The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments

December 31, 2008

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2(a) = Law Enforcement Criteria
2(d) = Law Enforcement Technique(s)
2(e) = Law Enforcement Procedure(s)
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FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

December 31, 2008

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

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

SUBJECT: Final Audit Report – The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments (Audit # 200740029)

This report presents the results of our review to assess the Internal Revenue Service's (IRS) progress in improving administration of the Earned Income Tax Credit (EITC) Program since Fiscal Year 2003. Our review included assessing oversight of the Program and efforts taken to improve compliance with and participation in the Program. This review was part of the Treasury Inspector General for Tax Administration Fiscal Year 2007 Annual Audit Plan and relates to the Fiscal Year 2007 Major Management Challenge of addressing erroneous and improper payments.

Impact on the Taxpayer

The IRS has implemented a number of initiatives designed to 1) educate taxpayers on the EITC requirements and assist them in determining EITC eligibility, 2) provide information and guidance to tax preparers, and 3) improve its examination processes to reduce burden on taxpayers. In addition, the IRS has successfully developed a number of processes to identify erroneous EITC payments prior to issuance. However, because compliance resources are limited and alternatives to traditional compliance methods have not been developed, the majority of the potentially erroneous EITC claims identified continue to be paid in error. The IRS reports $10 billion to $12 billion annually in erroneous EITC payments.

The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments

Synopsis

IRS efforts have resulted in some improved oversight and management of the EITC Program. These efforts include developing an EITC initiative to improve service, fairness, and compliance with EITC laws; establishing the EITC Program Office; and developing a Concept of Operations[1] that provides the IRS' vision for the Program. In addition, the IRS established two long-term goals for the Program: increasing Program participation and reducing erroneous payments.

> ***Limitations on the number of erroneous payments the IRS*** [redacted]

However, the IRS had not developed a consistent method to quantify its progress in meeting its two Program goals. The inability to measure progress in meeting these goals results from delays in obtaining necessary data and inconsistent measurement methods. The IRS plans to be able to report on Program participation late in 2008 and reducing erroneous payments in 2009.

In addition, although the IRS has successfully developed a number of processes to identify erroneous EITC payments prior to issuance, it was unable to stop the majority of these payments. For example, in Tax Year (TY) 2006, the IRS identified more than [redacted] potentially erroneous EITC claims via its Dependent Database process. However, the IRS selected for and closed by audit only about 161,000 [redacted] of these claims. Compliance resources are limited and alternatives to traditional compliance methods have not been developed, resulting in the majority of the potentially erroneous EITC claims identified being paid in error. Beginning in TY 2005, the IRS reallocated its examination resources across all areas of the tax code to address a greater number of higher income taxpayers. This decision limited the number of EITC audits the IRS performs each year, [redacted]

> ***The IRS has successfully combined the use of external data with probability filters to maximize the benefit gained from its examination resources by selecting the most productive cases.***

Although the IRS has developed better ways to identify EITC noncompliance, it needs to pursue additional alternatives to address the identified potentially erroneous EITC claims. Some alternatives to traditional compliance might require a legislative change. For example, to improve its selection of cases for audit using information contained in the Dependent Database, the IRS has spent millions of dollars developing probability filters. These filters [redacted] to determine the likelihood that an EITC claim is in fact erroneous. By combining the

[1] See Appendix V for a glossary of terms.

use of probability filters with external data included in the Dependent Database, the IRS increased its EITC audit change rate from 89.7 percent on TY 2004 tax returns to 93.9 percent on TY 2005 tax returns.

However, the IRS takes action to stop payment of only a small percentage of the erroneous claims. For example, for TY 2005, the IRS identified 594,312 EITC claims for which information contained in the Dependent Database identified that the [redacted] requirement did not appear to have been met for EITC claims totaling $1.3 billion. However, the IRS [redacted]

> ***Alternatives to traditional compliance methods are needed to reduce the billions of dollars in identified erroneous EITC payments.***

If further expansion of the math error authority[2] is not possible to cover cases identified using probability filters, the IRS needs to develop an alternative process that is less costly than an audit to protect revenue associated with erroneous EITC claims. The IRS should work with the Assistant Secretary of the Treasury for Tax Policy to obtain authority for an improved process that can make use of its success in combining external data with probability filters. If the IRS does not move beyond traditional compliance methods, it will be unable to significantly reduce the amount of erroneous EITC payments, which is estimated to be $10 billion to $12 billion annually. Put simply, the total Federal income tax paid by 1.5 million taxpayers in TY 2006 (roughly the population of Phoenix, Arizona) was used to fund erroneous EITC payments. As technology and data sharing among Federal Government agencies improve, the IRS must continually evaluate its ability to ensure that taxpayers are filing accurate tax returns and paying the correct amount of tax.

Recommendations

We recommended that the Commissioner, Wage and Investment Division, 1) conduct a study to identify alternative processes that will expand the IRS' ability to effectively and efficiently identify and adjust erroneous EITC claims for which data show that the taxpayer does not meet the EITC qualifying-child relationship and/or residency tests, and 2) work with the Assistant Secretary of the Treasury for Tax Policy to obtain the authority necessary to implement alternative processes to adjust erroneous EITC claims for which data show that the taxpayer does not meet the EITC qualifying-child relationship and/or residency tests.

[2] Congress authorized the IRS to correct certain mathematical or clerical errors on a tax return without opening an audit. This authority was later expanded to allow the IRS to adjust or disallow the EITC when a valid Social Security Number is missing for a child claimed for the EITC or when earned income is above the maximum level for the EITC.

Response

IRS management agreed with all of our recommendations. The IRS will continue its ongoing efforts to identify new alternatives to effectively expand its treatment of EITC errors while protecting taxpayer rights and minimizing taxpayer burden. As part of these efforts, management will conduct a study of Federal Case Registry information to determine its accuracy and applicability for exercising existing math error authority to deny the EITC during upfront processing of the tax return. The IRS will communicate any relevant results from its study to the Assistant Secretary of the Treasury for Tax Policy for his or her consideration. Management's complete response to the draft report is included as Appendix VI.

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 (Returns Processing and Account Services), at (202) 622-5916.

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Abbreviations

AEIC	Advance Earned Income Credit
EIC	Earned Income Credit
EITC	Earned Income Tax Credit
FY	Fiscal Year
IRS	Internal Revenue Service
SSN	Social Security Number
TY	Tax Year

Background

Created in 1975,[1] the Earned Income Tax Credit (EITC) is a refundable credit used to offset the impact of Social Security taxes on low-income families and to encourage them to seek employment rather than welfare. The amount of the Credit individuals receive depends on earned income,[2] the number of qualifying children, and filing status.

The number of taxpayers claiming the EITC grew from 6.2 million in Tax Year 1975 to 22.4 million in Tax Year 2006. During this period, amounts claimed rose from $1.2 billion to $43.7 billion.

The Internal Revenue Service (IRS) is charged with administration of the EITC, which includes developing strategies to improve the EITC Program, managing the Program's outcomes, and coordinating activities of support functions within the IRS. In 2003, the IRS established a centralized function, the EITC Program Office, to oversee administration of the Program. The mission of the Program Office is to ensure that all eligible individuals receive the EITC, while reducing the number of erroneous EITC claims. To accomplish its mission, the EITC Program Office coordinates with multiple functions within the IRS, including those involving tax return processing, communication and media relations, electronic tax administration, and compliance.

