



*Controls Can Be Improved to Ensure
Advance Earned Income Credit Reported on
Individual Income Tax Returns Is Accurate*

July 2006

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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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FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

July 5, 2006

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM:

Michael R. Phillips

Michael R. Phillips

Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Controls Can Be Improved to Ensure Advance
Earned Income Credit Reported on Individual Income Tax Returns Is
Accurate (Audit # 200540019)

This report presents the results of our review to determine whether processing controls for individual tax returns ensured 1) Advance Earned Income Credit (AEIC) payments reported by taxpayers were not greater than the maximum allowed by law and 2) AEIC payments reported by an employer on a Wage and Tax Statement (Form W-2) reconciled to the AEIC payments reported by the taxpayer on his or her individual income tax return.

Synopsis

The AEIC gives low-income taxpayers the opportunity to receive part of the Earned Income Tax Credit (EITC) during the year, although only a small portion of taxpayers who are eligible for the AEIC actually use it.¹ The Internal Revenue Service (IRS) has controls in place to verify the amount of the AEIC reported on an individual tax return to the Form W-2. It also provides guidance to employers on how to compute the amount of an individual's AEIC payments.

¹ The AEIC Program was designed to provide taxpayers a portion of their EITC throughout the year. Because the AEIC is an advance payment of the EITC, it is imperative that taxpayers report the actual amount of AEIC received during the year on their tax returns, regardless of whether that amount exceeds the legal limitation. Failure to report AEIC payments actually received could result in taxpayers receiving a greater refund than they are entitled to or paying less tax than they should. Conversely, reporting the AEIC when it is not received could result in taxpayers paying more tax than they owe.



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However, these controls do not effectively identify AEIC reporting errors or ensure employers pay individuals the correct amount of AEIC. As a result, some taxpayers could owe more tax than they can afford, while others could be paying tax for which they are not liable.

Ineffective controls sometimes result in taxpayers owing more tax than they can afford or paying tax for which they are not liable.

We reviewed a statistical sample of 166 of the 1,578 individual tax returns that reported more than the maximum allowed amount of AEIC in Tax Year 2004 and found that taxpayers accurately reported the AEIC on 135 (81 percent) of the returns. Sixteen percent (22 of 135) of these returns indicated taxpayers owed the IRS between \$250 and \$4,296 when they filed their returns. At the time we completed our audit, 12 of the 22 returns were still in balance-due status, ranging from \$292 to \$4,323.² While there could be other contributing factors to these balance-due conditions, receiving too much AEIC throughout the year can create hardship on taxpayers when they end up owing tax. Our evaluation of the guidance provided to employers indicates that, if used, it should help employers compute the correct amount of AEIC payments. However, the IRS could do a better job of highlighting the maximum allowed annual AEIC amount.

We also evaluated whether the IRS had controls in place to identify and correct AEIC reporting errors. As stated, taxpayers accurately reported the AEIC, even though it was more than the maximum amount allowed, on 135 (81 percent) of the 166 returns. Errors on another seven returns were identified and corrected by controls other than those designed for the AEIC Program. The remaining 24 returns (14 percent) contained AEIC reporting errors that were not identified and corrected by the IRS. Overall, for 13 of these 24 returns, taxpayers were assessed \$46,664 more tax than they should have been.³ Some of these reporting errors resulted from taxpayers incorrectly putting an amount other than the AEIC on the AEIC line of the tax return. For example, taxpayers put the amount of their withholding, their EITC, or their total income figure on the AEIC line. The IRS also created errors by incorrectly entering an amount on the AEIC line while inputting the tax returns to the processing system. Because AEIC payments are listed in the "Other Taxes" section of the U.S. Individual Income Tax Return (Form 1040) (so advance payments offset the EITC), these errors incorrectly increase the amount of tax.

While the IRS has specific procedures to review the amount of AEIC payments shown on tax returns, the small size of the AEIC Program appeared to reduce the effectiveness of these procedures. In addition, IRS employees did not identify the problems we noted. The IRS processed approximately 134 million Tax Year 2004 tax returns. Less than 1 percent of those reported AEIC payments. Therefore, the likelihood that IRS employees will follow the proper

² As of February 14, 2006.

³ There was no tax effect on the remaining 11 returns because the taxpayer or the IRS mistakenly input the 10 percent penalty for early withdrawal of an Individual Retirement Arrangement on the AEIC line on these returns.



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procedures related to the AEIC Program is reduced because so few returns report AEIC payments. However, the IRS could strengthen its computer check by adding additional criteria. For example, we found that adding an Adjusted Gross Income limit to the criteria used in the current computer check would have identified 17 of the 24 returns with AEIC errors, a 54 percent improvement over the current check.

Furthermore, computer controls are not effective for electronic returns. A Form W-2 submitted with an electronic return will generally match the tax return because of the way return preparation software compiles Form W-2 information and uses that information to create the tax return. As a result, IRS controls to match the AEIC payments on the Form(s) W-2 attached to an electronic tax return to the AEIC payments reported on the return would not identify input errors taxpayers make when they input their Form W-2 information to the software. While we looked at only a specific segment of returns reporting AEIC payments in this audit, we believe the conditions identified also apply to a similar percentage of all returns reporting AEIC payments because the types of AEIC payment reporting errors were not related to the criteria used to select our sample.

