



*Financial Controls Over the Health Coverage  
Tax Credit Advance Payment Process Need  
to Be Enhanced*

**May 2006**

**Reference Number: 2006-10-085**

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

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TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

May 26, 2006

**MEMORANDUM FOR** COMMISSIONER, WAGE AND INVESTMENT DIVISION

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

**SUBJECT:** Final Audit Report – Financial Controls Over the Health Coverage Tax  
Credit Advance Payment Process Need to Be Enhanced  
(Audit # 200510024)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) had established effective controls over advance payments made in connection with the Health Coverage Tax Credit (HCTC) program. We also reviewed selected samples of Tax Year (TY) 2004 HCTC advance payment-related transactions.

*Synopsis*

The HCTC was established by the Trade Adjustment Assistance Reform Act of 2002<sup>1</sup> to help certain displaced workers and certain retirees pay for their health insurance by establishing a tax credit for 65 percent of the premium cost for qualified coverage. The Act also includes a provision that allows for the incremental advance payment of the HCTC by the Department of the Treasury directly to a taxpayer's health plan administrator. The taxpayer is responsible for paying the remaining 35 percent of the health coverage premium. In TY 2005, over \$70 million in advance payments were made on behalf of approximately 22,000 taxpayers who either lost their jobs because of increased imports or for whom pension plans were terminated by former employers due to severe financial difficulties. To participate in the program, individuals must first complete an application attesting to their eligibility and provide a current health coverage invoice.

Generally, adequate procedures and controls have been established to ensure HCTC advance payment amounts are accurate. We analyzed a judgmentally selected sample of 82 taxpayers for

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<sup>1</sup> Pub. L. No. 107-210, 116 Stat. 933 (2002).



## *Financial Controls Over the Health Coverage Tax Credit Advance Payment Process Need to Be Enhanced*

whom advance payments were made in TY 2004 and found the advance payments were consistent with the application information and documentation provided by the taxpayers. Also, taxpayers participating in the advance payment program are notified monthly of the amount and due date of their portion of the health care premium.

The IRS is continually evaluating the advance payment process to identify opportunities for improvement. For example, in September 2005, the IRS implemented a number of systemic improvements to the advance payment program that should allow it to better identify changes in active participants' eligibility status. Also, the IRS has adequately promoted the availability of the advance payment option. Monthly HCTC advance payments made by the Department of the Treasury increased from \$3 million in January 2004 to \$6 million in December 2005. Total annual HCTC advance payments made by the Department of the Treasury similarly increased from \$55 million in TY 2004, the first full year the HCTC advance payment option was available, to over \$70 million in TY 2005.

We did, however, identify three critical areas in which we believe controls over the HCTC advance payment program need to be enhanced. First, controls over the tracking and collection of receivables resulting from advance payments subsequently identified to have been made in error need to be improved. For example, a review of a judgmental sample of 52 taxpayers who received erroneous advance payments identified an average lapse of 479 calendar days between the initial identification of the potentially erroneous payments and the IRS' first contact with the taxpayers to request repayment. The total amount of the receivables associated with the 52 taxpayers was \$73,667.

Second, advance payment program information provided to taxpayers annually for use in preparing their tax returns is confusing and insufficiently detailed to readily support the taxpayers' calculations of any yearend credits they may be due. Also, the instructions for the TY 2005 Health Coverage Tax Credit (HCTC) Advance Payments (Form 1099-H)<sup>2</sup> contained incorrect information regarding key data being reported on the Form. We advised IRS management of our concerns on January 9, 2006; they agreed with our conclusions and prepared a one-page notice for inclusion with Form 1099-H for TY 2005. The notice clarified the information provided on Form 1099-H and included additional instructions regarding how this information should be used in calculating any yearend credit.

Finally, although the advance payment program provided over \$70 million in advance credit payments in TY 2005, the IRS does not have a reliable and comprehensive measure of the accuracy of information provided by taxpayers in connection with their participation in this program. The IRS has evidence suggesting this is a potential tax compliance issue, by virtue of its study of compliance trends relating to taxpayers who claimed the credit in TY 2003. The IRS

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<sup>2</sup> Form 1099-H provides a taxpayer with the total amount of qualified health insurance payments paid in advance to a qualified health insurance coverage provider by the Department of the Treasury on the taxpayer's behalf.



## *Financial Controls Over the Health Coverage Tax Credit Advance Payment Process Need to Be Enhanced*

reviewed returns of 2,284 taxpayers who claimed the yearend credit. These reviews resulted in the IRS adjusting about one-third of the returns, as 773 credits worth \$3 million were partially or wholly denied. Thus, the IRS needs to commit to an ongoing process addressing this compliance issue to ensure all taxpayers claiming the HCTC are properly entitled to and have properly calculated these benefits.

