The Earned Income Tax Credit Income Verification Test Was Properly Conducted

May 2005

Reference Number: 2005-40-093

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

May 27, 2005

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Earned Income Tax Credit Income Verification Test Was Properly Conducted (Audit # 200440050)

This report presents the results of our review of the Earned Income Tax Credit (EITC) income verification test. The overall objective of this review was to determine whether the Internal Revenue Service (IRS) properly classified, selected, and processed test cases and accurately summarized and reported the results of the Fiscal Year (FY) 2004 EITC income verification test. The income verification test was conducted in conjunction with the IRS Automated Underreporter (AUR) Program.[1]

The EITC is a refundable tax credit designed to help move low-income working taxpayers above the poverty level. However, the credit has had historical compliance problems. The IRS estimated that between 27 and 32 percent of the $31 billion in EITC claimed on Tax Year 1999 returns should not have been paid.

Beginning in FY 2004, the IRS tested three of the main concepts contained in its long-term vision for improving its EITC Program: certification of qualifying child residency requirements, verification of filing status, and verification of income. This audit is the fifth in a series of audits we have conducted to monitor the IRS' testing of its long-term EITC vision.

In summary, the EITC income verification test was designed to help the IRS identify ways to ensure taxpayers claiming the EITC properly report their income. Overall, the test met the IRS' expectations. The IRS established several business objectives for the income verification test. To meet these objectives, the IRS developed specific business

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

rules to classify and select cases for the test. The IRS properly classified and accurately selected cases for the test based upon these established business rules.

As of January 31, 2005, additional assessments totaling $248 million for about 213,000 taxpayers had been made because the EITC was either eliminated or reduced during the income verification test.[2] Additional taxes totaling about $130 million[3] resulting from changes to the income reported by these taxpayers were also assessed.[4] Assessments made during the test were accurate in 93 percent of the cases we reviewed. The accuracy rate we identified is similar to that for the overall AUR Program. We also evaluated the timeliness with which the IRS responded to taxpayer correspondence and issued notices to taxpayers. The IRS timely corresponded with or issued notices to taxpayers in 96 percent of the cases we reviewed.

The IRS also developed a new tool, the EITC AUR Case Tracking Report, to keep management informed of interim test results. The Case Tracking Report was created because information could not be obtained from the Enforcement Revenue Information System (ERIS)[5] used by the AUR Program until several months after the test started. We evaluated the accuracy of the Case Tracking Report and identified some inconsistencies. While these inconsistencies affected the interim tracking and reporting of test results, the IRS will be able to use the ERIS, a more reliable source, to compile and report the final results for the FY 2004 test. In addition, the IRS was able to improve the ERIS and will no longer need to use the Case Tracking Report to track and report interim results for the FY 2005 test.

We also verified that the IRS used the information it gathered from the FY 2004 test to make several key changes to its FY 2005 test. These included modifying the selection of cases to improve productivity, identifying and addressing the issue of stolen identity, and separating certain self-employed taxpayers claiming the EITC into a segment that will be worked separately.

<u>Management's Response</u>: The IRS indicated it was taking a number of steps to reduce erroneous EITC payments and was pleased the verification of income test has proven so effective. The IRS was also pleased our review recognized verification of income through the AUR Program as an effective enforcement tool that promotes compliance and protects revenue. Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the IRS managers affected by the report results. Please contact me at (202) 622-6510 if you have questions or Michael R.

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[2] In a small number of cases, the changes resulted in a higher EITC. The amount shown represents the net amount of assessments resulting from the EITC being reduced or eliminated.
[3] This includes interest and penalties, if applicable, less any additional withholding due the taxpayers.
[4] In a small number of cases, the changes resulted in a lower tax liability. The amount shown represents the net amount of additional taxes assessed.
[5] The ERIS is a cross-functional database that tracks the amount and timing of revenue from all IRS enforcement actions.

