

**Management Controls Over the Proof of  
Concept Test of Earned Income Tax Credit  
Certification Need to Be Improved**

**December 2003**

**Reference Number: 2004-40-032**

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DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

December 19, 2003

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

*Gordon C. Milbourn III*

FROM: Gordon C. Milbourn III  
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Management Controls Over the Proof of  
Concept Test of Earned Income Tax Credit Certification Need  
to Be Improved (Audit # 200340047)

This report represents the results of our review of the Proof of Concept Test for Earned Income Tax Credit (EITC) certification. The objective of the review was to determine if the Internal Revenue Service (IRS) has an effective process to test its Concept of Operations (CONOPs) 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.

The EITC is a refundable credit available to taxpayers who file returns with certain earned income. Historically, the EITC Program has been vulnerable to high rates of noncompliance. Based on an IRS report, an estimated \$8.5 to \$9.9 billion (27 to 32 percent) of the estimated \$31 billion in EITC claims made by taxpayers in Tax Year 1999 should not have been paid.<sup>1</sup> In February 2002, the Department of the Treasury and the IRS announced that a Task Force would study how the IRS administers the EITC, with the emphasis on improving EITC compliance. One of the recommendations of the Task Force was to require certain types of taxpayers who have been 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

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<sup>1</sup> IRS report, *Compliance Estimates for Earned Income Tax Credit on 1999 Returns*, dated February 28, 2002.

requirements<sup>2</sup> before the credit is allowed. The IRS plans to test the concept of EITC certification for residency requirements during the 2004 Filing Season.<sup>3</sup>

The IRS concept for certifying EITC requirements includes systemically certifying as many taxpayers as possible.<sup>4</sup> The IRS accurately identified and used all the data in its current computer databases that are necessary to systemically certify the qualifying children of taxpayers claiming the EITC. In addition, the IRS used an appropriate systematic sampling approach to select the sample for the Test and appropriately validated the data. This should provide the IRS with some assurance that the actions of the sampled taxpayers fairly represent the anticipated actions of the group of taxpayers claiming the EITC from which the sample was selected.

During our audit period, the IRS recognized the need for consolidated executive leadership of its EITC Program and appointed the Director, EITC, to lead the administration of the Program. The IRS also made a number of changes to the scope of the Test. However, as of September 11, 2003, the IRS had not developed management reports to monitor the progress of the Test or established a process to identify and track the costs, including dollars, associated with conducting the Test and evaluating its results. Continued changes to the scope of the Test and insufficient management controls can negatively affect the usefulness of the results. In addition, the IRS has not established measures to analyze the success of the Test.

Subsequent to our testing, the IRS began taking steps to strengthen its controls over the Test. For example, the IRS developed an EITC Proof of Concept Workplan to monitor its progress toward completing key elements of the Proof of Concept Test. While we did not evaluate the adequacy of the Workplan during this review, the development of the plan is the first step toward improving the IRS' oversight of the Test.

We understand that the IRS will continue to modify its EITC Proof of Concept Test as it progresses. We plan to conduct additional audit work on the Test as part of our overall Strategy on the IRS' Implementation of the Earned Income Tax Credit Concept of Operations.

We recommended that the Commissioner, Wage and Investment Division, strengthen the controls over the Test to be able to effectively measure and analyze its success.

Management's Response: IRS management agreed with our recommendation to strengthen controls over the Test and identified a number of initiatives it has undertaken since the completion of our audit work. However, management disagreed with our conclusion concerning the establishment of performance measures for the Test. The IRS stated that only through its Proof of Concept Test will it know to what extent it will

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<sup>2</sup> Residency requirement refers to the requirement that the qualifying child lived with the taxpayer in the United States for more than one-half of the year.

<sup>3</sup> The period from January through mid-April when most individual income tax returns are filed.

