
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



***While Progress Has Been Made, Limits on the
Number of Examinations Reduce the
Effectiveness of the Earned Income Tax
Credit Recertification Program***

July 3, 2008

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

July 3, 2008

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

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

SUBJECT: Final Audit Report – While Progress Has Been Made, Limits on the Number of Examinations Reduce the Effectiveness of the Earned Income Tax Credit Recertification Program (Audit # 200740033)

This report presents the results of our review to evaluate the effectiveness of the Earned Income Tax Credit (EITC) recertification process and assess the corrective actions taken to address recommendations presented in our prior reports¹ and their impact on the current process. This audit was included in our Fiscal Year 2007 Annual Audit Plan.

Impact on the Taxpayer

While the EITC program has been successful in helping millions of taxpayers, the Internal Revenue Service (IRS) still receives a substantial number of excessive or incorrect EITC claims. 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. In response to this legislation, the IRS initiated the EITC Recertification Program. The recertification program has been successful in helping reduce the high level of fraud and abuse in the EITC program. However, since Calendar Year 2005, the IRS' use of a dollar tolerance is limiting the number of recertification examinations, which reduces the effectiveness of the program.

¹ Appendix V provides a list of these reports and associated recommendations.

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Synopsis

Congress established the EITC to help alleviate poverty and provide work incentives to lower-income taxpayers. While the EITC program has been successful in helping millions of taxpayers, the IRS receives a substantial number of excessive or incorrect EITC claims. The IRS implemented the EITC Recertification Program to prevent taxpayers who have incorrectly claimed the credit from receiving the credit again until they can prove they are entitled.

The EITC Recertification Program is effective in helping reduce EITC overclaims.

A number of improvements have been made in response to our previous recommendations,² including improved accuracy in adding and removing indicators, improved communication with taxpayers, and improved training for tax examiners. However, beginning in Calendar Year 2005, the IRS Commissioner set a case limitation on the number of examinations of EITC-related returns, including recertification cases. Limiting the number of EITC recertification examinations resulted from the IRS using a dollar tolerance.

(b)(7)(E)

(b)(7)(E)

specific language in Treasury Regulations³ which states that if any item of information on Form 8862 is incorrect or inconsistent with any item on the return, the taxpayer will be treated as not demonstrating eligibility for the EITC. Specifically, for

Procedures followed on EITC recertification cases under tolerance do not meet the intent of Treasury Regulations.

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² Appendix V provides a listing of these recommendations.

³ 26 CFR Section 1.32-3.



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(b)(7)(E)

Furthermore, recertification is frequently denied despite the taxpayer attaching a Form 8862 to their tax return. For Tax Year 2005, approximately (b)(7)(E) returns requiring recertification with a Form 8862 attached were denied the EITC. This represents [] percent of all returns requiring recertification with a Form 8862 attached. The denied EITC claims associated with these returns totaled approximately [] million. (b)(7)(E) (b)(7)(E) (b)(7)(E)

(b)(7)(E) For Tax Year 2006, approximately [] taxpayers had EITC claims that were under tolerance and were recertified. These taxpayers had EITC claims totaling [] million and were recertified

(b)(7)(E)

Over 5 years, erroneous EITC payments associated with claims under tolerance could total [] million. (b)(7)(E)

The IRS is not working the Problem Correction Reports in a timely manner. The same issue was previously reported.

In addition, the IRS is not working the Problem Correction Reports in a timely manner. These reports identify EITC cases, including recertification cases that appear to have a problem. Working these reports⁴ ensures that taxpayers receive EITC refunds in a timely manner when recertifying. Our testing identified that only 1 of the 10 IRS campus⁵ locations we sampled had worked these reports in a timely manner. One

campus had not worked the reports in almost a year. We recommended corrective actions and the IRS implemented our suggestions on October 12, 2007. Working the Problem Correction Reports in a timely manner will help ensure that taxpayers receive their suspended EITC refunds after recertification.

Recommendations

The Commissioner, Wage and Investment Division, should 1) ensure that the information on the Form 8862 is correct and consistent with information on the tax return prior to recertifying the taxpayer and 2) require the National Office analysts receiving the Problem Correction Reports to submit an annual summary of their findings to the Chief, EITC Examination, Wage and Investment Division.

⁴ IRS procedures require these reports to be reviewed within 5 days of issuance. Reports are issued on a monthly basis.

⁵ The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



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Response

IRS management agreed with one recommendation and disagreed with the other recommendation. (b)(7)(E)

(b)(7)(E) However, all returns with the recertification Form 8862 attached, claiming a qualifying child, go through the same rigorous screening and selection process as other EITC returns.

The IRS has already taken corrective action and requested that the campuses send monthly confirmation to the National Office analysts that the problem correction reports are being worked. The National Office analysts will monitor these reports and will provide an annual summary to the Chief, EITC Examination after the end of the fiscal year.