Less than 1 percent of EITC recipients use the AEIC option.⁴ The minimal participation has been a continuing concern for Congress. The Government Accountability Office is currently analyzing data associated with the AEIC and EITC Programs, comparing AEIC and EITC compliance issues, reviewing legislative and administrative changes to the AEIC since 1992, evaluating the status of prior Government Accountability Office recommendations, and considering potential changes to improve AEIC implementation.

Recommendations

We recommended the Director, Submission Processing, consider adding additional criteria to the current IRS error code programming to improve the IRS' ability to identify and correct AEIC payment reporting errors. The Director, Submission Processing, should also reemphasize the use of the current review procedures for paper returns and consider developing additional procedures for electronic returns.

Response

IRS management agreed with our first recommendation and is requesting changes to existing criteria that will result in better detection of payment reporting errors. IRS management also agreed with the first part of our second recommendation. They have completed several actions to reinforce and reemphasize the review procedures, including revising the Internal Revenue

⁴ This figure does not include taxpayers that receive AEIC payments but do not file a tax return reporting the payments.



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Manual to require verification of the AEIC entry by IRS employees and issuing alerts to employees.

However, IRS management did not agree with part of our second recommendation. They believe there is no practical way for the IRS to ensure either taxpayers or return preparers do not make input errors when entering Form W-2 information. The IRS believes the taxpayer or tax preparer is responsible for accurately inputting the AEIC amounts on electronic returns. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment

Because the IRS currently is unable to verify the Form W-2 during electronic processing of returns, we agree with the IRS' reasons for not implementing part of our second recommendation.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 622-5916.



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Background

In 1975, Congress amended the Internal Revenue Code to provide a credit to taxpayers with certain earned income.¹ This refundable credit, known as the Earned Income Tax Credit (EITC), was established to offset the impact of Social Security taxes and increases in cost-of-living expenses on low-income families and to encourage them to seek employment rather than welfare. The EITC offsets the amount of tax owed, if any, and may result in a refund to the taxpayer. In 1978, Congress established the Advance Earned Income Credit (AEIC).² The AEIC allows taxpayers who (1) have at least one qualifying child,³ (2) fall within certain income limits, and (3) expect to claim the EITC on their current year tax returns to receive part of the EITC in advance with their pay during the year. A taxpayer could receive a maximum of \$1,563 in AEIC payments for Tax Year (TY) 2004.

The number of AEIC recipients is small compared to the overall number of EITC recipients. Despite the fact that this advance payment option has been in effect since 1979, less than 1 percent of eligible taxpayers actually use this option.⁴ While the volume of individual income tax returns claiming the EITC remained constant at approximately 22 million between TYs 2003 and 2004, the volume of returns showing AEIC payments decreased from 135,358 to 127,017. The amount of AEIC payments reported by taxpayers also decreased, from approximately \$64 million to \$62 million, for the same period. Conversely, claims for the EITC grew from approximately \$38 billion to \$40 billion.

***Very few eligible
EITC taxpayers choose
to participate in the
AEIC Program.***

Taxpayers who choose to receive the AEIC file an Earned Income Credit Advance Payment Certificate (Form W-5) with their employers. Figure 1 illustrates the information a taxpayer must provide on the Form W-5.

¹ Tax Reduction Act - Title I: Refund of 1974 Individual Income Taxes, Pub. L. No. 94-12.

² Revenue Act of 1978, Pub. L. No. 95-600.

³ A qualifying child is any child who meets the following conditions: (1) the child is the taxpayer's son, daughter, adopted child, stepchild, or a descendant of any of them; or the taxpayer's brother, sister, stepbrother, stepsister, or a descendant of any of them whom the taxpayer cared for as he or she would his or her own child; or a foster child; (2) at the end of 2004, the child is under age 19, or under age 24 and a full-time student, or any age and permanently and totally disabled; and (3) the child lived with the taxpayer in the United States for over one-half of 2004.

⁴ This figure does not include taxpayers that receive AEIC payments but do not file a tax return reporting the payments.



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Figure 1: Form W-5

Form W-5 Department of the Treasury Internal Revenue Service Print or type your full name	Earned Income Credit Advance Payment Certificate ▶ Use the current year's certificate only. ▶ Give this certificate to your employer. ▶ This certificate expires on December 31, 2004.	OMB No. 1545-1342 2004
		Your social security number : : : : : :
<p>Note: If you get advance payments of the earned income credit for 2004, you must file a 2004 Federal income tax return. To get advance payments, you must have a qualifying child and your filing status must be any status except married filing a separate return.</p>		
<p>1 I expect to have a qualifying child and be able to claim the earned income credit for 2004, I do not have another Form W-5 in effect with any other current employer, and I choose to get advance EIC payments . . . <input type="checkbox"/> Yes <input type="checkbox"/> No</p> <p>2 Check the box that shows your expected filing status for 2004: <input type="checkbox"/> Single, head of household, or qualifying widow(er) <input type="checkbox"/> Married filing jointly</p> <p>3 If you are married, does your spouse have a Form W-5 in effect for 2004 with any employer? <input type="checkbox"/> Yes <input type="checkbox"/> No</p> <p><small>Under penalties of perjury, I declare that the information I have furnished above is, to the best of my knowledge, true, correct, and complete.</small></p>		
Signature ▶ _____		Date ▶ _____
Cat. No. 10227P		

Source: The IRS web site, IRS.gov.

