

**Millions of Dollars in Erroneous Education
Credits Continue to Be Allowed**

September 2001

Reference Number: 2001-40-183

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 20, 2001

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Pamela J. Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Millions of Dollars In Erroneous Education Credits Continue to Be Allowed

This report presents the results of our review to determine if the Internal Revenue Service (IRS) ensures that Education Credits are processed correctly. In summary, we found that the IRS was at risk of lost revenue of approximately \$20.56 million because it did not have automated controls in place to identify and resolve erroneous Education Credits. We originally reported that erroneous Education Credits were being allowed nationwide in a separate Treasury Inspector General for Tax Administration (TIGTA) report covering the 1999 Filing Season. Based on the results of our current audit, the IRS continues to allow these credits erroneously to taxpayers.

We recommended the IRS implement controls to identify and resolve errors on tax returns with the Education Credit. Specifically, it should implement effective controls to identify and resolve Education Credit cases where the filing status is married filing separately or the Adjusted Gross Income is over the maximum limit. In addition, the IRS should develop a process to identify and deny the credit to taxpayers that received the Education Credit and were also claimed as a dependent on another taxpayer's tax return during the same tax year.

Management's response was due on September 19, 2001. As of that date, management had not responded to the draft report.

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 M. Susan Boehmer, Acting Assistant Inspector General for Audit (Wage and Investment Income Programs), at (770) 936-4590.

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Executive Summary

In 1997, the Congress created the Education Credit,¹ which was designed to assist low- and middle-income taxpayers with tuition expenses incurred by students pursuing college degrees or vocational training. The Education Credit is comprised of two separate credits for post-secondary educational expenses and became effective for Tax Years 1998 and subsequent. The two separate credits included in this legislation are the Hope Scholarship and the Lifetime Learning Credits.

This report contains the results of our review to determine if the Internal Revenue Service (IRS) ensures that Education Credits are processed correctly. The audit scope focused on testing controls designed to prevent the posting of a tax return with an unqualified Education Credit to the IRS computer system. The review is part of the discretionary audit coverage under the Wage and Investment Division and the Treasury Inspector General for Tax Administration's (TIGTA) Fiscal Year 2001 audit plan.

Results

During the year 2000, the IRS did not have controls in place to effectively validate the requirements before allowing the \$4.4 billion in Education Credits given to 6.1 million taxpayers. Although taxpayers provided information needed to ensure they met basic qualifications, most of this information was not effectively used to validate the Education Credits.

In addition, the IRS did not require taxpayers to provide information that would allow the IRS to validate several other requirements for claiming the Education Credit. Instead, it relied on voluntary taxpayer compliance to ensure that the 6.1 million taxpayers are qualified to claim the credit. For instance, the IRS did not require taxpayers to certify that the student had not completed the first 2 years of post-secondary education or that the student was enrolled in a program that lead to a degree or certification, both of which are requirements for claiming the Education Credit. As a result, the IRS cannot provide reasonable assurance that all the requirements for claiming the \$4.4 billion in Education Credits were met.

¹ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 app.).

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We originally reported that erroneous Education Credits were being allowed nationwide in a separate TIGTA report covering the 1999 Filing Season.² Based on the results of our current audit, the IRS continues to allow these credits erroneously to taxpayers.

Information Provided by Taxpayers Is Not Used to Validate Many of the Requirements for Millions of Dollars Allowed in Education Credits

Although taxpayers provided information on their tax returns about whether they could be claimed by someone else as a dependent, their filing status, and their adjusted gross income amounts (AGI), the IRS did not use the information when it processed the Education Credits. For instance, the IRS did not ensure that taxpayers claimed by someone else as a dependent were denied the Education Credit on their own returns. As a result, the IRS allowed approximately \$19.5 million nationwide in potentially erroneous Education Credits on Tax Year 1999 tax returns processed between January 16 and September 9, 2000. In addition, the IRS did not ensure taxpayers that filed using the married filing separately filing status or had AGI amounts over maximum limits were denied the Education Credit. As a result, the IRS allowed approximately \$1.06 million in potentially erroneous Education Credits to taxpayers whose Tax Year 1999 tax returns were processed either electronically or at the Atlanta or Kansas City Submission Processing Centers between January 16 and September 9, 2000.