### *Recommendations*

We recommended the Director, HCTC Program, establish general time standards for the processing of advance payment-related receivables and develop an audit trail linking advance payment receivables activity with the HCTC advance payment program taxpayer account ledger.<sup>3</sup> Further, the Director, HCTC Program, should track receivables balances and recovery rates for both erroneous yearend refunds and erroneous advance payments, to aid in assessment of whether a change in the treatment of these types of liabilities is warranted. We also recommended the Director, HCTC Program, revise Form 1099-H instructions for TY 2006 and study the feasibility of providing additional information on Form 1099-H to better assist taxpayers in calculating the yearend credit. Finally, we recommended the Director, HCTC Program, initiate a process providing for routine evaluation of the compliance characteristics of a representative sample of taxpayers receiving the HCTC through the advance payment program.

### *Response*

IRS management agreed with all of our recommendations. A manual process that allows the HCTC Program Office to associate taxpayer receivable records in a subsidiary ledger with the HCTC advance payment program taxpayer accounting ledger has been established. The IRS is also taking the necessary actions to establish general time standards for processing advance payment-related receivables consistent with IRS Examination function guidelines. Additionally, receivables balances and recovery rates for advance erroneous payments are currently tracked in a receivables ledger and are being used to make decisions in the treatment of repayment activities. The IRS has also revised Form 1099-H and its associated instructions to clarify the information provided to taxpayers and is considering seeking the authority to eliminate Form 1099-H entirely. Finally, the IRS will provide for the development of a representative sample of taxpayers receiving advance payments, to evaluate their compliance characteristics. Management's complete response to the draft report is included as Appendix IV.

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<sup>3</sup> The system of records on which HCTC advance payment transaction information is captured, accumulated, and compiled.



*Financial Controls Over the Health Coverage Tax Credit Advance  
Payment Process Need to Be Enhanced*

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*Office of Audit Comment*

In our opinion, eliminating Form 1099-H, as the IRS indicated it is considering, could have an adverse impact on taxpayers' ability to accurately calculate any yearend credit they may be due. Form 1099-H assists taxpayers by summarizing advance HCTC payments made to the taxpayers' health plan administrators. Taxpayers may also claim a credit at yearend for any payments they made directly to their health plan administrators for eligible coverage provided during the tax year.

Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.



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*Financial Controls Over the Health Coverage Tax Credit Advance  
Payment Process Need to Be Enhanced*

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*Table of Contents*

**Background** .....Page 1

**Results of Review** .....Page 2

    Generally, Adequate Controls Have Been Established to Ensure  
    Advance Payment Amounts Are Accurate .....Page 2

    Controls Over the Tracking and Collection of Health Coverage Tax  
    Credit-Related Receivables Need to Be Improved .....Page 3

Recommendations 1 through 3:.....Page 5

    Advance Payment Information Provided to Taxpayers for Use in  
    Preparing Their Tax Returns Is Incomplete and Confusing .....Page 5

Recommendations 4 and 5: .....Page 7

    The Internal Revenue Service Lacks a Reliable and Comprehensive  
    Measure of the Overall Accuracy of Information Provided by  
    Taxpayers in Connection With Their Participation in the Health  
    Coverage Tax Credit Advance Payment Program. ....Page 7

Recommendation 6:.....Page 8

**Appendices**

    Appendix I – Detailed Objective, Scope, and Methodology .....Page 9

    Appendix II – Major Contributors to This Report .....Page 11

    Appendix III – Report Distribution List .....Page 12

    Appendix IV – Management’s Response to the Draft Report .....Page 13



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*Financial Controls Over the Health Coverage Tax Credit Advance  
Payment Process Need to Be Enhanced*

---

## *Background*

The Trade Adjustment Assistance Reform Act of 2002<sup>1</sup> established the Health Coverage Tax Credit (HCTC) to help certain individuals pay for health insurance by establishing a tax credit for 65 percent of the premium cost for qualified coverage. Taxpayers eligible to claim the credit fall into two categories:

- Trade-affected workers who have lost their jobs because of increased imports or a shift in production to another country. These taxpayers are classified as either Trade Adjustment Assistance or Alternative Trade Adjustment Assistance eligible.
- Individuals for whom pensions are being paid by the Pension Benefit Guarantee Corporation because their pension plans were terminated when their former employers went bankrupt or experienced other severe financial difficulties. These individuals must also be at least 55 years of age and not entitled to receive Medicare benefits.

