Administration of the Earned Income Tax Credit Program Has Improved, but Challenges Continue

August 2005

Reference Number: 2005-40-133

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

August 26, 2005

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Administration of the Earned Income Tax Credit Program Has Improved, but Challenges Continue (Audit # 200540012)

This report presents the results of our review of the Earned Income Tax Credit (EITC) Program. The overall objective of this review was to assess the Internal Revenue Service's (IRS) progress in improving the administration of the EITC Program since Fiscal Year 2002. This review was a follow-up audit to a report we issued in June 2003,[1] in which we reported that long-term performance goals and measures were needed and fragmented management reduced the effectiveness of efforts to improve administration of the EITC Program.

The EITC is a refundable credit available to taxpayers with certain amounts of earned income to offset the impact of Social Security taxes on low-income families and to encourage them to seek employment rather than welfare. Historically, the EITC Program has been vulnerable to high rates of noncompliance. The IRS has estimated between $8.5 and $9.9 billion (27 to 32 percent) of the $31.3 billion in EITC claims made by taxpayers for Tax Year 1999 should not have been paid. The IRS is in the process of performing a National Research Program that will provide more current data based on a sample of Tax Year 2001 income tax returns.

Progress has been made in improving the administration of the EITC Program. The IRS has developed strategies and initiatives that should improve both EITC Program participation and compliance by taxpayers. The IRS has developed the EITC Reform Initiative to address backlogs of EITC Program examinations, minimize taxpayer burden during the audit process, improve communication with taxpayers, increase outreach

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

efforts, enhance compliance efforts, and pilot a certification process for higher risk taxpayers.

In June 2003, we reported that long-term performance goals and measures had not been established for the EITC Program. The IRS has since established long-term performance goals and measures to evaluate its progress in improving the EITC Program. The long-term measures are the percentage of Eligible Taxpayers Who File for the EITC and the percentage of EITC Claims Paid in Error. Although the IRS established the measures and goals, it had not updated these measures since the measures were established.

The IRS appointed an executive to head the EITC Office, who reports directly to the Commissioner, Wage and Investment Division. The executive still faces the difficulty of holding accountable the functions that complete EITC Program work. Most of these functions do not report to the EITC Office. For example, the Stakeholder Partnerships, Education, and Communication function is responsible for education and outreach, and the Field Assistance function is responsible for assistance with the preparation of tax returns claiming the EITC and resolution of issues related to EITC notices. Both of these functions report to the Customer Assistance, Relationships, and Education function.

To address this issue, the EITC Office developed Service Level Agreements that are negotiated with each function involved in the administration of the EITC Program. The Service Level Agreements document and formalize the services being provided by the operating and functional divisions, as well as the support the EITC Office will provide to the respective divisions. We believe this mechanism will increase the accountability of functions with EITC Program responsibility, but the EITC Office needs to ensure it regularly evaluates the effectiveness of the Agreements.

The IRS continues to face other challenges in administering the EITC Program, including the complexity of the tax law and the changing emphasis on the EITC Program by both Congress and the Government Accountability Office. The EITC Program eligibility rules are difficult and complicated for both taxpayers and the IRS. An analysis performed by the National Taxpayer Advocate shows that many low-income taxpayers struggle to determine EITC Program eligibility.

In addition, the level of emphasis on the EITC Program is shifting toward other areas of tax law enforcement. Recently, both Congress and the Government Accountability Office combined EITC Program concerns with the broader area of tax law enforcement. With the changing emphasis on the EITC Program, the EITC Office should be prepared to face the possibility that it may have to operate with fewer funds yet continue to produce a valuable product.

We recommended the Director, EITC, closely analyze the results of the Service Level Agreements. If the desired results are not being achieved, the Director should consider elevating the level of management that signs the Agreement.

Management's Response: IRS management agreed with our recommendation. The EITC Office will monitor and analyze the results set out in the Service Level Agreement with the Wage and Investment Division Compliance function as it is implemented. As part of this process, the EITC Office will evaluate the effectiveness of the Service Level Agreement in facilitating the achievement of EITC Program objectives and will modify the Service Level Agreement, including the level of management that signs the Agreement, as necessary and appropriate. 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 recommendation. 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) 927-7085.

Table of Contents

Background

The Earned Income Tax Credit (EITC) is a refundable credit available to taxpayers with certain amounts of earned income. In 1975, Congress amended the Internal Revenue Code[1] to provide the EITC to offset the impact of Social Security taxes on low-income families and to encourage them to seek employment rather than welfare. For example, a working family with an income of $25,000 is helped with the EITC because they may be eligible to claim from $849 to $2,197, depending on the filing status and number of eligible children in the family.