Summary of Recommendations

The IRS needs to implement controls to identify and resolve errors on tax returns with the Education Credit. Specifically, it should implement effective controls to identify and resolve Education Credit cases where the filing status is married filing separately or the AGI is over the maximum limit. In addition, the IRS needs to develop a process to identify and deny the credit to taxpayers that received the Education Credit and were also claimed as a dependent on another taxpayer's tax return during the same tax year.

Management's Response: Management's response was due on September 19, 2001. As of that date, management had not responded to the draft report.

² *Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions* (Reference Number 2000-40-045, dated March 2000).

Objective and Scope

Our overall objective was to determine if the IRS was processing the Education Credit correctly.

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) correctly processed Education Credits. This audit is one in a series designed to evaluate the IRS' processing of tax credits commonly claimed by Wage and Investment taxpayers¹. This review is part of the discretionary audit coverage under the Wage and Investment Division and the Treasury Inspector General for Tax Administration's (TIGTA) Fiscal Year 2001 audit plan.

We conducted this audit at the National Headquarters and the Atlanta and Kansas City Submission Processing Centers (ATSPC and KCSPC, respectively) between October 2000 and January 2001. We computer analyzed approximately 6.1 million Tax Year (TY) 1999 tax returns claiming over \$4 billion in Education Credits that were processed nationwide between January and September 2000. This audit was performed in accordance with *Government Auditing Standards*.

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

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

Background

Passed as part of the Taxpayer Relief Act of 1997, the Education Tax Credits became effective in TY 1998

Education Credits were included in the Taxpayer Relief Act of 1997² to assist low- and middle-income taxpayers with tuition expenses they incurred for college degrees or vocational training. The legislation included two types of Education Credits—the Hope Scholarship Credit and the Lifetime Learning Credit.

1. The Hope Scholarship Credit provides a maximum credit of \$1,500 per student for each of the first 2 years of post-secondary education. This consists of a 100 percent credit for the first \$1,000 of tuition expenses paid and a 50 percent credit for the next \$1,000 of tuition.
2. The Lifetime Learning Credit allows a credit of 20 percent of qualified tuition expenses, up to \$5000, paid by the taxpayer for any year the Hope Scholarship Credit is not claimed.

Both credits are available for tuition the taxpayers paid for themselves, their spouses, or their dependents. The credits are phased out as the taxpayers' adjusted gross income (AGI) increases. Taxpayers are no longer eligible for the Education Credit when their AGI reaches \$50,000 (or \$100,000 for married taxpayers filing joint returns). These credits are nonrefundable and claimed on Education Credits (Hope and Lifetime Learning Credits) (Form 8863).

In the first 2 years since the creation of the Education Credit, \$7.9 billion was claimed on 10.9 million tax returns.

The number and amount of Education Credits claimed have significantly increased since the first year of the

² Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 app.).

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credit. For example, between January 16 and September 9, 2000, the IRS reported that it processed 6.1 million Education Credits totaling \$4.4 billion. In the initial year of the Education Credit (TY 1998), there were 4.8 million returns filed, totaling \$3.5 billion in credits for a combined total of 10.9 million tax returns receiving \$7.9 billion Education Credits in the first two years since its creation.

In a previous TIGTA review,³ we reported that, during the credit's first year, millions of erroneous Education Credits were allowed to taxpayers.

Results

The IRS did not effectively use the information provided by taxpayers when it processed 6.1 million Education Credits for TY 1999.⁴ Instead, it primarily relied on voluntary taxpayer compliance to ensure that the taxpayers were qualified to claim the credit. As a result, it did not have a high assurance that all of the credits were correct.

The IRS did not effectively use taxpayer information to validate Education Credit claims.

We found that the IRS allowed \$20.56 million in potentially erroneous Education Credits on approximately 31,000 TY 1999 tax returns. Although taxpayers provided information on their tax returns about their filing status, AGI amounts, and whether they could be claimed by someone else as a dependent, the IRS did not effectively use the information when it processed the Education Credits.