The IRS disagreed with our outcome measure. The IRS stated that limiting the number of recertification audits allows the IRS to pursue noncompliance by more egregious taxpayers. Pursuing these other noncompliant taxpayers will yield in excess of (b)(7)(E) million in revenue protected in comparison to the (b)(7)(E) million we computed from performing recertification audits for under-tolerance taxpayers. Management's complete response to the draft report is included as Appendix VII. (b)(7)(E) (b)(7)(E)

Office of Audit Comment

The continued use of tolerance amounts for these cases provides an avenue for taxpayers to bypass recertification and could undermine the credibility of the process. For these cases, the IRS informs taxpayers who have had their EITC denied as the result of an examination that they will not receive the credit in future years unless they prove they are eligible, (b)(7)(E)

(b)(7)(E)

(b)(7)(E) Although the IRS stated that a more balanced approach to EITC audits would yield in excess of (b)(7)(E) million in revenue protected compared with the (b)(7)(E) million we calculated for our outcome measure, it did not provide data to support this position during the course of our audit. Furthermore, it does not adequately take into consideration the effect of recertification on subsequent compliance. We have detailed in our report that EITC noncompliance remains high with recertification filers. The majority of recertification audits in which the taxpayer provided a Form 8862 resulted in the denial of the EITC. For Tax Year 2005, (b)(7)(E) percent of the recertification audits conducted on returns with a Form 8862 attached resulted in a denial of the EITC claims totaling (b)(7)(E) million. (b)(7)(E) (b)(7)(E)

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

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Abbreviations

CY	Calendar Year
EIC	Earned Income Credit
EITC	Earned Income Tax Credit
IRS	Internal Revenue Service
TY	Tax Year

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Background

Congress established the Earned Income Tax Credit (EITC) to help alleviate poverty and provide work incentives to lower-income taxpayers. The EITC is a refundable credit available to lower-income, working taxpayers when they file their income tax returns. The amount of credit taxpayers can receive is based on their income level and whether or not they have children who meet age, dependency, and residency requirements. We use the term “child-related EITC” for the EITC with qualifying children and the term “income-only EITC” for the EITC with no qualifying children.

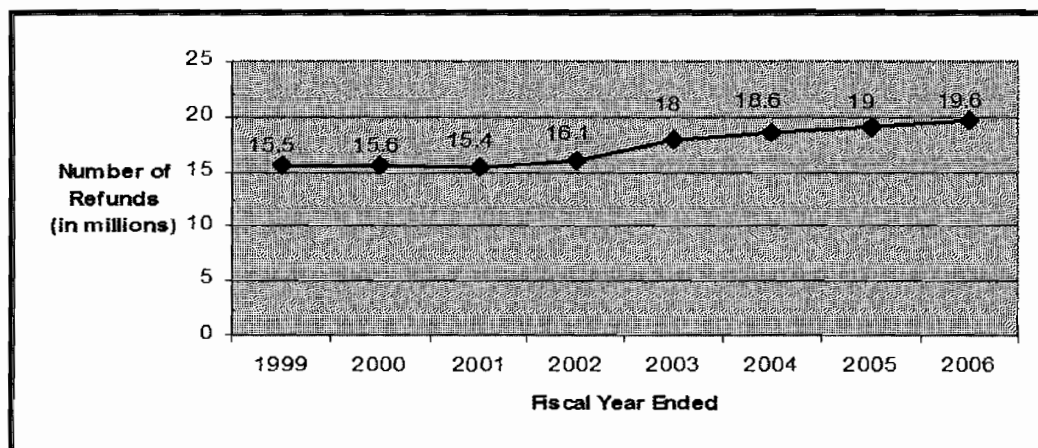
Figure 1: EITC Maximum Amounts – Tax Year 2006

Income-only	\$412
Child-related - One child	\$2,747
Child-related - Two children	\$4,536

Source: *Earned Income Credit (EIC) (Publication 596)*.

The EITC program continues to grow. From Fiscal Years 1999 to 2006, the number of refunds issued increased by 4.1 million (26 percent), while the amount of refunds increased by \$11.1 billion (43 percent). At the end of Fiscal Year 2006, 19.6 million EITC refunds were issued totaling \$36.6 billion.

Figure 2: Number of EITC Refunds Issued

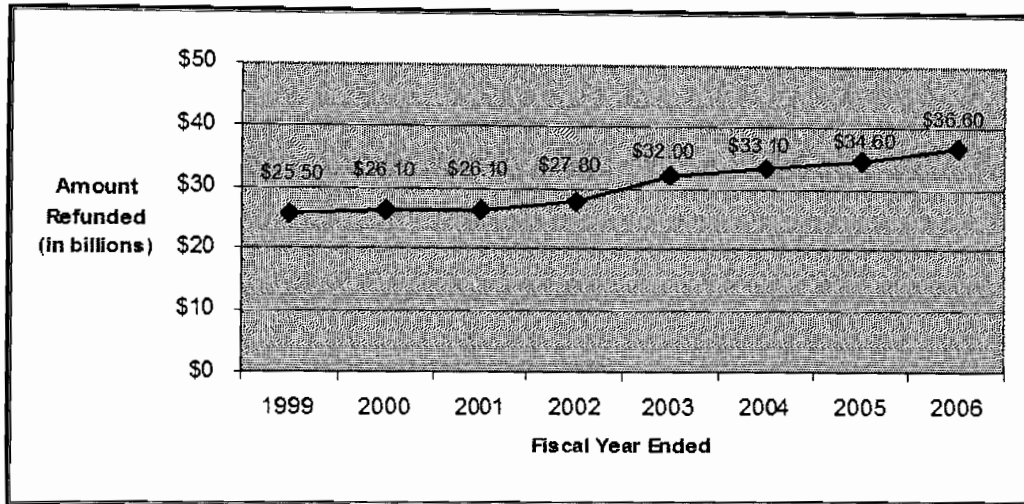


Source: *Internal Revenue Service (IRS) Data Books 1999-2006*.



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Figure 3: Amount of EITC Refunds Issued



Source: IRS Data Books 1999-2006.

While the EITC program has been successful in helping millions of taxpayers, the IRS receives a substantial number of excessive or incorrect EITC claims. The IRS conducted an EITC Compliance Study for Tax Year (TY) 1999 using information from almost 20 million taxpayers who had claimed approximately \$31 billion in EITC for that year. The results of this study showed approximately 10 million taxpayers received \$10 billion in improper EITC benefits.