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

Table of Contents

Background

The Earned Income Tax Credit (EITC), enacted 30 years ago, is a refundable tax credit designed to help move low-income working taxpayers above the poverty level. For Tax Year (TY) 2003, the Internal Revenue Service (IRS) reported that approximately 21.7 million taxpayers received EITC totaling $38.1 billion. For TY 2004, taxpayers can receive a credit as high as $4,300 depending upon their income, filing status, and number of eligible children. While this provides a significant benefit, the IRS has also historically experienced compliance problems with this credit. The most recent IRS study of EITC compliance estimated that for TY 1999 between 27 and 32 percent of the $31 billion in EITC claims should not have been paid.

A joint Department of the Treasury and IRS task force, formed in February 2002 to study the administration of the EITC, offered suggestions for improving compliance. The IRS compiled these suggestions into a Concept of Operations outlining its future vision for the EITC Program. The first step in implementing this long-term vision was to test several of the vision's key concepts. Beginning in Fiscal Year (FY) 2004, the IRS tested three of the main concepts contained in its long-term vision.

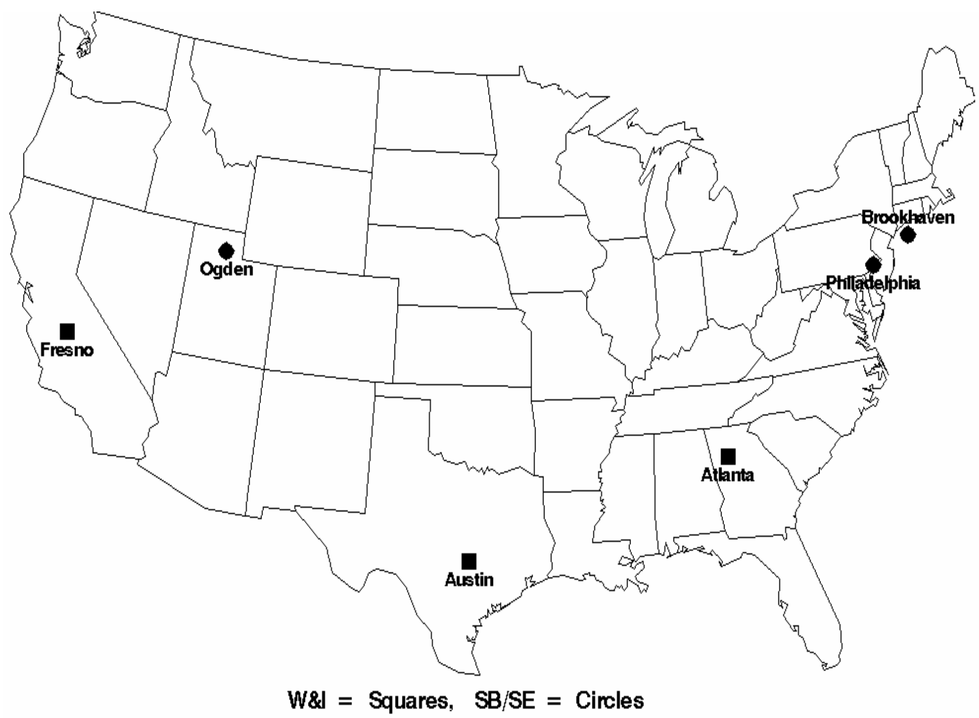
- Certification of Qualifying Child Residency Requirements.
- Verification of Filing Status.
- Verification of Income.

The EITC Office, which is part of the IRS Wage and Investment (W&I) Division, is responsible for the overall administration of the EITC Program. This requires coordinating with over 20 different IRS functions that administer some portion of the EITC. This is the fifth in a series of audits we have conducted to monitor the IRS' testing of its long-term EITC Program vision. See Appendix IV for a list of prior reports. This audit focused on the income verification test.

The IRS identifies taxpayers that misreport their income through an annual matching program known as the Automated Underreporter (AUR) Program. The AUR Program compares the information reported by third parties, such as employers and banks, with what was reported by taxpayers on their individual income tax returns.

An AUR Program case is created when the comparison of the tax return to the third-party information documents identifies a discrepancy between these two sources. Cases are categorized into 57 categories (wages, unemployment compensation, dividends, etc.). The categories are further subdivided into seven subcategories based upon the potential tax change. The AUR Program is administered by the Compliance functions in the W&I and Small Business/Self-Employed (SB/SE) Divisions and operates at six sites in IRS campuses.[1] The 300,000 taxpayers in the income verification test were worked by the 3 W&I Division AUR Program sites.