Employers calculate and administer the AEIC payments. A Form W-5 remains in effect until the end of the calendar year unless the taxpayer revokes it or files another Form W-5. Employers report the AEIC payments in box 9 of the taxpayer’s Wage and Tax Statement (Form W-2). Taxpayers who receive AEIC payments are automatically required to file a Federal tax return and report the AEIC payments received throughout the year on their individual income tax returns as “Other Taxes.” The EITC is used to offset tax, including the AEIC. Figure 2 illustrates how a taxpayer is to report AEIC payments on his or her tax return.

Figure 2: Portion of the TY 2004 U.S. Individual Income Tax Return (Form 1040)

Other Taxes	57 Self-employment tax. Attach Schedule SE				57
	58 Social security and Medicare tax on tip income not reported to employer. Attach Form 4137				58
	59 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required				59
	60 Advance earned income credit payments from Form(s) W-2				60
	61 Household employment taxes. Attach Schedule H				61
	62 Add lines 56 through 61. This is your total tax ▶				62
Payments	63 Federal income tax withheld from Forms W-2 and 1099	63			
	64 2004 estimated tax payments and amount applied from 2003 return	64			
	65a Earned income credit (EIC)	65a			
	b Nontaxable combat pay election ▶ 65b	65b			
	66 Excess social security and tier 1 RRTA tax withheld (see page 54)	66			
	67 Additional child tax credit. Attach Form 8812	67			
	68 Amount paid with request for extension to file (see page 54)	68			
	69 Other payments from: a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136 c <input type="checkbox"/> Form 8885	69			
	70 Add lines 63, 64, 65a, and 66 through 69. These are your total payments ▶				70
Refund	71 If line 70 is more than line 62, subtract line 62 from line 70. This is the amount you overpaid				71
	72a Amount of line 71 you want refunded to you ▶				72a
Direct deposit? See page 54 and fill in 72b, 72c, and 72d.	▶ b Routing number <input type="text"/>				
	▶ d Account number <input type="text"/>				
	▶ c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings				
	73 Amount of line 71 you want applied to your 2005 estimated tax ▶	73			
Amount You Owe	74 Amount you owe. Subtract line 70 from line 62. For details on how to pay, see page 55 ▶				74
	75 Estimated tax penalty (see page 55)				75

Source: The IRS web site, IRS.gov.



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The AEIC Program was designed to provide taxpayers a portion of their EITC throughout the year. Because the AEIC is an advance payment of the EITC, it is imperative that taxpayers report the actual amount of AEIC payments received during the year on their tax returns, regardless of whether that amount exceeds the legal limitation. Failure to report AEIC payments actually received could result in taxpayers receiving a greater refund than they are entitled to or paying less tax than they should. Conversely, reporting AEIC payments not received could result in taxpayers paying more tax than they owe.

While the focus of this review was to evaluate the IRS process to ensure AEIC payments were correctly reported by taxpayers, the minimal participation in the advance payment program has also been a continuing concern for Congress. In 1990, Congress requested a study of the AEIC Program to address a number of issues, including the lack of participation.⁵ In response, the Government Accountability Office issued a report in 1992 that identified a number of causes and related recommendations to address the limited use of the advance payment option. However, since that time, there has not been a significant increase in the use of the advance payment option. The Joint Committee on Taxation recently requested that the Government Accountability Office perform another study of the AEIC Program. The Government Accountability Office is currently analyzing data associated with the AEIC and EITC Programs, comparing AEIC and EITC compliance issues, reviewing legislative and administrative changes to the AEIC since 1992, evaluating the status of prior Government Accountability Office recommendations, and considering potential changes to improve AEIC implementation.

This review was performed at the Internal Revenue Service (IRS) National Headquarters in Washington, D.C., in the EITC and Submission Processing Offices during the period July 2005 through February 2006. The audit was conducted in accordance with *Government Auditing Standards*. The scope of the work performed in this review was limited to an assessment of the IRS controls to prevent the reporting of AEIC payments that exceed the maximum allowed amount set by law. Our review did not encompass an assessment of the internal controls for all returns reporting AEIC payments. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

⁵ Omnibus Budget Reconciliation Act of 1990 (OBRA), Pub. L. No. 101-508, § 11113, 104 Stat. 1388, 1801 (also cited as § 11113 of the Revenue Reconciliation Act of 1990).