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 address the compliance issues. If taxpayers do not provide adequate support to prove that they are 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 taxpayers from receiving the EITC until they can prove they are entitled to receive the credit. Once the taxpayer provides the IRS Examination function with supporting documentation to prove 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."

Taxpayers with intentionally erroneous or fraudulent claims are prohibited from claiming future EITC for a number of years. The disallowance (ban) period is 2 tax years after the most recent tax year for which there was a final determination that the taxpayer's EITC claim was due to recklessness or intentional disregard for the rules or regulations. The disallowance period increases to 10 years if the IRS determines the taxpayer's EITC claim was due to fraud.



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The IRS uses several different values to identify the accounts of taxpayers who have some or all of their EITC denied by the Examination function. These values are referred to as “recertification indicators.”

Figure 4: EITC Recertification Indicators

Indicator	Description of IRS Determination	Total number of indicators for TY 2005
1	Child used to claim the EITC was not the taxpayer’s qualifying child. The taxpayer must go through the recertification process for the next return where the child-related EITC is claimed.	970,950
2	EITC was denied. The improper claim was due to reckless or intentional disregard of EITC rules and regulations, then the negligence penalty is assessed. The taxpayer is banned from receiving the EITC for 2 tax years.	30,796
4	EITC was denied. The improper claim for the EITC was due to fraud. Taxpayer is banned from claiming the EITC for 10 tax years.	363
9	EITC was reduced or not permitted for any other reason, such as an adjustment to a taxpayer’s income or expense(s). The taxpayer will be required to recertify on his or her next return claiming the EITC.	495

Source: IRS Internal Revenue Manual Section 4.19.14 and the Individual Master File.¹

Tax returns claiming the EITC during the banned years are posted to the Individual Master File, and a notice is generated to inform the taxpayer of the EITC disallowance. Once the 2-year or 10-year ban period expires, the IRS changes the recertification indicator from a “2” or “4” to a “1,” requiring the taxpayer to recertify for the next return claiming the child-related EITC.

This review of the EITC Recertification Program was performed at the IRS National Headquarters in the offices of Compliance, Program Management; Stakeholder Management, Program Oversight Coordination; and Policy and Strategic Planning in Lanham, Maryland, and in the Fresno, California, Submission Processing Site during the period July 2007 through January 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. The scope of our

¹ The IRS database that maintains transactions or records of individual tax accounts.



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review was limited to an assessment of the processes and procedures used by the IRS to ensure that EITC claims with recertification indicators were properly processed. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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Results of Review

Program Improvements Have Been Made, and the Recertification Program Is Effective in Reducing Overclaims

The recertification program is effective in reducing the number of EITC overclaims. We selected a statistical sample of 174 taxpayers who had EITC recertification indicators placed on their accounts based on having the EITC denied on their TY 2005 income tax returns. We analyzed these same taxpayer accounts for TY 2006 and determined that 67 percent of the taxpayers changed their filing pattern regarding the EITC. These taxpayers either did not claim the EITC in TY 2006 or provided the necessary supporting documentation to justify the EITC claimed. The remaining 33 percent of the taxpayers continued to claim the EITC but were denied the credit in part or in whole either through examination or during returns processing or

b)(7)(E)

Recertification Indicators were properly set

Using the same sample previously discussed, we determined that the EITC recertification indicators were properly and accurately placed on the taxpayers' accounts. The indicators were input after the tax returns were examined and the EITC claimed was disallowed. In addition, the indicators were properly removed from the taxpayers' accounts when the taxpayers had subsequently provided adequate support to certify that they were entitled to the EITC.

The programming for the 2- and 10-year bans has been revised to correct a programming problem which caused an incorrect time period for the EITC ban. However, a new condition has arisen due to the programming correction. The current programming removes the banned year recertification data from the taxpayer's account when the period for the ban has expired. Without this information, other IRS business units or functions will no longer be able to use this information to stop an overclaim if the taxpayer attempts to file an amended return or a late filed tax return to obtain the EITC for a banned year after the ban period has expired. The IRS identified this condition prior to our review and is in the process of having the next eligible tax year remain on the account.



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Communication with taxpayers was improved

The IRS improved communications with taxpayers by revising the notices to taxpayers subject to recertification, indicating that they may still be entitled to the income-only EITC and by clearly explaining why the EITC is not being allowed, along with information on avoiding a ban on receiving the EITC. The IRS also explained that filing the Information To Claim Earned Income Credit After Disallowance (Form 8862) does not in itself recertify taxpayers and will likely result in an examination. In the letters informing taxpayers of the EITC denial, the IRS now provides instructions on where to obtain the Form 8862.

Another notice was revised to emphasize that recertifying taxpayers must meet EITC requirements and warned of the likelihood of an examination and potential for a ban. The notice also reflected the revised Form 8862 requirements and identified the first tax year for which the taxpayer may again be able to claim the EITC. In addition, the IRS implemented a separate notice to inform taxpayers that they had been recertified to receive the EITC.

Form 8862 instructions were revised to remind taxpayers that they must meet the EITC requirements and further advise taxpayers on how to obtain more information. The IRS revised its Earned Income Credit (EIC) (Publication 596) to provide information reminding taxpayers that they must qualify to claim the EITC by meeting all the rules described in the Publication. The Publication also warns taxpayers about the 2- and 10-year bans.

Appropriate tax examination training was conducted

In a prior audit,² we determined that bans were not applied consistently among compliance sites and were not always correct. There were significant differences in the emphasis on ban training and the criteria tax examiners used to determine reckless or intentional disregard for the EITC rules. As a result, some taxpayers who tried to prove EITC eligibility were banned while others who abused the EITC were not always banned. We recommended that compliance site management ensure that all EITC tax examiners receive adequate ban training.

