remains the only revenue program fund to be considered a high risk for improper payments despite numerous indicators that other refundable tax credits (e.g., the Additional Child Tax Credit (ACTC))<sup>6</sup> also potentially result in significant improper payments. On March 20, 2014, the OMB issued supplemental improper payment guidance to Treasury clarifying the requirement for annual risk assessments of all refundable tax credits. Specifically, the OMB guidance clarified that *all refundable credits* are subject to IPERA requirements as they represent an additional outlay of funds by the Government.

However, in September 2014<sup>7</sup> we reported that the methodology the IRS uses to conduct the risk assessment of refundable credits continues to provide an inaccurate assessment of the risk of improper payments. For example, based on its materiality to the IRS's financial statements, Treasury selected the ACTC as one of the revenue program funds for which the IRS must perform an improper payment risk assessment. The IRS has conducted the annual risk assessment of the ACTC as required by Treasury each year since Fiscal Year 2011 and continually rated the risk of improper payments associated with the ACTC as low.

The low risk rating is despite our review of the IRS's own enforcement data, which indicates that the ACTC improper payment rate is similar to that of the EITC. We estimated that the potential ACTC improper payment rate for Fiscal Year 2013 was between 25.2 percent and 30.5 percent, with potential ACTC improper payments totaling between \$5.9 billion and \$7.1 billion. The OMB defines a program as having significant improper payments when improper payments exceed both 1.5 percent of program outlays and \$10 million of all program or activity payments made during the fiscal year reported or exceed \$100 million at any percent of program outlays.

We recommended that the IRS ensure that the results of the ACTC improper payment risk assessment accurately reflect the high risk associated with ACTC payments and provide a reliable estimate of improper payments. In addition, the assessment should include an evaluation of available National Research Program (NRP) and enforcement data when determining the overall risk of improper payments. The IRS disagreed with this recommendation.

<sup>6</sup> The ACTC is intended to reduce the individual income tax burden for families, better recognize the financial responsibilities of raising dependent children, and promote family values.

<sup>7</sup> TIGTA, Ref. No. 2014-40-093, *Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments* (Sept. 2014).



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In their response to our April 2015 report,<sup>8</sup> IRS management implied that our estimate of the ACTC improper payment rate was incomplete and misleading because we did not account for misclassifications between the refundable ACTC and the nonrefundable Child Tax Credit (CTC). A misclassification of ACTC occurs when as a result of an audit the IRS determines that the taxpayer could have claimed more CTC and should have claimed less ACTC. The offsetting adjustments to the tax return result in a shift or reclassification of credits from the ACTC to the CTC.

Subsequent to the completion of the April 2015 audit, we performed additional analysis to calculate the improper payment rate and amount to include only those tax returns for which there was no reclassification of the ACTC to the CTC. These are claims for which the IRS disallowed the ACTC and no change was made to the taxpayers' CTC or the CTC was disallowed. This still resulted in a Fiscal Year 2013 estimated improper payment rate of 12.8 percent with estimated improper payment dollars of \$3 billion.<sup>9</sup> We shared these results with the IRS in July 2015. It should be noted that the resulting improper payment rate and amount for claims for which there was no reclassification between the ACTC and the CTC still exceeded the IPERA criteria for rating the program as having a significant risk of improper payments.

***The NRP was used to estimate EITC improper payments***

The IRS uses its NRP as the primary source of data to estimate the annual EITC improper payment rate. The NRP provides the IRS with compliance information that is statistically representative of the taxpayer population. The IRS uses each tax year's<sup>10</sup> NRP results to update the EITC improper payment rate.

Although the NRP process results in a more current estimate of the accuracy of EITC claims than previous methods, the estimated improper payment rate for a given fiscal year is not based on current year data. Because of the time it takes to complete the annual NRP, the IRS's annual estimate of the improper payment rate is based on data that are approximately three years old. For example, EITC improper payment rates for Fiscal Year 2015 are based on information from Tax Year 2011 tax returns that were processed in Calendar Year 2012.<sup>11</sup> Figure 1 shows the improper payment rate formula and figures the IRS used to compute the estimated EITC improper payment rate for Fiscal Year 2015.

<sup>8</sup> TIGTA, Ref. No. 2015-40-044, *Assessment of Internal Revenue Service Compliance With the Improper Payment Reporting Requirements in Fiscal Year 2014* (Apr. 2015).

<sup>9</sup> We estimate that the potential ACTC improper payment rate is between 10.6 percent and 15 percent and the potential improper payment dollars is between \$2.5 billion and \$3.5 billion.

<sup>10</sup> 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.

<sup>11</sup> Tax Year 2011 was the most current NRP data available at the time the IRS computed the estimated Fiscal Year 2015 improper payment rate.



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**Figure 1: EITC Improper Payment Rate Formula and Figures Used for Fiscal Year 2015**

<u>Total EITC Improper Payments – Total Claims Protected/Recovered</u> <u>Total EITC Claims</u>
<b>Total EITC Improper Payments</b> – The difference between the amount of the EITC claimed by the taxpayer on his or her tax return and the amount the taxpayer should have claimed. This amount includes EITC overclaims and EITC underpayments. This amount totaled \$17.3 billion.
<b>Total Claims Protected/Recovered</b> – The amount of EITC overclaims that the IRS prevents from being paid through prerefund examinations or recovers after being paid through Automated Underreporter document matching and post-refund examinations. This amount totaled \$2.5 billion.
<b>Total EITC Claims</b> – The estimated amount of EITC claimed on all tax returns. This amount totaled \$62.3 billion. <sup>12</sup>
<b>Estimated Fiscal Year 2015 Improper Payments</b> – This is computed by multiplying the estimated Improper Payment Rate by the estimate of total claims for the year. The estimate of Fiscal Year 2015 improper payments is \$15.6 billion.

Source: TIGTA's review of IRS EITC information provided to the Treasury for inclusion in the Department of the Treasury Agency Financial Report Fiscal Year 2015.

**A prior TIGTA review identified that the structure of the Premium Tax Credit (PTC) increases the complexity of assessing and reporting improper payments**

The Patient Protection and Affordable Care Act<sup>13</sup> (hereafter referred to as the Affordable Care Act) created the Health Insurance Marketplace, also known as the Exchange. The Exchange is where individuals find information about health insurance options, purchase qualified health plans and, if eligible, obtain help paying premiums. The Affordable Care Act also created a new refundable tax credit, the PTC, to assist eligible taxpayers with paying their health insurance premiums. The funds used to make Advance PTC (APTC) payments are drawn from the PTC budget fund included in the IRS's budget and subsequently allocated to the Department of Health and Human Services for use in paying the APTC.

