Letter Report: The Internal Revenue Service Did Not Thoroughly Validate the Accuracy of the Mortgage Interest Credits and the Related Mortgage Interest Deductions

July 2001

Reference Number: 2001-40-121

TD P 15-71

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

July 24, 2001

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Pamela J Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Letter Report - The Internal Revenue Service Did Not Thoroughly Validate the Accuracy of the Mortgage Interest Credits and the Related Mortgage Interest Deductions

This report presents the results of our review to determine if the Internal Revenue Service (IRS) correctly processed Mortgage Interest Credits (MIC). In summary, we found that the IRS did not validate the accuracy of approximately 102,000 MICs processed for Tax Year 1999. As a result, it did not have an assurance that approximately $121 million in credits were correct.

We recommended that the Commissioner, Wage and Investment Division, should: (1) take additional steps to ensure taxpayers receive all MICs that they are entitled and (2) improve controls during the processing of the credit to provide reasonable assurance that the taxpayer does not [redacted]

Management's response was due on July 13, 2001. As of that date, management had not responded to the draft report.

The Treasury Inspector General for Tax Administration (TIGTA) has designated this report as Limited Official Use (LOU) pursuant to Treasury Directive TD P-71-10, Chapter III, Section 2, "Limited Official Use Information and Other Legends" of the Department of Treasury Security Manual. Because this document has been designated LOU, it may only be made available to those officials who have a need to know the information contained within this report in the performance of their official duties. This report must be safeguarded and protected from unauthorized disclosure; therefore, all requests for disclosure of this report must be referred to the Disclosure Unit within the TIGTA's Office of Chief Counsel.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Walter E. Arrison, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (770) 936-4590.

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Objective and Scope

The objective of this review was to determine if the IRS ensured the MIC was processed correctly.

The overall objective of this review was to determine if the Internal Revenue Service (IRS) correctly processed Mortgage Interest Credits (MIC). This audit is one in a series designed to evaluate the IRS' processing of tax credits commonly claimed by Wage and Investment taxpayers.[1]

We conducted this audit at the National Headquarters and the Atlanta and Kansas City Submission Processing Centers (ATSPC and KCSPC, respectively) between October 2000 and January 2001. We analyzed 404 tax returns claiming MICs that were processed either at these Centers or electronically between January 16 and September 9, 2000. This audit was performed in accordance with *Government Auditing Standards.*

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

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[1] The Treasury Inspector General for Tax Administration (TIGTA) has audits in process for the Adoption, Child and Dependent Care, Education, Elderly or the Disabled, and Mortgage Interest Credits. The TIGTA previously issued audit reports on the Earned Income Credit (*Management Advisory Report: Administration of the Earned Income Credit* (Reference Number 2000-40-160, dated September 27, 2000)) and the Child Tax and Additional Child Tax Credits (*The Internal Revenue Service Had a Successful 2000 Filing Season; However, Opportunities Exist to More Effectively Implement Tax Law Changes* (Reference Number 2001-40-041, dated January 31, 2001)).

Background

The MIC was established to provide housing assistance to low and moderate income families.

The MIC was established in 1984 as a means of providing housing assistance to families of low and moderate income. The credit is available to home buyers who meet household income and home purchase price limits established by the federal government.

State and local governments issue mortgage credit certificates, with credit rates ranging from 10 percent to 50 percent. This credit is claimed on the Individual Income Tax Return (Form 1040) and computed on the MIC (Form 8396). Generally, the credit is computed by multiplying the rate on the certificate by the amount of mortgage interest paid during the year. If the rate is more than 20 percent, the credit is limited to $2,000. Taxpayers can also carry forward credit amounts that are greater than their taxes from 3 previous years. The credit can reduce tax to zero, but if the credit is more than the tax the excess is not refunded.

Unlike several other credits, the MIC is not phased out as a taxpayer's adjusted gross income (AGI) increases. A taxpayer may claim the credit as long as he/she resides in the home for which the certificate applies, despite any increase in AGI. However, the taxpayer must reduce his/her mortgage interest deduction on Schedule A, Itemized Deductions of Form 1040, by the corresponding MIC.