³ *Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions* (Reference Number 2000-40-045, dated March 2000).

⁴ These figures represent all TY 1999 tax returns processed with the Education Credit between January 16 and September 9, 2000. (All return data available when we obtained the electronic information for review.) All subsequent references to TY 1999 tax returns in this report use this same processing period.

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Also, the IRS did not require taxpayers to provide information about whether they met certain requirements for claiming the Education Credit. For instance, the IRS did not require taxpayers to certify that the student had not completed the first 2 years of post-secondary education or that the student was enrolled in a program that lead to a degree or certification, both of which were requirements for claiming the Education Credit.

While the IRS could rely on subsequent examinations to validate the credits, it did not have an assurance that these requirements were met before the taxpayers were allowed the credits.

An overview of the requirements for receiving the Education Credit and whether the IRS validated the requirements before allowing the Credit is provided in Appendix V.

[Information Provided by Taxpayers Is Not Used to Validate Many of the Requirements for Millions of Dollars Allowed in Education Credits](#)

Dependency requirements

Taxpayers did not qualify for the Education Credit if they were claimed as a dependent on someone else's tax return.

According to the 1999 Individual Income Tax Return (Form 1040) instructions, taxpayers did not qualify for the Education Credit if they were claimed as a dependent on someone else's tax return.

We performed a computer analysis of approximately 6.1 million TY 1999 tax returns and identified 52,970 tax returns processed nationwide, with Education Credits totaling approximately \$33.5 million, where the taxpayers did not claim themselves as a dependency exemption.⁵

⁵ This also indicated that the taxpayer can be claimed as a dependent on someone else's tax return.

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We reviewed a statistically valid sample⁶ of 321 of these tax returns to determine if the taxpayer had actually been claimed on another tax return as a dependent. There were 181 (56 percent) tax returns in which the credit was allowed although the taxpayers were claimed as a dependent on another tax return. These 181 taxpayers received \$118,231 in Education Credits. On the remaining 140 tax returns, the taxpayers qualified for the Education Credit because they were not claimed as a dependent on another tax return.

We identified taxpayers that were allowed the Education Credit even though they were claimed as a dependent on another taxpayer's return.

Based on our 56 percent error rate, the IRS may have erroneously allowed approximately \$19.5 million in Education Credits on approximately 29,870 TY 1999 tax returns processed nationwide.

These erroneous Education Credits occurred because, during the processing of the tax returns, the IRS could not determine whether the taxpayers claiming the credit were claimed as a dependent on another tax return. Only after all tax returns are processed for the tax year can the IRS make this determination.

AGI limits

According to the 1999 Tax Guide for Individuals (Publication 17), taxpayers did not qualify for the Education Credit if their AGI was over \$100,000 for a married filing jointly filing status or over \$50,000 for single, head of household, and qualifying widow(er) filing status.

We identified tax returns that were allowed the Education Credit although the AGI amounts exceeded maximum limits.

We performed a computer analysis and identified 4,241 TY 1999 tax returns processed nationwide, with

⁶ Sample based on 95 percent confidence, 5 percent precision margin, and 70 percent expected rate of occurrence on population of 52,970.

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Education Credits totaling approximately \$4.3 million, and with AGI amounts over the maximum limits. Our computer analysis identified 776 tax returns, with Education Credits totaling \$749,907, that were processed either electronically or at the ATSPC or KCSPC. (In each of these cases, the IRS' data showed that the taxpayers' AGI exceeded the limits allowed for this credit.)

To validate our computer analysis, we reviewed a random sample of 100 of these tax returns. In addition to ensuring the accuracy of our computer analysis, we also reviewed the sample to obtain an estimate of the number of instances where the IRS data was incorrect.

On 88 of the 100 sampled tax returns (88 percent), the IRS allowed Education Credits totaling \$93,420 although the taxpayers reported AGI was in excess of the maximum allowable AGI limits. On the other 12 tax returns (12 percent), the IRS data was incorrect. For example, physical review of the returns showed that there was no entry on the line for the Education Credit and there was no Form 8863 attached. However, the IRS incorrectly transcribed an amount for the Education Credit.