Individuals receive the HCTC in two ways: in advance on a monthly basis or after the end of the year when they file their Federal income tax returns. Individuals are not required to itemize deductions or to owe Federal income taxes to receive the HCTC. The Internal Revenue Service (IRS) provides the end-of-year HCTC to the taxpayer, while any advance payments made by the Department of the Treasury on behalf of the taxpayer are paid to the health plan administrator (HPA) in the form of a premium payment. In Tax Year (TY) 2005, over \$70 million in advance payments were made on behalf of approximately 22,000 taxpayers. For the advance credit, the HCTC program remits payments directly to the HPA after the taxpayer is accepted for enrollment in the program. The credit could first be claimed for the month of December 2002, with TY 2003 being the first full year for the credit. Advance HCTC became available in TY 2003. Individuals receiving the advance HCTC may claim a credit at the end of the year for any months in which they were eligible for the credit but did not receive it in advance.

We conducted our review during the period August 2005 through February 2006 at the HCTC Program Office in Washington, D.C., the IRS Campus<sup>2</sup> in Andover, Massachusetts, and the IRS contractor sites in Reston, Virginia; Houston, Texas; and Waterloo, Iowa. The audit was conducted in accordance with *Government Auditing Standards*. 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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<sup>1</sup> Pub. L. No. 107-210, 116 Stat. 933 (2002).

<sup>2</sup> The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



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*Financial Controls Over the Health Coverage Tax Credit Advance  
Payment Process Need to Be Enhanced*

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*Results of Review*

**Generally, Adequate Controls Have Been Established To Ensure  
Advance Payment Amounts Are Accurate**

Advance payments are paid by the HCTC program directly to the insurer or HPA for individuals selecting the advance payment option. The individual is responsible for paying 35 percent of the health coverage premium, while the Department of the Treasury provides the remaining 65 percent. The HCTC program then disburses the full cost of the health care coverage directly to the insurer or HPA. To participate in the program, individuals must complete an application attesting to their eligibility and provide a current health coverage invoice. The day-to-day administration of the program is handled by a private contractor under the oversight of the IRS HCTC Program Office.

Generally, adequate procedures and controls have been established to ensure advance payment amounts are accurate. We analyzed a judgmentally selected sample of 82 taxpayers for whom advance payments were made in TY 2004 and found the advance payments were consistent with the application information and documentation provided by the taxpayers. Also, taxpayers participating in the advance payment program are notified monthly of the amount and due date of their portion of the health care premium.

The IRS is continually evaluating the advance payment process to identify opportunities for improvement. For example, the IRS carefully evaluated 171 instances in TYs 2004 and 2005 in which taxpayers for whom advance payments were made were subsequently determined to have been ineligible for 1 or more advance payments. As a result of these reviews, the IRS implemented a number of systemic improvements to more timely identify when taxpayers were no longer eligible to participate in the advance payment program.

Specifically, in September 2005, the HCTC Program Office developed an automated process to begin systemically identifying and notifying active participants nearing Medicare eligibility that they will no longer be eligible to participate in the advance payment program once they become eligible to receive Medicare benefits. A similar process was also developed regarding the identification and notification of taxpayers nearing the end of their Consolidated Omnibus Budget Reconciliation Act of 1985 eligibility, who likewise would be no longer eligible to participate in the advance payment program.<sup>3</sup>

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<sup>3</sup> Pub. L. No. 99-272, Title X, 100 Stat. 82, 222 (1986). The law requires certain employers with 20 or more employees to offer continued coverage for individuals, with certain exceptions, who would have otherwise lost employer-sponsored health coverage.





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## *Financial Controls Over the Health Coverage Tax Credit Advance Payment Process Need to Be Enhanced*

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Finally, the IRS has adequately promoted the availability of the advance payment option. Monthly HCTC advance payments by the Department of the Treasury increased from \$3 million in January 2004 to \$6 million in December 2005. Total annual HCTC advance payments made by the Department of the Treasury similarly increased from \$55 million in TY 2004, the first full year the advance payment option was available, to over \$70 million in TY 2005.

However, we did identify three critical areas in which financial controls over the HCTC advance payment process need to be enhanced.

- Controls over the tracking and collection of receivables resulting from advance payments subsequently identified have been made in error need to be improved.
- Advance payment program information provided to taxpayers annually for use in preparing their tax returns is incomplete and confusing.
- The IRS lacks a reliable and comprehensive measure of the accuracy of information provided by taxpayers in connection with their participation in the advance payment program.