Figure 1: IRS AUR Program Sites



Source: Treasury Inspector General for Tax Administration analysis of IRS sites.

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

Tax examiners at the AUR Program sites initially analyze each case through a screening process to determine if the discrepancy can be resolved without contacting the taxpayer. If the discrepancy can be resolved in this process, no further action is taken and the case is closed. If the discrepancy cannot be explained, the IRS will send the taxpayer a notice asking for an explanation.

In most cases, the first notice informs the taxpayer that what was reported on the tax return does not agree with what has been reported by third parties.[2] The taxpayer is told to respond within 30 calendar days. If the taxpayer does not respond to the initial notice, the IRS issues a Statutory Notice of Deficiency advising the taxpayer he or she has 90 days to respond or the additional taxes will be assessed. A taxpayer may also receive a Statutory Notice of Deficiency if he or she disagrees with the proposed assessment but does not provide the IRS with enough information to support the disagreement. See Appendix V for a flowchart of the AUR Program process.

The EITC income verification test was designed to help the IRS identify ways to ensure taxpayers claiming the EITC properly report their income. Accuracy of income reporting is critical to the accuracy of the EITC claimed since the credit is limited to certain income levels. Initially, the IRS planned to select 175,000 taxpayers for the test. However, due to changes in the certification of qualifying child residency requirements test, the number of returns was expanded to 300,000 taxpayers. The FY 2004 test involved TY 2002 returns.

We conducted this audit in the IRS W&I Division Headquarters in Atlanta, Georgia. We also conducted testing in the Atlanta, Georgia; Fresno, California; and Austin, Texas, AUR Program sites. We conducted our testing during the period August 2004 through February 2005. 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.

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[2] The IRS refers to this as a CP 2000 notice.

Cases Were Properly Classified and Accurately Selected Based Upon Established Business Rules

The IRS established a new set of business rules to classify and select taxpayers for the income verification test. Our analysis showed cases were properly classified and accurately selected for the test based on those business rules.

Compliance problems with the EITC are not new to the AUR Program. Potential changes to the EITC were always considered as part of the IRS' process to resolve income discrepancies. However, the IRS did not separately select cases with EITC claims. The IRS established new business rules for the income verification test and a separate population of EITC cases was created.

The IRS had several business objectives for this test.

- Separately identify EITC cases.
- Identify repeat offenders that underreport income to claim the EITC.
- Identify cases with the highest potential assessments.
- Gather baseline data for future case selections.

To meet these objectives, the IRS developed a set of business rules to classify and select AUR Program EITC cases. First, the IRS created a separate segment or file that contained all TY 2002 AUR Program cases in which the EITC had been claimed. There were a total of 915,087 cases in this file for TY 2002. It then analyzed historical AUR information for TYs 1999 through 2001 to determine if taxpayers had repeatedly underreported their income. The IRS grouped these taxpayers into four classes.

(1) Egregious Repeaters – Prior history of being selected and worked in the same AUR Program category for at least 2 of the 3 prior tax years, and the cases resulted in additional tax assessments in both years.

(2) Repeater Worked – Prior history of being selected and worked by the AUR Program in at least 1 of the 3 prior tax years.

(3) Repeater Not Worked – Prior history of underreporting income for at least 1 of the 3 prior years, and the AUR Program did not select the taxpayer during this period.[3]

(4) Other – No prior history of being identified by the AUR Program.

The IRS established criteria to select cases for the test from these four classes. The criteria were designed to include potential repeat offenders, cases with the highest potential EITC assessment, and cases selected at random that would be used to develop a baseline. Figure 2 shows, by class, the numbers of taxpayers classified and selected for the income verification test.

Figure 2: Number of Taxpayers Selected for the Income Verification Test

Class	Total Inventory	Cases Selected	Percentage of Total
Egregious Repeater	818	818	100
Repeater Worked	100,342	64,007	64
Repeater Not Worked	119,272	61,399	51
Other	694,655	173,776	25
Grand Totals	**915,087**	**300,000**	**33**

Source: IRS W&I Compliance Division.