The Internal Revenue Service (IRS) is responsible for administering the EITC Program. Since 1975, additional legislation has been passed in an attempt to clarify the qualifications for the EITC and make it easier for more people to claim it. This has made administration of the EITC Program more complex. The IRS has changed from the use of a single line on the tax return for the EITC to a 53-page publication and schedule in Tax Year (TY) 2004 devoted to EITC Program instructions and computations.[2]

The number of taxpayers claiming the EITC grew substantially from 1975 until 1995 but has since remained relatively steady. The number of taxpayers claiming the EITC increased from about 6.2 million in TY 1975 to 21.7 million in TY 2003. The total amount of the EITC claimed increased from $1.2 billion to $38 billion. During the same period, the average credit increased from about $202 to $1,754. Figures 1 and 2 present the total number of taxpayers claiming the EITC and the total dollars claimed.

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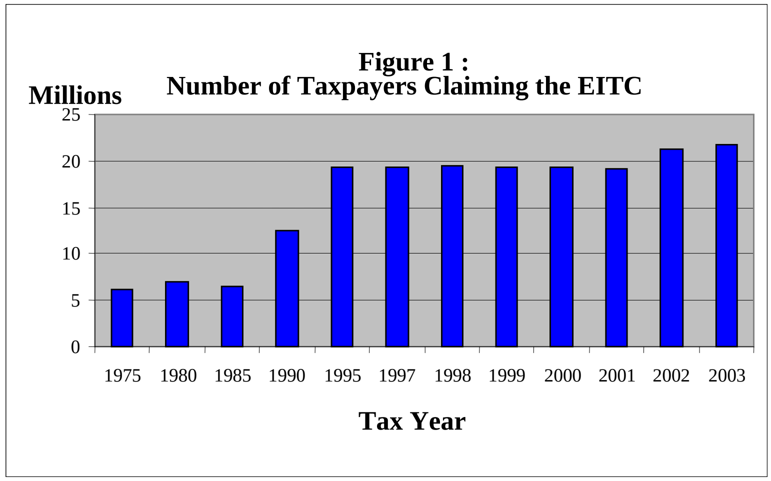
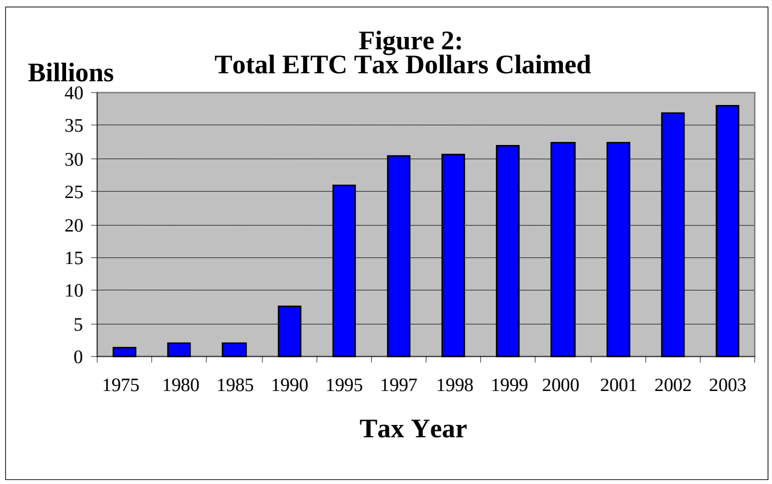
[1] Tax Reduction Act of 1975, Pub. L. No. 94-12, § 204, 89 Stat. 26, 30-32.
[2] See Appendix IV for details on the EITC Program rules.



Source: IRS Statistics of Income Bulletins and IRS processing reports.



Source: IRS Statistics of Income Bulletins and IRS processing reports.

Historically, the EITC Program has been vulnerable to high rates of noncompliance. In February 2002, the IRS estimated that, for TY 1999, between $8.5 and $9.9 billion (27 to 32 percent) of the $31.3 billion in EITC claims made by taxpayers should not have been paid.

To help improve administration of the EITC Program and reduce noncompliance, Congress provided the IRS with a special appropriation for 5 years totaling $716 million for Fiscal Years (FY) 1998 through 2002. For FY 2003, Congress provided an additional $146 million appropriation. These separate appropriations allowed funds designated for the EITC Program to be tracked separately from other enforcement funding. However, in FY 2004, the funds designated for the EITC Program were merged into the general Tax Law Enforcement (TLE) account. The EITC Program portion of the TLE budget was almost $197 million in FY 2004.