<sup>4</sup> Systemic certification occurs when the IRS uses all available data to determine if the taxpayer satisfies the qualifying child residency and relationship requirements prior to contacting the taxpayer.

achieve the goal of reducing erroneous payments while maintaining participation. Management's complete response to the draft report is included as Appendix VI.

Office of Audit Comment: The Office of Management and Budget (OMB)<sup>5</sup> defines performance measures as either (1) a target level of performance expressed as a tangible, measurable objective, against which actual achievement can be compared, including a goal expressed as a quantitative standard, value, or rate, or (2) a particular value or characteristic used to measure output or outcome. Without performance measures (referred to as targets by the IRS) for the Proof of Concept Test, neither the IRS nor its stakeholders will have sufficient information to determine if the concepts the IRS is testing should be implemented into the IRS' EITC Program. We do not plan to elevate this disagreement to the Department of the Treasury for resolution.

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 Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

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<sup>5</sup> OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget* (revised July 2003).

**Management Controls Over the Proof of Concept Test  
of Earned Income Tax Credit Certification Need to Be Improved**

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## **Management Controls Over the Proof of Concept Test of Earned Income Tax Credit Certification Need to Be Improved**

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### **Background**

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The Earned Income Tax Credit (EITC) is a refundable credit available to taxpayers who file returns with certain earned income. The requirements taxpayers must satisfy to qualify for the EITC can be found in Appendix IV.

The Congress has long been concerned with the administration of the EITC Program. Erroneous EITC claims are a source of significant loss of revenue for the Federal Government. In its Tax Year (TY) 1999 compliance study, the Internal Revenue Service (IRS) estimated that between \$8.5 and \$9.9 billion (27 to 32 percent) of the \$31 billion in EITC claimed for TY 1999 should not have been paid.<sup>1</sup> Taxpayers claiming a child who did not meet the qualifications for the EITC was one of the main causes of these errors.

The Department of the Treasury and the IRS announced on February 28, 2002, that a Task Force would examine the administration and complexity of the EITC. The Treasury Assistant Secretary for Tax Policy and the IRS Commissioner headed the Task Force. It focused on compliance and administrative issues stemming from the complexity of the EITC. The Task Force used the TY 1999 compliance study as the basis for its recommendations. The IRS used these recommendations to develop a future vision for administering the EITC. This vision is outlined in the IRS' EITC Concept of Operations (CONOPs).

One of the Task Force recommendations was to ask taxpayers who claim the EITC and meet certain criteria to verify that the children claimed on the returns meet the EITC residency and relationship requirements before the taxpayers receive the credit. See Appendix V for an explanation of these requirements. The IRS' CONOPs outlines three ways taxpayers can prove or certify their eligibility for the EITC based on the relationship and residency requirements:

1. A taxpayer can provide supporting documentation before the tax return is filed (precertification).

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<sup>1</sup> IRS report, *Compliance Estimates for Earned Income Tax Credit on 1999 Returns*, dated February 28, 2002.

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2. A taxpayer can include the supporting documentation with the tax return when the return is filed.
3. A taxpayer can provide the supporting documentation in response to an IRS request after the tax return has been filed.

According to the CONOPs, the IRS' intent is to get the majority of qualifying taxpayers to precertify for the EITC, to help ensure the taxpayers' refunds are not delayed once the returns are filed and the refunds are processed.<sup>2</sup>

The first step the IRS is taking to implement its future vision for EITC certification is to test the basic concepts outlined in the CONOPs. This test is referred to as a Proof of Concept Test and is intended to provide the IRS with information necessary to either modify or validate the certification concept outlined in the CONOPs. The Proof of Concept Test consists of three parts designed to test concepts for improving EITC compliance:

- A test of the qualifying child(ren) residency requirements (certification).
- A test of filing status requirements.
- A test of underreported income.

This audit focused on the Proof of Concept Test of EITC certification and is referred to as "the Test" for the purposes of this report.

The IRS originally planned to test the precertification outlined in its CONOPs (number 1 above) during the summer of 2003. The IRS has since changed the scope of its Test. The changes the IRS made to its Test are provided in Table 1. As a result of these changes, the IRS is no longer testing its concept of EITC precertification.