The IRS responded by providing an appropriate level of training to tax examiners on Internal Revenue Manual revisions to the 2-year ban and implemented an EITC Recertification Job Aid to remind tax examiners to remove recertification indicators and release frozen refunds when automation will not. The job aid was also incorporated into the Internal Revenue Manual.

² *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).

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Limiting the Number of Examinations Reduces the Effectiveness of the Recertification Program

While the recertification program has been successful in helping reduce the high level of fraud and abuse in the EITC program, changes to the recertification program have reduced its effectiveness. Beginning in Calendar Year (CY) 2005, the IRS Commissioner set a case limitation (or "cap") on the number of EITC-related returns. Specifically, to manage the high volume of potentially fraudulent or abusive EITC claims being sent for examination, the IRS began using a dollar tolerance to limit the number of EITC related returns including recertification cases³ sent to the Examination function.

The dollar tolerance was the same for CYs 2005 and 2006 and then was raised significantly in early March of CY 2007. The IRS could not provide information on how the dollar tolerances were established. The IRS responded that it did not perform analyses to substantiate tolerance amounts. However, the IRS did state that imposing the cap shifted resources to other areas to improve overall audit coverage. The IRS also noted that setting a tolerance allows the IRS to conduct more higher-yielding audits, and that some of these EITC recertification returns might be audited under other IRS compliance programs. However, according to the IRS, EITC audits are relatively inexpensive in comparison to other types of audits. Therefore, audits in other areas could take longer and cost more than recertification audits, decreasing the overall audit revenues in comparison to conducting more EITC recertification audits.

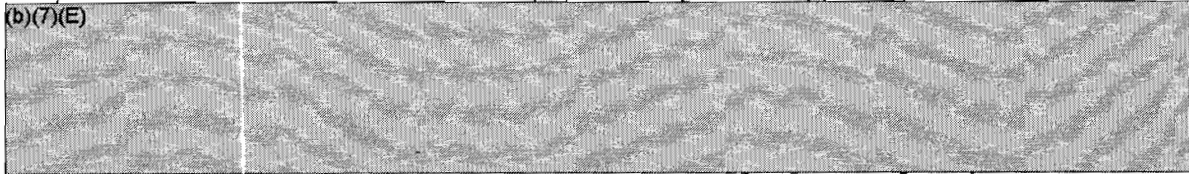
Furthermore, placing a cap on the number of EITC cases that can be examined reduces the effectiveness of the recertification program. The IRS has stated that, for CY 2008 processing, it has adjusted the tolerance amount down for recertification EITC cases. For TY 2006, approximately [redacted] taxpayers with EITC claims totaling [redacted] million were recertified. These [redacted] Over 5 years, erroneous EITC payments could total [redacted] million for [redacted] tax returns.⁴ [redacted]

(b)(7)(E)

[redacted] (b)(7)(E) Over 5 years, erroneous EITC payments could total [redacted] million for [redacted] tax returns.⁴ [redacted] (b)(7)(E)

(b)(7)(E)

The initial examination which set the indicator was to help prevent the taxpayer from receiving any future child-related EITC until the taxpayer could provide supporting documentation. The



For the purposes of illustration, assume that Taxpayer A had the child-related EITC disallowed in a prior year and had a recertification indicator placed on his or her account. When

³ Taxpayers who already have a recertification indicator and then file a tax return claiming the child-related EITC.

⁴ See Appendix IV for details on the outcome measure.



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Taxpayer A files his or her next tax return and claims the child-related EITC, the recertification indicator would stop the refund of the EITC amount until the taxpayer provides documentation proving eligibility to claim the child-related EITC.

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(b)(7)(E)

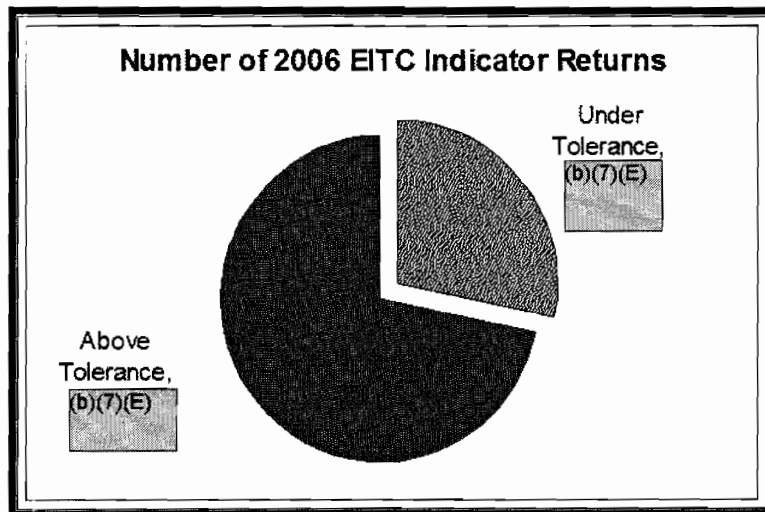
Not only is the IRS treating taxpayers inequitably, but this practice could also result in taxpayers ignoring the recertification requirements due to their inconsistent enforcement.

(b)(7)(E)

See Figure 5 for

number of recertification returns above and below the tolerance amount.

Figure 5: Impact of Dollar Tolerance on TY 2006



Source: Treasury Inspector General for Tax Administration review of Master File⁵ and Return Transaction information of tax returns filed in CY 2007.