Although participation and dollars claimed have continued to increase, the EITC Program continues to be vulnerable to a high rate of noncompliance, including incorrect or erroneous claims for the EITC caused by taxpayer error and resulting from fraud. For example:

- In February 2002, the IRS estimated that between $8.5 billion and $9.9 billion (27 percent to 32 percent) of the $31.3 billion in EITC claims made by taxpayers in Tax Year (TY) 1999 should not have been paid.[3]
- In 2005, the IRS estimated that between $9.6 billion and $11.4 billion (23 percent to 28 percent) of the $41.3 billion in EITC claims paid for TY 2004 returns were paid in error.[4]

[1] All dates in this report are calendar year unless otherwise noted.
[2] See Appendix V for a glossary of terms.
[3] The TY 1999 compliance rate does not account for payments identified and stopped by the IRS as part of its compliance efforts.
[4] Estimates for TY 2004 include claims paid in error and a factor for erroneous payments identified and recovered by the IRS, as well as a factor for the impact of the TY 2002 tax law changes.

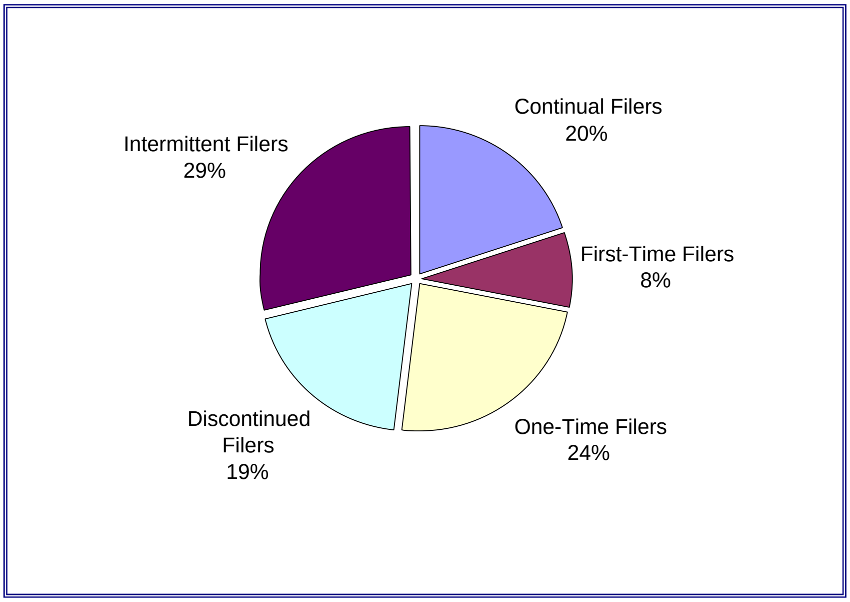
Put simply, the total Federal income tax paid by 1.5 million taxpayers in TY 2006 (roughly the population of Phoenix, Arizona) was used to fund erroneous EITC payments.

The IRS continues to face challenges in improving the EITC Program

EITC eligibility rules are complicated and cause taxpayers to make errors while attempting to interpret and apply the tax laws to their individual situations. An analysis performed by the National Taxpayer Advocate[5] identified that many low-income taxpayers struggle to determine their eligibility for the EITC. Some taxpayers lack an understanding of the eligibility issues related to family status, such as the dependency exemption and Head of Household filing status.

In addition, the changing population of taxpayers who claim the EITC increases the difficulty the IRS faces in improving EITC compliance. The IRS has conducted numerous studies showing how taxpayers move in and out of the EITC Program and has plans to conduct more. Figure 1 shows that approximately one-third of EITC claimants each year are intermittent[6] or first-time claimants.

Figure 1: Movement of Taxpayers in the EITC Program (Processing Years 2000 - 2006)[7]



Source: IRS study - Exploratory Trend Analysis of EITC TYs 1999 - 2005.

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[5] *National Taxpayer Advocate 2004 Annual Report to the Congress*, issued December 2004.
[6] Some taxpayers claim the EITC in 1 year but not the next, then file and claim the Credit again at a later time.
[7] Discontinued Filers are taxpayers who had consistently claimed the EITC but who stopped filing a tax return or no longer qualified for the EITC.

A large part of EITC compliance depends on the taxpayers' understanding of the EITC eligibility rules and how to properly claim the Credit. In programs with a stable population, compliance should improve as more taxpayers become familiar with program rules. However, EITC rules are frequently revised as a result of changes to the tax law. The ever-changing EITC population and changes in eligibility requirements reduce the effectiveness of the IRS' education and outreach efforts because the IRS must continually educate new claimants.

This review was performed at the IRS Wage and Investment Division Headquarters in Atlanta, Georgia, in the Office of Electronic Tax Administration and Refundable Tax Credits during the period October 2007 through August 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Results of Review

Although Some Improvements Have Been Made in the Administration of the Earned Income Tax Credit Program, a Process to Measure Progress in Meeting Program Goals Is Still Needed

Since Fiscal Year (FY) 2003, the Treasury Inspector General for Tax Administration has performed reviews to assess the IRS' administration of the EITC Program.[8] IRS efforts have resulted in some improved oversight and management of the EITC Program. As a result of a FY 2003 assessment by the Office of Management and Budget, the IRS established two long-term goals for the Program:

IRS efforts have resulted in improved oversight and management of the EITC Program.

1. Increasing Program participation.
2. Reducing erroneous payments.

These goals relate directly to the mission of the EITC Program Office. However, processes have not been developed to consistently measure progress in meeting these goals, and methodologies used to measure EITC compliance were inconsistent, resulting in the inability to compare yearly results. Although the IRS does not have a process to consistently measure progress in increasing participation, indicators show that improvements have been made. Specifically, the IRS has implemented a number of initiatives that appear to have resulted in increases to the numbers of 1) taxpayers who claim the EITC from year to year and 2) new EITC claimants from 1 year to the next.

In addition, the IRS has established a number of processes to identify and prevent the issuance of erroneous EITC payments. However, resource constraints prevent the IRS from making any significant impact on stopping the billions of dollars in erroneous payments identified by these processes annually.

The IRS has initiated a number of actions to improve its ability to administer the EITC Program

Since FY 2003, the IRS has initiated a number of actions that have improved its ability to administer the EITC Program. These actions have resulted in increased oversight and coordination and a more focused approach to improving participation and compliance. Actions include:

[8] Appendix IV provides a list of these reports and associated recommendations.

- Developing a five-point EITC initiative in 2003 to improve service, fairness, and compliance with the EITC law. This initiative included reducing backlogs of EITC Program examinations, improving communication with taxpayers, increasing outreach efforts, enhancing compliance efforts, and testing a certification process for higher risk taxpayers.
- Establishing the EITC Program Office in 2003 and aligning the Office directly under the Commissioner, Wage and Investment Division. Direct reporting ensured that the Program received the emphasis needed to address its compliance problems and coordinated the oversight of many EITC activities under one executive. Activities include oversight of the EITC outreach efforts and compliance activities, such as the pre-refund audit program.
- Implementing Service Level Agreements between the EITC Program Office and its partner functions within the IRS to increase accountability for EITC activities performed by those organizations. These Agreements outline commitments agreed to with other functions within the IRS to assist in EITC activities.
- Developing a Concept of Operations that provides a roadmap of the IRS' vision for the Program. The EITC Program Office regularly updates the Concept of Operations as new research and data are obtained and analyzed.
- Establishing long-term performance measures that reflect the Program's anticipated outcomes over time: percentage of eligible taxpayers who file for the EITC and percentage of EITC claims paid in error.

The IRS had not established a consistent method to measure EITC participation and compliance

The IRS had not developed a consistent method to quantify its progress in meeting its two Program goals. The inability to measure progress in meeting these goals results from delays in obtaining necessary data and inconsistent measurement methods. The IRS has since developed a methodology that it believes will allow it to consistently measure its progress in meeting Program goals once the needed data are available. The IRS plans to be able to report on Program participation late in 2008 and reducing erroneous payments in 2009. Because we plan to continue to monitor IRS efforts in developing these measurement processes, we made no recommendations for this issue in this report.