We selected a judgmental sample of 100 cases (25 cases from each of the classes) and obtained historical information for TYs 1999 through 2002 to verify whether each of the cases was properly classified and selected according to the IRS' selection rules. Our analysis showed that 99 of the 100 cases were properly classified and accurately selected.

One case was erroneously classified in the Repeater Worked class. The misclassification resulted when the tax examiner

[3] Each year, the AUR Program identifies many more underreporter cases than can be selected and worked by IRS staff.

did not recognize that additional taxes had been assessed in a case that involved a recomputed Statutory Notice of Deficiency. The IRS has to issue a revised or recomputed Statutory Notice of Deficiency when a taxpayer is able to show that part of the discrepancy and corresponding proposed assessment is incorrect. The IRS plans to correct this oversight in its selection process before selecting cases for the FY 2006 income verification test.[4]

Cases Were Accurately and Timely Processed

It is important the IRS accurately and timely process cases in the income verification test to ensure taxpayers involved in the test do not experience any more burden than is necessary. Our analysis of cases in the test indicates the IRS accurately and timely processed AUR Program EITC cases.

The IRS used the same processes and procedures to work cases in the income verification test that it uses for all AUR Program cases. As of January 31, 2005, the IRS had made additional assessments totaling $248 million for about 213,000 taxpayers because their EITC was either eliminated or reduced during the test.[5] Additional taxes totaling about $130 million[6] resulting from changes to the income reported by these taxpayers were also assessed.[7]

We selected a statistical sample of 130 cases from the 300,000 cases in the test to verify whether changes to the EITC and additional taxes were accurate. We eliminated 13 of the 130 cases because they had been closed without action.[8] We determined the IRS correctly computed the proposed tax and credit changes in 109 (93 percent) of the remaining 117 cases. In addition, assessments posted

[4] At the time we advised the IRS of the error, case selections had already been made for the FY 2005 income verification test.
[5] In a small number of cases, the changes resulted in a higher EITC. The amount shown represents the net amount of assessments resulting from the EITC being reduced or eliminated.
[6] This includes interest and penalties, if applicable, less any additional withholding due the taxpayers.
[7] In a small number of cases, the changes resulted in a lower tax liability. The amount shown represents the net amount of additional taxes assessed.
[8] We did not review cases closed without action, other than those that were closed because they were below the IRS' tolerance.

accurately to the IRS Individual Master File[9] in all 86 cases in which the taxpayer either had agreed to the proposed changes or had not responded to the Statutory Notice of Deficiency. The accuracy rate we identified is similar to the overall accuracy rate for the AUR Program. In addition, only 2 of the 8 errors we identified affected the taxpayer's EITC.

An AUR case can take several months to resolve depending upon the number and type(s) of notices issued, how quickly taxpayers respond, and the amount of time the IRS takes to process those responses. To ensure the process moves as quickly as possible, the IRS has established time standards. These include standards for replying to taxpayer correspondence, issuing the Statutory Notice of Deficiency, making assessments subsequent to the Statutory Notice of Deficiency, and making assessments after taxpayer agreement to the proposed tax and credit changes. Specifically:

- The IRS must initiate a response to a taxpayer within 30 calendar days of the receipt of taxpayer correspondence.
- Issuance of a Statutory Notice of Deficiency must be initiated within 30 calendar days after the time period allowed for taxpayers to respond to the CP 2000 notice has expired.
- When a taxpayer does not respond to the Statutory Notice of Deficiency within the time allowed, the additional taxes must be assessed within 30 calendar days of the expiration of that time. Conversely, if a taxpayer responds and agrees to the proposed changes, the additional taxes are to be assessed within 30 calendar days of receipt of the taxpayer's agreement.

We used the same statistical sample of 130 cases from our accuracy test to verify whether the IRS met these timeliness standards. We eliminated 20 of the 130 cases because

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

taxpayer contact by the IRS had not been necessary.[10] The IRS met the timeliness standards in 106 (96 percent) of the remaining 110 cases.

Problems Tracking and Reporting Interim Test Results Were Resolved

While the IRS accurately identified and selected cases for the income verification test and processed those cases accurately and timely, we identified inaccuracies in a new tool the IRS created to monitor and track the interim results of the test. However, these inaccuracies will not affect the final results of the current test or future tests.