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Results of Review

The IRS has controls in place to verify the amount of AEIC payments reported on an individual tax return to that reported on the Form(s) W-2. It also provides guidance to employers on how to compute the amount of an individual's AEIC payments. However, these controls do not effectively identify AEIC reporting errors or ensure employers pay individuals the correct amount of AEIC. As a result, some taxpayers could owe more tax than they can afford, while others could be paying tax for which they are not liable.

Payment by Employers of More Advance Earned Income Credit Than Is Allowed by Law May Result in Taxpayers Owning Tax

An analysis of the Forms W-2 filed by employers for TYs 2002 through 2004 showed employers paid 8,760 taxpayers more AEIC than was allowed. While this number represents less than 1 percent of the taxpayers who received the AEIC, some of these taxpayers may have to pay back more AEIC than they can afford when they file their tax returns. The resulting balance due could occur when the taxpayer does not have enough EITC to offset the additional tax owed.

We reviewed a statistical sample of 166 of the 1,578 individual tax returns that reported more than the maximum amount of AEIC payments allowed in TY 2004 and found taxpayers accurately reported the AEIC on 135 (81 percent) of the returns. Sixteen percent (22 of 135) of these returns indicated taxpayers owed the IRS between \$250 and \$4,296 when they filed their returns. At the time we completed our audit, 12 of the 22 returns were still in balance-due status, ranging from \$292 to \$4,323.⁶ While there could be other contributing factors to these balance-due conditions, receiving too much AEIC throughout the year can cause a hardship if it results in a balance due from the taxpayer at the end of the year.

Employers have guidance available to assist them in determining how much AEIC can be paid to an employee in a year. However, this guidance does not highlight the maximum amount that can be paid annually; therefore, employers may be overlooking the limit. This guidance is available in *Circular E, Employer's Tax Guide* (Publication 15) and instructs the employer that for TY 2004 the maximum amount of AEIC a taxpayer could receive was \$1,563. This Publication also contains tables to assist employers in calculating AEIC payments. The tables provide different AEIC amounts based on the payroll period, the taxpayer's filing status, and whether the taxpayer's spouse receives the AEIC. We believe Publication 15 provides adequate guidance to help employers compute the amount of AEIC to which a taxpayer is entitled. The IRS could highlight the annual limitation on total AEIC paid and suggest employers use the allowed annual

⁶ As of February 14, 2006.



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limit to check the accuracy of their computations of AEIC payments; however, because of the small number of employers paying their employees over the maximum allowed amount of AEIC, we are making no formal recommendation in this area.

Reporting Errors Can Cause Taxpayers to Pay Tax They Do Not Owe

For a paper tax return, IRS employees are required 1) to compare the amount reported as the AEIC payments on the tax return to the amount shown in box 9 of the attached Form(s) W-2 before the return is entered into the IRS processing system and 2) to correct any errors identified. Once a return is entered into the processing system, a computer check determines if the reported AEIC payments exceed a set limit. This computer check applies to both paper and electronic returns. If the AEIC payments reported on the tax return exceed the set limit, the return is taken out of the processing stream for review. IRS employees are to correct any errors caused in processing and any misplaced entries on the tax return. They are also required to total the AEIC payments from the attached Form(s) W-2 and compare that total to what is reported on the tax return. If the AEIC payment amounts are different, the employees should change the amount on the return to match the total for the Form(s) W-2 and send the taxpayer a notice explaining the difference. If the amounts are equal, the IRS will accept the AEIC payment amount reported on the return and send the return on through the processing system.

As of August 20, 2005, the IRS had processed approximately 125,000 TY 2004 returns reporting AEIC payments of \$61 million. We reviewed a statistical sample of 166 of the 1,578 returns that reported AEIC payments greater than the maximum allowed by law to determine if the IRS had controls in place to identify and correct the reported AEIC. We found that taxpayers accurately reported the AEIC, even though it was more than the maximum allowed, on 135 (81 percent) of the 166 returns. Errors on another seven returns were identified by controls other than those designed for the AEIC Program and corrected. The remaining 24 returns (14 percent) contained AEIC reporting errors that were not identified and corrected by the IRS. Some of these reporting errors resulted from taxpayers incorrectly putting an amount other than the AEIC payments on the AEIC line of the tax return. For example, taxpayers put the amount of their withholding, their EITC, or their total income figure on the AEIC line. The IRS also created errors by incorrectly entering an amount on the AEIC line while inputting the tax returns to the processing system.

The IRS' failure to identify and correct these AEIC reporting errors caused taxpayers to pay more tax than they owed on 13 (54 percent) of the 24 returns with unidentified errors. Taxpayers were assessed \$46,664 more tax on these 13 returns than they should have been.⁷ We estimate

We estimate taxpayers were assessed about \$444,000 in tax they did not owe due to errors on their tax returns.

⁷ There was no tax effect on the remaining 11 returns because the taxpayer or the IRS mistakenly input the 10 percent penalty for early withdrawal of an Individual Retirement Arrangement on the AEIC line on these returns.



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228 taxpayers were incorrectly assessed taxes totaling approximately \$444,000 in TY 2004 because the IRS did not effectively identify and correct AEIC reporting errors.⁸ Not correcting these errors could result in taxpayers paying too much tax and affects the accuracy of tax records on the IRS' computer systems.