### ***Controls Over the Tracking and Collection of Health Coverage Tax Credit-Related Receivables Need to Be Improved***

The statute governing the HCTC does not specify how to disallow or recover either erroneous yearend or advance payments. All other refundable credits are specifically addressed in the Internal Revenue Code as being subject to deficiency procedures, which means they can be disallowed by the IRS only through a formal examination. However, the HCTC was not expressly included with other credits in the statute. Accordingly, the IRS has taken the position that the HCTC, whether paid for a taxpayer in advance or claimed by the taxpayer at the end of the year on a tax return, can be disallowed without a formal examination if found to be erroneous. The amount disallowed is treated as an erroneous refund. When the IRS subsequently identifies that an advance HCTC payment was made erroneously, it establishes a receivable on a separate, manual ledger maintained by the HCTC Program Office. These receivables are then forwarded to the IRS Andover Campus Accounts Management branch for collection from the taxpayers. As of January 2006, 165 receivables related to erroneous advance payments totaling \$337,976 had been forwarded to the Andover Campus Accounts Management branch for collection processing.

As discussed previously, the IRS carefully evaluates instances of erroneous payments to assess trends and identify areas where procedures need to be enhanced. However, our review of controls over the tracking and collection of advance payment-related receivables identified a number of areas where improvement is needed.

- Collection actions taken on advance payment-related receivables were not always timely. Our review of a judgmental sample of 52 taxpayers who received erroneous advance



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## *Financial Controls Over the Health Coverage Tax Credit Advance Payment Process Need to Be Enhanced*

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payments, for which documentation was readily available, indicated there was an average lapse of 479 calendar days between the initial identification of the potentially erroneous payment and the first contact of the taxpayers by the Accounts Management branch to request repayment. The total amount of the receivables associated with the 52 taxpayers was \$73,667. Some of the delay is attributable to the IRS' initial lack of a dedicated methodology for collecting advance payment-related receivables. The IRS informed us it did not anticipate the need for a methodology for controlling and collecting advance payment-related receivables when it first established the HCTC program. The IRS is presently reviewing an additional 274 cases to determine whether any advance payments were made in error and receivables need to be established. The IRS needs to establish minimum timeliness standards to guide this process in the future.

- The advance payment program taxpayer account ledger<sup>4</sup> is not periodically updated to reflect receivable-related transactions, and an audit trail has not been established between the advance payment program taxpayer account ledger and the receivables ledger. As a result, advance payment receivables-related transaction activity is not included in any of the financial reports produced from the taxpayer account ledger and is available to program management only on an ad hoc basis. The absence of these key controls decreases the reliability of the data produced by the receivables ledger.

In addition, a Treasury Inspector General for Tax Administration report issued in December 2004<sup>5</sup> identified that the classification of HCTC yearend refund disallowances as erroneous payments could compromise the collectibility of the assessments because of limited actions available due to the statute of limitations applicable to this type of liability. That audit, which focused on the HCTC claimed at yearend, recommended that the IRS review the legal status of yearend HCTC disallowances and determine if legislative action is necessary to change the classification of liabilities relating to the disallowance of yearend HCTC refunds. This audit identified similar concerns regarding erroneous advance payment refunds. For example, as of January 2006, the IRS had already determined that \$20,417 (6 percent) of the \$337,976 in erroneous advance payments was uncollectible due to expired statutes.

In response to our prior recommendation, the IRS noted it had been working with the Office of Chief Counsel to find appropriate methods for collecting erroneous yearend payments within the context of the existing law. The IRS further stated it will maintain that dialogue and determine the need for and/or the possibility of legislative clarification in that area. In our opinion, it is critical that the IRS carefully track receivables balances and recovery rates of both erroneous yearend refunds and erroneous advance payments as the program matures, to aid in its assessment of whether a legislative change is warranted.

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<sup>4</sup> The system of records on which HCTC advance payment transaction information is captured, accumulated, and compiled.

<sup>5</sup> *The Health Coverage Tax Credit Was Accurately Processed During the 2004 Filing Season* (Reference Number 2005-40-017, dated December 2004).



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*Financial Controls Over the Health Coverage Tax Credit Advance  
Payment Process Need to Be Enhanced*

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## **Recommendations**

**Recommendation 1:** The Director, HCTC Program, should establish an audit trail between the HCTC advance payment program taxpayer account ledger and the receivables ledger and develop procedures requiring the regular update of the taxpayer account ledger with data from the receivables ledger.

**Management's Response:** IRS management agreed with this recommendation. A manual process has been established that allows the HCTC Program Office to associate taxpayer receivable records in a subsidiary ledger with the advance payment program taxpayer account ledger. The IRS is also investigating automated solutions for directly updating the HCTC advance payment program taxpayer ledger that will remove the need for a receivables subsidiary ledger.

**Recommendation 2:** The Director, HCTC Program, should establish general time standards for the processing of advance payment-related receivables.

