PREPARED TESTIMONY
OF
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COMMISSIONER
WAGE & INVESTMENT DIVISION
INTERNAL REVENUE SERVICE
JOINT HEARING BEFORE
THE HOUSE WAYS & MEANS
SUBCOMMITTEES ON SELECT REVENUE MEASURES and OVERSIGHT
ON
ENERGY TAX POLICY AND TAX REFORM
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INTRODUCTION AND SUMMARY

Chairman Tiberi and Ranking Member Neal; Chairman Boustany and Ranking Member Lewis, my name is Richard Byrd and I am Commissioner of the Wage & Investment division at the Internal Revenue Service. I appreciate the opportunity to testify before the subcommittees on the residential energy property tax credits and plug-in electric and alternative motor vehicle tax credits and the ongoing efforts by the IRS to ensure proper administration of the laws relating to them.

The number of tax credits affecting individuals and businesses has grown in recent years. For example, the American Recovery and Reinvestment Act (ARRA or Recovery Act) contained more than 50 tax provisions, including tax credits, which cover a broad spectrum of tax relief, ranging from higher education to energy efficiency incentives. It is important to note that the tax credits being discussed today are not refundable tax credits.

The residential energy property tax credits and the plug-in electric and alternative motor vehicle tax credits have the potential to reduce dollar-for-dollar a person's tax liability. Such credits cannot reduce a person's tax bill to less than zero but they could increase a taxpayer's refund if he or she paid too much in estimated tax, or had too much tax withheld over the tax year – as many people do.

In administering tax credits, the IRS must deliver the benefits that the legislation provides in the intended time frame, while ensuring that appropriate and prudent controls and filters are in place to minimize errors and fraud. This is not an either/or proposition. We must do both well.

From the first day after ARRA was signed into law, the IRS worked quickly and effectively to ensure that taxpayers and businesses received, as soon as possible, the benefits of ARRA tax-related provisions while protecting against fraud. In addition to the energy credit discussed today, the IRS also implemented a wide variety of other tax provisions; quickly made procedural changes and modifications to numerous systems; and through December 2010, speeded delivery of an estimated $260 billion in ARRA-related tax benefits to taxpayers.

The IRS also conducted a very successful filing season in 2010. The IRS processed 142 million individual tax returns and issued 109 million refunds totaling over $328 billion, which is especially significant given the additional workload generated by the enactment of ARRA and the Worker Homeownership and Business Assistance Act of 2009.

To summarize, the IRS is running a balanced program for Recovery Act tax-related provisions. We have processed tax credit claims as quickly as possible while working to deter fraud. The IRS has stopped many questionable claims and audited others, while putting additional protections in place for future claims that may be made. The IRS seeks and continues to make improvements in this area.

SUMMARY OF CONSUMER ENERGY TAX CREDIT INCENTIVES

The American Recovery and Reinvestment Act provided incentives for individual taxpayers to invest in energy-efficient products. In many cases, ARRA extended consumer energy tax incentives originally introduced in the Energy Policy Act of 2005 and amended in the Emergency Economic Stabilization Act of 2008.

Residential Energy Property Credit (Section 1121). ARRA increased the energy tax credit for homeowners who made energy efficient improvements to their existing homes. The credit rate was increased to 30 percent of the cost of all qualifying improvements and raised the maximum credit limit to $1,500 for improvements placed in service in 2009 and 2010.

The credit applied to improvements such as adding insulation, energy efficient exterior windows and energy-efficient heating and air conditioning systems to existing homes.

A similar credit was available for 2007, but was not available in 2008. The standards contained in ARRA for products that qualified as “energy efficient” for purposes of this tax credit were higher than those for the credit that was available in 2007. The new credit took effect after December 31, 2008 and the IRS issued guidance (Notice 2009-53) on June 1, 2009 that allowed manufacturers to certify that their products placed in service after February 17, 2009 met these new standards.

However, until guidance was released, homeowners could generally continue to rely on manufacturers’ certifications that were provided under the old guidance. For exterior windows and skylights, homeowners could continue to depend on “Energy Star” labels in determining whether property purchased before June 1, 2009 qualified for the tax credit.

Residential Energy Efficient Property Credit (Section 1122). This energy tax credit was intended to help individual taxpayers pay for qualified residential alternative energy equipment, such as solar hot water heaters and solar electric systems, geothermal heat pumps, small wind systems, residential fuel cells and “microturbine” system turbines. The new law removed some of the previously imposed maximum amounts and allowed for a credit equal to 30 percent of the cost of qualified systems placed in service before December 31, 2016.