If we reduce our population of 776 error cases by 12 percent (to allow for data errors), we estimate that the IRS allowed erroneous Education Credits on 679 tax returns processed either electronically or at the ATSPC or KCSPC. The total erroneous Education credit amount associated with these 679 tax returns was calculated to be \$711,691.

While we did not test the 3,465 Education Credits where the reported AGI was in excess of the maximum AGI limits that were processed at the other 8 Submission Processing Centers,⁷ we have no reason to believe that this condition would not also exist in these locations. In addition, our computer analysis showed the Education Credit was allowed on over 100 TY 1999 tax returns

⁷ During the 2000 Filing Season, the IRS processed individual income tax returns at 10 Submission Processing Centers.

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processed nationwide with AGIs of over \$200,000. These were not the middle-or low-income taxpayers the Education Credit was created to assist.

Filing status requirement

Taxpayers did not qualify to claim the Education Credit if their filing status was married filing separately.

According to the 1999 Form 1040 instructions, taxpayers did not qualify for the Education Credit if their filing status was married filing separately.

We performed a computer analysis and identified 2,806 TY 1999 tax returns processed nationwide, with Education Credits totaling approximately \$2 million, and with the married filing separately filing status. Our computer analysis identified 537 of these tax returns, with Education Credits totaling \$371,855, that were processed either electronically or at the ATSPC or KCSPC. (In each of these cases, the IRS' computerized data showed that the filing status was married filing separately.)

We identified tax returns that were allowed the Education Credit although the filing status was married filing separately.

To validate our computer analysis, we reviewed a random sample of 50 of these tax returns. In addition to ensuring the accuracy of our computer analysis, we also reviewed the sample to obtain an estimate of the number of instances where the IRS data was incorrect.

On 46 of the 50 tax returns (92 percent), the IRS erroneously allowed \$27,094 in Education Credits because the taxpayers' filing status was married filing separately. In the remaining four tax returns (8 percent), the IRS data was incorrect. For example, physical review of the return showed that the IRS incorrectly transcribed the filing status.

If we reduce our population of 537 error cases by 8 percent (to allow for data errors), we estimate that the IRS allowed erroneous Education Credits on 494 tax returns processed either electronically or at the ATSPC or KCSPC. The total erroneous Education credit

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amount associated with these 494 tax returns was calculated to be \$353,262

While we did not test the 2,269 Education Credits with the married filing separately filing status that were processed at the other 8 Submission Processing Centers, we have no reason to believe that this condition would not also exist in these locations.

These conditions occurred because the IRS did not have an automated procedure to identify and disallow the Education Credit when taxpayers used the married filing separately filing status or their AGI was over the maximum limit. For the 2000 Filing Season, the IRS postponed programming of the computer controls designed to both validate the filing status of taxpayers claiming the Education Credit and disallow the Education Credit if the taxpayer's AGI is over the limit based on filing status. While the IRS had manual procedures⁸ designed to identify these tax returns, they were subject to the risk of human error.

Recommendations

1. The Commissioner, Wage and Investment Division, should develop a process to identify and deny taxpayers the Education Credit when they were also claimed as a dependent on another taxpayer's return.
2. The Commissioner, Wage and Investment Division, should automate the controls designed to identify and resolve returns with the Education Credit when the AGI is over the maximum limit or the filing status is married filing separately.

Management's Response: Management's response was due on September 19, 2001. As of that date, management had not responded to the draft report.

⁸ Our audit did not include an evaluation of the effectiveness of these manual procedures.

Conclusion

Due to the postponement of computer programming to validate Education Credits, the IRS could not ensure that all of the credits were processed properly.

In the 2 years⁹ since the inception of the Education Credit, the IRS has been unable to provide a high degree of assurance that the \$7.9 billion given to 10.9 million taxpayers was appropriate. The IRS did not have automated controls in place to validate qualifications for the Education Credit, nor did it require taxpayers to provide information on certain other Credit requirements.

⁹ Tax Years 1998 and 1999.