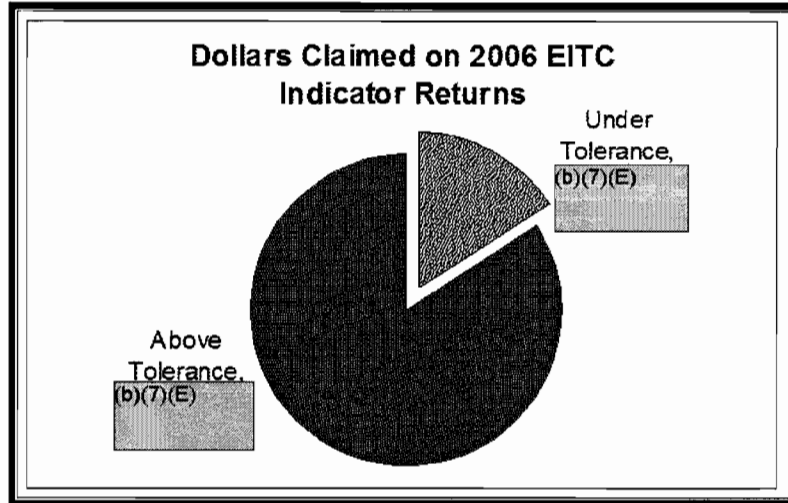
⁵ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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Figure 6 provides the monetary impact for EITC recertification cases impacted above and below the tolerance amount.

Figure 6: Monetary Impact of Dollar Tolerance on TY 2006



Source: Treasury Inspector General for Tax Administration review of IRS Master File and Return Transaction information of tax returns filed in CY 2007.

Tolerance procedures do not meet the intent of Treasury Regulations

According to Department of the Treasury Regulations,⁶ "a taxpayer...is ineligible to file a return claiming the EIC subsequent to the denial until the taxpayer demonstrates eligibility. If a taxpayer demonstrates eligibility...the taxpayer need not comply with those requirements for any subsequent taxable year unless the Service again denies the EIC as a result of deficiency procedures. No claim for the EIC filed subsequent to the denial is allowed unless the taxpayer properly completes Form 8862, demonstrating eligibility for the EIC, and otherwise is eligible for EIC. If any item of information on Form 8862 is incorrect or inconsistent with any item on the return, the taxpayer will be treated as not demonstrating eligibility for EIC."

(b)(7)(E) [Redacted text block] Regulations indicate that if there are any

⁶ Treas. Reg. §1.32-3. The full text is included in Appendix VI



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incorrect or inconsistent items on the Form 8862, the taxpayer has not demonstrated eligibility for the EITC.

(b)(7)(E)

Furthermore, recertification is frequently denied (b)(7)(E) their tax return. For TY 2005, approximately [redacted] returns that required recertification, claimed EITC, and had Form 8862 attached were sent to the Examination function. Of those, approximately (b)(7)(E) percent) were denied [redacted] million (b)(7)(E) percent) of the [redacted] billion in claims based on the followup recertification examination.

(b)(7)(E) (b)(7)(E) (b)(7)(E) (b)(7)(E)

Recommendation

Recommendation 1: The Commissioner, Wage and Investment Division, should ensure that information on the Form 8862 is correct and consistent with information on the tax return before recertifying taxpayers.

Management's Response: IRS management disagreed with this recommendation.

(b)(7)(E) However, all returns with the recertification Form 8862 attached, claiming a qualifying child, go through the same rigorous screening and selection process as other EITC returns.

The IRS also disagreed with the associated outcome measure. The IRS stated that limiting the number of recertification audits allows the IRS to pursue noncompliance by more egregious taxpayers. Pursuing these other noncompliant taxpayers will yield in excess of [redacted] million in revenue protected in comparison to the [redacted] million we computed from performing recertification audits for under-tolerance taxpayers.

(b)(7)(E)

(b)(7)(E)

Office of Audit Comment: (b)(7)(E)

(b)(7)(E) For these cases, the IRS informs taxpayers who have had their EITC denied as the result of an examination that they will not receive the credit in future years unless they prove they are eligible,

(b)(7)(E)



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(b)(7)(E) Although the IRS stated that a more balanced approach to EITC audits would yield in excess of [redacted] million in revenue protected compared with the [redacted] million we calculated for our outcome measure, it did not provide data to support this position during the course of our audit. Furthermore, it does not adequately take into consideration the effect of recertification on subsequent compliance. We have detailed in our report that EITC noncompliance remains high with recertification filers. The majority of recertification audits in which the taxpayer provides a Form 8862 resulted in the denial of the EITC. For Tax Year 2005, [redacted] percent of the recertification audits conducted on returns with a Form 8862 attached resulted in a denial of the EITC claims totaling (b)(7)(E) [redacted] million.

Problem Correction Reports Were Not Being Worked in a Timely Manner

In a prior report,⁷ we recommended that the IRS 1) ensure that Problem Correction Reports identify unresolved suspended refunds, 2) issue procedures for completing actions for the Problem Correction Reports within specified time periods, and 3) evaluate monthly summary reports to assure that the Problem Correction Reports are worked timely. Working these reports in a timely manner helps ensure taxpayers receive their EITC refunds when recertifying. These reports detail EITC cases--including recertification cases--which appear to have a problem, such as refunds that have been suspended for an unreasonable length of time. IRS guidelines require that the Problem Correction Reports be worked within 5 days and the annotated reports be retained for 6 months. However, there is no assignment of responsibility for ensuring that these actions are taken.

The IRS has not worked the Problem Correction Reports as required by its own written procedures. Only one campus⁸ could supply us with 6 full months of reports and another campus had not worked the reports in almost a year. In addition, not all of the reports received were annotated to indicate that they were worked. The campuses should have provided us with 300 reports for the 6-month period for our review.⁹ We received only 196 reports (65 percent), of which only 13 (4 percent) indicated that timely actions were taken to resolve the problem cases. We reviewed a small sample of five different Problem Correction Reports that were sent to us to determine the types of problems that needed to be resolved. While some of the problems listed were internal IRS activities that might not have a direct impact on the taxpayers, we did identify more than 12,000 items related to the release of taxpayer refunds. Without timely action

⁷ *The Earned Income Credit Recertification Program Continues to Experience Problems* (Reference Number 2005-40-039, dated March 2005).