The IRS participated in a joint Treasury-IRS task force to study EITC Program noncompliance. In response to recommendations made by the task force, the IRS has been testing different concepts in its approach to noncompliance. For example, the IRS is requiring a test group of higher risk taxpayers to precertify their eligibility for the EITC. These taxpayers must certify prior to receiving the EITC that they lived with the children they claim for the EITC for the required length of time. The IRS also created an Executive Advisory Council, made up of IRS executives involved in the administration of the EITC Program, to help provide better oversight and coordination of the administration of the Program.

The IRS is in the process of performing a National Research Program that will provide more current data based on a sample of 46,000 TY 2001 tax returns. The National Research Program will provide compliance measures for different types of taxes and different groups of taxpayers. Taxpayers that claim the EITC will be part of this Program.

The President's Administration has made elimination of improper payments a major focus of the President's Management Agenda.[3] Through the Improving Financial Performance and Eliminating Improper Payments Program[4] Initiatives, the President is holding Federal Government agency managers accountable for strengthening financial management controls so Federal agencies can better detect and prevent improper payments and, thus, better ensure taxpayer dollars are spent wisely and efficiently. In addition, in an effort to eliminate improper payments, the

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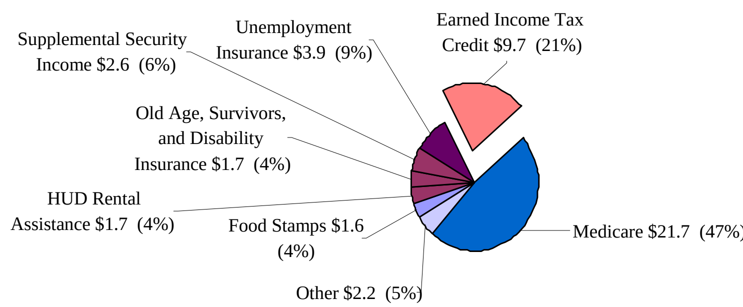
[3] An improper payment occurs when Federal Government funds go to the wrong recipient, the recipient receives an incorrect amount of funds, or the recipient uses the funds improperly.
[4] *Improving the Accuracy and Integrity of Federal Payments* (Office of Management and Budget, dated January 25, 2005).

President signed the Improper Payments Information Act of 2002.[5]

Federal Government agencies implemented various requirements of the Improper Payments Information Act of 2002 in FY 2004. The results are captured in a common reporting format in each agency's Performance and Accountability Report. The first year established the baseline on which short- and long-term program improvement strategies and priorities will be based.

Seven individual Federal Government programs account for approximately 95 percent of the total IRS improper payments reported in FY 2004. The EITC Program makes up 21 percent of the total improper payments.[6]

Figure 3:
$45.1 Billion Improper Payments by Major Program
(in billions)



Source: Improving the Accuracy and Integrity of Federal Payments (Office of Management and Budget, dated January 25, 2005).
HUD = Department of Housing and Urban Development.

This audit is a follow-up review to our report issued in June 2003[7] and was conducted in the EITC Office of the IRS Wage and Investment (W&I) Division in Atlanta, Georgia. This audit was conducted in accordance with *Government Auditing Standards* during the period January 2005 through May 2005. Detailed information on

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[5] Pub. L. No. 107-300, 116 Stat. 2350 (2002).
[6] This estimate is an FY 2004 projection based on the most recent EITC Program error study from TY 1999.
[7] *Opportunities Exist to Improve the Administration of the Earned Income Tax Credit* (Reference Number 2003-40-139, dated June 2003).

our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Progress Has Been Made to Improve the Administration of the Earned Income Tax Credit Program

The IRS has developed strategies and initiatives that should improve both EITC Program participation and compliance by taxpayers. The IRS developed an EITC Strategy in the FY 2003–2004 W&I Division Strategy and Program Plan. This Strategy was to implement a more comprehensive approach to the delivery of EITC Program services.

Subsequent to the development of the EITC Strategy, the IRS developed the EITC Reform Initiative. This Initiative addresses reducing backlogs of EITC Program examinations, minimizing taxpayer burden during the audit process, improving communication with taxpayers, increasing outreach efforts, enhancing compliance efforts, and piloting a certification process for higher risk taxpayers.

Several projects and initiatives have been developed that address the five points of the EITC Reform Initiative.

Audit process initiatives

To improve the existing audit process, the IRS has developed:

- The Risk-Based Scoring and Selection system, which enhances the selection of returns and identifies the best treatment streams based upon the risk score.
- The Selection/Assignment and Decision Support Tool, which enhances the categorization and prioritization of returns within each treatment category and improves case building and case determination.
- The Corporate Inventory Management/Routing System, which routes the next best case to the next best examiner.