Plug-in Electric Drive Vehicle Credit (Section 1141). The Recovery Act modified the credit for qualified plug-in electric drive vehicles purchased after December 31, 2009. To qualify, vehicles must be newly purchased, have four or more wheels, have a gross vehicle weight rating of less than 14,000 pounds, and draw propulsion using a battery with at least four kilowatt hours that can be recharged from an external source of electricity. The minimum amount of the credit for qualified plug-in electric drive vehicles is $2,500 and the credit tops out at $7,500, depending on the battery capacity. The full amount of the credit will be reduced with respect to a manufacturer's vehicles after the manufacturer has sold at least 200,000 vehicles in the United States. The credit will then phase out over a year.

Plug-In Electric Vehicle Credit (Section 1142). ARRA also created a special tax credit for two types of plug-in vehicles: (1) certain low-speed electric vehicles; and (2) two- or three-wheeled vehicles. The amount of the credit is 10 percent of the cost of the vehicle, up to a maximum credit of $2,500 for purchases made after February 17, 2009, and before January 1, 2012.

To qualify, a vehicle must be either a low-speed vehicle propelled by an electric motor that draws electricity from a battery with a capacity of 4 kilowatt hours or more, or be a two- or three-wheeled vehicle propelled by an electric motor that draws electricity from a battery with the capacity of 2.5 kilowatt hours or more. A taxpayer may not claim this credit if the plug-in electric drive vehicle credit is allowable.

Plug-In Hybrid Conversion Kits (Section 1143). In addition, ARRA provided a tax credit for plug-in electric drive conversion kits. The credit is equal to 10 percent of the cost of converting a vehicle to a qualified plug-in electric drive motor vehicle. Vehicles placed in service after February 17, 2009 are eligible for this credit, but the credit does not apply to conversions made after December 31, 2011. The maximum amount of the credit is $4,000. A taxpayer may claim this credit even if the taxpayer claimed a hybrid vehicle credit for the same vehicle in an earlier year.

Treatment of Alternative Motor Vehicle Credit as a Personal Credit Allowed Against AMT (Section 1144). Starting in 2009, the Recovery Act allows the Alternative Motor Vehicle Credit, including the tax credit for purchasing hybrid vehicles, to be applied against the Alternative Minimum Tax (AMT). Prior to the new law, the Alternative Motor Vehicle Credit could not be used to offset the AMT. This means the credit could not be taken if a taxpayer owed AMT or was reduced for some taxpayers who did not owe AMT.

PROCESSING OF RETURNS WITH TAX CREDITS

The IRS takes very seriously the need to prevent erroneous and fraudulent claims for tax credits. To the extent possible, it is important to process returns in such a way that identifies problems at an early stage. Tax returns that contain claims for tax credits first go through standard processing procedures we have established for all returns, whether they are filed on paper or electronically. Returns with tax credit claims are also subjected to various filters during return processing to identify potentially erroneous credits.

Our normal processing for all returns involves matching them with certain pieces of information. Returns are “rejected” and not allowed to enter the system for a number of reasons. For example, we reject over 1.7 million returns because an invalid or duplicate Social Security number was used.

If a return is accepted, it is sent to our Submission Processing Function. We next determine if math error issues exist. Math error authority under the Internal Revenue Code allows IRS to make adjustments to a return without performing an examination. Specific math error authority has been granted for the certain specific credits (e.g., the Earned Income Tax Credit and the First Time Homebuyer's Credit).

Math error authority is also available for tax provisions generally for errors in computation, use of incorrect Social Security numbers, claims for more than the statutory limit and several other enumerated items. If a math error issue is identified, an adjustment can be made immediately to the taxpayer’s return, reducing potentially erroneous claims that could result in an erroneous refund. In appropriate cases, math error authority can help the IRS better administer tax credits and reduce erroneous refunds when it allows proactive/pre-refund corrections to erroneous or fraudulent claims. Absent math error authority, adjustments can only be made through an examination.

In some cases, requiring documentation from taxpayers and disallowing claims when such documentation is not provided is also an effective tool. However, this approach is most effective when the documentation can be verified using third-party data and the number of claimants is relatively small.

It is important to note that electronic filing is preferable because of its efficiency, accuracy and lower processing costs. Currently, requiring taxpayers to submit documentation forces them to submit a paper return that must be processed manually, thereby eliminating e-file’s benefits. Thus, in requiring taxpayers to submit documentation, the IRS must recognize the additional burden this places on taxpayers and the IRS.

After being checked for math error issues, returns then go through the IRS’ electronic fraud detection system (EFDS). This system is designed to identify schemes and patterns. If a return is flagged in EFDS, it is routed to a group of IRS employees to work during which time the full refund is frozen.

Returns are also sent through the IRS’ Dependent Database Process (DDB). This process uses business rules and filters to select cases for examination. Third-party information (e.g., the Federal Case Registry) is used in making these selections. If a return is flagged in this process, the portion of the refund attributable to the flagged issue is frozen.