⁸ 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.

⁹ Ten campuses x 6 months x 5 reports = 300 reports.



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by IRS employees to resolve the problems shown on these reports, taxpayer refunds might not be released or might not be released in a timely manner.

Figure 7: Problem Correction Report Explanation

Report	Explanation	Number of records within report type for 6-month period
Type 1	Examination has been completed but another IRS business unit has frozen the refund.	151
Type 2	Examination has been completed but the refund has not been released.	610
Type 3	Examination is open, refund has been released.	10,099
Type 4	Refund is being held, examination not opened yet, possible prior examination is still open or there is repeat behavior by the taxpayer.	321
Type 5	Refund is frozen and it can be determined 1) the indicator and refund should be released, or 2) an incorrect disposal code was used.	1,111
Total records for all report types		12,292

Source: Treasury Inspector General for Tax Administration review of IRS reports and the IRS Internal Revenue Manual.

Campuses do provide suggestions to National Office analysts to improve the usefulness of the reports. However, the IRS was unable to provide evidence to show that monthly summary reports were reviewed to assure the reports were worked in a timely manner. We discussed this issue with the IRS employees and management responsible for oversight of these reports. They indicated that the reports were not routinely reviewed by them nor did they receive a monthly confirmation when the reports were worked by the campuses. As a result, they were not aware that one campus had not worked the reports in almost a year. We recommended that the campuses send a written confirmation to the analysts each month after the reports had been worked. We also suggested that the analysts randomly require a copy of the reports be sent to them to ensure that the reports are being worked in a timely manner.

Management Action: On October 12, 2007, the Chief, EITC Examination, Wage and Investment Division, issued an email indicating that campuses must send monthly confirmations to the National Office analyst that Problem Correction Reports have been worked and that random copies of the annotated reports would be requested. The Small Business/Self-Employed



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Division analyst issued an email on October 19, 2007, indicating that the Small Business/ Self-Employed Division campuses would follow the same procedures.

Recommendation

Recommendation 2: The Commissioner, Wage and Investment Division, should require the National Office analysts, who receive the Problem Correction Reports, to submit an annual summary of their findings to the Chief, EITC Examination, Wage and Investment Division.

Management's Response: IRS management agreed with this recommendation. They have already taken corrective action and requested that the campuses send monthly confirmation to the National Office analysts that the problem correction reports are being worked. The National Office analysts will monitor these reports and will provide an annual summary to the Chief, EITC Examination, after the end of the fiscal year.

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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to evaluate the effectiveness of the EITC recertification process and assess the corrective actions taken to address recommendations presented in our prior reports of the EITC recertification process and their impact on the current process. To accomplish the objective, we evaluated the recertification program and the changes made by the IRS in response to our recommendations and reviewed additional data to identify any significant unresolved conditions. To accomplish our objective, we:

- I. Determined how effective the recertification program is in reducing erroneous or improper claims.
- II. Assessed whether the recertification indicators are accurate by selecting a statistically valid random sample from the Treasury Inspector General for Tax Administration Data Center Warehouse¹ files of accounts with a Transaction Code² 765 (reversal of earned income tax credit) posted in CY 2006 and an EITC allowed greater than \$412. The IRS "IMFComp" file for 'TaxTC2005652' was used to locate all Transaction Code 765 accounts where the transaction date was greater than or equal to January 1, 2006, and the EITC amount was greater than \$412. This gave us a useable population of 313,462. We used a statistical calculator to compute the sample size based on a 50 percent error rate. After computing an actual error rate of 2 percent, we adjusted the sample size to 174 accounts while still maintaining the 95 +/- 5 percent confidence level and reviewed the cases. The data used are considered sufficiently reliable by relying on the Treasury Inspector General for Tax Administration Data Center Warehouse documentation and the 100 percent match to IRS data during analyses. We analyzed the data and discussed the results with the IRS.
- III. Determined if the EITC recertification and 2-year ban were properly applied by examiners and if taxpayers were being accurately informed of the recertification process and the ban.

¹ The Treasury Inspector General for Tax Administration Data Center Warehouse – "A Data Warehouse is an architecture used to maintain critical historical data that have been extracted from operational data storage and transformed into formats accessible to an organization's analytical community." The mission of the Data Warehouse is to provide data and data access services; centralize storage, security, and administration of files; and develop uniform and user-friendly interfaces for users to access data.

² Transaction Codes are used for adjusting and researching a taxpayer's account. They are used to record actions on the account by the IRS.



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- A. Assessed whether the IRS Job Aid for examiners issued in 2005 for the EITC recertification process is comprehensive, conforms to the Internal Revenue Manual, and is being used by examiners.
- B. Verified whether the IRS was following procedures for applying the 2-year ban prior to the initial contact letter as required by the Internal Revenue Manual.
- IV. Determined if recertification accounts were properly resolved for suspended refunds.
 - A. Evaluated IRS actions to ensure that 1) Problem Correction Reports identify unresolved suspended refunds, 2) procedures are adequate for completing actions for the reports within the specified period, and 3) monthly summary reports are worked in a timely manner. We discussed the results with IRS Headquarters analysts.
 - B. Reviewed Problem Correction Reports to determine if they were worked in a timely manner. If they were not, we interviewed campus³ liaisons to determine why and obtained agreement to a recommendation to remedy a problem identified.