Results

The IRS has no assurance that millions of dollars allowed in MICs are correct.

The IRS did not validate the accuracy of the approximately 102,000 MIC claims totaling $121 million that it processed for Tax Year (TY) 1999.[2] (b)(7)(E) [redacted] As a result, the IRS did not have an assurance that the millions of dollars allowed were correct.

Our analysis showed that some taxpayers may not have received all of the credit they were entitled to, while others improperly benefited from (b)(7)(E) [redacted]

The IRS also could not validate several other requirements, (b)(7)(E) [redacted] While the IRS could rely on subsequent examinations to validate the credits, (b)(7)(E) [redacted]

Appendix IV provides an overview of the requirements for receiving this credit along with a corresponding explanation of the IRS' processing procedures.

[2] These figures represent all TY 1999 returns processed with the MIC between January 16 and September 9, 2000 (all return data available when we obtained the electronic information for review). All subsequent references to TY 1999 returns use this same processing period.

The Internal Revenue Service Relies on Taxpayers to Accurately Compute Millions of Dollars in Mortgage Interest Credits

Some taxpayers may not have received all the MIC they were entitled

Form 8396 instructs taxpayers to enter the rate shown on their certificate. However, the rate cannot be less than 10 percent or more than 50 percent. They are then instructed to multiply the rate by the amount of mortgage interest paid for the year on the home qualifying for the credit.

Taxpayers are using improper rates to compute the MIC.

Our computer analysis identified 42,954 MIC claims that were processed either electronically or at the ATSPC or KCSPC.[3] We reviewed a statistically valid sample of 202 of these credits.[4] Thirteen percent of the credits were computed using a certificate rate less than the 10 percent minimum. The rates for these credits ranged from 6 to 9.5 percent and resulted in the taxpayers receiving a total of at least $2,000 less in credits.

Based on the results of our sample, we estimate that 5,584 of the 42,954 taxpayers were entitled to additional credits of at least $390,880. While we did not test the other 59,046 returns with the MIC that were processed at the other eight IRS Submission Processing Centers, we have no reason to believe that this condition would not also exist in those other locations.

[3] This is from the total population of 102,000 TY 1999 returns with MICs processed nationwide by the IRS between January 16 and September 9, 2000.

[4] We used a 92.5 percent confidence level at +/- 3 precision and 5 percent error rate to determine the sample size.

In general, mortgage interest rates are less than 10 percent. This could indicate that taxpayers might be using their mortgage interest rates instead of the certificate rate to compute the credit. (b)(7)(E) [redacted]

Taxpayers were improperly benefiting from (b)(7)(E) [redacted]

Form 8396 instructs taxpayers (b)(7)(E) [redacted]

Taxpayers are benefiting from the (b)(7)(E) [redacted]

We reviewed a statistically valid sample of 202 tax returns from a population of 30,401, (b)(7)(E) [redacted]

Based on the results of our sample, 2,128 of the 30,401 taxpayers received \$2.7 million in erroneous mortgage interest deductions. While we did not test the other 71,599 returns, with the MIC, that were processed at the other 8 IRS Submission Processing Centers, we

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[5] This population was identified from the 102,000 TY 1999 returns with MICs processed nationwide by the IRS between January 16 and September 9, 2000. We used a 92.5 percent confidence level at +/- 3 precision and 5 percent error rate to determine the sample size.

[6] We limited our error cases to tax returns where the amounts of mortgage interest the taxpayer used to compute the MIC and mortgage interest deducted on Schedule A were the same.

have no reason to believe that this condition would not also exist in those other locations.

Recommendations

1. The Commissioner, Wage and Investment Division, should take additional steps to ensure taxpayers receive all MICs that they are entitled.

Management's Response: Management's response was due on July 13, 2001. As of that date, management had not responded to the draft report.

2. The Commissioner, Wage and Investment Division, should improve controls during the processing of the credit to provide reasonable assurance that the taxpayer does not (b)(7)(E) [redacted]

Conclusion

The IRS did not have validity checks in place when it processed 102,000 MIC claims. As a result, it did not have an assurance that these credits were accurate.