The IRS plans to use the Enforcement Revenue Information System (ERIS)[11] to formally report the results of the income verification test. However, there was a need to develop an interim reporting process because data from the ERIS would not be available for several months after the test started. This new tool, the EITC AUR Case Tracking Report, tracked the results of the income verification test on a weekly basis. The Case Tracking Report provided details of the test for each of the three AUR Program sites. It also showed results by each of the 57 AUR Program categories and 7 subcategories.

The Case Tracking Report provided the IRS a way to keep current on the test results and allowed it to determine which categories were more likely to result in changes to EITC claims.

According to the Government Accountability Office (GAO) *Standards for Internal Control in the Federal Government*,[12] an entity must have relevant, reliable, and timely communications relating to internal as well as external events for it to run and control its operations. We evaluated the Case Tracking Reports for overall accuracy and identified some inconsistencies.

- The total number of cases in the income verification test shown on the Reports did not agree with what was

[10] These cases were closed without action, indicating the IRS did not need to correspond with the taxpayer to resolve the income discrepancy.
[11] The ERIS is a cross-functional database that tracks the amount and timing of revenue from all IRS enforcement actions.
[12] GAO/AIMD-00-21.3.1 (November 1999).

included in the August 2004 preliminary report to the Congress.[13]

- The number of cases closed without action on the Reports did not match the number of cases reported to the Congress.
- The total proposed decreases in EITC claims were significantly different from the amounts shown for each income category. The proposed decreases in EITC claims are the estimated EITC changes the IRS expects to make.

While the last item was not part of the IRS' preliminary report to the Congress, the EITC Office used it to keep current on the test results.

Management Actions: When we informed the IRS of these inconsistencies, it indicated that, while it was aware the Case Tracking Report contained errors, it had been unable to look into the problems in detail. However, the IRS indicated the ERIS will be used to report the final test results. The ERIS has been used by the IRS for a number of years and tracks the amount and timing of revenue from all IRS enforcement actions. The IRS also subsequently advised us the ERIS can now provide timely data for the FY 2005 test. Therefore, the Case Tracking Report will no longer be used.

Test Results Were Used in the Planning and Implementation of the Fiscal Year 2005 Test

The IRS used the information it gathered from the FY 2004 test to make several key changes to its FY 2005 test. These included modifying the selection of cases to improve productivity, identifying and addressing the issue of stolen identity, and separating certain self-employed taxpayers claiming the EITC into a segment that will be worked separately.

Improving case selection to increase productivity

It is important that the IRS be able to select the most productive cases for the EITC AUR test so it can use its limited resources as efficiently as possible. The IRS was able to use information gathered from the FY 2004 test to

[13] *IRS Earned Income Tax Credit (EITC) Initiative, Status Report to the Congress – Department of the Treasury - Internal Revenue Service*.

make significant changes to its FY 2005 test that should improve the productivity of the cases selected for review.

In the FY 2004 test, the IRS was unable to accurately determine the potential EITC change and consider it in the total revenue impact of AUR Program EITC cases. The IRS was able to use the results of the FY 2004 test to add several new data entries for each EITC case to its analysis. This enabled the IRS to significantly improve the case selection process by calculating the total revenue impact for each case, as well as its estimated potential assessment amount. These calculations were built into the selection tool to identify the most productive cases for the FY 2005 test. The IRS estimates that potential assessments for the FY 2005 test will total approximately $413 million.

The FY 2004 test also showed that the selection of cases from certain AUR Program categories resulted in little or no change to the EITC. Selection from those categories was eliminated for the FY 2005 test. The IRS also compared FY 2004 test results to prior AUR Program statistics, including 5-year baseline rates for cases closed without action and cases in which the potential income discrepancy was resolved prior to contacting the taxpayer, and used this comparison to identify the most productive AUR Program categories for the FY 2005 test.

Assessing the impact of stolen identities

The IRS discovered in the FY 2004 test that a significant number of taxpayers were claiming stolen identity as the reason their income had not been reported. Through September 4, 2004, the IRS reported that almost 20,000 of the taxpayers in the test had claimed stolen identity. Recognizing this was a significant issue, the IRS performed in-depth analysis to identify certain common characteristics such as the geographic location of the taxpayers, tax preparers used, and employers. Actions are being taken by the IRS in the FY 2005 test to address the validity of stolen identity claims.