³ The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

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Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs)
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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Chief, Communications and Liaison CL
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Deputy Commissioner, Wage and Investment Division SE:W
Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS
Director, Compliance, Wage and Investment Division SE:W:CP
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, ETA and Refundable Credits, Wage and Investment Division SE:W:ETARC
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Appendix IV

Outcome Measure

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

Type and Value of Outcome Measure:

Cost Savings - Funds Put To Better Use – Potential; approximately [REDACTED] million in erroneous payments over a 5-year period (see page 7).

Methodology Used to Measure the Reported Benefit:

TY 2006 return information was accessed from data files available on the Treasury Inspector General for Tax Administration Data Center Warehouse.¹ Those taxpayer accounts that had an EITC indicator on them as of CY 2006 week 52 were collected from the Master File² Entity data.

This amount was further split between the first 8 processing cycles (cycles 200701 to 200708) in which the tolerance was lower and cycles 200709 and later in which the tolerance was raised significantly. As the Master File data are only updated twice a year on the Treasury Inspector General for Tax Administration Data Center Warehouse, any EITC amount claimed that did not have a cycle attached to it was assumed to be processed after cycle 200708. Samples of Social Security Numbers were checked against the Integrated Data Retrieval System³ posting cycle to confirm this was the correct approach.

¹ The Treasury Inspector General for Tax Administration Data Center Warehouse – “A Data Warehouse is an architecture used to maintain critical historical data that have been extracted from operational data storage and transformed into formats accessible to an organization’s analytical community.” The mission of the Data Warehouse is to provide data and data access services; centralize storage, security, and administration of files; and develop uniform and user-friendly interfaces for users to access data.

² The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

³ IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer’s account records.



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TY 2006 Analysis:

	Actual Returns	Actual Amounts
TY 2006	(b)(7)(E)	million
Less Income-Only EITC	(b)(7)(E)	million
Less EITC claims more than the tolerance amount	(b)(7)(E)	million
Results – EITC claims under the tolerance amount	(b)(7)(E)	million

Source: IRS Master File data.

The IRS stated that it will be raising the tolerance amount for recertification of EITC cases processed in CY 2008. We estimate that this will result in almost (b)(7)(E) recertification cases worth \$ (b)(7)(E) million per year; the 4-year projection is for (b)(7)(E) cases and \$ (b)(7)(E) million. For TY 2005, there were (b)(7)(E) EITC claims for \$ (b)(7)(E) billion with an indicator on the account. There were (b)(7)(E) EITC claims examined (with an EITC indicator) that had \$ (b)(7)(E) million in EITC disallowed. Using the number denied divided by the number claimed produces an (b)(7)(E) percent change rate on the number of returns and an (b)(7)(E) percent change rate on the EITC amount disallowed.

5-Year Projection:

	Projected Number of Returns	Projected EITC Amount
TY 2007 – 2010 (4 years)	(b)(7)(E)	million
TY 2006 Actual	(b)(7)(E)	million
Total for 5 years	(b)(7)(E)	million
TY 2005 Denial Percentage	(b)(7)(E)	(b)(7)(E)
Result – EITC Denial	(b)(7)(E)	million

Source: Treasury Inspector General for Tax Administration analysis.



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Appendix V

Prior Audit Report Recommendations

Our audit report, *Application of the Earned Income Credit Two-Year Ban Could Be More Consistent, Accurate, and Clear to Taxpayers*¹ was issued in 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 EIC during the ban period without conducting an examination. We made six recommendations to ensure that the ban is consistently and correctly used:

- Recommendation 1 – To help ensure that 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 that 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 that 2-year bans are consistently and correctly applied, the IRS should make sure that Compliance site management takes appropriate actions to help ensure that all EITC examiners receive adequate ban training, consider the ban on each EITC examination they work, and properly apply the ban guidelines.
- Recommendation 4 – To help ensure that 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 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 79A² to emphasize that recertifying

¹ Reference Number 2005-40-015.

² CP79A is a notice informing the taxpayer a ban was imposed.



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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 EIC. 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.

Our audit report *The Earned Income Credit Recertification Program Continues to Experience Problems*³ was issued in 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 6 recommendations in our March 2005 report to address these continuing conditions:

- Recommendation 1 – To help ensure that 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 that guidelines are consistently followed. Recertification guidelines should explain the EIC Recertification Program complexities and nuances so managers, analysts, 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.

³ Reference Number 2005-40-039.

⁴ *Improvements Are Needed in the Earned Income Credit Recertification Program* (Reference Number 2001-40-030, dated December 2000).



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- Recommendation 2 – To help ensure that 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 that future requests for programming are of sufficient detail to ensure that 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 that the EIC allowed for recertification cases reflects the approval of Examination function employees.
- Recommendation 3 – To help ensure that EIC recertification indicators on taxpayer accounts are accurate and taxpayers receive the EIC only when they are entitled to it, the IRS should ensure that required quality reviews of nonexamined 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 that non-examined closures are appropriate.
- Recommendation 4 – To further ensure that taxpayers receive EIC refunds affected by the recertification process in a timely manner, the IRS should ensure that 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 that the Problem Correction Reports are worked in a timely manner.
- Recommendation 5 – To further ensure that 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 might 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 that 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.



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Appendix VI

Department of the Treasury Regulation

26 CFR § 1.32-3 – Eligibility requirements after denial of the earned income credit

(a) *In general.* A taxpayer who has been denied the earned income credit (EIC), in whole or in part, as a result of the deficiency procedures under subchapter B of chapter 63 (deficiency procedures) is ineligible to file a return claiming the EIC subsequent to the denial until the taxpayer demonstrates eligibility for the EIC in accordance with paragraph (c) of this section. If a taxpayer demonstrates eligibility for a taxable year in accordance with paragraph (c) of this section, the taxpayer need not comply with those requirements for any subsequent taxable year unless the Service again denies the EIC as a result of the deficiency procedures.