The IRS performed an initial assessment of risks and controls related to PTC claims similar to the ones completed on refundable credits that were selected for review by the Treasury. The risk assessment performed in Fiscal Year 2015 found medium risk susceptibility for PTC improper payments.

<sup>12</sup> The IRS uses an estimate for current year EITC claims because it does not know the actual amount at the time it is required to submit improper payment estimates to the Treasury for inclusion in the Agency Financial Report. The estimate of EITC claims is based on a budget projection prepared by the Treasury's Office of Tax Analysis. The IRS's most recent estimate is \$65.6 billion.

<sup>13</sup> Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of the U.S. Code), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. No. 111-152, 124 Stat. 1029.



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The funds to make APTC and PTC payments were appropriated to the IRS. As such, it would follow that the IRS would be responsible for assessing the risk of PTC improper payments and complying with the other improper payment requirements. However, the IRS is not solely responsible for administering the PTC.

The Department of Health and Human Services Centers for Medicare and Medicaid Services oversees implementation of certain Affordable Care Act provisions related to the Exchanges, which have sole responsibility for determining whether an individual is eligible to purchase health insurance through the Exchange as well as determining the amount of the APTC he or she is eligible to receive. The IRS is responsible for determining the amount of the PTC a taxpayer is entitled to receive. Because the IRS and Department of Health and Human Services are both responsible for the administration of the PTC, improper PTC payments can result from weaknesses in either agency's programs. As a result, the IRS cannot solely assess the risk of PTC improper payments.

This review was performed with information obtained from the Office of the Chief Financial Officer and the Office of Research, Analysis, and Statistics located at the IRS Headquarters in Washington, D.C., and the Wage and Investment Division, Office of Return Integrity and Compliance Services, in Atlanta, Georgia, during the period November 2015 through March 2016. 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.



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## Results of Review

### Assessment of Internal Revenue Service Fiscal Year 2015 Compliance With Improper Payment Reporting Requirements

The IRS provided all required improper payment information to the Treasury for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2015* with the continued exception of not reporting an overall EITC improper payment rate of less than 10 percent. Figure 2 provides a summary of our evaluation of IRS compliance with the various improper payment requirements.

**Figure 2: IRS Compliance With Improper Payment Requirements for the EITC Program for Fiscal Year 2015**

Improper Payment Requirement	Source of Requirement	Provided by IRS
Conduct a program-specific risk assessment for each program or activity identified by the Treasury.	IPERA	Yes
Publish an improper payment estimate for the EITC.	IPERA	Yes
Report an improper payment rate of less than 10 percent for the EITC.	IPERA	No
Provide the methodology for identifying and measuring EITC improper payments.	Executive Order	Yes
Publish annual reduction targets for the EITC and discuss progress toward meeting those targets. <sup>14</sup>	IPERA	Yes
Provide plans and supporting analysis for meeting the reduction targets for EITC improper payments.	Executive Order	Yes
Publish a programmatic corrective action plan for the EITC.	IPERA	Yes
Report on actions the IRS intends to take to prevent future EITC improper payments.	IPERIA	Yes
Report on efforts taken or planned to recapture EITC improper payments.	IPERA / IPERIA	Yes
Provide plans and supporting analysis for ensuring that the initiatives undertaken do not unduly burden program access and participation by eligible beneficiaries.	Executive Order	Yes
Provide required EITC information for posting to paymentaccuracy.gov website.	Executive Order IPERIA	Yes

<sup>14</sup> Supplemental measures were established in lieu of reduction targets.





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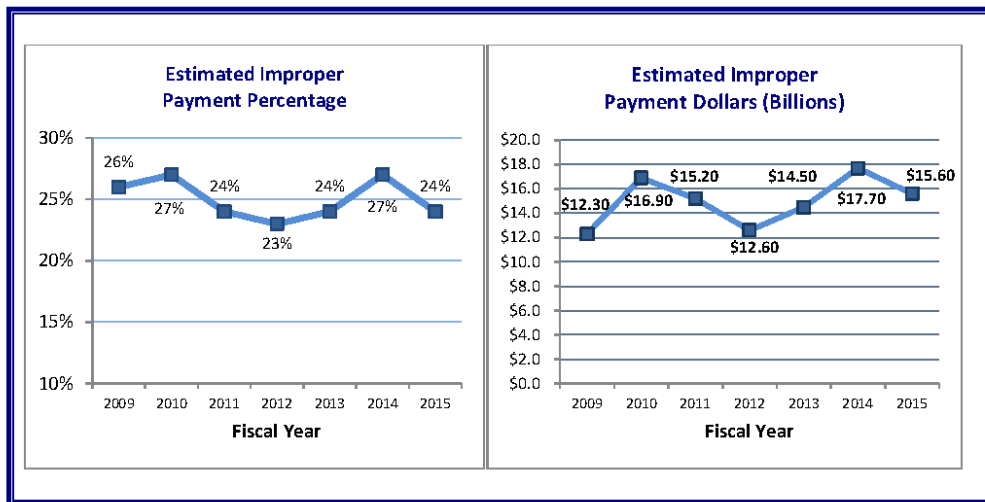
Improper Payment Requirement	Source of Requirement	Provided by IRS
Submit quarterly reports to TIGTA and the Council of the Inspectors General on Integrity and Efficiency and make available to the public a report on EITC improper payments identified by the agency.	Executive Order	N/A <sup>15</sup>

Source: TIGTA's review of IRS EITC information provided to the Treasury for inclusion in the Department of the Treasury Agency Financial Report Fiscal Year 2015.

**Billions of dollars in identified potentially erroneous EITC claims go unaddressed each year because the IRS does not have the needed error correction authority**

The IPERA requires agencies to report an annual improper payment rate of less than 10 percent. However, as shown in Figure 3, the IRS has made little improvement in reducing EITC improper payments.

**Figure 3: Estimated EITC Improper Payments for Fiscal Years 2009 Through 2015**



Source: Department of the Treasury Performance and Accountability Reports for Fiscal Years 2009 through 2011 and the Fiscal Years 2012 through 2015 Agency Financial Reports.