Detailed Objective, Scope, and Methodology

Our overall objective was to determine if the Internal Revenue Service (IRS) ensured that Education Credits were processed correctly. Specifically, we:

- I. Determined if the IRS allowed Education Credits on tax returns where the taxpayer was claimed as a dependent on another return.
 - A. Using a computer extract of the returns transaction file (RTF), identified 52,970 Tax Year (TY) 1999 tax returns processed nationwide between January 16 and September 9, 2000, where the dependency status indicator was '1.' (NOTE: A '1' in the dependency status indicator field means the taxpayer did not claim his or her self as a dependent on his or her own return; therefore, indicating that someone else could claim him or her as a dependent.)
 - B. Reviewed a statistically valid sample of 321 TY 1999 tax returns from the 52,970 tax returns identified in Step A. above, to determine an estimate of the number of taxpayers who received the Education Credit that were actually claimed as a dependent on another taxpayer's TY 1999 tax return. (Sample based on 95 percent confidence, 5 percent precision margin, and 70 percent expected rate of occurrence on the population of 52,970; expected rate of occurrence was determined from a review of 50 randomly selected tax returns from 12,991 filed electronically or at the ATSPC or KCSPC that were identified by our computer extract. We validated the 50 tax returns by comparing information from our computer extract to the physical tax returns.
 - C. Identified the documented manual and electronic controls in place to prevent the IRS from allowing the Education Credit on tax returns where taxpayers were claimed as a dependent on another tax return.
 - D. Interviewed IRS personnel at national and local levels to determine their procedures and controls for preventing Education Credits from being allowed to taxpayers who were claimed as a dependent on another tax return.
 - E. Analyzed and summarized the results of the 321 tax returns reviewed in the above tests.
- II. Determined if the IRS ensured taxpayers did not receive the Education Credit when their modified adjusted gross income (AGI) was \$50,000 or more (\$100,000 or more in the case of a joint return).
 - A. Using a computer extract of the RTF, identified 4,241 TY 1999 tax returns

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processed nationwide between January 16 and September 9, 2000, where taxpayers claimed the Education Credit with filing status 1 (single), 4 (unmarried head of household), or 5 (widow(er) with dependent child) and an AGI of \$50,000 or more and filing status 2 (married filing joint) and an AGI of \$100,000 or more. From these, the computer identified 776 TY 1999 tax returns that were processed either electronically or at the ATSPC or KCSPC.

- B. Validated the data received in the computer extract by obtaining and verifying information to the IRS' computer records for 100 randomly selected tax returns filed electronically or at the ATSPC or KCSPC.
 - C. Identified the documented manual and electronic controls in place to ensure that taxpayers were not allowed the Education Credit when their modified AGI was \$50,000 or more (\$100,000 or more in the case of a joint return).
 - D. Interviewed IRS personnel at the national and local levels to determine the procedures and controls in place to prevent Education Credits from being allowed to taxpayers whose AGI was in excess of the limits.
 - E. Analyzed and summarized the results of the cases reviewed from the above tests for the 100 randomly selected tax returns.
- III. Determined if the IRS allowed Education Credits on tax returns with the married filing separately filing status.
- A. Using a computer extract of the RTF, identified 2,806 TY 1999 tax returns processed nationwide between January 16 and September 9, 2000, with the Education Credit and the married filing separately filing status. From these, the computer identified 537 TY 1999 tax returns that were processed either electronically or at the ATSPC or KCSPC.
 - B. Validated the data received in the computer extract by obtaining and verifying information to the IRS computer records for 50 randomly selected tax returns filed electronically or at the ATSPC or KCSPC.
 - C. Identified the documented manual and electronic controls in place to prevent the IRS from allowing Education Credits to taxpayers whose filing status was married filing separately.
 - D. Interviewed IRS personnel at the national and local levels to determine their procedures and controls to prevent Education Credits from being allowed to taxpayers with the married filing separately filing status.
 - E. Analyzed and summarized the results of the 50 tax returns reviewed in the above tests.

Major Contributors to This Report

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Outcome Measures

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

The overall outcome measure of \$20.56 million (31,043 taxpayers) is comprised of 2 separate potential outcomes of Increased Revenue/Revenue Protection –\$19.5 million (for 29,870 taxpayers) and \$1.06 million (for 1,173 taxpayers).