In June 2003, we recommended that the Commissioner, Wage and Investment Division, establish for the EITC Program long-term goals and related measures that reflect the Program's anticipated outcomes over time.[9] We also recommended that the IRS establish a consistent

[9] *Opportunities Exist to Improve the Administration of the Earned Income Tax Credit* (Reference Number 2003-40-139, dated June 2003).

method to measure progress toward meeting these goals. The IRS agreed with the need to establish a process to measure EITC participation. However, the IRS disagreed with the need to establish a process to measure EITC compliance because it believed that an effective one already existed.

The Office of Management and Budget has raised similar concerns. It determined that the IRS' measure for EITC compliance did not meet the requirements of the Government Performance and Results Act of 1993[10] and stated that new measures were needed. The Office of Management and Budget rated the EITC Program as ineffective because the EITC compliance initiative failed to reduce erroneous EITC payments to acceptable levels.

Efforts have been initiated to measure progress in meeting Program goals. The IRS has developed two methodologies in an attempt to measure participation. However, delays in obtaining needed information have prevented the IRS from being able to evaluate which methodology best portrays participation in the EITC Program. The IRS has since made arrangements to receive the information that it believes is needed and anticipates being able to develop a process to measure the EITC participation rate by the end of 2008.

Methodologies used to measure EITC compliance were not consistent. However, IRS has plans in place to be able to consistently measure compliance from year to year.

The compliance rate used by the IRS was calculated using TY 1999 tax returns and has not been updated since 2002. Although the IRS has attempted to assess the level of EITC compliance since 2002, the methodologies used were not consistent. Therefore, no comparison could be performed to assess whether improvements were made. In 2005, the IRS established the EITC improper payment rate, which is the percentage of EITC payments paid in error. However, this rate is still not a current measure of EITC compliance because the improper payment rate is also not based on current tax returns. Although the rate was established in 2005, it was based on TY 2001 tax returns. In addition, the IRS' current goal for claims paid in error is not an actual rate based on more current tax returns; it is a forecasted rate based on the TY 2001 improper payment rate.

Beginning in 2009, the IRS plans to be able to begin updating the rate of claims paid in error annually. In 2007, the IRS began reviewing a stratified, randomly selected sample of individual tax returns claiming the EITC as a component of its National Research Program. In 2009, the IRS will use the results of the annual National Research Program reviews to update the rate for claims paid in error. In addition, the IRS plans to update its comprehensive EITC compliance study in 2012 using the first 3 consecutive years of National Research Program data. The IRS believes that this will enable it to measure its success in reducing erroneous payments. The IRS notes that after 2012, it should also be able to update its compliance study annually.

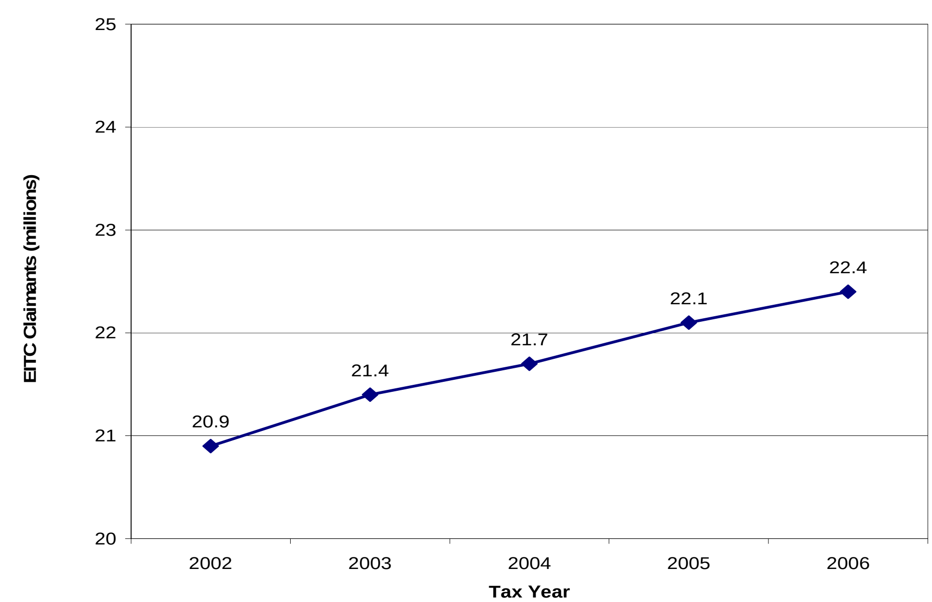
[10] Pub. L. No. 103-62, 107 Stat. 285 (codified as amended in scattered sections of 5 U.S.C., 31 U.S.C., and 39 U.S.C.).

Although the IRS is unable to measure the increase in EITC participation and the reduction in erroneous payments, indicators show some increase in EITC participation and the development of processes to successfully identify billions of dollars in potentially erroneous EITC payments.

Indicators show some increase in EITC participation

Analysis of two key indicators–the number of taxpayers who claim the EITC from year to year and the number of new EITC claimants from 1 year to the next–has increased. As shown in Figure 2, the number of taxpayers who claimed the EITC has grown steadily at an average rate of approximately 1.8 percent per year.

Figure 2: Growth in EITC Claimants (TYs 2002 - 2006)



Source: IRS EITC Fact Sheet TYs 2002 - 2006.

The number of new EITC claimants in the Program each year has also increased. These could be taxpayers who have claimed the EITC in the past but had stopped claiming the Credit and then began claiming it again, or taxpayers who have never claimed the EITC and are claiming it for the first time (see Figure 3[11]).

[11] Our analysis used TY 2002 as the base population of EITC claimants and compared claimant population to subsequent years.

Figure 3: New EITC Claimants (TYs 2003 - 2006)

Tax Year	Total EITC Claimants (millions)	New Claimants (millions)	Percentage of New Claimants
2003	21.4	6.9	32.2%
2004	21.7	6.9	31.8%
2005	22.1	7.0	31.7%
2006	22.4	7.2	32.1%

Source: IRS EITC Fact Sheet TYs 2002 - 2006 and our analysis of EITC Claimant Files on the Treasury Inspector General for Tax Administration Data Center Warehouse.

The IRS recognizes that the EITC-eligible population is constantly changing and has developed a strategic research plan to gain a better understanding of taxpayers' movement within the EITC Program. These projects will be useful in identifying new areas in which the IRS can focus its continued efforts to improve EITC participation. Projects include updating and analyzing trends for return characteristics and behavioral trends of EITC filers to determine why taxpayers move in and out of the EITC claimant population. Further, the IRS has initiated a number of actions to increase EITC participation, including:

- Partnering to conduct outreach with more than 300 coalitions, which represent hundreds of nonprofit organizations, financial institutions, and government agencies. These coalitions conduct their own local EITC outreach through direct mail and media efforts.
- Holding an annual National EITC Awareness Day to create national awareness of the EITC and educate the diverse EITC population. Actions include public appearances by members of Congress and key IRS executives to discuss the benefits of the EITC and focused assistance at IRS Taxpayer Assistance Centers.
- Improving information and tools available on the IRS web site (IRS.gov) to provide assistance to taxpayers, tax preparers, and the IRS EITC partners. For example, the IRS has updated the EITC Assistant, the EITC Electronic Toolkit for Tax Preparers, and the Electronic Toolkit for EITC Partners and has launched EITC Marketing Express.
- Providing key EITC Program information during annual Nationwide Tax Forums. Presentations were made to 14,800 tax preparers nationwide in 2007.
- Sending computer-generated notices proactively to taxpayers who file tax returns and appear to be eligible for the EITC but did not claim the Credit. For example, the IRS sent more than 650,000 notices based on information reported on TY 2006 returns.