<sup>15</sup> Effective for Fiscal Year 2014 forward, the dollar threshold for which agencies are required to report quarterly high-dollar improper payments is \$25,000 per individual. Because the maximum EITC an individual can receive is well below the \$25,000 threshold, the IRS would not be required to report any quarterly high-dollar payments for Fiscal Year 2014 forward.



**Without Expanded Error Correction Authority, Billions of Dollars in Identified Potentially Erroneous Earned Income Credit Claims Will Continue to Go Unaddressed Each Year**

We continue to report that IRS compliance resources are limited. Consequently, the IRS does not address the majority of potentially erroneous EITC claims despite having established processes that identify billions of dollars in potentially erroneous EITC payments. For example, the IRS identified approximately 5.7 million potentially erroneous EITC claims totaling approximately \$20.7 billion in Tax Year 2014 for which it does not have error correction authority to address. In Tax Year 2014, the IRS used math error authority<sup>16</sup> to identify and systemically correct<sup>17</sup> only 166,611 (less than 1 percent) of approximately 27.6 million EITC claims. The 166,611 returns claimed EITCs totaling \$227 million. Figure 4 shows the volumes and dollars associated with potentially erroneous EITC claims the IRS identifies compared to what was systemically corrected for Tax Years 2011 through 2014.

**Figure 4: Potentially Erroneous EITC Claims the IRS Identifies for Which It Does Not Have the Error Correction Authority to Address at the Time the Tax Return Is Processed**

Tax Year	Tax Returns Containing Potentially Erroneous EITC Claims	Credit Amount Claimed for Potentially Erroneous EITC	Tax Returns the IRS Identified and Systemically Corrected	Percentage of All Returns Claiming the EITC
2011	6.6 million	\$21.6 billion	270,492	0.9%
2012	6.5 million	\$21.9 billion	241,975	0.9%
2013	6.7 million	\$23.9 billion	194,127	0.7%
2014	5.7 million	\$20.7 billion	166,611	0.6%

Source: IRS provided the figures from created EITC "Factsheets" and Dependent Database<sup>18</sup> figures. The percentages were calculated by the TIGTA audit team.

<sup>16</sup> The IRS is granted math error authority in 26 U.S.C. § 6213(b). It can be used for certain purposes specified by Congress in 26 U.S.C. § 6213(g)(2) including correcting calculation errors and checking for other obvious noncompliance, such as claims above income and credit limits. If it is not specified in statute, the IRS cannot pursue assessment and collection activities without issuing a statutory notice of deficiency.

<sup>17</sup> The Internal Revenue Code provides for the use of math error authority to address erroneous EITC claims by systemically correcting mathematical or clerical errors on EITC claims, such as correcting entries made on the wrong line on the tax return or mathematical errors in computing income or the EITC. In addition, the IRS can use math error authority to adjust an EITC claim if a qualifying child's Social Security Number is not valid.

<sup>18</sup> The Dependent Database addresses noncompliance relevant to the EITC and other tax benefits related to the dependency and residency of children.



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As Figure 4 shows, the majority of potentially erroneous EITC claims the IRS identifies do not contain the types of errors for which it has error correction authority at the time a tax return is processed. The IRS can audit potentially erroneous EITC claims; however, doing so is more costly than addressing the claim using error correction authority. In addition, the number of potentially erroneous EITC claims the IRS can audit is further reduced by its need to allocate its limited resources among the various segments of taxpayer noncompliance to provide a balanced tax enforcement program. As a result, billions of dollars in potentially erroneous EITC claims go unaddressed each year.

***Recently Enacted Legislation Provides Additional Tools to Assist in Reducing Earned Income Tax Credit Improper Payments, but Existing Error Authorities Will Continue to Limit Their Usefulness***

Recently enacted legislative program integrity provisions included in the Consolidated Appropriations Act of 2016<sup>19</sup> are intended to ensure that the IRS has the information and time needed to verify the earned income of individuals claiming the EITC before the related refund is issued. According to the IRS, erroneous or fraudulent income accounts for 30 percent of the identified erroneous EITC payments. Provisions include:

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

Although the Consolidated Appropriations Act gives the IRS more time to verify EITC claims before refunds are issued, it did not expand the IRS's authority to systemically correct erroneous claims that are identified at the time tax returns are processed. Without expanded error correction authority, the IRS will be unable to prevent the issuance of billions of dollars in improper EITC payments despite identifying them. For example, in September 2014 we reported<sup>20</sup> that our analysis of Tax Year 2012 EITC claims for which the taxpayer claimed wages as the source of income to support the EITC identified 676,992 tax returns for which third-party Forms W-2 were not sent to the IRS by the employer for either the taxpayer or spouse listed on

<sup>19</sup> Pub. L. No. 114-113, 129 Stat. 2242 (2015).

<sup>20</sup> TIGTA, Ref No. 2014-40-093, *Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments* (Sept. 2014).



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the tax return.<sup>21</sup> These 676,992 tax returns claimed EITCs totaling more than \$1.7 billion. We will be conducting a separate audit to evaluate the IRS's implementation of these provisions.

The IRS, in conjunction with the Assistant Secretary of the Treasury for Tax Policy, has put forth a legislative proposal requesting additional error authority (hereafter referred to as correctable error authority). The IRS requested correctable error authority as part of its Fiscal Year 2017 budget submission. Under this proposal, the Treasury would have regulatory authority to permit the IRS to correct errors in cases in which:

1. The information provided by the taxpayer does not match the information contained in Government databases (e.g., income information reported on the tax return does not match Forms W-2 from the Social Security Administration). According to the IRS, reliable Government data sources include information obtained from the Social Security Administration, the Department of Health and Human Services, the Federal Bureau of Prisons, and the States' Departments of Corrections.
2. The taxpayer has exceeded the lifetime limit for claiming a deduction or credit.
3. The taxpayer has failed to include documentation with his or her return that is required by statute.

However, as of February 2016, the IRS had not been provided the requested authority.

***Annual Risk Assessments Continue to Underestimate the Risk of Refundable Credit Improper Payments***

Our review identified that the IRS performed risk assessments for each of the programs that the Treasury required the IRS to assess. However, we continue to find that the methodology the IRS uses to conduct these assessments still does not provide a valid assessment of the risk of improper payments for these credits. As such, the EITC remains the only revenue program fund to be considered high risk for improper payments.