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<sup>2</sup> A taxpayer may still be denied the EITC once the tax return is filed based on other EITC requirements that must be met. See Appendix IV for details of these requirements.

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**Table 1: Changes to the IRS Proof of Concept Test  
of EITC Certification**

Original Test	Revised Test
Test residency and relationship requirements.	Test residency requirements.
Ask for documentation during the summer, before the tax return is filed (precertification).	Ask for documentation when the return is filed (after January 1, 2004).
Test a sample of 45,000 taxpayers.	Test a sample of 25,000 taxpayers.

*Source: Various IRS press releases, public news articles, and discussions with IRS representatives.*

The IRS also recognized the need for consolidated executive leadership of its EITC Program. In early September 2003, the IRS appointed the Director, EITC, to lead the administration of the EITC Program.

The overall objective of this audit was to determine if the IRS has an effective process to test its CONOPs for EITC certification and prepare for implementation of the Test of 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.

This audit was performed between April and September 2003. Testing was conducted in the IRS' Office of the Commissioner, the Office of Research Analysis and Statistics, and the Office of Modernization and Information Technology Services in Washington, D.C., and the Wage and Investment Division's EITC Office in Atlanta, Georgia. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

During its preparations for the Test, the IRS used an appropriate systematic sampling approach to select the sample and appropriately validated data. In its future vision for the EITC Program, the IRS plans to systemically certify taxpayers for the EITC based on current EITC qualifying

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**The Process Used to Select the Sample for the Test Reflects the Process Outlined in the Future Vision**

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requirements for residency and data the IRS currently has on the taxpayers in its various computer databases. Taxpayers who cannot be systemically certified, because the information is either not available or is inconclusive, would be subject to a manual certification process. The systemic certification process the IRS used to identify the sample for its Test reflects the process outlined in its future vision for the EITC Program.

The IRS accurately identified and used all the data in its current computer databases that are necessary to systemically certify the qualifying children of taxpayers claiming the EITC. As part of this systemic certification process, the IRS also identified taxpayers who, based on past compliance studies, are at high risk of making erroneous claims for the EITC. The IRS then used a systematic sampling approach to select a sample of 25,000 taxpayers from the high-risk group for the Test.

The IRS validated that the taxpayers identified for both manual certification and the sample were similar in the percentage of male/female taxpayers, the filing status claimed, and the state in which the taxpayer filed the return. The IRS also validated the accuracy of the systemic certification determinations after each source of data was used and after the final determinations were made. The accuracy of the determination that a taxpayer would be subject to manual certification was also validated. This should provide the IRS with some assurance that the actions of the sampled taxpayers fairly represent the anticipated actions of the group of taxpayers claiming the EITC from which the sample was selected.

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### **Continued Change Could Jeopardize the Usefulness of the Test**

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Testing the concept of EITC certification is a commendable effort. However, the IRS did not consider all the risks when it did not obtain input from the Congress and other stakeholders, such as community-based low-income tax assistance programs and the American Bar Association, until after it had begun to implement the Test. After receiving responses from the Congress and stakeholders, the IRS revised the Test. We are concerned that the continued state of change related to the Test could jeopardize its usefulness.

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The General Accounting Office’s (GAO) *Standards for Internal Control in the Federal Government* state internal controls should provide for an assessment of the risks an agency faces from both internal and external sources. Once risks have been identified, they should be analyzed for their possible effect. One factor to be considered is whether consideration was given to risks arising from changing needs or expectations of the Congress, agency officials, and the public.

The IRS established goals and objectives for the Test but did not identify all risks that could impede the efficient and effective achievement of those objectives before expending resources to prepare for the implementation of the Test. As a result of concerns raised by the Congress and other stakeholders, the IRS changed the scope of the Test.

Table 2 illustrates the timeline and scope of the changes the IRS made to the Test.