Validating large deductions taken by self-employed taxpayers

The IRS determined a significant number of self-employed taxpayers reporting large gross receipts from a business on Profit or Loss From Business (Schedule C, Form 1040) were able to claim the EITC. These taxpayers were claiming enough deductions to reduce their net income to satisfy the limitations for receiving the EITC. For FY 2005, the IRS has selected cases of this type and assigned them to be examined.

Management's Response: The IRS indicated it was taking a number of steps to reduce erroneous EITC payments and was pleased the verification of income test has proven so effective. The IRS was also pleased our review recognized verification of income through the AUR Program as an effective enforcement tool that promotes compliance and protects revenue.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) properly classified, selected, and processed test cases and accurately summarized and reported the results of the Fiscal Year (FY) 2004 Earned Income Tax Credit (EITC) income verification test. To accomplish our objective, we:

I. Determined whether the IRS accurately classified and selected taxpayers for the income verification test based upon the four EITC classes established by the IRS.

   A. Obtained the detailed selection criteria for each of the four EITC classes.

   B. Selected a judgmental sample of 25 cases from each of the 4 EITC classes from the test population of 300,000 cases.[1]

   C. Retrieved historical taxpayer account information from the IRS Integrated Data Retrieval System (IDRS)[2] and Automated Underreporter (AUR) System[3] for each of the cases selected to verify whether each case had been properly classified and selected.

II. Determined whether AUR Program EITC cases were properly processed.

   A. Interviewed a key IRS official associated with the income verification test and reviewed IRS procedures to identify the procedures used in processing test cases to determine whether any new or special procedures were created for the test.

   B. Selected a statistical sample of 130 cases from the test population of 300,000 cases.[4]

   C. Obtained historical taxpayer account information from both the IDRS and AUR System for each of the 130 cases selected to verify whether the proposed changes to income taxes and credits were calculated properly. We also verified whether

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[1] A judgmental sample of each of the four EITC classes was used based upon the availability of limited audit staffing resources. A much larger sample of over 400 cases would have been required for a statistical sample from each of the classes.
[2] The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.
[3] The IRS computer system used to take data from individual tax returns for comparison to data from information returns reported by payers. Once a discrepancy is identified and an AUR Program case created, the AUR System is used to process the cases through to closure that may include the generation of notices of proposed assessments and eventual tax assessments that are posted to taxpayer accounts.
[4] We used a statistical sample that was selected from the total population of 300,000 cases rather than stratifying the sample over each of the 4 EITC classes. Statistical sampling was used to allow for the projection our audit results to the population of 300,000. Cases were selected using a 95 percent confidence level, an 8 percent expected error rate, and a +/- 4.75 percent precision level.

assessments were accurately posted to the IRS Individual Master File[5] for those taxpayers who either agreed to the proposed assessment or did not respond to the statutory notice of deficiency.

D. Obtained historical taxpayer account information from the AUR System for each of the 130 cases selected to determine whether the IRS took timely actions to respond to taxpayer correspondence, issued statutory notices of deficiency, and made tax assessments in those cases in which either the taxpayers agreed with the proposed assessments or did not respond within the time periods allowed by the Statutory Notices of Deficiency.

III. Determined whether the IRS accurately summarized and reported the results of the income verification test.

A. Identified the IRS reports used to track and report both interim and final test results.

B. Evaluated the overall accuracy of the EITC AUR Case Tracking Reports by calculating whether individual totals agreed with overall totals for certain report line items, such as the number of screened out[6] and no change[7] cases, and with the overall reported total test inventory of 300,000 cases.

IV. Determined what steps the IRS is taking or could take to identify any trends from the FY 2004 income verification test and how that information was being or could have been used for the FY 2005 test.

A. Discussed with a key IRS official associated with the income verification test what types of analyses were being made of the results from the FY 2004 test and what actions were being or will be taken based upon that analysis.