**Management's Response:** IRS management agreed with this recommendation and is taking the necessary actions to establish general time standards for processing advance payment-related receivables consistent with IRS Examination function guidelines.

**Recommendation 3:** The Director, HCTC Program, should track receivables balances and recovery rates for both erroneous yearend refunds and erroneous advance payments as the program matures, to aid in assessment of whether a change in the treatment of these types of liabilities is warranted.

**Management's Response:** IRS management agreed with this recommendation. The IRS currently tracks receivables balances and recovery rates for advance erroneous payments in a receivables ledger. The data collected in the ledger are being used to assist in making decisions on the treatment of repayment activities.

## **Advance Payment Information Provided to Taxpayers for Use in Preparing Their Tax Returns Is Incomplete and Confusing**

HCTC advance payment transaction information is captured, accumulated, and compiled by a contractor the IRS has tasked with the day-to-day execution of the advance payment program. Based on this information, the contractor annually issues a Health Coverage Tax Credit (HCTC) Advance Payments (Form 1099-H)<sup>6</sup> to program participants for use in preparing their tax returns. Form 1099-H summarizes advance payments made to the taxpayer's HPA. Taxpayers may also claim a credit at yearend for any payments they made directly to their HPAs for eligible coverage

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<sup>6</sup> Form 1099-H provides a taxpayer with the total amount of qualified health insurance payments paid in advance to a qualified health insurance coverage provider by the Department of the Treasury on the taxpayer's behalf.



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*Financial Controls Over the Health Coverage Tax Credit Advance  
Payment Process Need to Be Enhanced*

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provided during the tax year. When calculating the credit, taxpayers must first determine the number of months they received eligible coverage. Coverage must have been provided by the first of any particular month for the taxpayer to be eligible for the program. The next step in calculating the credit is determining how much was paid by the taxpayer and how much was paid through the advance payment program for all eligible months. This step is complicated by the fact that health insurance premiums are frequently paid in the month preceding the coverage month.

In our opinion, the information provided to taxpayers on Form 1099-H regarding advance payments is confusing and insufficiently detailed to readily support the taxpayers' calculations of any yearend credits they may be due. Specifically, Form 1099-H reports only the month and amount of any advance payment(s) made to the taxpayer's HPA; it does not provide any information on the coverage period associated with the payment(s). Also, the instructions for the TY 2005 Form 1099-H incorrectly inform the taxpayer that the amounts posted for each month on Form 1099-H reflect only those payments made by the first of that month, when actually the amount reported for each month reflects payments made any time during the month.

We advised IRS management of our concerns on January 9, 2006; they agreed with our conclusions and prepared a one-page notice for inclusion with Form 1099-H for TY 2005. The notice clarified the information provided on Form 1099-H and included additional instructions regarding how this information should be used in calculating any yearend credit. The IRS informed us that it presently does not accumulate sufficient data to accurately identify the coverage period associated with any particular advance payment.

HCTC program participants rely on the information provided on Forms 1099-H when preparing to claim the credit on their individual income tax returns. For example, if a taxpayer enrolls in the HCTC program during the year prior to receiving advance payments, he or she may be entitled to a credit at the end of the year for health coverage premiums paid. If the information provided on Form 1099-H is incorrect, the taxpayer could receive less credit than that to which he or she is entitled when preparing the required Health Coverage Tax Credit (Form 8885)<sup>7</sup> needed to claim the credit. As a result, taxpayers who lost their jobs due to foreign trade agreements or had their private employers' pension plans terminated may not be receiving the full benefits intended by law.

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<sup>7</sup> Form 8885 is used by taxpayers eligible for the HCTC during the tax year who have not claimed the advance HCTC for all eligible months.



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*Financial Controls Over the Health Coverage Tax Credit Advance  
Payment Process Need to Be Enhanced*

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## **Recommendations**

**Recommendation 4:** The Director, HCTC Program, should revise Form 1099-H instructions for TY 2006 to clearly indicate what the amount reported for each month on Form 1099-H actually reflects. In addition, Form 8885 and associated instructions should be revised to better explain how the information provided on Form 1099-H is used in claiming the yearend HCTC.

**Management's Response:** IRS management agreed with this recommendation. The IRS has revised Form 8885 and its instructions for TY 2006 and revised Form 1099-H and associated instructions. The HCTC Program Office is also considering seeking authority to eliminate Form 1099-H.

**Office of Audit Comment:** In our opinion, eliminating Form 1099-H, as the IRS indicated it is considering, could have an adverse impact on taxpayers' ability to accurately calculate any yearend credit they may be due. Form 1099-H assists taxpayers by summarizing advance payments made to the taxpayers' HPAs. Taxpayers may also claim a credit at yearend for any payments they made directly to their HPAs for eligible coverage provided during the tax year.