**Table 2: IRS Timeline for Changes to the Proof of Concept Test of EITC Certification**

Date	Action Taken
April 2003	The Congress learns of plans to test precertification of the EITC residency and relationship requirements for 45,000 taxpayers. The Test is scheduled to begin in August 2003.
June 2003	The IRS Commissioner formally announces the IRS will pilot an EITC certification effort. The announcement states the Test will involve 45,000 taxpayers and will be limited to a residency certification.
June 2003	The IRS announces a 30-day period in which interested parties can provide comments on its plan to precertify taxpayers for the EITC.
August 2003	The IRS announces it will now ask 25,000 taxpayers to certify eligibility for residency requirements when they file their returns. The Test will begin in the 2004 Filing Season. <sup>3</sup>

*Source: Various IRS press releases and public news articles.*

<sup>3</sup> The period from January through mid-April when most individual income tax returns are filed.

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In addition to the changes described in Table 2, changes in the forms and correspondence requesting the supporting documentation were also recommended but had not yet been finalized.

If the IRS continues to make significant changes to the Test, it may not have adequate time to incorporate those changes before the Test is scheduled to begin. As a result, the Test may not provide the IRS with sufficient information from which it can make an informed decision about the expansion of the certification process. We understand that the IRS will continue to modify its EITC Proof of Concept Test as it progresses. We plan to conduct additional audit work on the Test as part of our overall Strategy on the IRS' Implementation of the Earned Income Tax Credit Concept of Operations.

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### **Management Controls Over the Test Need to Be Improved**

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The IRS needs to establish additional controls such as quantifying goals, establishing measures, and improving oversight of and management information systems for the Test. Office of Management and Budget (OMB) Circular A-123<sup>4</sup> states, "Agency managers shall incorporate basic management controls in the strategies, plans, guidance, and procedures that govern their programs and operations." Management controls include processes for planning, organizing, directing, and controlling program operations. In addition, the *GAO Standards for Internal Control in the Federal Government* state that for an entity to run and control its operations, it must have relevant, reliable, and timely information.

### **Measures have not been established for the Test**

While the IRS has established a goal for the Test, it has not established what measures are necessary to analyze the success of the Test. The IRS informed us that the current Test is a statistical exercise, the purpose of which is to gather information about how taxpayers behave when the IRS does certain things. Therefore, the IRS does not believe it needs to establish measures at this time but should instead attempt to establish a baseline against which to measure future efforts.

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<sup>4</sup> OMB Circular A-123, *Management Accountability and Control* (revised, dated June 21, 1995).

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We agree that the purpose of the Test is to evaluate taxpayer behavior and that no one factor, but rather a combination of factors, would be required to either validate or refute the IRS' concept for EITC certification. However, the IRS needs to determine what combination of factors is necessary and what level of activity those factors need to achieve to justify continuing its long-range plans to certify EITC eligibility. Without such measures, neither the IRS nor the Congress can evaluate the effectiveness of the Test.

### **Oversight controls for the Test have been limited**

Although the IRS had taken steps to identify the information necessary to evaluate the Test results, the IRS was not able to provide sufficient documentation that it had established a process to provide on-going management oversight of the Test. As of September 11, 2003, the IRS had not developed management reports to monitor the progress of the Test or established a process to identify and track the costs, including dollars, associated with conducting the Test and evaluating its results.

Without these processes, the IRS cannot ensure that the Test is being conducted effectively and that resources are being allocated efficiently. It also has little assurance that the information it collects on the 50,000 EITC taxpayer accounts<sup>5</sup> being monitored as part of the Test is reliable.

The IRS has identified a number of data elements it plans to capture during the Test to evaluate its results. The IRS also has a detailed plan outlining how it plans to collect and evaluate the data at the conclusion of the Test. For example, the IRS selected a second sample of 25,000 taxpayers as a control group that will not be asked to certify the EITC residency requirement, so it can compare taxpayer behavior between the 2 samples.