B. Obtained copies of IRS reports illustrating the various analyses of the FY 2004 test results and the actions the IRS was taking for the FY 2005 test based upon the information gathered from those analyses.

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

[6] Each AUR Program case selected goes through a screening process to determine if the potentially unreported income may have been reported but on the wrong line of the tax return or if the discrepancy can be otherwise explained without having to contact and ask the taxpayer for an explanation. If it can be resolved in this process, no further action is taken and the case is “screened out.”

[7] If, after notifying a taxpayer of a potential discrepancy, the tax examiner determines discrepancies do not exist based upon taxpayer explanations, the case is closed without any additional tax or credit changes and is referred to as a “no change” case.

Appendix II

Major Contributors to This Report

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

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Appendix IV

Treasury Inspector General for Tax Administration and Government Accountability Office Reports on the Earned Income Tax Credit Proof of Concept Tests

The Treasury Inspector General for Tax Administration (TIGTA) and the Government Accountability Office (GAO) have conducted a number of reviews of the Internal Revenue Service Earned Income Tax Credit Proof of Concept Tests. Listed below are the reports that have been issued.

TIGTA Reports[1]

Management Controls Over the Proof of Concept Test of Earned Income Tax Credit Certification Need to Be Improved (Reference Number 2004-40-032, dated December 2003).

The Risk of Inaccurate Computer Changes Can Be Reduced in Future Tests of the Earned Income Tax Credit (Reference Number 2004-40-089, dated April 2004).

The Statistical Sampling Method Used in the Earned Income Tax Credit Proof of Concept Test Appears Valid (Reference Number 2004-40-100, dated May 2004).

Initial Results of the Fiscal Year 2004 Earned Income Tax Credit Concept Tests Provide Insight on Ways Taxpayer Burden Can Be Reduced in Future Tests (Reference Number 2005-40-006, dated October 2004).

GAO Reports[2]

Earned Income Credit: Qualifying Child Certification Test Appears Justified, but Evaluation Plan Is Incomplete (GAO-03-794, dated September 2003).

Earned Income Credit: Implementation of Three New Tests Proceeded Smoothly, But Tests and Evaluation Plans Were Not Fully Documented (GAO-05-92, dated December 2004).

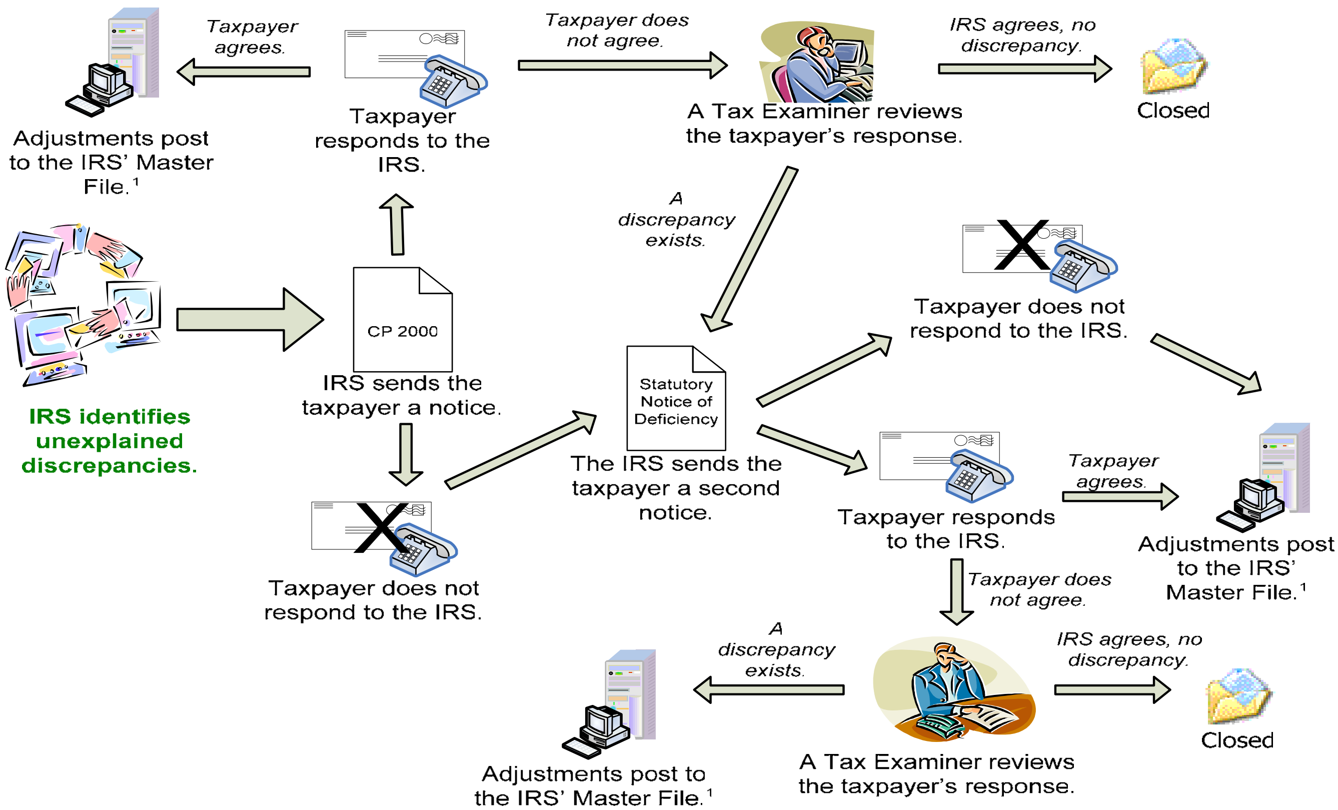
[1] Copies of these reports can be obtained at *www.treas.gov/tigta/*.
[2] Copies of these reports can be obtained at *www.gao.gov*.