**Recommendation 5:** The Director, HCTC Program, should explore the feasibility of accumulating the additional data needed to identify coverage periods and revise Form 1099-H reporting to include these additional data.

**Management's Response:** IRS management agreed with this recommendation and is already gathering this kind of information. In addition, the HCTC Program Office has already adopted our recommendations to improve the clarity of Form 1099-H.

## ***The Internal Revenue Service Lacks a Reliable and Comprehensive Measure of the Overall Accuracy of Information Provided by Taxpayers in Connection With Their Participation in the Health Coverage Tax Credit Advance Payment Program***

The advance payment program allows eligible taxpayers to receive the benefits provided by the HCTC incrementally through the tax year so they do not have to wait until the end of the year when they file their tax returns. The yearend tax credit and advance payment program processes are similar, as both generally rely on the taxpayers to self-attest their eligibility for the program. To assist taxpayers with the self-attestation process, the advance payment program application includes a check sheet that summarizes the eligibility requirements. The advance payment program also requires taxpayers to submit a copy of their most recent health coverage invoices with the applications. The program registration application and associated invoice are reviewed by a customer service representative employed by an IRS contractor. The IRS informed us that the purpose of the contractor review is to establish general eligibility for the program and gather



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*Financial Controls Over the Health Coverage Tax Credit Advance  
Payment Process Need to Be Enhanced*

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sufficient information to enter the taxpayer into the program. The customer service representatives do not confirm in detail all information provided by the taxpayer on the application, nor do they routinely contact the taxpayer's HPA to validate information regarding the taxpayer's coverage. Taxpayers participating in the advance payment program are also required to notify the IRS whenever changes occur to their health coverage policy information.

Although the advance payment program provided over \$70 million in advance credit payments in TY 2005, the IRS does not have a reliable and comprehensive measure of the accuracy of information provided by taxpayers in connection with their participation in this program. Timely, comprehensive, and reliable management information is critical to effective program oversight. To study compliance trends relating to taxpayers who claimed the credit in TY 2003, the IRS reviewed returns of 2,284 taxpayers who claimed the yearend credit. These reviews resulted in partial or complete denial of 773 credits totaling \$3 million. Approximately 500 examinations are in process or planned for taxpayers claiming the yearend credit in TY 2004.

The IRS HCTC Program Office informed us that its primary focus to date, regarding the advance payment program, has been developing and implementing the program and pursuing systemic improvements. Without reliable and comprehensive information regarding taxpayer compliance trends, the IRS HCTC Program Office can not effectively identify areas that require additional emphasis during the application review process or where documentation requirements need to be expanded.

### ***Recommendation***

**Recommendation 6:** To monitor taxpayer compliance trends, the Director, HCTC Program, should initiate a process providing for routine evaluation of the compliance characteristics of a representative sample of taxpayers receiving the HCTC through the advance payment program.

**Management's Response:** IRS management agreed with this recommendation and has established several initiatives to incorporate process reviews that monitor compliance trends. In June 2005, the HCTC program implemented a Vulnerability, Fraud, and Compliance Gap Risk Assessment process. A component of this process will provide for the development of a representative sample of taxpayers receiving advance payments, to evaluate their compliance characteristics.



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*Financial Controls Over the Health Coverage Tax Credit Advance  
Payment Process Need to Be Enhanced*

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## **Appendix I**

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

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) had established effective controls over advance payments made in connection with the Health Coverage Tax Credit (HCTC) program. To accomplish this objective, we:

- I. Determined whether the IRS had established effective procedures and controls to ensure the private contractor administering advance HCTC payments accurately records payment transactions and prevents and detects improper payments.
  - A. Interviewed HCTC Program Office and contractor personnel to ascertain procedures and controls over advance payments and associated taxpayer remittances.
  - B. Performed an onsite walk-through of the advance payment process and evaluated the status of controls ascertained above.
  - C. Analyzed a judgmental sample of 82 taxpayers for whom HCTC advance payments were made in Tax Year (TY) 2004. This sample was selected from a subpopulation of 11,049 of the total 18,784 taxpayers identified on the IRS Master File<sup>1</sup> database as having received an HCTC advance payment in TY 2004. The subpopulation was the result of a programming error that inadvertently excluded cases from our sample population. Our subsequent detailed analysis of the range and characteristics of the cases excluded indicated that their absence had no material effect on the reliability of our sample results. In addition, we reviewed a judgmental sample of 52 taxpayers who had received erroneous advance payments for TY 2004. This sample represented all erroneous payment receivables for which complete documentation was available at the time of our testing. As of January 2006, 165 receivables related to erroneous advance payments had been forwarded for collection processing. We used judgmental sampling to expedite our review and because we did not intend to project our results to the entire HCTC recipient population.
- II. Determined whether the IRS had established an effective methodology to monitor delivery of the HCTC advance payment program.
  - A. Evaluated the methodology used to accumulate and compile management information regarding the HCTC advance payment program.

