Letter Report: The Internal Revenue Service Effectively Implemented a Tax Law that Disqualified Certain Taxpayers from the Earned Income Tax Credit

May 2000

Reference Number: 2000-30-076

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

May 17, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

Pamela J Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Letter Report – The Internal Revenue Service Effectively Implemented a Tax Law that Disqualified Certain Taxpayers from the Earned Income Tax Credit

This report presents the results of our review of the Internal Revenue Service's (IRS) implementation of a tax law that disqualified certain taxpayers from the Earned Income Tax Credit (EITC). The overall objective of this audit was to evaluate the effectiveness of the IRS' corrective actions taken to fully implement the tax law that disqualified certain taxpayers with rental or royalty income from receiving the EITC. To accomplish the objective, we evaluated the effectiveness of efforts to recover erroneous EITC refunds for Tax Year 1996 and evaluated the effectiveness of efforts to prevent further erroneous EITC refunds.

In summary, the IRS took effective corrective actions in response to a prior report titled, *1997 Tax Season On-Line* (Reference Number 081106, dated January 16, 1998). Specifically, the IRS has now effectively implemented tax law changes that disqualified certain taxpayers with rental or royalty income from receiving the EITC, and has completed a recovery program for prior year refunds sent in error. The actions taken not only resulted in over $20 million in protected/increased revenue, but also seem to have educated taxpayers to the new law.

IRS management agreed with the benefits and conclusions outlined in this report. Management's comments have been incorporated into the report where appropriate, and the full text of their comments is included as an appendix.

Copies of this report are also being sent to the appropriate IRS managers. Please contact me at (202) 622-6510 if you have any questions, or your staff may call Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

Objective and Scope

Our objective was to evaluate the effectiveness of corrective actions taken to fully implement the tax law that disqualified certain taxpayers from receiving the EITC.

The objective of this audit was to evaluate the effectiveness of Internal Revenue Service (IRS) corrective actions taken to fully implement the tax law that disqualified certain taxpayers with rental or royalty income from receiving the Earned Income Tax Credit (EITC).[1] To accomplish the objective, we:

- Evaluated the effectiveness of efforts to recover erroneous EITC refunds for Tax Year (TY) 1996.
- Evaluated the effectiveness of efforts to prevent erroneous EITC refunds.

The audit work was conducted at the Brookhaven IRS Center from November 1999 through February 2000 in accordance with *Government Auditing Standards*. The scope was limited to an evaluation of the corrective actions taken in response to a prior audit report.[2]

Major contributors to this report are listed in Appendix I. Appendix II contains the Report Distribution List.

Background

Taxpayers were disqualified from the EITC if their net rental and royalty income combined with other disqualified income exceeded a dollar level set each year.

In a prior audit report, we stated that the IRS had not implemented a provision of law that disqualified certain taxpayers from receiving the EITC. Specifically, this law disqualified taxpayers from receiving the EITC if their net rental and royalty income, combined with other disqualified income, exceeded a dollar level set each year. In response to the report, Customer Service

[1] This tax law provision was included in the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193, 110 Stat. 2352.
[2] The audit report was titled, *1997 Tax Season On-Line* (Reference Number 081106, dated January 16, 1998).

Compliance management initiated a program to recover refunds issued in error for TY 1996. Forms and Submission Processing management planned to install systemic checks to prevent such refunds in future years.

Results

The IRS took effective corrective actions needed to implement tax law changes for the EITC.

The IRS took effective corrective actions needed to implement tax law changes for the EITC. The IRS substantially completed its recovery efforts for TY 1996 by assessing taxpayers for erroneous refunds received when the systemic checks for rental/royalty income were not in place. The IRS also effectively installed systemic checks beginning with TY 1997 to prevent the issuance of refunds of the EITC when taxpayers' rental or royalty income exceeded the allowable limits for the EITC eligibility.

Management assessed and prevented $20.1 million in erroneous EITC for TYs 1996 to 1998.

Management's corrective actions resulted in about $8.9 million in assessments of erroneous refunds of EITC issued for TY 1996. Further, these actions prevented about $11.2 million in erroneous EITC refunds for TYs 1997 and 1998.

The IRS' actions have been very effective in educating taxpayers to the new law.

Also, we believe that the IRS' actions have been very effective in educating taxpayers to the new law. IRS statistics show that, for TYs 1996 to 1998, 10,719 fewer ineligible taxpayers with rental or royalty income claimed the EITC. Erroneous EITC claims from these taxpayers decreased from $8.9 million to $3.7 million (58 percent) during the same period.