__Processes have been developed to successfully identify billions of dollars in erroneous EITC payments__

Prior to 2004, the IRS focused on ways to identify EITC noncompliance. As a result, it has successfully developed a number of processes to identify erroneous EITC payments. All of the efforts listed below, except for document matching, are performed prior to issuance of a potentially erroneous EITC payment.

- *Electronic Filing Filters* – The IRS reviews electronically filed tax returns before they are accepted for processing to ensure that specific information on the tax returns is accurate. For example, filters verify whether a valid Social Security Number (SSN) is present for each qualifying child being claimed for the EITC. Tax returns that do not have a valid SSN are rejected to the taxpayer for correction.

- *Math Error* – Congress authorized the IRS to correct certain mathematical or clerical errors on a tax return without opening an audit. This authority was later expanded to allow the IRS to adjust or disallow the EITC when a valid SSN is missing for a child claimed for the EITC or when earned income is above the maximum level for the EITC.

- *Dependent Database Audits* – The Dependent Database is made up of a collection of information databases that include birth certificate information and court documents used to establish a relationship and residency between the taxpayer and the qualifying children claimed on the tax return. Taxpayers must meet a relationship and a residency test to claim the EITC for the qualifying children listed on the tax return. Tax returns with an EITC claim are processed through the Dependent Database when the tax return is filed. [redacted] Two of the primary sources of information included in the Dependent Database are the Social Security Administration KIDLINK and the Department of Health and Human Services Federal Case Registry. The KIDLINK database includes birth records that associate the name and SSN of the birth parents with the name and SSN of the child. The Federal Case Registry is a collection of information provided by the States that includes divorce decrees and other child custody orders established in the United States court system.

- *EITC Recertification Audits* – Because of the potential EITC compliance problems, Congress passed legislation requiring taxpayers who had the EITC denied during examinations to prove eligibility before receiving the EITC again. The IRS initiated the EITC Recertification Program to implement this legislation and to address the compliance issues. If a taxpayer does not provide adequate support to prove that he or she is entitled to receive the EITC during an examination, the IRS will deny the EITC and place a "recertification" indicator on the taxpayer's account. This indicator prevents the taxpayer from receiving the EITC until the taxpayer can prove he or she is entitled to receive the Credit. Once the taxpayer provides the IRS Examination function with supporting documentation to prove that he or she is entitled to receive the EITC, the IRS will remove the recertification indicator from the taxpayer's account and issue the EITC. The IRS refers to this process as "recertification." These audits are conducted prior to payment of the EITC claim.

- *Document Matching* – Subsequent to the filing and processing of tax returns containing an EITC claim, the IRS matches third-party information documents to information reported on the tax return to identify unreported or underreported income that–if included on the tax return–would reduce the amount of EITC a taxpayer is entitled to.

Implementation of the above enforcement tools has protected billions of dollars in EITC revenue. Figure 4 provides an analysis of EITC enforcement results.

Figure 4: EITC Enforcement Results (TYs 2002 - 2006)

Enforcement Program	TY 2002	TY 2003	TY 2004	TY 2005	TY 2006
Math Error[12]	699,277	624,590	515,890	460,316	Not Available[13]
EITC Audit Closures[14]	421,889	472,022	527,969	517,617	502,519
Document-Matching Cases	Not Available[15]	228,028	324,419	364,020	394,217
Total Revenue Protected	$1.71 billion	$2.05 billion	$2.47 billion	$2.62 billion	$2.65 billion

Source: IRS EITC Fact Sheet TYs 2001 - 2005 and EITC Compliance Fact Sheet FYs 2003 – 2007 as of February 2008.

[12] EITC withheld from claimant; includes decreases in the amount of EITC claimed as well as disallowance of the full EITC claim.
[13] The TY 2006 results of the Math Error Program were not available from the IRS at the time we conducted our review.
[14] Includes results for all EITC audits, including Dependent Database and EITC Recertification Audits closed as of February 2008.
[15] TY 2003 (FY 2004) was the first year the IRS had a dedicated EITC Document-Matching Program. As a result, comparable statistics are not available for years prior to TY 2003.

Alternatives to Traditional Compliance Methods Are Needed to Reduce the Billions of Dollars in Identified Erroneous Earned Income Tax Credit Payments

The IRS continues to report that $10 billion to $12 billion in erroneous EITC payments are issued each year. Compliance resources are limited and additional alternatives to traditional compliance methods have not been developed, resulting in the majority of the potentially erroneous EITC claims identified being paid in error. Beginning in TY 2005, the IRS reallocated its examination resources across all areas of the tax code to address a greater number of higher income taxpayers. However, this decision limited the number of EITC audits that the IRS performs each year, [redacted] Figure 5 identifies the number of potentially erroneous EITC claims identified by the Dependent Database compared to the number of those tax returns selected for and closed by audit. [redacted]

Figure 5: Percentage of EITC Returns Audited - Dependent Database (TYs 2002 - 2006)

Tax Year	Number of EITC Returns Identified for Audit	Number of Returns Audited	Percentage of Returns Audited
2002	[redacted]	[redacted]	[redacted]
2003	[redacted]	[redacted]	[redacted]
2004	[redacted]	[redacted]	[redacted]
2005	[redacted]	[redacted]	[redacted]
2006	[redacted]	[redacted]	[redacted]

Source: Information from the IRS Dependent Database and the IRS Measuring Effectiveness of EITC Dependent Database - FYs 2003 - 2006 Final Reports.

IRS management recognizes the limitations faced in significantly reducing noncompliance using the traditional process of auditing tax returns. The IRS Commissioner stated that he did not believe that the IRS could audit its way to full compliance and needed to drive for innovation in its enforcement efforts.[16] In addition, the EITC Program Office notes in its Draft 2008 Concept of Operations that the IRS cannot fully address EITC noncompliance by simply auditing returns and must pursue alternatives to traditional compliance efforts. The Pre-Refund Concept of

[16] United States Department of Treasury Internal Revenue Service, 2008 Tax Analysts Conference, *The IRS Restructuring and Reform Act of 1998, 10 Years After Reform: What's Working, What's Not, What's Next*, July 18, 2008.

Operations also contains plans to evaluate the benefit of moving some of the IRS' current pre-refund compliance functionality into enhanced pre-refund options, including the math error program.

Although the IRS has developed better ways to identify EITC noncompliance, it has not pursued additional alternatives to address the identified potentially erroneous EITC claims. For example, the IRS has spent millions of dollars developing probability filters to improve its selection of cases for audit using information contained in the Dependent Database. These filters [redacted] to determine the likelihood that an EITC claim is in fact erroneous. Use of probabilities allows the IRS to maximize the benefit gained from its examination resources by working the most productive audits. By combining the use of probability filters with external data included in the Dependent Database, the IRS increased its EITC audit change rate from 89.7 percent on TY 2004 tax returns to 93.9 percent on TY 2005 tax returns.

Notwithstanding the success of combining external data with probability filters in identifying erroneous claims, the IRS takes action to stop payment for only a small percentage of these claims. For example, for TY 2005, the IRS identified 594,312 EITC claims for which information contained in the Dependent Database identified that the [redacted] requirement did not appear to have been met for EITC claims totaling $1.3 billion. However, the IRS [redacted]

To address erroneous EITC claims, the IRS conducts audits and, in some limited situations, uses math error processing. For example, the IRS has the authority to address EITC claims with an invalid SSN. When this condition is identified, the IRS can systemically adjust the amount being claimed for the EITC to disallow all or a portion of the EITC claim based on identification of the invalid SSN. Management officials from the EITC Program Office advised us that they continually evaluate EITC processes and programs for inclusion in math error processing. Criteria for possible inclusion include:

- Size of the error that could be addressed.
- Accuracy and consistency of the process or program results.
- Assurance that at least 95 percent of the returns identified will have an error.
- Non-discrimination against any segment of the population.
- Return on investment is greater than the cost of implementing the math error process.