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<sup>1</sup> The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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*Financial Controls Over the Health Coverage Tax Credit Advance  
Payment Process Need to Be Enhanced*

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- B. Analyzed key measures used by HCTC program management to measure program effectiveness.
- III. Evaluated HCTC Program Office efforts to educate taxpayers on the availability of the advance payment program.

As part of our evaluation of controls over HCTC advance payments, we reviewed computer-processed data from the IRS Master File and the HCTC advance payment program taxpayer account ledger<sup>2</sup> relating to TY 2004 advance payments. To assess the reliability of these data, we tested for missing data, values outside expected ranges, and dates outside valid time periods. We also compared source documents to the data to further validate our results. Our overall purpose in using these data was to test the operation of selected financial management internal controls, and we did not rely on the data alone to answer any of our objectives.

Overall, we found the data to be sufficiently reliable to meet our objective of assessing the operation of controls over routine payment transactions. However, our overall evaluation of internal controls over advance payments did identify that certain types of nonroutine payment-related transactions are not posted to the HCTC advance payment program taxpayer account ledger. The effect of this control weakness is discussed in detail in the second finding within the report.

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<sup>2</sup> The system of records on which HCTC advance payment transaction information is captured, accumulated, and compiled.





*Financial Controls Over the Health Coverage Tax Credit Advance  
Payment Process Need to Be Enhanced*

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**Appendix II**

*Major Contributors to This Report*

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*Financial Controls Over the Health Coverage Tax Credit Advance  
Payment Process Need to Be Enhanced*

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**Appendix III**

*Report Distribution List*

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Director, Strategy and Finance, Wage and Investment Division SE:W:S  
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    Chief, Customer Liaison, Wage and Investment Division SE:W:S:W



*Financial Controls Over the Health Coverage Tax Credit Advance  
Payment Process Need to Be Enhanced*

**Appendix IV**

*Management's Response to the Draft Report*



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
ATLANTA, GA 30308

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MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *for* Richard J. Morgante *Pamela G. Watson*  
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Financial Controls Over the Health  
Coverage Tax Credit Advance Payment Process Need to Be  
Enhanced (Audit # 200510024)

I reviewed the subject draft report and appreciate your recognition that adequate procedures and controls have been established over advance payments made in connection with the Health Coverage Tax Credit (HCTC) program. Because it is less than three years old, HCTC program administration continues to evolve. As you noted, we are continually evaluating our work – including the advance payment process – to ensure we have effective financial controls in place. In fact, we have already put measures in place to identify and prevent ineligible taxpayers from making HCTC claims and from receiving the credit – an improvement that has lowered the number of new receivables substantially.

Your report emphasizes three areas of opportunity for improvement – controls over the tracking and collection of HCTC-related receivables, advance payment information provided to taxpayers for preparing their tax returns, and measurement of the overall accuracy of information provided by taxpayers. We agree improvements can be made in the three areas you identified, and we are taking appropriate actions to address the recommendations included in the draft report.

I appreciate your audit staff's observations and recommendations, and their willingness to collaborate with the HCTC Program Office to improve the financial controls over the HCTC payment process. Our responses to your recommendations are detailed in the attachment. If you have any questions, please contact me at (404) 338-7060, or members of your staff may contact Stacey Becker, Deputy Director, Health Coverage Tax Credit Program, at (202) 283-9709.

Attachment



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Attachment

**RECOMMENDATION 1**

The Director, HCTC Program, should establish an audit trail between the HCTC advance payment taxpayer account ledger and the receivables ledger and develop procedures requiring the regular update of the taxpayer account ledger with data from the receivables ledger.

**CORRECTIVE ACTION**

We agree with this recommendation and have already established a manual process that allows us to associate taxpayer receivable records in a subsidiary ledger with the HCTC advance payment taxpayer account ledger. We are now investigating automated solutions for directly updating the HCTC advance payment taxpayer account ledger that will remove the need for a receivables subsidiary ledger. Before adopting an automated solution; however, we plan to evaluate the costs and benefits to determine if there is an appropriate return on investment (ROI). If the ROI warrants it, we will implement the automated processes.

**IMPLEMENTATION DATE**

September 15, 2006

**RESPONSIBLE OFFICIAL**

Deputy Director, Health Coverage Tax Credit

**CORRECTIVE ACTION MONITORING PLAN**

We will monitor this corrective action through the internal control and approval process.