In addition to the EITC, the Treasury required the IRS to evaluate the Fiscal Year 2015 improper payment risk for two other large refundable credits – the ACTC and the American Opportunity Tax Credit (AOTC).<sup>22</sup> Using the IRS's own compliance data, we computed a potential estimated improper payment rate for the ACTC and AOTC. Our analysis of ACTC and AOTC improper payment rates draws from the same data sources and methodologies the IRS uses to compute the potential improper payment rate for the EITC.

<sup>21</sup> Some of the tax returns we identified could also be the result of employer errors or employer nonreporting.

<sup>22</sup> The AOTC is intended to help offset the costs of higher education for taxpayers, their spouses, and dependents who qualify as eligible students.



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Our analysis identified a:

- Potential estimated ACTC improper payment rate for Fiscal Year 2015 of 24.2 percent, resulting in an estimated \$5.7 billion in potential ACTC improper payments.<sup>23</sup> This includes all ACTC claims for which the IRS disallowed some portion of the ACTC regardless of whether there was a change to the CTC. We estimate that the improper payment rate for only those ACTC claims for which no reclassification to the CTC<sup>24</sup> occurred is 13.5 percent, resulting in an estimated \$3.2 billion in potential improper payments.<sup>25</sup>
- Potential estimated AOTC improper payment rate for Fiscal Year 2015 of 30.7 percent, resulting in an estimated \$1.8 billion in potential AOTC improper payments.<sup>26</sup>

However, despite the IRS's own enforcement data, the IRS continues to determine the risk of improper ACTC and AOTC payments as low. Our computation of estimated improper payments for the ACTC and AOTC shows that both exceed the IPERA criteria for a significant risk of improper payments. Per the IPERA, any program that has gross annual improper payments that a) exceed both 1.5 percent of program outlays and \$10 million of all program or activity payments or b) exceed \$100 million at any percent of program outlays is considered as having significant risk.

**TIGTA methodology to compute potential ACTC and AOTC improper payments**

To compute the potential estimated improper rate for the ACTC and AOTC, we used the same data sources and methodologies to the extent possible that the IRS uses to estimate the EITC improper payment rate. For example, we used the results of the IRS's NRP 1040 Study for Tax Year 2011, which is the same study the IRS used to estimate the Fiscal Year 2015 EITC improper payment rate. In addition, we computed the estimated amount of potential ACTC and AOTC improper payments by applying our estimate of the potential improper payment rate to the OMB budget estimates that are consistent with the budget estimates used by the IRS to compute Fiscal Year 2015 EITC improper payments. Figure 5 shows the methodology we used to estimate the potential ACTC and AOTC improper payment rates for Fiscal Year 2015.

<sup>23</sup> We estimate that the potential ACTC improper payment rate for Fiscal Year 2015 is between 21.0 percent and 27.4 percent and the potential improper payment dollars is between \$4.9 billion and \$6.4 billion.

<sup>24</sup> A reclassification of the ACTC to the CTC occurs when, as a result of an audit, the IRS determines that the taxpayer could have claimed more CTC and should have claimed less ACTC.

<sup>25</sup> We estimate that the potential improper payment rate for cases with no reclassification to CTC is between 10.4 percent and 16.6 percent and the potential improper payment dollars is between \$2.4 billion and \$3.9 billion.

<sup>26</sup> We estimate that the potential AOTC improper payment rate for Fiscal Year 2015 is between 26.1 percent and 35.3 percent and the potential improper payment dollars is between \$1.6 billion and \$2.1 billion.



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**Figure 5: Methodology Used to Compute the Potential ACTC and AOTC Improper Payment Rate for Fiscal Year 2015**

<b>Potential Improper Payment Rate</b>	=	<b><u>Improper Payments – Overclaims Recovered</u></b> <b>Total Claims</b>
<p><b>Improper Payments</b> – The difference between the amount of the ACTC or AOTC claimed by the taxpayer on his or her tax return and the amount the taxpayer should have claimed based on NRP results for Tax Year 2011. This amount includes overclaims and underpayments. This amount totaled \$7.4 billion for the ACTC and \$3.5 billion for the AOTC.</p>		
<p><b>Overclaims Recovered</b> – The amount of ACTC or AOTC overclaims that the IRS prevents from being paid through activities such as math error processing and prerefund examinations or recovers after being paid through Automated Underreporter document matching and post-refund examinations.</p> <p style="padding-left: 40px;"><b>ACTC Overclaims Recovered</b> – This amount was estimated by applying the ratio of EITC overclaims recovered to EITC improper payments from the IRS's Fiscal Year 2015 EITC improper payment rate calculation. Using the EITC overclaims recovered ratio of 14.5 percent, we estimated the ACTC overclaims recovered to total \$1.1 billion.</p> <p style="padding-left: 40px;"><b>AOTC Overclaims Recovered</b> – We used data provided by the IRS for the amount recovered through prerefund examinations or recovered through Automated Underreporter document matching and post-refund examinations. AOTC overclaims recovered total \$335 million.</p>		
<p><b>Total Claims</b> – The amount of the ACTC or AOTC claimed on all tax returns based on the NRP results for Tax Year 2011. This amount totaled just less than \$26.0 billion for the ACTC and \$10.2 billion for the AOTC.</p>		
<b>Potential Improper Payment Dollars</b>	=	<b>Estimated Claims X</b> <b>Potential Improper Payment Rate</b>
<p><b>Estimated Fiscal Year 2015 Improper Payment Dollars</b> – This amount was computed by multiplying the estimated Improper Payment Rate by the estimate of total claims for that year.</p> <p style="padding-left: 40px;"><b>ACTC</b> – The estimate of ACTC Fiscal Year 2015 improper payments is \$5.7 billion.</p> <p style="padding-left: 40px;"><b>AOTC</b> – The estimate of AOTC Fiscal Year 2015 improper payments is \$1.8 billion.</p>		

*Source: TIGTA analysis of Tax Year 2011 1040 NRP ACTC and AOTC data and the IRS's calculation of the Fiscal Year 2015 EITC improper payment rate.*

**Actions are being taken in response to TIGTA's continued identification of the high risk associated with ACTC improper payments**

The IRS was aware that the risk of ACTC improper payments was high and met required IPERA reporting before it completed the Fiscal Year 2015 risk assessment and once again rated the risk



***Without Expanded Error Correction Authority, Billions of Dollars in Identified Potentially Erroneous Earned Income Credit Claims Will Continue to Go Unaddressed Each Year***

of improper payments relating to the ACTC as low. In September 2014<sup>27</sup> and again in April 2015,<sup>28</sup> we reported that our analysis of IRS enforcement data indicates that the risk of ACTC improper payments is high. We estimated that the ACTC improper payment rate for Fiscal Year 2013 was between 25.2 percent and 30.5 percent, with potential improper ACTC payments totaling between \$5.9 billion and \$7.1 billion.