Compliance initiatives

To enhance compliance efforts, the IRS is continuing to refine tests and strategies. For example:

- The IRS is testing new approaches to substantiate EITC Program eligibility for claimants with the Proof of Concept Tests for Qualifying Child, Filing Status, and Income Verification. The objective of these Tests is to minimize erroneous EITC payments while maximizing participation of eligible EITC claimants.
- The IRS is implementing changes to amended return processing to allow the capture and evaluation of information from the Earned Income Credit (Schedule EIC) during processing.

Outreach and education initiatives

The IRS also implemented initiatives to increase its outreach efforts. For example:

- The IRS delivers EITC Program education, outreach, and assistance initiatives through both national and local partners. The IRS has over 60 national partners, including the National League of Cities; the National Disability Institute; the United Way; the Center on Budget, Policy, and Performance; the United States Chamber of Commerce; and the Department of Justice. Over 270 coalitions nationwide are involved in local partnerships and community-based activities.
- The IRS conducts EITC Program awareness campaigns that include newspaper, radio, television, and mailings by utility companies, educational institutions, and social service agencies. Figure 4 presents an example of EITC Program advertising material.
- The IRS provides free tax preparation through its Volunteer Income Tax Assistance Program, which assists low-income taxpayers with filing their returns and claims each year.

Figure 4:
Example of EITC Program Advertising Material

Source: IRS outreach advertising material.

Long-Term Performance Goals and Measures Were Established

In 2003,[8] we reported that long-term performance goals and measures had not been established for the EITC Program. Both we and the Government Accountability Office (GAO) reported the need for the IRS to develop long-term goals and measures. In addition, during part of the FY 2004 budget process, the Office of Management and Budget (OMB) assessed the EITC Program using its Program Assessment Rating Tool.[9] The OMB gave the EITC Program an ineffective rating because of the significant amount of EITC Program noncompliance. While the IRS had a strong planning process closely linked to its budget process, it had not set performance goals that allowed it to demonstrate results or developed long-term performance goals for the EITC Program.

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[8] *Opportunities Exist to Improve the Administration of the Earned Income Tax Credit* (Reference Number 2003-40-139, dated June 2003).
[9] The Program Assessment Rating Tool was developed to assess the effectiveness of Federal Government programs and help improve management actions, budget requests, and legislative proposals directed at achieving results.

The IRS established two long-term measures to evaluate its progress and established goals for both measures. The long-term measures were:

- Percentage of EITC Claims Paid in Error. The FY 2004 goal range for this measure was from 22 to 27 percent.
- Percentage of Eligible Taxpayers Who File for the EITC. The FY 2004 goal for this measure was 80 percent.

Although the IRS established measures and goals, it had not updated either the percentage of EITC Claims Paid in Error or the percentage of Eligible Taxpayers Who File for the EITC since the measures were established.

Percentage of EITC Claims Paid in Error

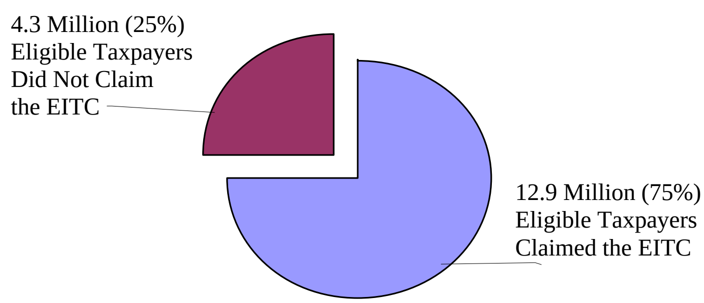
The most current estimate of EITC Claims Paid in Error continued to be between 27 and 32 percent. This figure was based on a study of TY 1999 returns completed in Calendar Year 2001. During our review, the IRS was in the process of performing a National Research Program that would provide more current data based on TY 2001 tax returns. The results of the National Research Program were not available at the time of this report.

The IRS has worked with the OMB and the Department of the Treasury to develop a methodology for estimating erroneous payments that is compliant with the Improper Payments Information Act of 2002. There are two areas for estimated error rates: the overall error rate and the estimated error rate for a particular high-risk component of the EITC Program, such as qualifying child. The OMB allowed the IRS to provide an estimated error rate for the qualifying child component because estimating the overall EITC Program error rate requires a full compliance study, such as the National Research Program, which takes several years to complete. The OMB allowed the IRS to estimate the error rate for the qualifying child component in the years between the compliance studies that provide estimates for the amount of EITC claimed.

Percentage of Eligible Taxpayers Who File for the EITC

The most current estimate of eligible Taxpayers Who File for the EITC was 75 percent of the 17.2 million eligible taxpayers, based on a GAO study performed in December 2001 (see Figure 5).[10] The IRS planned to employ the GAO methodology to estimate the percentage of eligible taxpayers who claim the EITC. However, the IRS informed us it was working to refine the methodology.