The IRS acknowledged the need to have a documented plan and an oversight process. However, the IRS believes that its plan to implement the Test in the 2004 Filing Season

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<sup>5</sup> The IRS will ask 25,000 taxpayers to provide certification documents as part of the test. The IRS will also capture data on an additional 25,000 taxpayers who are not contacted so it can compare taxpayer behavior.

## **Management Controls Over the Proof of Concept Test of Earned Income Tax Credit Certification Need to Be Improved**

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requires it to focus instead on the steps needed to implement the Test; for example, identifying needed changes to its computer systems and drafting the correspondence that will be sent to taxpayers. Therefore, while the IRS recognizes the need for a documented plan and oversight process, it has not prioritized either.

We agree that the IRS needs to prioritize its preparations for the certification test to meet the planned implementation date. However, it is critical that sufficient management controls and program oversight be established before the planned implementation date of the Test.

Subsequent to our testing, the IRS took steps to strengthen its controls over the Test. For example, the IRS developed an EITC Proof of Concept Workplan to monitor its progress toward completing key elements of the Proof of Concept Test. While we did not evaluate the adequacy of the Workplan during this review, its development is the first step toward improving the IRS' oversight of the Test.

### **Recommendation**

The Commissioner, Wage and Investment Division, should:

1. 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.

Management's Response: IRS management agreed with our recommendation and identified a number of initiatives it has undertaken since the completion of our audit work.

However, management disagreed with our conclusion concerning the establishment of performance measures for the Test. The IRS indicated it has stressed the importance of establishing a robust suite of measures from the inception of the Test. It also responded that the ultimate decision on how to proceed with the administration of the EITC would take place only after in-depth evaluation and consultation with its numerous stakeholders.

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Office of Audit Comment: OMB Circular Number A-11<sup>6</sup> defines performance measures as either (1) a target level of performance expressed as a tangible, measurable objective, against which actual achievement can be compared, including a goal expressed as a quantitative standard, value, or rate, or (2) a particular value or characteristic used to measure output or outcome. Without performance measures (referred to as targets by the IRS) for the Proof of Concept Test, neither the IRS nor its stakeholders will have sufficient information to determine if the concepts the IRS is testing should be implemented into the IRS' EITC Program.

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<sup>6</sup> OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget* (revised July 2003).

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**Appendix I**

**Detailed Objective, Scope, and Methodology**

The overall objective of this review was to determine if the Internal Revenue Service (IRS) has an effective process to test its Concept of Operations (CONOPs) for Earned Income Tax Credit (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. We performed the following audit tests:

- I. To determine whether the design and purpose of the Test were clear and properly aligned with the IRS' goals for the planned EITC precertification program, we evaluated whether the IRS' plan for the Test was logical, considering the current conditions and nature of the problem, and whether it is likely to yield the intended outcomes. We also evaluated the design of the Test to determine if it supports the business case for the EITC Task Force recommendations and determined if the IRS is tracking a control group for behavior comparison.
- II. To determine whether the IRS has set valid goals that focus on results and reflect the purpose of the Test, we identified the goals for the Test by reviewing the CONOPs, Evaluation Plan, and IRS Press Release IR-2003-97. We also identified key concepts in the certification process outlined in the CONOPs that are necessary to successfully test the certification concept (per the Test goals).
- III. To determine whether the EITC precertification Test Plan has sufficient elements of performance management to meet its goals and objectives, we analyzed the IRS' evaluation methodology. We determined whether the evaluation methodology included overall goals for the results of the Test, a method to gather the information needed to quantify the results of the Test, a method to compute the results of the Test, and a method to identify and track costs related to conducting the Test and evaluating the Test results. In addition, we determined whether the evaluation methodology included a method to assess whether the results of the Test support the business case for the EITC Task Force recommendations. We also identified the data available for management oversight and monitoring of the Test and analyzed the method the IRS plans to use to gather data and quantify the results of the Test to ensure the method is sound.
- IV. To determine if the methodology for the Test accurately reflects the systemic certification process, the identification of taxpayers for the manual certification process, and the sample selection process for the test group of taxpayers, we determined if the method used to systemically certify taxpayers for the Test aligns with the concept of systemic certification. We also reviewed the CONOPs and interviewed IRS personnel to determine if all taxpayers who cannot be systemically certified will be subjected to manual certification. In addition, we identified the criteria used to select the