Later in the process, when information returns filed by third parties are available, matching of tax returns to that data is performed.

CHALLENGES RELATED TO ENFORCEMENT OF TAX CREDITS

As with refundable tax credits, there are a number of factors that present challenges to our compliance efforts related to tax credits generally. They include the following:

Complexity. Complexity in the rules governing eligibility for and the operation of certain tax credits creates challenges for both taxpayers and the IRS. Mistakes in the application of the law cause a significant portion of claims that are made in error. As previously discussed, each of the energy related credits has different eligibility requirements and timeframes over which they are available.

Lack of Third Party Data. The IRS may lack real-time third-party data sources that could be used to verify taxpayers' eligibility for tax credit, such as documentation of homeownership that would support the purchase of qualifying home improvement products to claim the tax credit. Requiring such documentation can be an inefficient process that to date has required taxpayers to file paper returns and compels the IRS to rely more heavily on examinations to detect errors and fraud.

Hard-to-Detect Fraud. The IRS must confront, on an ongoing basis, refund schemes involving erroneous claims. This includes claims made by or on behalf of prisoners and underage individuals. The IRS has developed systems that provide special scrutiny to review prisoner refunds. The situation involving prisoners is not a simple process, because some inmates and their families are legally entitled to tax credits and refunds, and because the prisoner population is constantly changing. Recent efforts to address the prisoner issues include outreach to the states with the highest prisoner fraud, entering into agreements with states and the Federal Bureau of Prisons so that the IRS can disclose information on prisoner fraud, and increasing the number of prisoner returns that will be reviewed. The Administration's 2012 Budget includes a proposal to require state and federal prisons to provide information to IRS.

Tax Law Changes. The IRS often faces extremely compressed timeframes for implementing a new tax credit law. Developing new compliance checks and changing IRS' computer processing systems to implement new checks and screens/filters in the middle of a filing season present unique and difficult challenges. Such compressed timeframes are unforgiving. They do not provide us adequate time to develop, program and implement a robust and effective compliance strategy.

Further, unanticipated implementation needs such as IT system changes, testing, form creation, and other requirements can necessitate resource reallocations that affect the performance of core tax administration programs. Early planning to identify potential problems and allocate sufficient resources, including personnel with the appropriate skills and experience is a critical factor in successfully implementing new legislative requirements.

ENERGY CREDIT IMPLEMENTATION ISSUES

During 2010 (2009 tax year), the Residential Energy Property Credit and the Residential Energy Efficient Property Credit, provided nearly $6 billion to 6.7 million homeowners who weatherized their homes and made them more energy efficient. Both credits include multiple types of eligible expenditures with differing restrictions and unique criteria. During 2010 (2009 tax year), 34,724 individual taxpayers took advantage of the plug-in vehicle tax credits for personal and business use for a total of $150 million with each credit subject to different and complex eligibility requirements.

As with any new tax provision, we continually adapt our programs to improve the screening process as we gain experience with them. Over the course of administering these energy credits, a number of compliance issues were identified. The IRS took quick action to correct issues and continues to make additional improvements for the future. We have put in place procedures to prevent taxpayers from receiving credits in excess of limitations and are revising forms to request more specific information. We have also worked with software providers to better improve information related to these credits.

As part of our ongoing examination program, we are reviewing energy credit claims.. The IRS also continues to audit claims as warranted. The IRS continually assesses and evaluates present and emerging compliance risks across all taxpayer segments. As part of the IRS' ongoing research efforts and its 2011 examination plan, we will review a sample of Residential Energy Credit cases in a post-refund environment. Those warranting examination will be selected for audit, and the results will be factored into future examination plans.

While recognizing that initially improvements could have been made, it is important to note, however, that potential erroneous claims represent only a very small fraction of ARRA tax relief – less than 0.02 percent of the $260 billion in Recovery Act tax relief taxpayers received through December 2010. Nevertheless, the relative size of the problem does not diminish our commitment and dedication to take immediate action to put additional protections in place to stop improper vehicle payments. In addition, we are taking aggressive steps to recapture the credits people erroneously claimed.

CONCLUSION

Tax credits, such as the Residential Energy and Plug-In Vehicle tax credits, play an important role in fulfilling Congressional energy policies and intent, but are inherently subject to a number of administrative challenges. As with all aspects of tax administration, in the case of each tax credit, the IRS must determine the proper balance of taxpayer service and enforcement to ensure that benefit is afforded only to those taxpayers who are eligible. We are committed to that goal.

Mr. Chairman, this concludes my testimony. I appreciate the opportunity to testify about the IRS' efforts to ensure proper administration of the laws relating to the energy tax credits that are the subject of today's hearing.