Figure 5:
GAO Estimate of Taxpayers Eligible to Claim the EITC



Source: Earned Income Tax Credit Eligibility and Participation (GAO-02-290R, dated December 2001).

Executive-Level Oversight of the Earned Income Tax Credit Program Was Established

In June 2003, we reported that administration of the EITC Program was fragmented, which diffused the accountability of the Program results. There was no executive appointed to head EITC Program efforts to provide accountability and recognition to the value and importance of the Program to both its internal and external stakeholders.

Federal Government management control standards require that agencies ensure appropriate authority, responsibility, and accountability are defined and delegated to accomplish the mission of the organization.[11] The standards also require that an appropriate organizational structure be established to effectively carry out program responsibilities.

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[10] *Earned Income Tax Credit Eligibility and Participation* (GAO-02-290R, dated December 2001).
[11] OMB Circular A-123, as revised June 21, 1995.

The EITC Office has been in a state of fluctuation during the past 4 years. In FY 2001, it reported directly to the Commissioner, W&I Division. In July 2002, the EITC Office was moved to report to the Director, Strategy and Finance, W&I Division. In October 2003, it was placed back directly under the Commissioner, W&I Division. At that time, the IRS appointed an executive to direct the EITC Office, which is responsible for managing the EITC Program.

While we believe creating an executive-level position benefits the coordination and oversight of the EITC Office and related Program, that executive still faces the difficulty of holding accountable the functions that complete EITC Program work. Most of these functions do not report to the EITC Office. For example, the Stakeholder Partnerships, Education, and Communication function is responsible for education and outreach. The Field Assistance function is responsible for assistance with the preparation of tax returns claiming the EITC and resolution of issues related to EITC notices. Both of these functions report to the Customer Assistance, Relationships, and Education function. To address this, the EITC Office developed a mechanism that tied compliance and other functions to the W&I Division Strategic Plan.

A Service Level Management process was established to provide a framework for documenting, monitoring, and evaluating the levels of service provided to the EITC Program by the various organizations within the IRS.[12] Essential to this process are Service Level Agreements (SLA), which are negotiated with each function involved in the administration of the EITC Program. The SLAs document and formalize the services being provided by the operating and functional divisions, as well as the support the EITC Office will provide to the respective divisions. The EITC Office plans to establish with major functions SLAs that tie their EITC Program responsibilities to the EITC Strategic Plan.

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[12] See Appendix V for IRS offices and functions participating in the EITC Program.

At the time of our review, the EITC Office had finalized the SLA with the W&I Division Compliance function. However, this SLA was not signed until May 2005, which prevented us from being able to evaluate the results of the SLA process.

We believe the SLA process will increase the accountability of functions with EITC Program responsibility, but the EITC Office needs to ensure it regularly evaluates the effectiveness of the SLAs. If the EITC Office finds the SLAs are not being adhered to, it may be necessary to elevate the level of management that signs the SLAs, perhaps up to and including the Commissioner, W&I Division. This could allow more specific consequences for nonperformance of agreed upon items and could allow tying the deliverance of the Program to the executive's annual performance goals.

Recommendation

To ensure the SLA process is working as intended and the EITC Program is successful, the Director, EITC, should:

1. Closely analyze the results of the SLA currently in operation to ensure all functions are working within the agreements reached. If the Director, EITC, determines the desired results are not being achieved, the Director should consider elevating the level of management that signs the Agreement.

Management's Response: IRS management agreed with this recommendation. The EITC Office will monitor and analyze the results of the SLA with the W&I Division Compliance function as it is implemented. As a part of this process, the EITC Office will evaluate the effectiveness of the SLA in facilitating the achievement of EITC Program objectives and will modify the SLA, including the level of management that signs the Agreement, as necessary and appropriate.

The Internal Revenue Service Continues to Face Challenges in Improving the Earned Income Tax Credit Program

The IRS faces many challenges in administering the EITC Program, including the complexity of the tax law and the changing emphasis on the EITC Program by both Congress and the GAO.

Tax law complexity

The EITC Program eligibility rules are difficult and complicated for both taxpayers and the IRS. The complexity causes taxpayers and IRS employees to make errors while attempting to interpret and apply the tax laws to their individual situations. An analysis performed by the National Taxpayer Advocate (NTA) shows that many low-income taxpayers struggle to determine EITC Program eligibility.[13] Some taxpayers lack understanding of the eligibility issues related to family status, such as the dependency exemption and head of household filing status.

The IRS has several initiatives underway to educate taxpayers and their representatives about EITC Program eligibility, and the NTA is attempting to address many of the issues through administrative and legislative recommendations. The Working Families Tax Relief Act of 2004[14] made changes to family status definitions that may reduce the complexity of the determinations.