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25,000 taxpayers for the manual certification test and analyzed the selection criteria to determine if it is representative of the population and meets the criteria of the Test Plan. We also determined if the IRS validated the accuracy of the selection of the 25,000 taxpayers and assessed the adequacy of the validation process.



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**Appendix II**

**Major Contributors to This Report**

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**Appendix III**

**Report Distribution List**

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Operations Support OS  
Deputy Commissioner for Services and Enforcement SE  
Deputy Commissioner, Wage and Investment Division SE:W  
Chief, Information Technology Services OS:CIO:I  
Director, Earned Income Tax Credit, Wage and Investment Division SE:W:EITC  
Director, Office of Research, Analysis, and Statistics RAS  
Chief Counsel CC  
National Taxpayer Advocate TA  
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Office of Management Controls OS:CFO:AR:M  
Audit Liaison: GAO/TIGTA Liaison, Wage and Investment Division SE:W:S:PA

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**Appendix IV**

**Earned Income Tax Credit Rules for Tax Year 2002**

Below is a general description of the qualifications taxpayers must meet to be eligible for the Earned Income Tax Credit (EITC). A detailed description of these rules can be found in the Internal Revenue Service publication *Earned Income Credit* (Publication 596).

**Everyone must meet all of the following rules:**

- You must have a valid Social Security Number.
- Your filing status cannot be “married filing separately.”
- You must be a United States citizen or resident alien all year.
- You cannot file Foreign Earned Income (Form 2555) or Foreign Earned Income Exclusion (Form 2555-EZ).
- Your investment income must be \$2,550 or less.
- You must have earned income.

**Rules to meet if you have a qualifying child (must meet all):**

- Your child must meet the relationship, age, and residency tests (see Appendix V for a further explanation of the relationship and residency tests).
- Your qualifying child cannot be used by more than one person to claim the EITC.
- You cannot be a qualifying child of another person.

**Rules to meet if you do not have a qualifying child (must meet all):**

- You must be at least age 25 but under age 65.
- You cannot be the dependent of another person.
- You cannot be a qualifying child of another person.
- You must have lived in the United States more than one-half of the year.

**Figuring and claiming the EITC (must meet both rules):**

- Your adjusted gross income<sup>1</sup> must be less than:
  - \$33,178 (\$34,178 for married filing jointly) if you have more than 1 qualifying child.
  - \$29,201 (\$30,201 for married filing jointly) if you have 1 qualifying child.
  - \$11,060 (\$12,060 for married filing jointly) if you do not have a qualifying child.
- Your earned income must be less than:
  - \$33,178 (\$34,178 for married filing jointly) if you have more than 1 qualifying child.
  - \$29,201 (\$30,201 for married filing jointly) if you have 1 qualifying child.
  - \$11,060 (\$12,060 for married filing jointly) if you do not have a qualifying child.

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<sup>1</sup> Adjusted Gross Income is a taxpayer’s gross income for the year adjusted for certain exclusions from income provided for in the Internal Revenue Code.

**Earned Income Tax Credit  
Tests for Relationship and Residency  
Tax Year 2002**

Below is a general description of the relationship and residency requirements (for children claimed on a return) that taxpayers must meet to be eligible for the Earned Income Tax Credit. These qualifications can be found in the Internal Revenue Service publication *Earned Income Credit* (Publication 596).

**Relationship**

A qualifying child is a child who is your:

- Son.
- Daughter.
- Adopted child.
- Foster child.
- Stepchild.
- Grandchild.
- Sister.\*
- Brother.\*
- Stepsister.\*
- Stepbrother.\*

\* This relative (or his or her child or grandchild) qualifies if you care for the individual as you would your own child.