The IRS informed us that it is currently re-evaluating the improper payment risk assessment process for the ACTC. The IRS has assembled a cross-functional team of subject matter experts who have responsibility for administering the ACTC along with experts on internal control reviews and risk assessment and management. This team is exploring ways to revise the qualitative risk assessment process to more accurately address the risk associated with the ACTC. As such, the resulting assessment will incorporate an operational point of view when evaluating the risk. This approach differs from the IRS's reliance on only the existing Risk Assessment Questionnaire provided by the Treasury. The IRS is revising the Risk Assessment Questionnaire to include more program-related questions to better reflect IRS business processes and truly assess the risk of improper payments for refundable credits. According to IRS management, the cross-functional team completed a draft questionnaire and submitted it to IRS management for review and approval. Time frames for approval of this questionnaire and assessing risk based on the new questionnaire have not been determined.

Although the IRS is revising the risk assessment process for the ACTC, the IRS is not including a quantitative assessment for ACTC improper payment risk. Without a quantitative assessment of IRS compliance data, we believe that the IRS will be unable to effectively assess the improper payment risk for the ACTC and other refundable tax credits.

***IRS concerns relating to the computation of AOTC improper payment rate and amount***

When we provided our estimate of the potential AOTC improper payments to IRS management, the IRS raised the following concerns related to our estimate:

- ***A comparison of Tax Year 2011 AOTC claims to Fiscal Year 2015 expenditures and outlays should not be performed.***

When the IRS projects the total claims for the EITC, it adjusts the total income tax expenditures and outlays from the *Analytical Perspectives, Budget of the United States Government*, upwards to reflect that these amounts likely understate the amount of credit initially claimed on filed tax returns. IRS management stated that looking at the historical relationship between AOTC tax year claims and Analytical Perspectives fiscal

<sup>27</sup> TIGTA, Ref. No. 2014-40-093, *Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments* (Sept. 2014).

<sup>28</sup> TIGTA, Ref. No. 2015-40-044, *Assessment of Internal Revenue Service Compliance With the Improper Payment Reporting Requirements in Fiscal Year 2014* (Apr. 2015).



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year expenditures plus outlays, they were not sure they would calculate an upwards adjustment for the AOTC in the same manner they calculate the adjustment for the EITC. To address the IRS's concerns, our estimate of AOTC improper payments does not include an upwards adjustment.

- **The AOTC improper payment dollar estimate should not be limited to only the refundable portion of the credit.**

The maximum amount of the AOTC credit is up to \$2,500 per student, with the first 40 percent of qualified expenses refundable up to \$1,000. The remaining credit is nonrefundable. The IRS indicated that our calculation of the AOTC improper payment dollar estimate should also include the nonrefundable portion of the AOTC. This position is in direct contrast with the methodology we used and with which the IRS agreed provided an accurate assessment of estimated ACTC improper payment dollars.

In addition, the refundable portion of the AOTC credit represents an outlay to the Government because it is paid in excess of a taxpayer's liability. The IPERA defines significant improper payments as the total amount of overpayments plus underpayments made in the program during the fiscal year reported that a) exceeded both 1.5 percent of program outlays and \$10 million of all program or activity payments or b) exceeded \$100 million at any percent of program outlays. As such, we believe it is appropriate to apply the estimated improper payment rate to only the AOTC outlays.

### ***Recommendations***

The Chief Financial Officer and the Commissioner, Wage and Investment Division, should ensure that:

**Recommendation 1:** The revised ACTC improper payment risk assessment process includes a quantitative assessment for the ACTC improper payment risk using available NRP and enforcement data.

**Management's Response:** The IRS agreed with this recommendation. At the time of this audit, the IRS had already begun to revise the ACTC payment error risk assessment. When complete, the IRS agreed that the updated assessment would better reflect the inherent risks in administering refundable credits through the tax system.

**Recommendation 2:** The results of the AOTC improper payment risk assessment accurately reflect the high risk associated with AOTC payments. Completion of the AOTC improper payment risk assessment should include a quantitative assessment of the AOTC improper payment risk using available NRP and enforcement data.

**Management's Response:** The IRS agreed with this recommendation. The AOTC payment error risk assessment is also under revision. Once completed, the IRS agrees it will better reflect the inherent risks in administering refundable credits through the tax





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system. As noted in the IRS's response, the IRS will analyze NRP data, but this analysis will take place independent of the risk assessment process.

***Interagency Efforts Are Underway to Establish a Process to Evaluate Premium Tax Credit Improper Payment Risk***

As we previously reported, the IRS is not solely responsible for administering the PTC. The Department of Health and Human Services Centers for Medicare and Medicaid Services oversees implementation of certain Affordable Care Act provisions related to the Exchanges. For example, the Exchanges have sole responsibility for determining if an individual is eligible to purchase health insurance through the Exchange as well as determining the amount of the APTC the taxpayer is eligible to receive. The IRS is responsible for determining the amount of the PTC a taxpayer is entitled to receive. The ACA requires all individuals for whom APTC payments were made to an insurer to file a tax return to reconcile the APTC with the actual PTC they are entitled to receive based on the income and family size reported on their tax return. The IRS must also ensure that individuals who are entitled to an additional PTC amount receive it and those who received more PTC than they were entitled to receive repay the excess. Because the IRS and the Department of Health and Human Services are jointly responsible for the administration of the PTC, improper PTC payments can result from weaknesses in either agency's programs. As a result, the IRS cannot effectively assess the risk of PTC improper payments, estimate the improper payment rate and dollars, or establish corrective actions to address the causes of and reduce improper PTC payments on its own.

The OMB established an interagency working group in Fiscal Year 2015 that includes representatives from the IRS, Treasury, and the Department of Health and Human Services Centers for Medicare and Medicaid Services. The group was established as a collaborative effort to develop an assessment of improper payment risk across all payments made from the PTC budget fund account. The working group is conducting a comprehensive review of the PTC. The working group's goals include creating a consistent definition of an improper PTC payment; establishing policies, procedures, and tools that will allow the IRS to meet the necessary improper payment reporting requirements; and calculating an improper payment error rate for the PTC. In order to assist with these goals, the IRS and the Centers for Medicare and Medicaid Services have contracted with the same Federally Funded Research and Development Center (FFRDC). The FFRDC is currently assisting the IRS in developing a risk assessment process designed to facilitate interagency coordination and provide a comprehensive assessment of risk that takes into account activities by the Exchanges, the Department of Health and Human Services, and the IRS. According to the IRS, an update of the status and preliminary results of the comprehensive PTC risk assessment will be reported in the Fiscal Year 2016 Agency Financial Report.