The Internal Revenue Service Effectively Completed a Project to Recover Erroneous Earned Income Tax Credit Refunds from Tax Year 1996

In response to the prior audit report, Customer Service Compliance management initiated a program to recover refunds issued in error for TY 1996. The refunds were issued because systemic checks were not in place to prevent them. The IRS had not implemented a tax law provision that disqualified taxpayers from receiving the EITC when their rental/royalty income combined with other disqualified income exceeded specified levels.

In this review, auditors found that the IRS effectively completed the recovery project for erroneous TY 1996 refunds.

In the current review, auditors found that the IRS effectively completed the recovery project for erroneous TY 1996 refunds. To accomplish the recovery program, Customer Service Compliance personnel used a listing supplied by the Treasury Inspector General for Tax Administration of potential erroneous refunds identified in the prior review.

The following is a hypothetical example of a refund issued in error and subsequent assessment to recover the EITC portion of the refund. Assuming a taxpayer had net rental income of $3,000 and filed a 1996 tax return claiming the EITC of $1,000 and a total refund of $1,500, the IRS would have originally allowed the taxpayer the full refund, including the EITC. Later, during its recovery effort, the IRS would have assessed the taxpayer to recover the EITC amount ($1,000) because the taxpayer's net rental income of $3,000 exceeded the $2,200 limit for disqualified income.

As of January 21, 2000, Customer Service Compliance had substantially completed its program to recover the erroneous refunds. It reviewed 7,396 tax returns and assessed $8.9 million to recover erroneous refunds issued for TY 1996. By applying a screening procedure, the cases were completed in less than one hour each, with an average assessment of $1,210.

The Internal Revenue Service Effectively Installed Systemic Checks to Prevent Erroneous Earned Income Tax Credit Refunds Starting with Tax Year 1997

In the prior review, auditors reported that tax law changes were not implemented to prevent ineligible taxpayers from receiving the EITC. Because systemic checks were not in place to prevent them, thousands of refunds were issued erroneously to taxpayers.

Auditors found that the IRS effectively installed systemic checks in time for the processing of 1997 individual income tax returns.

In the current review, auditors found that the IRS effectively installed systemic checks in time for the processing of 1997 individual income tax returns. This prevented the issuance of erroneous refunds for TYs 1997, 1998 and beyond. Computer programs were updated to ensure that taxpayers did not receive erroneous EITC refunds when their rental/royalty income exceeded the level set for the tax year.

For TYs 1997 and after, when a taxpayer claims the EITC and his/her net rental/royalty income combined with other disqualified income exceeds the limit set for that tax year (e.g., $2,250 for 1997), the following steps are usually taken:

- An IRS tax examiner recomputes the disqualified income to determine if it exceeds the disqualified income limit.
- The tax examiner either allows the EITC if disqualified income is under the limit, or disallows it if it exceeds the limit by entering a code to the computer system.
- If the EITC is disallowed, the tax examiner enters another code to generate an explanatory notice to be mailed to the taxpayer.

For 1997 and 1998 tax returns, the IRS prevented $11.2 million of erroneous EITC from being refunded to 14,075 ineligible taxpayers. In 94 percent of these cases, the factor placing the taxpayers over the dollar limit was rental income.

The number of taxpayers with rental/royalty income claiming the EITC has also decreased substantially since the IRS installed systemic checks to prevent these EITC refunds. IRS statistics show that, for TYs 1996 to 1998, 10,719 fewer ineligible taxpayers with rental or royalty income claimed the EITC. Erroneous EITC claims from these taxpayers decreased from $8.9 million to $3.7 million (58 percent) during the same period.

Management's Response: IRS management agreed with the benefits and conclusions outlined in this report. Management's complete response to the draft report is included as Appendix IV.

Conclusion

The IRS took effective actions to correct problems described in a prior audit report, resulting in $20.1 million of revenue recovered/protected.

The IRS took effective actions to correct problems reported in the prior audit. The IRS took steps to complete a recovery program for erroneous refunds and to prevent further erroneous EITC refunds to ineligible taxpayers. These actions resulted in a total of $20.1 million in either assessments to recover issued refunds (TY 1996) or prevention of erroneous refunds (TYs 1997 and 1998). Also, the IRS' actions have been very effective in educating taxpayers to the new law, as evidenced by the reduction in erroneous EITC claims.