Changing emphasis on the EITC Program

The level of emphasis on the EITC Program is shifting toward other areas of tax law enforcement. Recently, both the GAO and Congress combined EITC Program concerns with the broader area of tax law enforcement.

In 2001, the GAO named EITC Noncompliance as a high-risk area because of the particularly high incidence of fraud and other forms of noncompliance. The GAO 2005 high-risk status report[15] combined the EITC Noncompliance and the Collection of Unpaid Taxes high-risk areas into a single area – Enforcement of Tax Laws. The GAO believes the focus of concern on tax law enforcement is not confined to any one segment of the taxpaying population or any single tax provision.

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[13] *NTA 2004 Annual Report to Congress.*
[14] Pub. L. No. 108-311, 118 Stat. 1166 (2004).
[15] *High Risk Series: An Update* (GAO-05-207, dated January 2005).

Congress dedicated a specific appropriation for EITC Program compliance initiatives (both to curb noncompliance and encourage participation) in FYs 1998 through 2003. However, in the FY 2004 budget, Congress returned to appropriating a single amount for the IRS to allocate among its various tax law enforcement efforts.

Merging the EITC Program funds into the TLE account allows the Commissioner, W&I Division, to maneuver dollars between programs. However, combining the funds made it more difficult for the EITC Office to track its funds. After the EITC Program funds were merged into the TLE account, the EITC Office had no way to monitor its fund separately, and special reports were developed by the Chief Financial Officer to allow the EITC Office to monitor funds more easily. The EITC Office relies on these reports to show the money budgeted and spent by the individual functions.

With both the GAO and Congress changing their emphasis on the EITC Program, the EITC Office should be prepared to face the possibility that it may have to operate with fewer funds yet still continue to produce a valuable product. Fewer funds could affect the future of the EITC Program because the result would likely be fewer outreach and education activities and fewer compliance initiatives. Since the Commissioner, W&I Division, has the flexibility to maneuver dollars between programs, funds may be redirected from the EITC Program to other TLE programs.

Appendix I

Detailed Objective, Scope, and Methodology

The objective of this review was to assess the Internal Revenue Service's (IRS) progress in improving the administration of the Earned Income Tax Credit (EITC) Program since Fiscal Year (FY) 2002. This was a follow-up audit to a report we issued in June 2003,[1] in which we reported that long-term performance goals and measures were needed and fragmented management reduced the effectiveness of efforts to improve administration of the EITC Program. We evaluated the IRS' progress in administering the EITC Program between October 1, 2002, and September 30, 2004.

Our testing was limited to reviewing IRS management reports in FYs 2003 and 2004 and discussing the EITC Program with appropriate officials. We did not conduct testing to verify the accuracy of the reports, nor did we do any tests to validate the data reported by the IRS. To accomplish our objective, we:

I. Determined the organizational structure, status, goals, and strategies for the EITC Program as of September 30, 2002. We reviewed our June 2003 audit report and the IRS' FY 2002 business plans and reports to determine the status of the EITC Program at the end of FY 2002.

II. Determined the changes and progress the IRS has made in the administration of the EITC Program.

   A. Identified the projects, programs, and initiatives the IRS implemented during FYs 2003 and 2004 in an effort to increase the number of eligible taxpayers who claim the EITC (EITC Program participation rate). We determined the impact of the Proof of Concept Tests by researching the IRS' FYs 2003 and 2004 strategic plans and meeting with appropriate IRS officials in the EITC Office.

   B. Identified Government Accountability Office concerns with the IRS' ability or efforts to improve participation in the EITC Program and reduce and prevent EITC overclaims. We determined which corrective actions the IRS indicated would be completed prior to the end of FY 2004.

   C. Evaluated the IRS' activities during FYs 2003 and 2004 to determine its progress in increasing participation in the EITC Program and reducing EITC overclaims by comparing FYs' 2003 and 2004 performance results to the results as of the end of FY 2002.

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

III. Evaluated the IRS' ability to significantly improve administration of the EITC Program as a result of changes made in the EITC Office and to the Program itself. We determined whether the Program changes addressed the recommendations made in our June 2003 report.

A. Determined how effectively the EITC Program funds were being tracked after they were merged with the Tax Law Enforcement account.

B. Determined whether the structure of the EITC Office allows adequate oversight of the employees working EITC Program cases by reviewing the concept of the Service Level Agreements.

C. Determined how the EITC Office keeps abreast of legislative changes and how it incorporates legislative changes into planning.

D. Determined what the IRS did to prepare for or address changes in the economy or taxpayer base that could affect EITC Program participation. We interviewed EITC Office personnel to determine what they use to forecast the EITC Program population and how this is incorporated into the strategic planning process.