**RECOMMENDATION 2**

The Director, HCTC Program, should establish general time standards for the processing of advance payment-related receivables.

**CORRECTIVE ACTION**

We agree with this recommendation and are taking the necessary actions to establish general time standards for processing advance payment-related receivables consistent with Internal Revenue Service Examination guidelines.

**IMPLEMENTATION DATE**

September 15, 2006

**RESPONSIBLE OFFICIAL**

Deputy Director, Health Coverage Tax Credit



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*Financial Controls Over the Health Coverage Tax Credit Advance  
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2

**CORRECTIVE ACTION MONITORING PLAN**

We will monitor this corrective action through the internal control and approval process.

**RECOMMENDATION 3**

The Director, HCTC Program, should track receivables balances and recovery rates for both erroneous year-end refunds and erroneous advance payments as the program matures, to aid in assessment of whether a change in the treatment of these types of liabilities is warranted.

**CORRECTIVE ACTION**

We agree with this recommendation. The HCTC Program Office currently tracks receivables balances and recovery rates for advance erroneous payments in a receivables ledger. We are using the data collected in the ledger to help us make decisions on the treatment of repayment activities. Additionally, we review data from end-of-year erroneous refunds to identify the root causes of the errors. As mentioned earlier, this analysis has already enabled us to modify our processes to screen for eligibility criteria. The HCTC Program Office is currently assessing the best method to obtain information about end-of-year receivables and recovery rates.

**IMPLEMENTATION DATE**

Completed March 30, 2006

**RESPONSIBLE OFFICIAL**

N/A

**CORRECTIVE ACTION MONITORING PLAN**

N/A

**RECOMMENDATION 4**

The Director, HCTC Program, should revise Form 1099-H instructions for TY 2006 to clearly indicate what the amount reported for each month on Form 1099-H actually reflects. In addition, the Form 8885 and associated instructions should be revised to better explain how the information provided on Form 1099-H is used in claiming the year-end HCTC.

**CORRECTIVE ACTION**

We agree with this recommendation and have completed this activity. Based on the advice we received during the TIGTA audit, we have revised Health Coverage Tax Credit (Form 8885) and instructions for Tax Year 2006 to simplify and remove references to HCTC Advance Payments (Form 1099-H); and revised the Form 1099-H and associated instructions. In particular, the reference made to "beginning of



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3

each month," which taxpayers had trouble understanding, was removed. We are also considering seeking authority to eliminate Form 1099-H.

**IMPLEMENTATION DATE**  
Completed March 30, 2006

**RESPONSIBLE OFFICIAL**  
N/A

**CORRECTIVE ACTION MONITORING PLAN**  
N/A

**RECOMMENDATION 5**  
The Director, HCTC Program, should explore the feasibility of accumulating the additional data needed to identify coverage periods and revise Form 1099-H reporting to include this additional data.

**CORRECTIVE ACTION**  
We agree with this recommendation and are already gathering this kind of information. In addition, we have already adopted a number of TIGTA's recommendations to improve the clarity of Form 1099-H, especially in respect to the coverage period. We revised the 1099-H for tax year 2006, and as noted previously, we are considering asking for authority to eliminate the Form 1099-H entirely.

**IMPLEMENTATION DATE**  
Completed March 30, 2006

**RESPONSIBLE OFFICIAL**  
N/A

**CORRECTIVE ACTION MONITORING PLAN**  
N/A

**RECOMMENDATION 6**  
To monitor taxpayer compliance trends, the Director, HCTC Program, should initiate a process providing for routine evaluation of the compliance characteristics of a representative sample of taxpayers receiving the HCTC through the advance payment program.

**CORRECTIVE ACTION**  
We agree with this recommendation and have established several initiatives to incorporate process reviews that monitor compliance trends. In June 2005, the program implemented a Vulnerability, Fraud and Compliance Gap Risk Assessment process. A



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4

component of this process will provide for the development of a representative sample of taxpayers receiving advance HCTC payments, in order to evaluate their compliance characteristics. Based on initial assessment findings, the HCTC Program Office has made a number of program changes to enhance taxpayer HCTC compliance. Currently, we are analyzing available taxpayer HCTC account data and erroneous payment root causes to determine which areas of taxpayer compliance warrant the attention of program compliance reviews. Data gathered from the results of program compliance reviews are being used to focus program and process enhancements to ensure HCTC compliance.

**IMPLEMENTATION DATE**

July 15, 2006

**RESPONSIBLE OFFICIAL**

Deputy Director, Health Coverage Tax Credit

**CORRECTIVE ACTION MONITORING PLAN**

We will monitor this corrective action through the internal control and approval process.