We will continue to evaluate the interagency working group's progress in developing a methodology for evaluating the PTC improper payment risk.



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## Appendix I

### ***Detailed Objective, Scope, and Methodology***

The overall objective of this review was to determine whether the IRS complied with the annual improper payment reporting requirements for Fiscal Year<sup>1</sup> 2015. This review evaluated the IRS's compliance with the reporting requirements contained in the IPERA of 2010;<sup>2</sup> Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*;<sup>3</sup> and the IPERIA of 2012.<sup>4</sup> The scope of this review included an assessment of the information that the IRS provided for inclusion in the *Department of the Treasury (Treasury) Agency Financial Report Fiscal Year 2015*. To accomplish our objective, we:

- I. Reviewed the *Department of the Treasury Agency Financial Report Fiscal Year 2015* published on November 16, 2015, to determine if the IRS was in compliance with the improper payment reporting requirements for Fiscal Year 2015. We compared the information contained in the Agency Financial Report to the improper payment reporting requirements outlined in the OMB Circular A-123, *Management's Responsibility for Internal Control*, guidance on improper payment reporting.
  - A. Determined if the IRS was in compliance with IPERA reporting requirements.
  - B. Determined if the IRS was in compliance with IPERIA reporting requirements.
  - C. Determined if the IRS was in compliance with Executive Order 13520 reporting requirements.
  - D. Reviewed information that the IRS provided to the Treasury for posting to the paymentaccuracy.gov website.
  - E. Determined if the information included in Fiscal Year 2015 Treasury Agency Financial Report relative to EITC improper payments accurately reflects the underlying information from the IRS and was posted to paymentaccuracy.gov or other Internet locations as required.

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

<sup>2</sup> Pub. L. No. 111-204, 124 Stat. 2224.

<sup>3</sup> Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs* (November 20, 2009).

<sup>4</sup> Pub. L. No. 112-248, 126 Stat. 2390.



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- II. Assessed the accuracy of the IRS's computation of the EITC improper payment rate and dollar amount.
  - A. Determined if the IRS revised the methodology used to compute the EITC improper payment rate and/or dollar amount since Fiscal Year 2014.
  - B. Determined if the IRS revised the methodology used to compute the EITC supplemental measures for FY 2015.
- III. Evaluated the adequacy of the IRS's risk assessments of the Treasury-identified revenue program funds.
  - A. Ensured that the required Risk Assessment Questionnaire was completed for each revenue program fund and identified the risk level for each.
  - B. Determined the potential ACTC improper payment rate for Fiscal Year 2015. We ensured that the IRS determination of improper payment risk is consistent with the potential improper payment rate. We used data from the IRS's NRP 1040 Study for Tax Year<sup>5</sup> 2011 and the OMB budget report and compiled the data needed to update the ACTC improper payment rate for Fiscal Year 2015.
    - 1. Used the contract statistician to compute the potential ACTC improper payment rate using the same methodology used to compute the Fiscal Year 2013 estimated improper payment rate.
    - 2. Using the same methodology as was used for Fiscal Year 2013, computed the total potential ACTC improper payment amount for Fiscal Year 2015.
  - C. Determined the potential AOTC improper payment rate for Fiscal Year 2015. We ensured that the IRS determination of improper payment risk is consistent with the potential improper payment rate. We used data from the IRS's NRP 1040 Study for Tax Year 2011 and the OMB budget report and compiled the data needed to update the AOTC improper payment rate for Fiscal Year 2015.
    - 1. Used the contract statistician to compute the potential AOTC improper payment rate by identifying the claims for the AOTC that were partially or fully disallowed by the IRS in the NRP study of Tax Year 2011 returns and computed the potential improper payment rate for Fiscal Year 2015.
    - 2. Identified the claims for the AOTC that were partially or fully disallowed by the IRS in the NRP study of Tax Year 2011 returns and computed the potential improper payment amount for Fiscal Year 2015.

<sup>5</sup> 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.



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- IV. Evaluated the IRS's efforts to evaluate the risk of PTC improper payments.
- A. Obtained information regarding the OMB interagency working group's progress on defining PTC improper payments and assessing their risk including the timeline for finalizing the definition and assessing risk based on that definition.
  - B. Determined the steps the IRS took to assess the risk of PTC improper payments for Fiscal Year 2015 including the risk of improper APTC payments. We determined if the process used provided a reasonable assessment of the risk of improper PTC payments for Fiscal Year 2015.
  - C. Evaluated the qualitative assessment of all refundable credits, specifically the processes used to assess the PTC.
    - 1. Evaluated the risk assessment being conducted by the FFRDC by identifying the scope of work and specific requirements that the FFRDC will provide to the IRS.
    - 2. Determined the extent of the IRS collaboration with the Department of Health and Human Services Centers for Medicare and Medicaid Services on the FFRDC project.
    - 3. Determined how the IRS, the Department of Health and Human Services Centers for Medicare and Medicaid Services, and the Treasury plan to use the results of the FFRDC assessment to define and quantify PTC improper payments.

**Data validation methodology**

During this review, we relied on data received from the IRS for the NRP on the ACTC, the AOTC, and the EITC for Tax Year 2011. We also obtained extracts from the IRS's Individual Master File<sup>6</sup> and Returns Transaction File<sup>7</sup> databases for Processing Years<sup>8</sup> 2014 and 2015 that were available on the TIGTA's Data Center Warehouse.<sup>9</sup> Before relying on the data, we ensured that each file contained the specific data elements we requested. In addition, we selected random samples of each extract and verified that the data in the extracts were the same as the data captured in the IRS's Integrated Data Retrieval System.<sup>10</sup> We also performed analysis to ensure the validity and reasonableness of our data such as ranges of dollar values, transaction dates, and tax periods. Based on the results of our testing, we believe that the data used in our review were reliable.

<sup>6</sup> The Individual Masterfile is an IRS database that maintains transactions or records of individual tax accounts.

<sup>7</sup> An IRS database containing transcribed tax returns for individuals that includes most forms and schedules.

<sup>8</sup> The calendar year in which the tax return or document is processed by the IRS.