E. Determined how the EITC Office communicates with Congress and outside stakeholders to gather stakeholder opinions.

F. Reviewed the Wage and Investment Division Strategic Plan to determine whether the IRS had established long-term goals and related measures for the EITC Office that reflect anticipated outcomes. We determined whether the IRS had established a consistent method to measure progress toward its long-term goals and whether the method includes an assessment of the frequency with which the measures are computed.

Appendix II

Major Contributors to This Report

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Sandra L. Hinton, Auditor

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Wage and Investment Division SE:W
Director, Earned Income Tax Credit SE:W:EITC
Acting Director, Strategy and Finance, Wage and Investment Division SE:W:S
Acting Chief, Performance Improvement, Wage and Investment Division SE:W:S:PI
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaisons:
    Director, Communications and Liaison TA:CCL
    Acting Senior Operations Advisor, Wage and Investment Division SE:W:S

Appendix IV

Earned Income Tax Credit Program Rules

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 Internal Revenue Service publication *Earned Income Credit* (EIC) (Publication 596).

Everyone must meet all of the following rules:

- Your Adjusted Gross Income[1] and earned income must be less than:
  - $34,458 ($35,458 for married filing jointly) if you have more than 1 qualifying child.
  - $30,338 ($31,338 for married filing jointly) if you have 1 qualifying child.
  - $11,490 ($12,490 for married filing jointly) if you do not have a qualifying child.
- 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 $2,650 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.
- 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.

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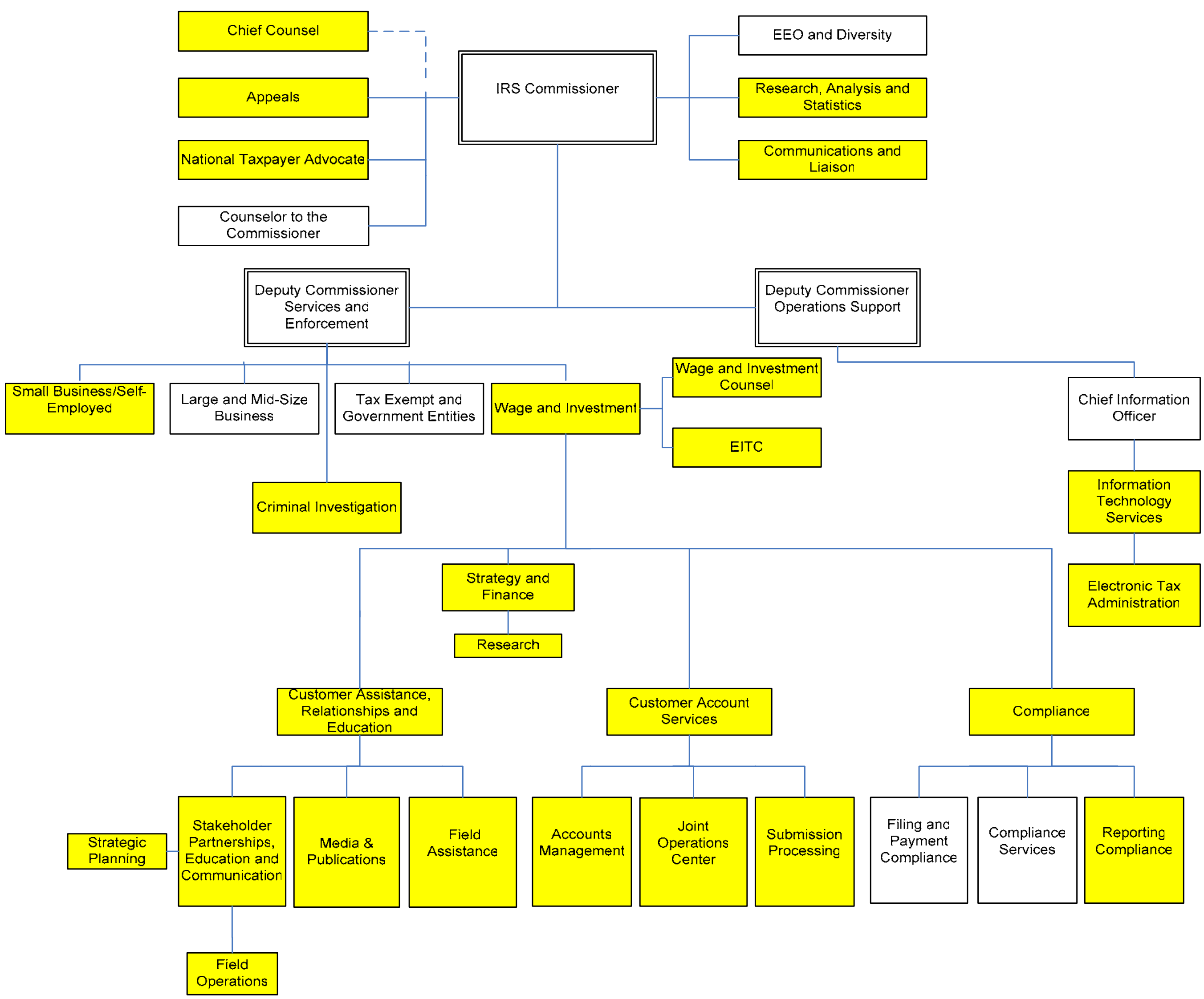
[1] Adjusted Gross Income is a taxpayer's gross income for the year adjusted for certain exclusions from income provided for in the Internal Revenue Code.