**Residency**

A qualifying child is a child who lived with you in the United States for more than one-half of the year.

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Appendix VI

**Management's Response to the Draft Report**



COMMISSIONER  
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
ATLANTA, GA 30308

RECEIVED  
DEC 15 2003

DEC 12 2003

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX  
ADMINISTRATION

FROM:

Henry O. Lamar, Jr.

Commissioner, Wage and Investment Division

SUBJECT:

Draft Audit Report – Management Controls Over the Proof of  
Concept Test of Earned Income Tax Credit (EITC) Certification  
Need to be Improved (Audit # 200340047)

Thank you for providing us a copy of your draft report on the EITC Proof of Concept test. We have derived benefits from this review and from your involvement in our ongoing planning and implementation process. I look forward to a continuing and productive working relationship as we strive to improve the way in which the IRS administers the EITC.

The certification proof of concept is one of a number of new approaches we are testing to improve EITC compliance, while maintaining participation by eligible taxpayers. Because it is a test, and because we modified our approach several times over the last six months, many of the management controls you cited were not in place at the time you completed your review.

Today, however, we have significant controls in place – including a complete work project plan broken down to specific activities with the names of responsible individuals and due dates. This comprehensive project management plan is regularly updated and reviewed by my top staff and me. We also designed a management information system that will provide relevant, timely data throughout the test. Additionally, we are working with our Research function and independent contractors to finalize a comprehensive evaluation plan.

On a more strategic level, the IRS has developed a new management infrastructure designed to bring top-level attention to EITC administration. We are centralizing and consolidating numerous EITC-related functions under a single executive. That executive is accountable for all aspects of the EITC – from outreach to compliance – and will have the ability to ensure coordinated and consistent approaches to EITC issues.

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However, I take issue with your conclusion concerning the establishment of performance measures. You reported that, "the IRS does not believe it needs to establish measures at this time but should instead attempt to establish a baseline against which to measure future efforts." To the contrary, since the inception of this test, we have stressed the importance of establishing a robust suite of measures.

You also pointed out the need to establish specific numerical targets for evaluating the success of the pilot. Our goal is to reduce erroneous EITC payments while maintaining participation by eligible taxpayers. A primary purpose of the proof of concept test is to determine the extent to which we can accomplish this goal. Ultimately, the decision on how to proceed will take place only after in-depth evaluation and consultations with our numerous stakeholders.

In summary, our goal is a fair and balanced EITC program – one that clearly encourages eligible taxpayers to apply while reducing an unacceptably high rate of erroneous claims.

My comments to your recommendation are attached.

If you have any questions, please contact me, or David R. Williams, Director, EITC, at (202) 622-5440.

## **Management Controls Over the Proof of Concept Test of Earned Income Tax Credit Certification Need to Be Improved**

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### **Attachment**

#### **Recommendation**

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.

#### **Corrective Action**

As noted, we have made significant progress in establishing effective management controls over the proof of concept test. Specifically, we have:

- Consolidated all aspects of the EITC Program under the leadership of an Executive Director.
- Established a comprehensive project management plan that is regularly updated and reviewed by the Director.
- Consolidated test case processing at the Kansas City Campus along with a group of specially trained examiners.
- Designed a comprehensive management information system (MIS) to capture relevant information about the test, and to facilitate effective case processing.
- Established a process to account for test-related expenditures (at the functional level).
- Obtained the help of an independent contractor to assist us in designing a comprehensive project evaluation plan.

While these are important accomplishments, we will take the following additional steps to improve the administration of this initiative.

- Using our project management process, ensure that all activities necessary for a successful test are timely and accurately completed.
- Along with an independent contractor, complete the project evaluation plan.

#### **Implementation Date**

January 9, 2004

#### **Responsible Official**

Director, EITC