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Appendix I

Major Contributors to This Report

Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs)
Richard J. Dagliolo, Director
Robert K. Irish, Audit Manager
Philip W. Peyser, Senior Auditor
Carol Gerkens, Auditor

Appendix II

Report Distribution List

Deputy Commissioner (Operations) C:DO
Commissioner, Small Business/Self Employed Division S
Chief Operations Officer OP
Office of the National Taxpayer Advocate C:TA
Assistant Commissioner (Customer Service) OP:C
Assistant Commissioner (Examination) OP:EX
Assistant Commissioner (Forms and Submission Processing) OP:FS
Director, Office of Program Evaluation and Risk Analysis M:OP
National Director, Customer Service Compliance, Accounts and Quality OP:C:A
National Director for Legislative Affairs CL:LA
Office of Management Controls M:CFO:A:M
Office of Chief Counsel CC
Compliance Branch OP:C:A:CP
Chief, Examination Section OP:C:A:CP:E
TIGTA Liaisons:
- Earned Income Tax Credit Program Office OP
- Customer Service OP:C
- Submission Processing OP:FS:S:Q:S

Appendix III

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended actions from a prior report[1] have had on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Finding #1 and recommendation:
In the prior review, auditors reported that tax law changes were not implemented for Tax Year (TY) 1996 to prevent ineligible taxpayers from receiving the Earned Income Tax Credit (EITC). The current audit found that the Internal Revenue Service (IRS) effectively completed the recovery project for erroneous TY 1996 refunds. To accomplish the recovery project, Customer Service Compliance personnel used a listing supplied by Treasury Inspector General for Tax Administration (TIGTA) of potential erroneous refunds identified in the prior review.

Type of Outcome Measure:
Increased revenue

Value of the Benefit:
Customer Service Compliance reviewed 7,396 tax returns and assessed $8.9 million to recover erroneous refunds issued for TY 1996.

Methodology Used to Measure the Reported Benefit:
We determined the results of assessments made to recover erroneous refunds from TY 1996 by using the Customer Service Compliance report of assessments made (Audit Information Management System Table 35). We verified that the assessments were recorded under the correct program (Project Code 695).

[1] The audit report was titled, *1997 Tax Season On-Line* (Reference Number 081106, dated January 16, 1998).

Finding #2 and recommendation:
The IRS effectively installed systemic checks for the processing of TY 1997 and 1998 individual income tax returns.

Type of Outcome Measure:
Revenue protection

Value of the Benefit:
For TYs 1997 and 1998 tax returns, the IRS prevented $11.2 million of erroneous EITC from being refunded to 14,075 ineligible taxpayers.

Methodology Used to Measure the Reported Benefit:
Using TIGTA computer extracts, we determined the number and dollar amount of erroneous EITC refunds prevented by systemic checks installed for TYs 1997 and 1998. We applied the same screening criteria used by Customer Service Compliance for recovery of TY 1996 erroneous refunds. That is, if they were screened-out for TY 1996, we also omitted them from TY 1997 and 1998 computations. We validated the computer extracts for both years by comparing 50 cases from each listing to IRS records.

We counted only those cases in which the rental/royalty income pushed the disqualified income over the allowable amount, and the taxpayer was issued a notice explaining that he/she did not qualify for the EITC because the disqualified income exceeded the dollar limit. Disqualified income limits were $2,250 for TY 1997 and $2,300 for TY 1998.

Appendix IV

Management's Response to the Draft Report

COMMISSIONER

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

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MAY 0 2 2000
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May 2, 2000

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: for Charles O. Rossotti
Commissioner of Internal Revenue

SUBJECT: Draft Letter Report - The IRS Effectively Implemented a Tax Law that Disqualified Certain Taxpayers from the Earned Income Tax Credit (Audit #200030004)

Thank you for the opportunity to respond to your draft letter report entitled "The IRS Effectively Implemented a Tax Law that Disqualified Certain Taxpayers from the Earned Income Tax Credit (EITC)." We agree with the benefits outlined in your report.

Your report found the IRS has now effectively implemented tax law changes that prevent ineligible taxpayers with rental or royalty income from receiving the EITC. By installing systemic checks, we prevented $11.2 million in EITC refunds from being issued to ineligible taxpayers for tax years 1997 and 1998. In addition, our records show 10,719 (58 percent) fewer taxpayers with rental/royalty income claimed EITC for tax years 1996 to 1998. This change in taxpayer behavior is proof that our efforts to educate the taxpaying public about this new law were successful and resulted in a decrease of $5.2 million in erroneous claims filed.

We also completed a recovery program, initiated by Customer Service Compliance, for 1996 refunds sent in error. They reviewed 7,396 tax returns which resulted in a recovery of $8.9 million. To reduce the cost of the recovery, they developed a screening procedure that allows cases to be completed in less than 1 hour.

Again, thank you for the opportunity to respond to your report. If you have any questions, please contact me or Robert Wilkerson Assistant Commissioner (Customer Service), at (202) 622-5044.