Math Error Processing

- **Uses fewer resources than traditional audits.**
- **Traditionally used to correct a tax return based on a known event or error.**
- **Allows the IRS to address 100 percent of cases for which the authority is granted.**
- **Allows for correction of errors before issuance of a tax refund.**

Certain criteria for EITC Program Office consideration of expansion of math error processing are already being met by the IRS Dependent Database process. Our analysis of Dependent Database statistics for TY 2005 showed that the IRS adjusted the amount of EITC being claimed in 95.4 percent of the 103,009 instances [redacted] If the IRS was able to systemically adjust the EITC claims using math error processing [redacted] it could address $5.6 billion in erroneous EITC claims over a 5-year period. Nonetheless, management does not plan to pursue expansion of math error authority to include these cases because they believe that use of probability filters to identify these cases is inconsistent with the intent of math error authority.

> ***Despite the success of combining probability filters with external data to identify erroneous claims, no action is taken to stop most of these claims.***

If further expansion of the math error authority is not possible to cover cases identified using probability filters, the IRS needs to develop alternative processes that are less costly than an audit to protect revenue associated with erroneous EITC claims. These alternatives might require legislative changes. The IRS should work with the Assistant Secretary of the Treasury for Tax Policy to obtain legislative authority for an improved process that can make use of its success in combining external data with probability filters. If the IRS does not move beyond traditional compliance methods, it will be unable to significantly reduce the amount of erroneous EITC payments, which is estimated to be $10 billion to $12 billion annually. As technology and data sharing among Federal Government agencies improve, the IRS must continually evaluate its ability to ensure that taxpayers are filing accurate tax returns and paying the correct amount of tax.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Conduct a study to identify alternative processes that will expand the IRS' ability to effectively and efficiently identify and adjust erroneous EITC claims for which data show that the taxpayer does not meet the EITC qualifying-child relationship and/or residency tests.

> ***Management's Response:*** IRS management agreed with this recommendation. The IRS will continue its ongoing efforts to identify new alternatives to effectively expand its treatment of EITC errors while protecting taxpayer rights and minimizing taxpayer burden. As part of these efforts, the IRS will conduct a study of Federal Case Registry

information to determine its accuracy and applicability for exercising existing math error authority to deny the EITC during upfront processing of the tax return.

Recommendation 2: Work with the Assistant Secretary of the Treasury for Tax Policy to obtain the authority necessary to implement alternative processes to adjust erroneous EITC claims for which data show that the taxpayer does not meet the EITC qualifying-child relationship and/or residency tests.

Management's Response: IRS management agreed with this recommendation and will communicate any relevant results from their corrective action to Recommendation 1 to the Assistant Secretary of the Treasury for Tax Policy for his or her consideration.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall audit objective was to assess the IRS' progress in improving administration of the EITC Program since FY 2003. Our review included assessing oversight of the Program and efforts taken to improve compliance with and participation in the Program. To accomplish this objective, we:

I. Identified IRS initiatives and legislative changes implemented during FYs 2003 through 2007 to increase the number of eligible taxpayers who claim the Credit and reduce or prevent EITC overclaims.[1] We met with the Director of the EITC Program to discuss efforts implemented; reviewed various EITC and Wage and Investment Division performance reports, the IRS EITC Research Plans for FYs 2005 through 2007, and the 2007 EITC Communications Plan; and determined whether the IRS had successfully implemented new EITC programs and tools described in its March 2004 Concept of Operations document.

II. Evaluated the IRS' ability to significantly improve administration of the EITC Program as a result of Program changes, implementation of initiatives identified in Step I., and changes to the EITC Program Office.

A. Determined the progress the IRS has made in establishing a consistent method to measure EITC participation as recommended in a June 2003 Treasury Inspector General for Tax Administration report.[2]

B. Evaluated the IRS' performance during FYs 2003 through 2007 to determine whether 1) participation in the EITC improved and 2) EITC overclaims were reduced by analyzing available IRS data for participation and overclaims. We were unable to validate the reliability of the IRS data. Information needed to recreate the IRS studies used to determine estimated participation rates and compliance rates was not available.

C. Determined whether initiatives identified in Step I. affected participation and compliance by performing trend analysis using EITC data from the IRS and the Treasury Inspector General for Tax Administration Data Center Warehouse EITC Claimant File. We verified a judgmental sample of seven records in the Claimant File, one for each processing year and tax year from 2003 through 2007, to

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[1] See Appendix V for a glossary of terms.

[2] *Opportunities Exist to Improve the Administration of the Earned Income Tax Credit* (Reference Number 2003-40-139, dated June 2003).

information in the IRS Integrated Data Retrieval System to ensure that the data had been pulled correctly when the File was created. We were unable to validate the reliability of the IRS data. Information needed to recreate the IRS studies used to determine estimated participation rates and compliance rates was not available.

D. Identified barriers the IRS faces in being able to make significant improvements to compliance with the EITC.

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)
Russell P. Martin, Director
Deann Baiza, Audit Manager
Karen Fulte, Lead Auditor
Linda Bryant, Senior Auditor
Sharla Robinson, Senior Auditor
Sandra L. Hinton, Auditor
Bonnie Shanks, Auditor

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, Electronic Tax Administration and Refundable Credits, Wage and Investment Division SE:W:ETARC
Director, Earned Income Tax, Wage and Investment Division SE:W:ETARC:E
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Senior Operations Advisor, Wage and Investment Division SE:W:S

Appendix IV

Prior Audit Report Recommendations

Below are brief synopses of the Treasury Inspector General for Tax Administration reports issued during FYs 2003 through 2007 that addressed management and oversight of the EITC Program as well as the performance of individual EITC compliance programs. The IRS agreed to take corrective action on the recommendations listed below except where noted.

Not All Available Information Was Considered When Examining Tax Returns at the Austin Campus During the Fiscal Year 2000 Earned Income Credit Initiative
(Reference Number 2003-40-037, dated December 2002). The overall objective of the review was to determine whether employees at the IRS Austin, Texas, Campus[1] appropriately closed correspondence examinations and considered available systemic information, specifically where it relates to the self-employment income reported by taxpayers and the EITC available to them. The Treasury Inspector General for Tax Administration received a Congressional inquiry regarding an allegation made by IRS employees that the Compliance function at the Austin Campus incorrectly closed examination cases during the FY 2000 EITC Initiative. Tax returns examined as part of this Initiative were closed inappropriately without the IRS considering systemic information to verify taxpayers' self-employment income. We made one recommendation:

- Recommendation 1 – The IRS should consult with the Office of Chief Counsel to determine the effect of the disallowance of taxpayers' self-employment income and Social Security quarter credits and whether the IRS' actions violated the taxpayers' rights or entitlements.

Not All Available Information Was Considered When Self-Employment Income Was Examined During the Fiscal Year 2000 Earned Income Tax Credit Initiative
(Reference Number 2003-40-135, dated June 2003). The overall objective of the review was to determine whether IRS employees appropriately closed correspondence examinations and considered available systemic information, specifically where it related to the self-employment income reported by taxpayers and the EITC available to them. This review was a continuation of our work that began with an allegation made by IRS employees that the Correspondence Examination function at the Austin Campus inappropriately closed correspondence examination cases during the FY 2000 EITC Initiative. We found that taxpayer accounts were adjusted without consideration of all available systemic information and that the campuses could have expended correspondence examination resources more effectively. We made two recommendations:

[1] See Appendix V for a glossary of terms.

- Recommendation 1 – The IRS should consult with the IRS' Office of Chief Counsel to determine the effect on taxpayers' rights and entitlements when valid self-employment income was disallowed for some of the taxpayers examined under the FY 2000 EITC Initiative.
- Recommendation 2 – The IRS should ensure that IRS campuses properly research and classify tax returns for all future EITC initiatives, especially for those tax returns that cannot be electronically screened.