Type and Value of Outcome Measure:

- Increased Revenue/Revenue Protection – Potential; \$19.5 million (see page 4).

Methodology Used to Measure the Reported Benefit:

Dependency Requirements - \$19.5 million; 29,870 taxpayers

The \$19.5 million is comprised of the increased revenue/revenue protection from creating a process to identify and deny the Education Credit when the taxpayer is claimed as a dependent on someone else's tax return.

The methodology used to measure the \$19.5 million included using automated computer query techniques to identify tax returns with the Education Credit and on which the taxpayers had not claimed themselves as a dependent, indicating that someone else could claim them as a dependent. We queried the IRS' computer system for Tax Year (TY) 1999 tax returns processed between January 16 and September 9, 2000, that met our criteria and identified 52,970 tax returns nationwide, totaling approximately \$33.5 million in Education Credits.

We reviewed a statistically valid sample of 321 of these tax returns to validate the information received from the query. (Sample based on 95 percent confidence, 5 percent precision margin, and 70 percent expected rate of occurrence on population of 52,970.) These 321 returns were selected from tax returns processed nationwide.

We identified 181 of the 321 (56 percent error rate) tax returns in which the taxpayer claimed and received Education Credits, totaling \$118,231, while also being claimed as a dependent exemption on someone else's tax return. We verified that the taxpayer was in fact claimed as a dependent on someone else's tax return through use of the IRS Integrated Data Retrieval System. The average credit amount for these 181 tax returns was \$653. By applying the error rate (56 percent) from our sample review against the 52,970 tax returns identified from our computer query, and then multiplying this number (29,870 tax returns) by the average credit amount from our sample (\$653), we estimate

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\$19.5 million in potentially erroneous Education Credits were allowed to taxpayers nationwide.

Type and Value of Outcome Measure:

- Increased Revenue/Revenue Protection – Potential; \$1.06 million; 1,173 taxpayers (see page 5).

Methodology Used to Measure the Reported Benefit:

The \$1.06 million is comprised of the increased revenue/revenue protection from creating an automated system to identify and resolve errors on tax returns claiming the Education Credit. This includes identifying tax returns claiming the Education Credit with either a married filing separately filing status or an adjusted gross income (AGI) over the maximum limit.

The methodology used to measure the \$1.06 million included using an automated computer query technique to identify tax returns claiming the Education Credit and either a married filing separately filing status or an AGI over the maximum limit filed either electronically or at the Atlanta or Kansas Submission Processing Center (ATSPC or KCSPC, respectively). Once we identified the nationwide population of tax returns processed between January 16 and September 9, 2000, that met these criteria, we reviewed a random sample of 100 tax returns for the maximum AGI limits criteria and 50 tax returns for the married filing separate filing status to validate our data.

Adjusted Gross Income Limits - \$711,691; 679 taxpayers

By querying the IRS computer system for TY 1999 tax returns processed between January 16 and September 9, 2000, we identified 4,241 returns processed nationwide with AGI over the maximum limits, with Education Credits totaling \$4.26 million. We reviewed a random sample of 100 tax returns to validate the information received from our query. These 100 tax returns were selected from those processed either electronically or at the ATSPC or KCSPC. The makeup of the 100 tax returns included 50 tax returns from married filing jointly taxpayers and 50 tax returns from either single, head of household, or qualifying widow(er) taxpayers.

There were 776 tax returns, with total Education Credits of \$749,907, processed either electronically or at the ATSPC or KCSPC. Of these 776 tax returns, 437 were from married filing jointly taxpayers with AGI amounts over \$100,000 and 339 were from either single, head of household, or qualifying widow(er) taxpayers with AGI amounts over \$50,000.

We identified 88 of the 100 (88 percent error rate) tax returns in which taxpayers actually claimed and received the Education Credit (totaling \$93,420) while having an AGI over the maximum limit. Of these 88, there were 42 tax returns (84 percent) from married filing jointly taxpayers that received \$46,438 in erroneous Education credits and 46 tax

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returns (92 percent) from either single, head of household, or qualifying widow(er) taxpayers that received \$46,982 in erroneous Education credits.