While the IRS has specific procedures to review the amount of AEIC payments shown on tax returns, the small size of the AEIC Program appeared to reduce the effectiveness of these procedures. In addition, IRS employees did not identify the problems we noted. The IRS processed approximately 134 million TY 2004 tax returns. Less than 1 percent of those reported AEIC payments. The likelihood that IRS employees will follow the proper procedures related to the AEIC Program is reduced because there are so few returns on which AEIC payments are reported.

We evaluated the IRS' computer check to determine if it could be modified to improve the IRS' ability to correct AEIC payment reporting errors. Adding an Adjusted Gross Income limit to the criteria used in the current computer check would have identified 17 of the 24 returns with AEIC payment reporting errors we identified, a 54 percent improvement over the current computer check.

While we looked at only a specific segment of returns reporting AEIC payments in this audit, we believe the conditions identified also apply to a similar percentage of all returns reporting AEIC payments because the types of AEIC payment reporting errors were not related to the criteria we used to select our sample. Therefore, improvements that enable the IRS to better identify and correct the inaccurate reporting of AEIC payments would improve the overall processing and accuracy of all returns reporting AEIC payments.

Computer controls are not effective for electronic returns

The IRS also needs to improve its AEIC data validation for electronic returns. Electronic returns are generally prepared by the taxpayer or tax preparer by inputting information from Forms W-2, Forms 1099,⁹ and other documents into a questionnaire. The computer program uses the responses to the questionnaire to complete the tax return. If the taxpayer or tax preparer makes an error when entering information from a Form W-2 (or other information document), the error will be carried over to the tax return as well as the electronic version of the Form W-2 compiled by the software program for transmission to the IRS. For example, a taxpayer incorrectly inputs the amount shown as dependent care benefits (box 10) on his or her Form W-2 as an AEIC

⁸ The dollar estimate is projected using a 95 percent confidence level and a precision range of \pm \$299,668. The number of taxpayers was projected using a 95 percent confidence level and a precision range of \pm 5.08 percent. See Appendix IV for details.

⁹ A Form 1099 is used to report various information to taxpayers. For example, a Form 1099-INT reports interest income, a Form 1099-DIV reports dividends and distributions, and a Form 1099-MISC reports miscellaneous income.



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payment (box 9) when filling out the questionnaire. The computer program will incorrectly show the dependent care benefits as an AEIC payment on the tax return (see Figure 3).

Figure 3: Portions of the TY 2004 Form 1040 and Form W-2

d Employee's social security number 123-45-6789		9 Advance EIC payment		10 Dependent care benefits 2,860.00	
e Employee's first name and initial Last name J. Taxpayer 124 Main St. Anywhere, ST 12345		11 Nonqualified plans		12a	
		13 Statutory employee <input type="checkbox"/> Retirement plan <input type="checkbox"/> The party who pays <input type="checkbox"/>		12b	
		14 Other		12c	
				12d	
f Employee's address and ZIP code		15 State Employee's state ID number		16 State wages, tips, etc.	
		17 State income tax		18 Local wages, tips, etc.	
				19 Local income tax	
				20 Locality name	

Form W-2 Wage and Tax Statement 2004 Department of the Treasury—Internal Revenue Service

Other Taxes	57 Self-employment tax. Attach Schedule SE	57	
	58 Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	58	
	59 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59	
	60 Advance earned income credit payments from Form(s) W-2	60	\$2,860 00
	61 Household employment taxes. Attach Schedule H	61	
	62 Add lines 56 through 61. This is your total tax	62	

The taxpayer incorrectly entered the amount from this box in response to a question related to the AEIC.

The computer then generated the amount to the incorrect line on the Form 1040.

Source: The IRS web site, IRS.gov.

IRS procedures instruct the employee to compare the AEIC amount found on the tax return to the amount shown on the attached Form W-2. The amounts will generally match because the electronic Form W-2 was also created using the information from the questionnaire. As a result, the IRS will accept the return even though the AEIC payment amount may not be correct. Of the 166 returns we reviewed, 90 were filed electronically. Either the taxpayer or the tax preparer incorrectly input the amount for AEIC payments into the generated Form W-2 in 5 (6 percent) of the 90 electronic returns. The growth in electronic filing makes it imperative that the IRS ensure its controls to verify the accuracy of information on a tax return are still effective for electronic returns.

Recommendations

Recommendation 1: The Director, Submission Processing, should consider adding additional AEIC criteria to the current error code programming to improve the IRS' ability to identify AEIC payment reporting errors. For example, consider adding criteria such as income limits and/or whether the taxpayer has a qualifying child, in addition to the current AEIC payment dollar limit, to better identify errors.



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Management's Response: IRS management agreed with the recommendation and is requesting changes to existing criteria that will result in better detection of payment reporting errors. The new criteria will use more exact dollar thresholds based upon filing status. The IRS considered the examples we suggested and determined the additional thresholds would be more efficient than adding new criteria based on income limits and/or a qualifying child.