<sup>9</sup> A TIGTA repository of IRS data.

<sup>10</sup> IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



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**Internal controls methodology**

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



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**Appendix II**

***Major Contributors to This Report***

Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account  
Services)  
Deann L. Baiza, Director  
Kathleen A. Hughes, Audit Manager  
J. Edmund Carr III, Lead Auditor  
Linda M. Valentine, Senior Auditor



***Without Expanded Error Correction Authority, Billions of Dollars in Identified Potentially Erroneous Earned Income Credit Claims Will Continue to Go Unaddressed Each Year***

Appendix III

***Report Distribution List***

Commissioner  
Office of the Commissioner – Attn: Chief of Staff  
Deputy Commissioner for Operations Support  
Deputy Commissioner for Services and Enforcement  
Commissioner, Wage and Investment Division  
Director, Office of Legislative Affairs  
Director, Office of Program Evaluation and Risk Analysis  
Director, Office of Research  
Director, Office of Research, Analysis, and Statistics  
Director, Return Integrity and Compliance Services, Wage and Investment Division  
Director, Office of Audit Coordination

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Appendix IV

***Treasury Inspector General for Tax Administration  
Audit Reports on Improper Payments***

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

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

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

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

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

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

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

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





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Appendix V

**Internal Revenue Service Programs Identified for Improper Payment Risk Assessments**

The following IRS programs were identified by the Department of the Treasury for improper payment risk assessments for Fiscal Year 2015.

IRS Program	Type of Program	Level of Risk Identified
Affordable Health Care Program	Administrative	Low
Business Systems Modernization	Administrative	Low
Tax Law Enforcement	Administrative	Low
Taxpayer Services	Administrative	Low
Adoption Credit	Revenue	Low
Alternative Minimum Tax Credit Refunds	Revenue	Low
American Opportunity Credit	Revenue	Low
Build America Bonds	Revenue	Low
Child (Tax) Credit Payments	Revenue	Low
Corporation Tax Credit Refunds	Revenue	Low
EITC Disbursements <sup>1</sup>	Revenue	High
Health Care Credit Payments	Administrative	Low
Information System	Administrative	Low
Informant Reimbursement	Revenue	Low
New Clean Renewable Energy Bonds	Revenue	Low
Premium Assistance Credit	Revenue	Medium
Qualified Energy Conservation Bond	Revenue	Low
Qualified Zone Academy Bonds	Revenue	Low
Qualified School Construction Bonds	Revenue	Low
Refund Collection	Revenue	Low
Refund Collection – Interest	Revenue	Low
Small Business Health Insurance Tax Credit	Revenue	Low

Source: IRS Office of the Chief Financial Officer.

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

Appendix 2  
TIGTA's Assessment of IRS's Compliance With the Improper Payment Reporting  
Requirements in Fiscal Year 2015



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Appendix VI

***Management's Response to the Draft Report***



CHIEF FINANCIAL OFFICER

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

April 21, 2016

MEMORANDUM FOR MICHAEL E. MCKENNEY  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

Ursula S. Gillis *Ursula S. Gillis*  
Chief Financial Officer

SUBJECT:

Draft Audit Report - Without Expanded Error Authority,  
Billions of Dollars in Identified Potentially Erroneous Earned  
Income Credit Claims Will Continue to Go Unaddressed  
Each Year (Audit #201640001)

We have reviewed your draft audit report titled, "Without Expanded Error Authority, Billions of Dollars in Identified Potentially Erroneous Earned Income Credit Claims Will Continue to Go Unaddressed Each Year." I was pleased that the report continues to acknowledge the challenges the IRS faces in administering the Earned Income Tax Credit (EITC) program. Your audit properly recognizes that many of the EITC payment errors are related to the structure of the program and additional IRS authorities provided by the Congress, including expanded error correction authority, would help us to better address erroneous EITC claims. This is also true for the Additional Child Tax Credit (ACTC) and the American Opportunity Tax Credit (AOTC).

The IRS continues to work with the Department of the Treasury, which supports expanded error correction authority as well as other legislative changes beyond those recently provided in the Consolidated Appropriations Act of 2016 that will help us improve compliance and reduce overclaims related to refundable credits. We agree with you about the importance of properly accounting for payments made through the tax system for such useful benefits for the EITC, ACTC, and AOTC. We continue to use every tax administration tool and technique available to us as well as vigorously explore additional data sources and partners to verify claim eligibility, deter overclaims, and reduce payment errors. Without additional authorities granted to us by Congress, our ability to reduce payment errors in benefit programs administered through the tax system remains extremely challenging.

Your report properly states the qualitative risk assessment the IRS uses to assess the risk of improper payments complies with Office of Management and Budget (OMB) guidance and continues to find payment errors associated with the ACTC and the AOTC as low risk. This is an important distinction. While the dollar value of estimated improper payments may exceed the threshold established by IPERA and related

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legislation, these errors are driven by the way these programs were structured in the laws passed by Congress. The Treasury Inspector General for Tax Administration (TIGTA), Government Accountability Office (GAO), and OMB have all acknowledged that payment errors for these programs are attributable to the statutory design of the credits within the tax system, and not rooted in internal control weaknesses, financial management deficiencies, or financial reporting failures.

The IRS began taking steps in late FY 2015 to improve the risk assessment process for the refundable tax credits. As part of that effort, we are continuing to evaluate the risk assessments and identify opportunities to make them more robust. Additionally, we are planning to conduct analyses of National Research Program (NRP) data, which will be taking place independent of the risk assessment process. At the same time, however, without legislative changes, there is little that the IRS can do to reduce payment errors in refundable tax credits. This is demonstrated by our EITC experience. Despite years of studies, audits, and considerable investment of resources in reporting, analyses, development of supplemental measures, and other activities, the estimated EITC improper payment rate has remained relatively constant. Unfortunately, this experience tells us that implementing TIGTA's recommendations will provide little, if any, additional insight on how to reduce the error rates.

This is one of the reasons why, in March 2014, OMB agreed with the Department of the Treasury that the IRS could estimate noncompliance related to non-EITC refundable credits as part of the tax gap estimation process, and report on it in the Agency Financial Report (AFR) under income tax burden and tax gap. This context and treatment allows for the appropriate resource focus within the IRS's compliance strategy. Otherwise, we would have to divert a disproportionate amount of resources to refundable credits away from higher compliance risks at a considerable opportunity cost.