We then estimated the total erroneous Education credits for tax returns processed either electronically or at the Atlanta or Kansas City Submission Processing Centers. We calculated this total in 2 parts. First, we applied the respective error rates (84 percent and 92 percent) from the 2 samples against the total number of tax returns for each sample (437 married filing jointly taxpayers and 339 either single, head of household, or qualifying widow(er) taxpayers) to arrive at 679 tax returns. We then applied the respective percentages of erroneous dollar amounts (94 percent and 96 percent) from the 2 samples against the total Education Credit amount for each sample (\$410,969 married filing jointly taxpayers and \$338,938 either single, head of household, or qualifying widow(er) taxpayers). This calculation resulted in \$711,691 (\$386,311 and \$325,380, respectively) of combined potentially erroneous Education Credits on TY 1999 tax returns that were processed either electronically or at the ATSPC or KCSPC. Dividing the combined Education Credit total of \$711,691 by the combined number of taxpayers of 679 (367 and 312) resulted in an overall average credit amount of \$1,048.

Filing Status Requirement - \$353,262; 494 taxpayers

By querying the IRS' computer system for TY 1999 tax returns filed between January 16 and September 9, 2000, we identified 2,806 returns with a married filing separately filing status that received approximately \$2 million in Education Credits. We reviewed a random sample of 50 tax returns to validate the information received from the query. These 50 returns were selected from those processed either electronically or at the ATSPC or KCSPC. Of the 2,806 tax returns, 537, with total Education Credits of \$371,855, were processed either electronically or at the ATSPC or KCSPC.

We identified 46 of the 50 (92 percent error rate) tax returns in which the taxpayer actually claimed and received the Education Credit (totaling \$27,102) while using the married filing separately filing status. By applying the error rate (92 percent) from our sample review against the total number of tax returns identified from our computer query (537) we calculated 494 tax returns with erroneous Education Credits that were processed either electronically or at the ATSPC or KCSPC. We then applied the percentage of erroneous Education credit amount (95 percent) from the sample against the total Education Credit that were processed either electronically or at the ATSPC or KCSPC (\$371,855). This calculation resulted in \$353,262 in potentially erroneous Education Credits were allowed in TY 1999.

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Appendix V

Requirements to Claim the Education Credit

<u>Requirement</u>	<u>Does the Internal Revenue Service (IRS) validate the requirement before the credit is allowed?</u>
The taxpayer's filing status cannot be 'Married Filing Separately' (MFS – Filing Status 3).	Yes. The IRS had manual procedures to disallow the credit if the filing status was 'married filing separately'; however, the controls were not working effectively.
The taxpayer must be able to claim himself or herself as a dependent on his or her tax return and not be claimed on another tax return.	No. The IRS could not determine if the taxpayer was able to claim himself or herself during returns processing.
The taxpayer's modified adjusted gross income (AGI) cannot be \$50,000 or more for single, head of household, or qualifying widow(er) taxpayers and not \$100,000 or more in the case of a joint return.	Yes. The IRS had manual procedures to disallow the credit if the AGI was over maximum limits; however, the controls were not working effectively.
The Education Credit must be reduced appropriately when the taxpayer's modified AGI is between \$40,000 and \$50,000 for single, head of household, or qualifying widow(er) taxpayers and between \$80,000 and \$100,000 in the case of a joint tax return.	No. The IRS did not have controls in place to ensure the credit was reduced as the AGI reaches the phase-out range.
The Education Credit cannot exceed the maximum limits. The Hope Credit limit is \$1,500. The Lifetime Learning Credit limit is \$1,000.	No. The IRS did not have controls in place to ensure that the Education Credit did not exceed the maximum limits.