Recommendation 2: The Director, Submission Processing, should reemphasize current review procedures for paper returns and consider developing additional procedures for electronic returns to ensure AEIC payments reported are not the result of an input error made when entering Form W-2 information.

Management's Response: IRS management agreed in part with this recommendation. They have completed several actions to reinforce and reemphasize the review procedures, including revising the Internal Revenue Manual to require verification of the AEIC entry by IRS employees and issuing alerts to employees. All actions were completed as of May 3, 2006. These procedures apply to both paper and electronic returns.

IRS management did not agree with the second part of our recommendation. They believe there is no practical way for the IRS to ensure either taxpayers or return preparers do not make input errors when entering Form W-2 information. The taxpayer or tax preparer is responsible for accurately inputting the AEIC amounts on electronic returns.

Office of Audit Comment: Because the IRS currently is unable to verify the Form W-2 during electronic processing of returns, we agree with the IRS' reasons for not implementing part of this recommendation.



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Appendix I

Detailed Objectives, Scope, and Methodology

The overall objectives of this review were to determine whether processing controls for individual tax returns ensured 1) Advance Earned Income Credit (AEIC) payments reported by taxpayers were not greater than the maximum allowed by law and 2) AEIC payments reported by an employer on a Wage and Tax Statement (Form W-2) reconciled to the AEIC payments reported by the taxpayer on his or her individual income tax return. To accomplish our objectives, we:

- I. Determined if the Internal Revenue Service (IRS) has controls in place to limit the amount of AEIC reported by taxpayers by researching the *Handbook for Authorized e-file Providers of Individual Income Tax Returns* (Publication 1345), the Internal Revenue Manual, and the Functional Specification Package.¹
- II. Determined the volume of tax returns that reported AEIC payments and the total AEIC reported for Tax Years (TY) 2003 and 2004.
 - A. Extracted data from the Individual Master File² Return Transaction File,³ which is stored on the Treasury Inspector General for Tax Administration (TIGTA) Data Center Warehouse.⁴ We used the criterion of “reported AEIC payments were greater than \$0” for returns filed in TYs 2003 and 2004.
 - B. Determined the number of returns that reported AEIC payments and the total amount of AEIC payments reported for TYs 2003 and 2004.
- III. Determined if AEIC payments in excess of the annual limit are being allowed by analyzing the data for TY 2004 tax returns that had AEIC payments reported on the Return Transaction File extract obtained in Step II.A.
 - A. Identified 1,578 TY 2004 tax returns reporting AEIC payments greater than the annual limit of \$1,563.

¹ A Functional Specification Package is the primary deliverable that results from structured analysis. It includes data flow diagrams, which graphically depict business processes and the data interfaces among these processes; data definitions, which define and document the interfaces on the data flow diagrams; and process specifications, which specify the data transformations among the business processes.

² This is the IRS database that maintains transactions or records of individual tax accounts.

³ The Return Transaction File contains line items transcribed during return processing and other fields such as math calculations.

⁴ The TIGTA Data Center Warehouse provides data and data access services; centralizes storage, security, and administration of files; and develops uniform and user-friendly interfaces for users to access data.



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- B. Reviewed a statistical attribute sample of TY 2004 returns reporting AEIC payments greater than \$1,563. We used a 95 percent confidence level, a 14 percent expected error rate, and a ± 5 percent precision level to obtain our statistical sample size of 166 returns.
- IV. Determined if the IRS has a system in place to identify and reconcile employers' reported AEIC payments to the AEIC payments the taxpayers report on their tax returns.
- A. Interviewed Submission Processing Office management to determine if an analysis is performed comparing the amounts employers report on Forms W-2 as AEIC payments to the amounts of AEIC payments the taxpayers report on their tax returns. We also obtained information on education initiatives related to the AEIC Program and obtained information on the Automated Underreporter Program⁵ in relation to the AEIC Program.
- B. Obtained a computer extract of AEIC payments greater than \$0 reported by employers on Forms W-2 for TYs 2002-2004. To validate the data, we visually inspected the data to ensure they were logical and the proper data were included in the fields. Also, for the 2004 data file, we ensured the amount reported on the Form W-2 file correlated to the amount shown on the Integrated Data Retrieval System.⁶ We also matched the Form W-2 AEIC amounts to the AEIC payments reported on the tax returns from our statistical sample of 166 TY 2004 tax returns selected in Step III.B. The results of these reviews ensured our data were reliable.

⁵ The IRS Automated Underreporter Program is a compliance program designed to verify the accuracy of income and various other items reported on a taxpayer's return by matching the information on the return to information reported to the IRS by third parties.

⁶ The Integrated Data Retrieval System is an IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.



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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Wage and Investment Division SE:W
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Chief, Performance Improvement, Wage and Investment Division SE:W:S:PI
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
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Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaison: Senior Operations Advisor, Wage and Investment Division SE:W:S



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Appendix IV

Outcome Measure

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; \$443,589 in erroneous tax assessments on 228 tax returns (see page 5).