Appendix V

The Automated Underreporter Program Process

The Internal Revenue Service (IRS) identifies taxpayers that misreport their income through an annual matching program known as the Automated Underreporter (AUR) Program. The AUR Program compares the information reported by third parties, such as employers and banks, with what was reported by taxpayers on their individual income tax returns. Tax examiners at the AUR Program sites initially analyze each case through a screening process to determine if the discrepancy can be resolved without contacting the taxpayer. If the discrepancy can be resolved in this process, no further action is taken and the case is closed. If the discrepancy cannot be explained, the IRS will send the taxpayer a notice asking for an explanation.

Flowchart of the AUR Program Process[1]



Source: Treasury Inspector General for Tax Administration analysis of IRS processes.

[1] The IRS Master File is a database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

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
MAY 20 2005

MAY 20 2005

MEMORANDUM FOR PAMELA J. GARDINER
ASSISTANT INSPECTOR GENERAL FOR AUDIT

FROM: Henry O. Lamar, Jr. Henry O. Lamar, Jr.
Commissioner, Wage and Investment Division

SUBJECT Draft Audit Report: The Earned Income Tax Credit Income Verification Test Was Properly Conducted (Audit # 200440050)

Thank you for this opportunity to respond to your report entitled, *"The Earned Income Tax Credit Income Verification Test Was Properly Conducted."* We are taking a number of steps to reduce erroneous Earned Income Tax Credit (EITC) payments and are pleased that the verification of income test has proven so effective. As you referenced in your report, the IRS is continuing to use information gained from the test to identify and address specific areas of income misreporting. These include:

- improving our ability to validate stolen identity claims; and
- modifying the way we select returns to ensure the cases identified and worked have a high certainty of erroneously reported income or deductions.

Testing approaches before implementing them, as we have done with the verification of income test, has drawn support from organizations such as the Center for Budget and Policy Priorities and the National Taxpayer Advocate. Most recently, in Senate Finance Committee testimony, Comptroller General David Walker recommended the IRS evaluate error reduction efforts to assess their effectiveness and specifically cited the EITC tests. I am pleased your review recognized verification of income through the Automated Underreporter (AUR) Program as an effective enforcement tool that promotes compliance and protects revenue.

We would also like to recognize the audit team's professionalism during this audit. The IRS staff that worked with your audit team provided positive feedback regarding observations your team shared about our AUR case methodology. As a result, we have tweaked our selection criteria, thereby strengthening the selection methodology. We are always seeking opportunities to improve ways we administer the EITC, and value your insight into this program.