In your report, you used data from our NRP to calculate estimates of potential improper payment rates for ACTC and AOTC. While we agree that your mathematical calculations are correct, your methodology differs from the approach used to calculate the EITC improper payment rate. The EITC methodology estimates a rate for the entire amount of the credit, not just the portion of the refundable credit that is considered to be an outlier. The IRS and Treasury are currently working with OMB on a process for consistent compliance analytics for other refundable credits, beyond those for EITC, in the AFR within the existing section on income tax burden and tax gap, under a new subsection for refundable credits.

We will continue to evaluate our internal controls through risk assessments, currently under revision to better reflect the inherent challenges in administering refundable credits through the tax system, and through reviews of existing legislative proposals in an effort to determine whether we need to expand them to address other

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noncompliance related to these credits. In addition, we plan further NRP analyses of ACTC and AGTC errors, and plan to develop supplemental measures that will help us monitor our progress in addressing them. Our existing strategies to mitigate risks are already evolving based on recent legislation and our experience. As we have with the EITC, we continuously explore other data sources and partners to reduce payment error rates.

Our comments to your recommendations are addressed in the attached document. If you have any questions, please contact me at (202) 317-6400, or a member of your staff may contact John Pekarik, Associate Chief Financial Officer for Corporate Planning and Internal Control, at (202) 803-9151.

Attachment



***Without Expanded Error Correction Authority, Billions of  
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Attachment

The Chief Financial Officer and the Commissioner, Wage and Investment (W&I) Division should ensure that:

**RECOMMENDATION 1**

The revised ACTC improper payment risk assessment process includes a quantitative assessment for ACTC improper payment risk using available NRP enforcement data.

**CORRECTIVE ACTION**

At the time of this audit, the IRS had already begun to revise the ACTC payment error risk assessment. When complete, we agree that the updated assessment will better reflect the inherent risks in administering refundable credits through the tax system.

**IMPLEMENTATION DATE**

July 31, 2016

**RESPONSIBLE OFFICIAL**

Ken Corbin, Director W&I Return Integrity and Compliance Services (RICS)

**RECOMMENDATION 2**

The results of the AOTC improper payment risk assessment accurately reflect the high risk associated with AOTC payments. Completion of the AOTC improper payment risk assessment should include a quantitative assessment of AOTC improper payment risk using available NRP and enforcement data.

**CORRECTIVE ACTION**

The AOTC payment error risk assessment is also under revision, which, once completed, we agree will better reflect the inherent risks in administering refundable credits through the tax system. As noted in our response letter, the IRS will analyze NRP data but this analysis will take place independent of the risk assessment process.

**IMPLEMENTATION DATE**

July 31, 2016

**RESPONSIBLE OFFICIAL**

Ken Corbin, Director W&I Return Integrity and Compliance Services (RICS)



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C.  
MAY 13, 2016

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

**FROM:** Brodi L. Fontenot  
Assistant Secretary for Management

Dorrice Roth  
Deputy Chief Financial Officer

**SUBJECT:** Management Response to Draft Report – Treasury was not in  
Compliance with IPERA for Fiscal Year 2015 Due to High Improper  
Payment Rate for the Earned Income Tax Credit Program

We have reviewed the subject draft report and appreciate the opportunity to respond. Treasury recognizes the importance of achieving full compliance with IPERA, which includes complying with the government-wide implementation guidance issued by the Office of Management and Budget (OMB) in Memorandum M-15-02, Appendix C to Circular No. A-123, *Requirements for the Effective Estimation and Remediation of Improper Payments*, and OMB Circular A-136, *Financial Reporting Requirements*. Last year, Treasury worked diligently to implement the Office of Inspector General (OIG) FY 2014 recommendations.

During FY 2016, the IRS continues to work with Treasury on expanded error correction authority as well as other legislative changes beyond those recently provided in the Consolidated Appropriations Act of 2016 that will help improve compliance and reduce overclaims related to refundable credits. According to the Treasury Inspector General for Tax Administration's report, without expanded error correction authority, IRS will not be able to prevent the issuance of billions of dollars in improper EITC payments.

During FY 2015, Treasury and IRS began taking steps to improve the risk assessment process for the refundable tax credits. As part of that effort IRS is continuing to evaluate the risk assessments and evaluate and identify opportunities to make them more robust.

Treasury will continue improve upon its annual IPERA guidance to facilitate bureaus and offices' submission of the necessary improper payments information that Treasury will then report in the Agency Financial Report (AFR) in accordance with OMB requirements.

Attached are our corrective actions in response to your recommendations. If you have any questions, please let us know, or your staff may contact Toya Craig, Assistant Director, Risk and Control Group (RCG), at (202) 622-0935.

Attachment

Attachment

**Recommendation 1:**

We recommend the Assistant Secretary for Management ensure that:

1. Treasury update its IPERA guidance to clarify the reporting
2. The Risk and Control Group strengthen its review and oversight of the data reported by components on payment recapture audits to accurately reflect the results of recapture audits.

**Corrective Action 1:** Management agrees with this recommendation. Treasury intends to reinforce and enhance the current department-wide guidance concerning disposition of recaptured improper payments. Consistent with the recommendation, Management will continue to ensure that recaptured improper payments are disposed of in accordance with OMB Circular No. A-123, Appendix C requirements.

**Implementation Date:** September 30, 2016

**Responsible Official:** Assistant Secretary for Management

**Recommendation 2:**

We recommend the Assistant Secretary for Management works with IRS as necessary to ensure TIGTA's recommendations related to the ACTC and AOTC improper payments risk assessment processes are implemented, and appropriate action is taken to report on and reduce improper payments associated with these refundable tax credit programs.

**Corrective Action 2:** Management agrees with this recommendation. During FY 2015, Treasury and IRS began taking steps to improve the risk assessment related to the Additional Child Tax Credit (ACTC) and the American Opportunity Tax Credit (AOTC).

**Implementation Date:** November 15, 2016

**Responsible Official:** Assistant Secretary for Management

Appendix 4  
Major Contributors to this Report

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James Hodge, Director, Financial Statement and Procurement Audits  
Catherine Yi, Audit Manager  
Kenneth Harness, Auditor-in-Charge  
Rufus Etienne, Auditor  
Robert Hong, Auditor  
Gerald Kelly, Referencer  
Shiela Michel, Referencer



**The Department of the Treasury**

Secretary of the Treasury  
Deputy Secretary of the Treasury  
Assistant Secretary for Management  
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



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