Methodology Used to Measure the Reported Benefit:

We obtained the total population of 1,578 Tax Year (TY) 2004 tax returns that reported Advance Earned Income Credit (AEIC) payments over the maximum allowed amount. The maximum amount of AEIC a taxpayer could have received from an employer in TY 2004 was \$1,563. We used an attribute sampling method to select a statistical sample of 166 tax returns from the Individual Master File¹ Return Transaction File,² which is stored on the Treasury Inspector General for Tax Administration Data Center Warehouse.³ We used a 95 percent confidence level, a 14 percent expected error rate, and a ± 5 percent precision level to select the statistical sample.

The sample was used to determine if AEIC payments in excess of the limit are being allowed. We also determined what action the Internal Revenue Service has taken to resolve the accounts for which incorrect amounts of AEIC payments were processed. If no action had been taken, we determined the effect of the incorrect AEIC payments reported (refund, balance due, etc). We applied variable sample formulas to project the dollar effect of the incorrect AEIC payments that were processed.

We determined 24 (14 percent) of the 166 tax returns had incorrect AEIC payment amounts processed, resulting in \$46,664 in erroneous tax assessments. We determined the mean, or average, tax effect per case was \$281.11. The mean per case multiplied by the population results in a total effect of \$443,589.⁴ When these results are applied to the population using the variable

¹ This is the Internal Revenue Service database that maintains transactions or records of individual tax accounts.

² The Return Transaction File contains line items transcribed during return processing and other fields such as math calculations.

³ The Data Center Warehouse provides data and data access services; centralizes storage, security, and administration of files; and develops uniform and user-friendly interfaces for users to access data.

⁴ The numbers presented here may not provide the same results due to the rounding of numbers.



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sampling formulas, we estimate that \$443,589 ±\$299,668 in erroneous tax assessments (i.e., the taxpayers did not owe the tax) were made on TY 2004 tax returns. We used the following formula to determine the range within which the actual value can be projected at the desired confidence level:

$$A = Z \frac{s}{\sqrt{n}} \left(\sqrt{1 - \frac{n}{N}} \right)$$

Where:

n = sample size of 166.

Z = standard deviation factor for a 95 percent confidence level is 1.96.

s = standard deviation of the sample is \$1,319.68.

N = population size of 1,578.

A = precision per case of \$189.90.

The total population of 1,578 multiplied by the precision per case of \$189.90 results in a total precision of \$299,668. When we apply this precision, we are 95 percent confident the amount of the erroneous tax assessments falls between \$143,921 and \$743,257.⁵

Using the same statistical sample described above, we determined 24 (14 percent) of the 166 tax returns were processed with inaccurate AEIC payment amounts. We estimate 228 ±80 TY 2004 tax returns were processed with erroneous AEIC payment amounts. We used the following formula to determine the range of the actual number of incorrect records on the Individual Master File:

$$\sigma_p = \sqrt{\frac{p(1-p)(1-f)}{n-1}}$$

Where:

p = the percentage (in decimals) of items possessing the attribute is 14.

n = the number of items sampled is 166.

N = the number of items in the universe is 1,578.

f = the sampling fraction (n/N) is .105196.

The computation above provides a confidence level of 68 percent. Because we prefer to use a 95 percent confidence level when reporting sampling results, we had to multiply the results of the computation above by the standard deviation factor of 1.96 for a 95 percent confidence level.

This results in a precision of ±5.08 percent. When the precision is multiplied by our population, we have a total precision of ±80 tax returns. We are 95 percent confident the number of

⁵ The numbers presented here may not provide the same results due to the rounding of numbers.



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TY 2004 tax returns filed with incorrect AEIC payments is 228 ± 80 and that the actual number of tax returns ranges from 148 to 308.⁶

⁶ The numbers presented here may not provide the same results due to the rounding of numbers.



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Appendix V

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

RECEIVED
JUN 13 2006

JUN 08 2006

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *for* Richard J. Morgante *Paula S. Watson*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Controls Can Be Improved to Ensure
Advance Earned Income Credit Reported on Individual Income
Tax Returns Is Accurate (Audit # 200540019)

I reviewed the subject draft report and appreciate you acknowledging the IRS has controls in place to verify the amount of Advance Earned Income Credit (AEIC) reported on individual tax returns to the Form W-2 (Wage and Tax Statement). We also appreciate your recognition that the guidance we provide to employers on how to properly compute the amount of AEIC payments results in a high percentage of correct payments. We believe that our communications, on the phone, in person, on-line, and in several of our publications, aid employers in their key administrative role of assisting their employees to properly determine the correct amount of AEIC payments. You noted that 127,017 taxpayers received AEIC in 2004, while only 1,578 reported receiving more than the maximum amount of AEIC allowed. Furthermore, less than one percent of the AEIC recipients for Tax Years 2002 through 2004 received more AEIC payments than allowed.