Appendix V

Earned Income Tax Credit Program Organization Chart

The shaded functions in the organization chart below are responsible for various aspects of the Earned Income Tax Credit Program.



Source: Developed from Internal Revenue Service information. EEO = Equal Employment Opportunity.

Appendix VI

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

COMMISSIONER
WAGE AND INVESTMENT DIVISION

RECEIVED
JUL 29 2005

JUL 28 2005

MEMORANDUM FOR PAMELA J. GARDINER
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Pamela G. Watson for Richard J. Morgante
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report: Administration of the Earned Income Tax Credit Program has Improved but Challenges Continue (TIGTA 200540012)

We have reviewed your report entitled "Administration of the Earned Income Tax Credit Program has Improved but Challenges Continue." Your assessment of the Earned Income Tax Credit (EITC) Program is timely and relevant, as we continue to implement changes centered around our balanced approach to increasing participation and reducing errors.

We are pleased that your report recognizes the progress we have made to improve the administration of the EITC. Your report identifies a broad range of strategies and initiatives completed or underway that should improve both EITC participation and noncompliance. We have made many improvements to how we administer the EITC since you last reviewed the program. For example, we have established two long term performance goals: 1) increase the percent of eligible taxpayers who file for EITC, and 2) reduce the percent of EITC claims paid in error, with corresponding measures and targets. We are in the process of developing specific methodologies through which we can measure our progress towards achieving these goals.

Despite these improvements and the changes we made to the organizational structure of the EITC Office (including its placement as a direct report to the Commissioner of Wage and Investment Division), the task of coordinating EITC activities across multiple IRS functions and operating divisions remains a challenge for the EITC Office, as you point out in your report. Equally challenging is the task of holding the functions accountable for the performance of their EITC work, especially since none of the functions report directly to the Director, EITC.

To help us better assess the EITC services the functions provide the EITC Office, we are implementing a Service Level Management process that provides a framework for documenting, monitoring, and evaluating the levels of service provided to the EITC Program by the other IRS functions through Service Level Agreements (SLA). We agree with your recommendation that we should closely analyze the results of the SLA currently in operation to ensure that the process works effectively.

We will continue to align our efforts with the IRS Commissioner's Five-point Plan that seeks to reduce burden on taxpayers, improve IRS audit processes, increase outreach, address unreported income, and test new approaches to reducing EITC errors. The SLAs will be critical to gauging the success of our efforts. We would appreciate your feedback on our progress with the SLA process once it becomes fully implemented.

Attached please find our specific plan of action to monitor and analyze the results of the SLA currently in place. If you have any questions, please call me at (404) 338-7060, or members of your staff may contact David R. Williams, Director, Earned Income Tax Credit, at (202) 622-9630.

Attachment

Attachment

RECOMMENDATION

To ensure that the Service Level Agreement (SLA) process is working as intended and that the EITC Program is successful, the Director, EITC should closely analyze the results of the SLA currently in operation to ensure all functions are working within the agreements reached. If they determine that desired results are not being achieved, the Director, EITC should consider elevating the level of management that signs the agreement.

CORRECTIVE ACTIONS

The EITC Office will monitor and analyze the results set out in the SLA with W&I Compliance as it is implemented. As a part of this process, we will evaluate the effectiveness of the SLA in facilitating the achievement of EITC program objectives. As necessary and appropriate, we will modify the SLA, including the level of management that signs the agreement.

IMPLEMENTATION DATE

May 15, 2006 – Evaluate the results of the W&I Compliance SLA and modify the SLA as appropriate.

RESPONSIBLE OFFICIAL

Director, EITC, Wage & Investment Division

CORRECTIVE ACTION MONITORING PLAN

The Director, EITC Strategic Operations and the Team Leader, EITC Program Evaluation and Support will monitor the effectiveness of the W&I Compliance SLA as it is implemented and make modifications to it as appropriate.