Appendix I

Major Contributors to This Report

Walter E. Arrison, Assistant Inspector General for Audit (Wage and Investment Income Programs)
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Appendix II

Report Distribution List

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Field Director, Submission Processing, Kansas City W:CAS:SP:KC

Appendix III

Outcome Measures

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

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 5,584 taxpayers entitled to $390,880 more in Mortgage Interest Credit (MIC) (see page 4).

Methodology Used to Measure the Reported Benefit:
Our computer analysis identified approximately 102,000 Tax Year (TY) 1999 tax returns processed with the MIC nationwide between January 16 and September 9, 2000. We reviewed a statistically valid sample of 202 tax returns from a population of 42,954 tax returns processed either electronically or at the Atlanta or Kansas City Submission Processing Centers (ATSPC and KCSPC, respectively). We found 26 (13 percent) tax returns where taxpayers used a Mortgage Credit Certificate rate less than the 10 percent minimum rate required to compute the credit. We projected the 13 percent error rate to the sample sites as follows:

Total Mortgage Interest paid for the 26 cases with certificate rates less than 10%	$117,802
Mortgage Interest paid at 10% minimum rate[1]	$ 11,780
Total MIC allowed the 26 taxpayers	$ 9,973
Additional Amount of MIC owed to taxpayers (11,780 - 9,973)	$ 1,807
Average Amount of MIC owed to taxpayers ($1807 / 26)	$ 70
Total Number of Taxpayers affected (42,954 x 13%)	5,584
Total Dollars more in MIC that could be owed to taxpayers (5,584 x $70)	$390,880

[1] Minimum amount of mortgage interest that should have been used by these taxpayers for computing the credit based on the information the taxpayers provided on their tax returns (10 percent of $117,802.)

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Type and Value of Outcome Measure:

- Revenue Protection – Potential; $405,000 in tax revenue (based on 2,128 taxpayers with $2.7 million in excess mortgage interest deductions) (see page 5).

Methodology Used to Measure the Reported Benefit:
Our computer analysis identified a nationwide population of approximately 73,355 tax returns filed (b)(7)(E) [redacted] We reviewed a statistically valid sample of 202 tax returns from a population of approximately 30,401 tax returns processed either electronically or at the ATSPC or KCSPC. We found 14 (7 percent) tax returns where taxpayers improperly (b)(7)(E) [redacted] We projected the 7 percent error rate as follows:

(b)(7)(E) [redacted]

[2] We limited our error cases to tax returns where (b)(7)(E) [redacted]
(b)(7)(E) [redacted]

Appendix IV

Requirements to Claim the Mortgage Interest Credit (MIC)

Requirements	(b)(7)(E) [redacted]
Taxpayers must be issued a qualified Mortgage Credit Certificate by a state or local governmental unit or agency under a qualified program.	
Taxpayers must live in the home that the certificate relates to as their main home. Taxpayers must enter the address of their main home on the Form 8396 and Form 1040.	
Mortgage interest paid (line 1 of Form 8396) should be limited to only the share of interest the taxpayer held, if someone else other than a spouse filing jointly shared an interest in the home.	
The certificate rate shall not be less than 10 percent or more than 50 percent.	
Taxpayers are limited to $2000 on line 3 of Form 8396 if the certificate rate is more than 20 percent.	
Mortgage interest deductions on Schedule A (Form 1040) must be reduced by the amount computed on line 3 of Form 8396.	

(b)(7)(E) [redacted]
(b)(7)(E) [redacted]

[2] We tested this requirement and did not identify any significant problems.

Requirements	(b)(7)(E) [redacted]
Taxpayers are not allowed the credit when the mortgage interest is paid to a related person.	
Unused portions of the MIC can be carried forward to the next 3 years or until used, whichever comes first.	
Taxpayers must be reissued a certificate to claim the MIC for refinanced mortgages. The reissued certificate must also meet certain requirements (e.g., same holder and property, certified indebtedness cannot exceed outstanding balance on existing certificate, credit rate cannot exceed the rate on existing certificate, etc.)	

(b)(7)(E) [redacted]

(b)(7)(E) [redacted]