We recognize that when AEIC recipients owe taxes it may represent a financial hardship. You concluded from your sample of 166 returns with AEIC payments in excess of the maximum allowed that 22 owed taxes when they filed their returns. As you noted, there are many reasons a taxpayer may owe taxes when they file their return. A payment in excess of the maximum amount of AEIC is just one of the numerous possibilities. There was no data provided in the audit to conclude that the amounts owed resulted from an overpayment of AEIC. Finally, there are numerous situations where taxpayers are entitled to AEIC at some point during the year, but because of common life changing events such as marriage, job changes, divorce, etc., their eligibility may change. If an AEIC recipient is not alert to the impact of these changes, they may receive an overpayment and need to repay a portion of the AEIC received. Although we empathize with these taxpayers, we also acknowledge that they had the use of the additional money throughout the year, and it is appropriate for them



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to pay the proper amount of tax owed. Our collection policies allow us considerable flexibility to deal with taxpayers experiencing financial hardships. While it may seem desirable to further reduce the number of AEIC recipients who receive more than the maximum AEIC allowed, it is not practical to establish controls that could prevent the extremely small volume of potential overpayments from occurring.

We reviewed the 24 returns containing AEIC errors that the IRS did not identify and correct. We concur with your statement that, although procedures are in place, these errors can go undetected during processing because of the small number of AEIC returns among the approximately 134 million individual income tax returns processed. I appreciate your notation that even though your sample of 166 returns identified that 14 percent had an undetected AEIC reporting error, there were no tax consequence to taxpayers in 11 of the returns sampled. The erroneous entries represented taxes owed for the 10 percent early withdrawal penalty, thus, the tax calculation was correct and these 11 taxpayers suffered no consequence from the undetected error. In effect, while the sample indicates an undetected error rate of 14 percent, the error rate of returns with potential negative tax consequences would be reduced to 7.8 percent with the exclusion of the "no tax consequence" returns. We do acknowledge, however, that the error detection process can be improved. Submission Processing has already taken the following actions to address your observation:

- Revised the Internal Revenue Manual (IRM) for data transcription to require verification of entries on Form W-2, box 9 and the AEIC Lines on the Forms 1040 and 1040A.
- Issued an alert to remind Data Transcribers to exercise extreme care when entering an amount for AEIC.
- Issued an alert reminding Tax Examiners in Code and Edit to follow the recently revised IRM instructions regarding returns with AEIC.
- Requested a systemic check with revised dollar thresholds to improve detection of potential AEIC reporting errors.

We anticipate the actions outlined above will have a positive impact and further reduce the number of undetected errors. As a result of our review of the sample returns your audit team provided, we are correcting those errors that had a negative impact on taxpayers. We appreciate your willingness to share this information.

With respect to your recommendation concerning taxpayer or preparer e-file input errors, I have concluded there is not a compelling reason to establish additional controls. The overall volume of taxpayers filing with AEIC is small, errors are few, and our efforts to improve the detection of reporting errors outlined above apply to both paper and electronically-filed returns. In addition, there currently is not a practical control methodology that is appropriate to the limited situation described.



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I have reviewed the outcome measure reported in Appendix IV of the report and agree with your reported potential benefit in the amount of \$443,589. 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 David L. Medeck, Director, Customer Account Services, at (404) 338-8910.

Attachment



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Attachment

RECOMMENDATION 1

The Director, Submission Processing, should consider adding additional AEIC criteria to the current error code programming to improve its ability to identify AEIC payment reporting errors. For example, consider adding criteria such as income limits and/or whether the taxpayer has a qualifying child, in addition to the current AEIC payment dollar limit, to better identify errors.

CORRECTIVE ACTION

We are requesting changes to our existing criteria that will result in better detection of payment reporting errors. The new criteria will use more exact dollar thresholds based upon filing status. We considered the examples TIGTA suggested and determined that the additional thresholds would be more efficient than adding new criteria based on income limits and/or a qualifying child.

IMPLEMENTATION DATE

February 15, 2007

RESPONSIBLE OFFICIAL

Director, W&I CAS, Submission Processing

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 2

The Director, Submission Processing, (a) should reemphasize current review procedures for paper-filed returns, and (b) consider developing additional procedures for electronically-filed returns to ensure AEIC payments reported are not the result of an input error made when entering Form W-2 information.

CORRECTIVE ACTION

Recommendation 2 contains two parts. We agree with part (a) of the recommendation, and have completed the actions outlined below to reinforce and reemphasize the review procedures. All actions were completed as of May 3, 2006. These procedures apply to both paper and electronic returns.

- Revised the IRM for data transcription to require verification of entries on Form W-2, box 9 and the AEIC Lines on the Forms 1040 and 1040A.
- Issued an alert to remind Data Transcribers to exercise extreme care when entering an amount for AEIC.
- Issued an alert reminding Tax Examiners in Code and Edit to follow the recently revised IRM instructions regarding returns with AEIC.



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We do not agree with part (b) of the recommendation since there is no practical way for the IRS to ensure that either taxpayers or return preparers do not make input errors when entering Form W-2 information. The taxpayer or tax preparer is responsible for accurately inputting the AEIC amounts on electronically filed returns.

IMPLEMENTATION DATE

- (a) Completed – May 3, 2006
- (b) N/A

RESPONSIBLE OFFICIAL

- (a) N/A
- (b) N/A

CORRECTIVE ACTION MONITORING PLAN

- (a) N/A
- (b) N/A