Opportunities Exist to Improve the Administration of the Earned Income Tax Credit (Reference Number 2003-40-139, dated June 2003). The overall objective of the review was to assess the IRS' progress in improving administration of the EITC Program since September 30, 2000. We made two recommendations to improve administration of the Program:

- Recommendation 1 – To help measure the success of the Program, the IRS should establish long-term goals and related measures for the EITC Program that reflect the Program's anticipated outcomes over time.
- Recommendation 2 – To help measure the success of the Program, the IRS should establish a consistent method to measure progress toward its long-term goals. The method should include an assessment of the frequency with which the measures are computed.

Taxpayers Were Assessed Additional Tax for Advance Earned Income Credit Payments Not Received (Reference Number 2003-40-126, dated June 2003). The overall objective of the review was to determine whether the IRS had reasonable assurance during tax return processing that the Advance Earned Income Credit (AEIC) payments reported by taxpayers were correct. The AEIC allows employees who are eligible for the EITC to receive a portion of that credit in advance with their pay during the year. These taxpayers are required to file a Federal tax return and report the AEIC payments as additional tax, which is offset by the EITC that they might be entitled to receive. We made one recommendation:

- Recommendation 1 – To help improve the processing of the AEIC, the IRS should establish procedures to ensure the reported AEIC payment amounts are reconciled with the Form W-2[2] amounts and correctly input during processing of individual income tax returns.

The Selection of Earned Income Tax Credit Returns for Examination Can Be Improved to Further Prevent Erroneous Payments (Reference Number 2004-40-004, dated October 2003). The overall objective of the review was to determine whether the IRS' process for selecting EITC cases for examination is providing the best effect on compliance and fairness to taxpayers. Specifically, we determined whether the Dependent Database examination case selection process for EITC returns results in the greatest benefit at the least cost (cost-benefit) while ensuring that taxpayers are treated fairly and uniformly under the law. The IRS has a good process for

[2] Wage and Income Statement (Form W-2).

evaluating the results of the Dependent Database case selection process that allows for necessary adjustments to be made. In addition, the types of returns selected for examination through the Dependent Database process are representative of taxpayers who claim the EITC based on qualifying children. However, the IRS cannot determine if the selection process ensures that resources are being used to provide the greatest cost-benefit because it does not use cost data and yield in the evaluation of the case selection process. We made two recommendations:

- Recommendation 1 – To improve the Dependent Database case selection process, the IRS should complete an analysis of the historical Dependent Database examination data to determine if there is a relationship among the direct examination time, rules identified, and disposition of examinations. If there is a relationship, cost-benefit data should be incorporated into the criteria used in the rule score for the Dependent Database case selection process. Absent a relationship, an average cost of examinations should be used to conduct a cost-benefit analysis to incorporate into the rule score.
- Recommendation 2 – The IRS should incorporate a cost-benefit analysis into the Dependent Database Risk-Based Scoring Model planned for implementation in January 2004.

Management Controls Over the Proof of Concept Test of Earned Income Tax Credit Certification Need to Be Improved (Reference Number 2004-40-032, dated December 2003). The overall objective of the review was to determine whether the IRS has an effective process to test its Concept of Operations for EITC certification and prepare for implementation of the Proof of Concept Test of EITC certification (the Test) for qualifying child residency requirements. Because of changes in the scope of the Test, the scope of this audit was limited to an evaluation of the IRS' general planning and preparations to implement the Test. A Task Force had studied how the IRS administers the EITC, with emphasis on improving EITC compliance. The Task Force recommended requiring certain types of taxpayers identified as at high risk of making erroneous EITC claims to verify that the children claimed for EITC purposes satisfy the Credit's relationship and residency requirements before the Credit is allowed. The IRS tested the concept of EITC certification for residency during the 2004 Filing Season. We made one recommendation:

- Recommendation 1 – To improve program oversight, the IRS should strengthen the controls over the Proof of Concept Test of EITC certification to be able to effectively measure and analyze the success of the Test.

The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit (Reference Number 2004-40-089, dated April 2004). The overall objective of the review was to determine whether the IRS had accurately updated all computer systems as necessary for the 2004 EITC Proof of Concept Test (the Test) in a timely manner. The Test was IRS' first step toward implementing the future vision for administering the EITC that was developed from recommendations made by a Task Force that examined the administration and complexity of the EITC. A number of computer systems and programs had to be revised to implement the Test. We made three recommendations:

- Recommendation 1 – To improve assurance that needed computer system changes are properly identified and accurately implemented, the IRS should work within the established guidelines to the extent possible when requesting necessary computer program changes related to the future vision of the EITC Program. While it may not be feasible to follow the full process for all changes, following as much of the process as possible will increase the assurance that requested computer system changes are programmed and implemented as intended.
- Recommendation 2 – For those instances in which using the formal request for computer changes is not feasible, the IRS should work with the Modernization and Information Technology Services function to establish a process to document the communication of requested business requirements. The documentation should include a record of discussions and electronic mail in which system changes are informally discussed and agreed upon.
- Recommendation 3 – To increase assurance that computer systems affected by future tests of the IRS' vision for the EITC are operating as intended, the IRS should meet with the Modernization and Information Technology Services function as early as possible in Calendar Year 2004 to establish guidelines or milestones identifying when final system change requests will be received and programming completed for future anticipated EITC tests. This agreement should provide increased assurance that, if these milestones are met, there will be sufficient time for proper testing of system changes prior to implementation.

The Statistical Sampling Method Used in the Earned Income Tax Credit Proof of Concept Test Appears Valid (Reference Number 2004-40-100, dated May 2004). The overall objective of the review was to determine the usefulness of the Test in enabling the IRS to make decisions regarding the future of its EITC Program. This audit focused on the statistical sampling methodologies used to select the various samples for the Test. However, we did not assess the selection criteria used for each sample. In addition, because the IRS had an independent third party validate the design of the Certification of Qualifying Child Residency Requirements (Certification) portion of the Test, our review of the Certification sample was limited to asking the Treasury Inspector General for Tax Administration's contracted statistician to review and provide an overall assessment of the third-party report. Overall, the statistical sampling method used to select the samples for the Test appears adequate and should provide reliable information on which to base future decisions.

We made no recommendations in this report, but we did express some concerns with the sizes of the sub-samples in the Certification portion of the Test and the impact that IRS contact with taxpayers included in this portion could have on the Test results. While these concerns do not affect the reliability of the samples, they could affect interpretation of the Test results. We suggested that the IRS use caution when interpreting and relying upon these results.

Initial Results of the Fiscal Year 2004 Earned Income Tax Credit Concept Tests Provide Insight on Ways Taxpayer Burden Can Be Reduced in Future Tests (Reference Number 2005-40-006, dated October 2004). The overall objective of the review was to determine whether tax returns included in the IRS EITC concept tests were processed accurately. This audit focused on the certification of the qualifying child residency and filing status tests. The first test of the IRS' certification concept involved 25,000 taxpayers who were asked to validate that the children they claimed for the EITC had lived with them for more than 6 months of Calendar Year 2003. The IRS' test to validate the filing status asked 36,000 taxpayers filing as Head of Household or Single to provide documentation supporting their filing status. We made one recommendation to avoid unnecessarily burdening taxpayers during future EITC concept tests:

- Recommendation 1 – The IRS should incorporate information gathered from the FY 2004 qualifying child residency and filing status concept tests into the planning and design of future EITC concept tests. Information related to increased or unnecessary burden should be used to ensure burden on taxpayers included in those tests is reduced as much as possible.

Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers (Reference Number 2005-40-015, dated December 2004). The overall objective of the review was to determine whether the IRS effectively implemented the 2-year ban. The ban is an important tool to help the IRS combat noncompliance. It not only encourages compliance but also helps to conserve resources because the IRS can deny the EITC during the ban period without conducting an examination. We made six recommendations to ensure the ban is consistently and correctly used:

- Recommendation 1 – To help ensure 2-year bans are consistently and correctly applied, the IRS should revise and distribute written ban guidelines that are clear, complete, and consistent with other IRS programs and procedures and accurately reflect the law.

- Recommendation 2 – To help ensure 2-year bans are consistently and correctly applied, the IRS should consider using available data to identify EITC examination cases with apparent abuse before taxpayers are contacted. Examiners could review these cases, which might otherwise be worked completely by the automated system and propose a ban on the initial examination report when warranted.

- Recommendation 3 – To help ensure 2-year bans are consistently and correctly applied, the IRS should make sure Compliance site management takes appropriate actions to help ensure all EITC examiners received adequate ban training, considered the ban on each EITC examination they work, and properly applied the ban guidelines.

- Recommendation 4 – To help ensure the correct tax years are banned, the IRS should revise the ban programming to consider unfiled and late filed tax returns. We believe this could be accomplished, in part, by establishing a computer field that contains the first tax year after the ban expires. This field could be used to determine which tax returns should be banned and which would require recertification. This field could also be used to help prevent actions subsequent to return processing that incorrectly allow the Earned Income Credit (EIC) for a banned tax year.

- Recommendation 5 – To help taxpayers comply with 2-year ban requirements and help them avoid the ban, the IRS should revise the CP 79A[3] to emphasize that recertifying taxpayers must meet EITC requirements, warn of the likelihood of an examination and potential for another ban, and reflect the revised Information To Claim Earned Income Credit After Disallowance (Form 8862) requirements when claiming the EITC without qualifying children. The revised notice should also include the first tax year for which the taxpayer may again be able to claim the EITC. If ban programming is revised as suggested in Recommendation 4, this tax year information would be available.
- Recommendation 6 – To help taxpayers comply with 2-year ban requirements and help them avoid the ban, the IRS should revise Form 8862 instructions and *Earned Income Credit (EIC)* (Publication 596) to emphasize that recertifying taxpayers must meet EITC requirements and to warn taxpayers about the ban. Also, the Commissioner, Wage and Investment Division, should revise Form 8862 instructions and the individual tax form instructions to explain (or provide a reference that explains) which years are banned.

The Earned Income Credit Recertification Program Continues to Experience Problems (Reference Number 2005-40-039, dated March 2005). The overall objective of the review was to evaluate the corrective actions taken by the IRS in response to the recommendations in our December 2000 report on the IRS EIC Recertification Program.[4] Our December 2000 report recommendations were intended to better safeguard Federal Government funds and help ensure the protection of taxpayer rights with the least amount of burden to taxpayers. The March 2005 report includes an evaluation of the EIC Recertification Program as it relates to the effectiveness of the corrective actions taken by the IRS in response to our prior report recommendations. The conditions identified in our December 2000 report included not accurately removing recertification indicators, not releasing suspended refunds in a timely manner, not clearly and accurately communicating with taxpayers, and the need to change certain processing procedures and the recertification criteria for certain taxpayers. We made six recommendations in our March 2005 report to address these continuing conditions:

- Recommendation 1 – To help ensure EIC recertification indicators on taxpayer accounts are accurate and taxpayers receive the EIC only when they are entitled to it, the IRS should develop clear, consistent, and comprehensive guidelines explaining when taxpayers are recertified and ensure guidelines are consistently followed. Recertification guidelines should explain the EIC Recertification Program complexities and nuances so managers, analysts,

[3] CP 79A is a computer-generated notice informing the taxpayer a ban was imposed.
[4] *Improvements Are Needed in the Earned Income Credit Recertification Program* (Reference Number 2001-40-030, dated December 2000).

programmers, and other individuals will be able to know exactly how the Program should be implemented. This will allow IRS employees to know what should be included in processing procedures, letters to taxpayers, tax publications, tax packages, and tax forms.

- Recommendation 2 – To help ensure EIC recertification indicators on taxpayer accounts are accurate and taxpayers receive the EIC only when they are entitled to it, the IRS should correct existing EIC Recertification Program computer programming and ensure future requests for programming are of sufficient detail to ensure applicable IRS employees know exactly what is needed. The computer programming should be sufficiently tested to identify and correct potential problems prior to implementation. In addition, computer programming should ensure the EIC allowed for recertification cases reflects the approval of Examination function employees.
- Recommendation 3 – To help ensure EIC recertification indicators on taxpayer accounts are accurate and taxpayers receive the EIC only when they are entitled to it, the IRS should ensure required quality reviews of non-examined closures are performed, the results are evaluated, and corrective actions are taken if appropriate. The IRS should change Examination function inventory reports to include counts for each type of non-examined closure for each EIC Program. These inventory reports should be evaluated to help ensure non-examined closures are appropriate.
- Recommendation 4 – To further ensure taxpayers receive EIC refunds affected by the recertification process in a timely manner, the IRS should ensure Problem Correction Reports identify unresolved suspended refunds, issue procedures for completing actions for the Problem Correction Reports within specified time periods, and evaluate monthly summary reports to assure the Problem Correction Reports are worked in a timely manner.
- Recommendation 5 – To further ensure taxpayers are properly and accurately notified about their involvement in the EIC Recertification Program and information provided to the taxpayers after filing their return is complete and understandable, the IRS should further revise communications to taxpayers to specifically inform them when they are recertified and notify potentially eligible taxpayers subject to recertification that they may still be entitled to the income-only EIC. The IRS should also revise communications to clearly explain why the EIC is not being allowed, that filing Form 8862 does not by itself recertify taxpayers, and that filing Form 8862 will likely result in an examination. Additionally, the IRS should include Form 8862 with the letters that deny the EIC because Form 8862 was not filed.
- Recommendation 6 – To ensure taxpayers are not required to file unnecessary Forms 8862 and taxpayers receive the EIC, the IRS should change computer programming, where appropriate, so electronically filed returns claiming the income-only EIC are not rejected because Forms 8862 are not filed.

The Earned Income Tax Credit Income Verification Test Was Properly Conducted (Reference Number 2005-40-093, dated May 2005). The overall objective of the review was to determine whether the IRS properly classified, selected, and processed test cases and accurately summarized and reported the results of the FY 2004 EITC income verification test. The income verification test was conducted in conjunction with the IRS Automated Underreporter Program and was designed to help the IRS identify ways to ensure taxpayers claiming the EITC properly report their income. While the IRS accurately identified and selected cases for the income verification test and processed those cases accurately and in a timely manner, we identified inaccuracies in a new tool that the IRS created to monitor and track the interim results of the test. However, these inaccuracies will not affect the final results of the current test or future tests. We made no recommendations.

Administration of the Earned Income Tax Credit Program Has Improved, but Challenges Continue (Reference Number 2005-40-133, dated August 2005). The overall objective of the review was to assess the IRS' progress in improving administration of the EITC Program since FY 2002. This review was a followup audit to a report we issued in June 2003, in which we reported that long-term performance goals and measures were needed, and fragmented management reduced the effectiveness of efforts to improve administration of the EITC Program. We made one recommendation to ensure that the Service Level Agreement process is working as intended and the EITC Program is successful:

- Recommendation 1 – To help ensure the Service Level Agreement process is working, the IRS should closely analyze the results of the Service Level Agreement currently in operation to ensure all functions are working within the agreements reached. If the Director, EITC, determines the desired results are not being achieved, the Director should consider elevating the level of management that signs the Agreement.