Millions of Dollars in Erroneous Education Credits Continue to Be Allowed

<u>Requirement</u>	<u>Does the IRS validate the requirement before the credit is allowed?</u>
The Hope Credit cannot be claimed for a student who is taking less than half of the normal full-time work load for his or her course of study for at least one academic period beginning during the calendar year.	No. The IRS did not determine if the student was taking less than half of the normal full-time workload for his or her course of study for at least one academic period beginning during the calendar year. ¹
The Hope Credit cannot be claimed for a student who is not enrolled in a program that leads to a degree, certificate, or other recognized educational credential for at least one academic period beginning during the calendar year.	No. The IRS did not determine if the student was enrolled in a program that lead to a degree, certificate, or other recognized education credential for at least one academic period beginning during the calendar year. ²
The Hope Credit cannot be claimed for a student who has completed the first 2 years of post-secondary education (generally, the freshman and sophomore years of college) as of the beginning of the calendar year.	No. The IRS did not determine if the student had completed the first 2 years of post-secondary education as of the beginning of the calendar year. ³
The Hope Credit cannot be claimed for more than 2 years for each eligible student.	No. The IRS did not determine if the Hope Credit was claimed for more than 2 years for each eligible child. ⁴

¹ We did not test this requirement because specific information about whether the student is taking at least half of the normal full-time work load for his or her course of study for at least one academic period beginning during the calendar year is not provided by the taxpayer on the return.

² We did not test this requirement because specific information about whether the student is enrolled in a program that leads to a degree, certificate, or other recognized education credential for at least one academic period beginning during the calendar year is not provided by the taxpayer on the return.

³ We did not test this requirement because specific information about whether the student has completed the first 2 years of post-secondary education as of the beginning of the calendar year is not provided by the taxpayer on the return.

⁴ We did not test this requirement because specific information about whether the Hope Credit has been claimed during the past 2 years is not provided by the taxpayer on the return.

Millions of Dollars in Erroneous Education Credits Continue to Be Allowed

<u>Requirement</u>	<u>Does the IRS validate the requirement before the credit is allowed?</u>
Expenses claimed for the Education Credit cannot also be claimed as higher education expenses on Schedule A or C.	No. The IRS did not determine if the expenses claimed for the Education Credit were also claimed as higher education expenses on Schedule A or C. ⁵
Qualified tuition and related expenses must be paid to an eligible educational institution.	No. The IRS did not determine if the qualified tuition and related expenses were paid to an eligible educational institution. ⁶
Expenses used to compute the Education Credit amount must be “qualifying expenses.”	No. The IRS did not determine if the expenses incurred were “qualified expenses.” ⁷
The taxpayer and/or spouse cannot be a nonresident alien for any part of the tax year.	No. The IRS did not determine if the taxpayer and/or spouse were a nonresident alien for any part of the tax year. ⁸
The taxpayer may not have a felony conviction for possession/distribution of a controlled substance.	No. The IRS did not determine if the taxpayer had a felony conviction for possession/distribution of a controlled substance. ⁹

⁵ We did not test this requirement because specific information about whether the expenses claimed for the Education Credit are also claimed as higher education expenses on Schedule A or C is not provided by the taxpayer on the return.

⁶ We did not test this requirement because specific information about whether the qualified tuition and related expenses were paid to a qualified educational institution is not provided by the taxpayer on the return.

⁷ We did not test this requirement because specific information about whether the expenses incurred were “qualified” is not provided by the taxpayer on the return.

⁸ We did not test this requirement because specific information about whether the taxpayer and/or spouse was a non-resident alien during the year is not provided by the taxpayer on the return.

⁹ We did not test this requirement because specific information about whether the taxpayer has a criminal conviction for possession/distribution of a controlled substance is not provided by the taxpayer on the return.

Millions of Dollars in Erroneous Education Credits Continue to Be Allowed

<u>Requirement</u>	<u>Does the IRS validate the requirement before the credit is allowed?</u>
The taxpayer must pay qualified tuition and related expenses for himself or herself, his or her spouse, or a dependent that is claimed as an exemption on the tax return.	No. The IRS did not determine if the taxpayer paid qualified tuition and related expenses for himself or herself, his or her spouse, or a dependent that was claimed as an exemption on the tax return. ¹⁰

¹⁰ We did not test this requirement because specific information about whether the taxpayer has paid qualifying tuition and expenses for him or herself, his or her spouse, or a dependent that can be claimed on the return is not provided by the taxpayer on the return.