(b) *Denial of the EIC as a result of the deficiency procedures.* For purposes of this section, denial of the EIC as a result of the deficiency procedures occurs when a tax on account of the EIC is assessed as a deficiency (other than as a mathematical or clerical error under Section 6213(b)(1)).

(c) *Demonstration of eligibility.* In the case of a taxpayer to whom paragraph (a) of this section applies, and except as otherwise provided by the Commissioner in the instructions for Form 8862, "Information To Claim Earned Income Credit After Disallowance," no claim for the EIC filed subsequent to the denial is allowed unless the taxpayer properly completes Form 8862, demonstrating eligibility for the EIC, and otherwise is eligible for the EIC. If any item of information on Form 8862 is incorrect or inconsistent with any item on the return, the taxpayer will be treated as not demonstrating eligibility for the EIC. The taxpayer must follow the instructions for Form 8862 to determine the income tax return to which Form 8862 must be attached. If the taxpayer attaches Form 8862 to an incorrect tax return, the taxpayer will not be relieved of the requirement that the taxpayer attach Form 8862 to the correct tax return and will, therefore, not be treated as meeting the taxpayer's obligation under paragraph (a) of this section.

(d) *Failure to demonstrate eligibility.* If a taxpayer to whom paragraph (a) of this section applies fails to satisfy the requirements of paragraph (c) of this section with respect to a particular taxable year, the IRS can deny the EIC as a mathematical or clerical error under Section 6213(g)(2)(K).

(e) *Special rule where one spouse denied EIC.* The eligibility requirements set forth in this section apply to taxpayers filing a joint return where one spouse was denied the EIC for a taxable year prior to marriage and has not established eligibility as either an unmarried or married taxpayer for a subsequent taxable year.



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(f) *Effective date.* This section applies to returns claiming the EIC for taxable years beginning after December 31, 1997, where the EIC was denied for a taxable year beginning after December 31, 1996.

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Appendix VII

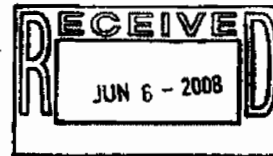
Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30338

JUN 04 2008



MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report -- While Progress Has Been Made, Limits on the Number of Examinations Reduce the Effectiveness of the Earned Income Tax Credit Recertification Program (EITC) (Audit # 200740033)

I reviewed your draft report and agree with your overall conclusion that the recertification program is effective in reducing overclaims. As you acknowledged in your report, we made a number of significant improvements to this program, including improved accuracy in adding and removing indicators, automating the release of suspended EITC refunds, improved communications with taxpayers, and improved training for tax examiners. However, I disagree that limits on the number of examinations reduce the effectiveness of the Recertification Program, which is only one component of the EITC Program.

We strive to balance our limited enforcement resources to provide examination coverage across all taxpayer segments by focusing on areas with the highest compliance risk requiring coverage, or maximizing yield. We disagree with your first recommendation to ensure information on the Form 8862 is correct and consistent with information on the tax return before recertifying taxpayers. To do so would require an audit of every tax return with a Form 8862 attached. Prudent stewardship of our enforcement staff does not allow us to devote employees to just this one program.

We are using the guidance, tools, and flexibility provided by the recertification regulations to help us administer a balanced EITC program. Although we cannot examine all recertification cases to identify inconsistency, in FY 2007 all returns with the recertification Form 8862 attached, claiming a qualifying child, went through the same rigorous screening and selection process as other EITC returns.

Our balanced approach includes coverage of other components of EITC error in addition to the significant number of recertification audits we conduct. Limits placed on the number of examinations in the Recertification Program allow us to pursue

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noncompliance by more egregious taxpayers, such as those examined by our Questionable Refund Program. Our decisions are made with consideration of both the overall EITC program as well as Servicewide strategies, such as reducing the tax gap.

We disagree with your five year cost savings outcome measure of [redacted] billion from the examination of the below tolerance recertification returns. The cost savings cited does not recognize the impact from enforcement action achieved in other than recertification audits. The data indicates that the EITC cases examined, in lieu of the below tolerance recertification cases, are significantly more productive and will yield in excess of [redacted] million in revenue protected over the same five year period. Your outcome measures do not reflect the benefits derived by a more balanced approach to egregious EITC claims.

Attached are our comments to your recommendations. If you have any questions, please call me at (404) 338-7060 or Jim Grimes, Director, Compliance, at (404) 338-9904.

Attachment

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Attachment

RECOMMENDATION 1

The Commissioner, Wage and Investment Division, should ensure information on the Form 8862 is correct and consistent with information on the tax return before recertifying taxpayers.

CORRECTIVE ACTION

We disagree with this recommendation. [REDACTED]

[REDACTED] However, all returns with the recertification Form 8862 attached, claiming a qualifying child, go through the same rigorous screening and selection process as other EITC returns.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 2

The Commissioner, Wage and Investment Division, should require the National Office analysts who receive the Problem Correction Reports to submit an annual summary of their findings to the Chief, EITC Examination, Wage and Investment Division.

CORRECTIVE ACTION

We agree with this recommendation and have already taken corrective action. As you indicated in your report, we requested that the campuses send monthly confirmation to the National Office analysts that the problem correction reports are being worked. The National Office analysts will monitor these reports and will provide an annual summary to the Chief, EITC Examination after the end of the fiscal year.

IMPLEMENTATION DATE

December 15, 2008

RESPONSIBLE OFFICIAL

Director, Reporting Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

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

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