Controls Can Be Improved to Ensure Advance Earned Income Credit Reported on Individual Income Tax Returns Is Accurate (Reference Number 2006-40-103, dated July 2006). The overall objective of the review was to determine whether processing controls for individual tax returns ensured 1) AEIC payments reported by taxpayers were not greater than the maximum allowed by law, and 2) AEIC payments reported by an employer on a Form W-2 reconciled to the AEIC payments reported by the taxpayer on his or her individual income tax return. The AEIC Program was designed to provide taxpayers with 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. We made two recommendations to improve administration of the AEIC:

- Recommendation 1 – The IRS 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.

- Recommendation 2 – The IRS 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.

Appendix V

Glossary of Terms

Data Center Warehouse – A collection of IRS data housed by the Treasury Inspector General for Tax Administration for the purpose of conducting data analysis.

Dependent Database – A risk-based audit selection tool used by the IRS to identify tax returns for audit. The Database is made up of a collection of information databases that include birth certificate information and court documents used to establish a relationship and residency between the taxpayer and the qualifying children claimed on the tax return. The IRS uses information contained in the Dependent Database [redacted]

Earned Income – A modified calculation of total income in which some items are included while others are not.

EITC Concept of Operations – Provides a roadmap of the IRS' vision for the EITC Program.

EITC Overlcaim – The amount of the EITC claimed by a taxpayer above the amount to which he or she is entitled.

EITC Qualifying Child – A child who meets certain tests of relationship, age, and residency. A qualifying child must be the taxpayer's son, daughter, adopted child, stepchild, grandchild, or eligible foster child. The taxpayer's brother, sister, stepbrother, stepsister, half brother, or half sister (or their child) may also be a qualifying child. The child must have lived with the taxpayer in the United States for more than one-half of the tax year.

Federal Case Registry – A collection of information provided by the States that includes divorce decrees and other child custody orders established in the United States court system.

Filing Season – The period from January through mid-April when most individual income tax returns are filed.

Integrated Data Retrieval System – IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

IRS Campus – 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.

National Research Program – An annual review of a stratified, randomly selected sample of individual returns to evaluate individual taxpayer compliance.

National Taxpayer Advocate – The head of the Taxpayer Advocate Service. The Taxpayer Advocate Service serves as an advocate for taxpayers who need assistance resolving tax matters with the IRS.

Pre-Refund Concept of Operations – An agency-wide vision for improving the IRS' ability to identify and stop erroneous tax payments before the payments are made to taxpayers.

Putative Father – A person who is generally assumed to be the father of the child but for whom paternity has not been proven.

Taxpayer Assistance Center – An IRS office with employees who answer questions, provide assistance, and resolve account-related issues for taxpayers face to face.

Appendix VI

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

COMMISSIONER
WAGE AND INVESTMENT DIVISION

RECEIVED
DEC 12 2008

DEC 12 2008

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard Byrd, Jr.
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments (Audit # 200740029)

I reviewed your draft report and agree with your recognition of the advances made by the Earned Income Tax Credit (EITC) Program. As you acknowledged in your report, IRS made a number of significant improvements to the program, including development of two long term strategic goals, increasing participation of eligible taxpayers and reducing erroneous payments, and the establishment of methodologies to consistently measure these goals. The IRS implemented several initiatives aimed at achieving progress toward these goals, such as expanded outreach and education strategies to promote participation and education about the credit among both taxpayers and preparers. Another example is the improvements to examination selection processes that reduce taxpayer burden while increasing revenue protected. Through these and other efforts, the number of taxpayers claiming EITC from Tax Year (TY) 2002 to 2006 increased by 1.5 million and the amount of revenue protected increased by almost $1 billion.

I appreciate your insightful recognition of the continuing challenges faced by the EITC Program. The credit's eligibility rules are very complicated, particularly the requirements to meet the relationship and residency tests. The complexity in applying these rules to common real-life situations is a challenge for both taxpayers and preparers, and influences EITC error. Also, the IRS cannot independently validate whether taxpayers meet eligibility requirements for EITC. Beyond information reporting on income (W-2s and 1099s, e.g.), the IRS lacks the data necessary to confirm taxpayers are EITC-eligible. For example, there is no definitive database that establishes the relationship between the claimants and the children they are claiming. Nor is there a database that contains the living arrangements for these individuals. Without this knowledge, the IRS is unable to determine eligibility without the use of compliance tools such as audits. The changing EITC population, with only 20 percent consistently claiming EITC from year-to-year, complicates our efforts to identify and reach this population to inform and educate them about the credit.

As such, I agree that alternatives to traditional compliance methods are needed to address EITC error. The IRS believes we cannot audit our way to EITC compliance as we are continuing to study and test new and innovative solutions to the error problem. Some of our efforts are discussed below.

- Qualifying Child Residency Certification – Over a three year period, IRS tested a new treatment that required taxpayers to provide verification they met the EITC residency requirement before they received the EITC. Although the test was successful in deterring ineligibles and resulted in protected revenue, other factors such as taxpayer burden and return on investment influenced our decision not to implement this concept. However, the selection criteria used to successfully identify the potential non-compliant population for this study were incorporated into our model for examination case selection.

- Soft Notices – The IRS currently sends over 150,000 notices annually in situations where a qualifying child for EITC purposes is claimed by more than one taxpayer. The notices ask taxpayers to self-correct. This is an inexpensive approach to successfully address this type of error. In 85 percent of the cases where a soft notice was sent for TY 2002, the taxpayer did not repeat their behavior in the subsequent year. We are also studying the use of soft notices for other areas of EITC non-compliance.

- Preparer Treatments – The IRS recognized that a preparer focus might prove to be an effective new direction since 70 percent of EITC returns are prepared by paid preparers. By correcting the behavior of one preparer, many EITC taxpayers may be affected. The IRS is testing the effectiveness of various preparer treatments, including due diligence audits, educational visits, and educational/compliance contacts with new EITC preparers. The goal is to establish a suite of progressive treatments that will cost effectively address preparer noncompliance.

We plan to continue our efforts to identify new sources of information to verify EITC eligibility, additional math error options, and alternative compliance treatments to address EITC error. As with all strategic business decisions to achieve a balanced compliance program across all areas of the tax gap, the IRS will consider the protection of taxpayer rights and impact on taxpayer burden as part of any new solutions.

Attached are our comments to your recommendations. If you have any questions, please call me at (404) 338-7060, or a member of your staff may contact Verlinda Paul, Director, Earned Income Tax Credit, at (404) 338-7112.

Attachment

RECOMMENDATION 1
The Commissioner, Wage and Investment Division should conduct a study to identify alternative processes that will expand the IRS' ability to effectively and efficiently identify and adjust erroneous EITC claims for which data show that the taxpayer does not meet the EITC qualifying-child relationship and/or residency tests.

CORRECTIVE ACTION
The IRS will continue its ongoing efforts to identify new alternatives to effectively expand its treatment of Earned Income Tax Credit (EITC) error while protecting taxpayer rights and minimizing taxpayer burden.

As part of these efforts, we will conduct a study of Federal Case Registry information to determine its accuracy and applicability for exercising existing math error authority to deny the EITC during upfront processing of the tax return.

IMPLEMENTATION DATE
April 15, 2010

RESPONSIBLE OFFICIAL
Director, Earned Income Tax Credit, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control process.

RECOMMENDATION 2
The Commissioner, Wage and Investment Division should work with the Assistant Secretary of the Treasury for Tax Policy to obtain the authority necessary to implement alternative processes to adjust erroneous EITC claims for which data show that the taxpayer does not meet the EITC qualifying-child relationship and/or residency tests.

CORRECTIVE ACTION
We will communicate any relevant results from our corrective action to Recommendation 1 to the Assistant Secretary of the Treasury for Tax Policy for his or her consideration. However, this is a tax policy issue and, as such, is under the purview of the Treasury Department.

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL
N/A

CORRECTIVE ACTION MONITORING PLAN

N/A