Revised Refundable Credit Risk Assessments Still Do Not Provide an Accurate Measure of the Risk of Improper Payments

April 28, 2017

Reference Number: 2017-40-030

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.

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REVISED REFUNDABLE CREDIT RISK ASSESSMENTS STILL DO NOT PROVIDE AN ACCURATE MEASURE OF THE RISK OF IMPROPER PAYMENTS

Highlights

Final Report issued on April 28, 2017

Highlights of Reference Number: 2017-40-030 to the Internal Revenue Service Chief Financial Officer.

IMPACT ON TAXPAYER

The Improper Payments Elimination and Recovery Act (IPERA) of 2010 and subsequent legislation strengthened agency reporting requirements and redefined "significant improper payments" in Federal programs. The Office of Management and Budget has declared the Earned Income Tax Credit (EITC) Program a high-risk program that is subject to reporting in the Department of the Treasury (Treasury) Agency Financial Report. The IRS estimates that 24 percent or $16.8 billion in EITC payments were issued improperly in Fiscal Year 2016.

WHY TIGTA DID THE AUDIT

This audit was initiated because TIGTA is required to assess the IRS's compliance with the reporting requirements contained in the IPERA; Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*; and the Improper Payment Elimination and Recovery Improvement Act of 2012. The objective of this review was to determine whether the IRS complied with the annual improper payment reporting requirements for Fiscal Year 2016.

WHAT TIGTA FOUND

The IRS provided all required improper payment information to the Treasury for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2016* with the continued exception of not reporting an overall EITC improper payment rate of less than 10 percent.

In response to prior TIGTA recommendations, the IRS revised its annual risk assessment process. However, the revised assessment still does not provide a valid assessment of risk of refundable tax credit improper payments. The IRS rated the risk of improper payments associated with the Additional Child Tax Credit and the American Opportunity Tax Credit in Fiscal Year 2016 as medium. However, based on the IRS's compliance data, TIGTA estimates that the potential Additional Child Tax Credit improper payment rate for Fiscal Year 2016 is 25.2 percent, with potential improper payments totaling $7.2 billion, and estimates that the potential American Opportunity Tax Credit improper payment rate for Fiscal Year 2016 is 24.1 percent, with potential improper payments totaling $1.1 billion.

While the Protecting Americans from Tax Hike Act of 2015 expanded the IRS's tools to reduce refundable credit improper payments, it did not expand the IRS's math error authority. As a result, the IRS must audit each questionable tax return. The number of questionable returns the IRS can audit is limited to available resources.

In addition, the IRS's assessment of the risk of Premium Tax Credit improper payments may not be reliable. The methodology used to assess risk does not include a quantitative analysis of IRS compliance data. The methodology also does not include an assessment of the risk of improper Advance Premium Tax Credit Payments.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS ensure that the methodology used to conduct the Annual Improper Payment Risk Assessment for refundable tax credits, including the Premium Tax Credit, includes a quantitative assessment of IRS compliance data. TIGTA also recommended that the IRS work with the Centers for Medicare and Medicaid Services to develop a collaborative strategy to assess the comprehensive risk of improper Premium Tax Credit payments.

The IRS did not agree with TIGTA's recommendations.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

April 28, 2017

MEMORANDUM FOR CHIEF FINANCIAL OFFICER

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Revised Refundable Credit Risk Assessments Still Do Not Provide an Accurate Measure of the Risk of Improper Payments (Audit # 201740001)

This report presents the results of our review to determine whether the Internal Revenue Service complied with the annual improper payment reporting requirements for Fiscal Year 2016. This audit is included in our Fiscal Year 2017 Annual Audit Plan and addresses the major management challenge of Reducing Fraudulent Claims and Improper Payments.

Management's complete response to the draft report is included as Appendix VII.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services).

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Appendices

Abbreviations

ACTC	Additional Child Tax Credit
AOTC	American Opportunity Tax Credit
APTC	Advance Premium Tax Credit
CMS	Department of Health and Human Services Centers for Medicare and Medicaid Services
CTC	Child Tax Credit
EITC	Earned Income Tax Credit
IPERA	Improper Payments Elimination and Recovery Act
IPERIA	Improper Payments Elimination and Recovery Improvement Act
IPIA	Improper Payments Information Act
IRS	Internal Revenue Service
NRP	National Research Program
OMB	Office of Management and Budget
PATH Act	Protecting Americans from Tax Hikes Act of 2015
PTC	Premium Tax Credit
TIGTA	Treasury Inspector General for Tax Administration

Background

The Office of Management and Budget (OMB) defines an improper payment as any payment that should not have been made, was made in an incorrect amount, or was made to an ineligible recipient. Agency Inspectors General have responsibility for evaluating agency information related to improper payments. The Improper Payments Information Act (IPIA) of 2002[1] requires Federal agencies, including the Internal Revenue Service (IRS), to estimate the amount of improper payments and report to Congress annually on the causes of and the steps taken to reduce improper payments. The IPIA also requires agencies to address whether they have the information systems and other infrastructure needed to reduce improper payments. The annual report must also describe steps the agency has taken to ensure that agency managers are held accountable for reducing improper payments. The following legislation and Executive Order clarified and expanded the IPIA requirements:

- **Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*** – signed by the President on November 20, 2009, increased Federal agencies' accountability for reducing improper payments while continuing to ensure that Federal programs serve and provide access to their intended beneficiaries. It requires Federal agencies to provide their agency Inspector General with detailed information on efforts to identify and reduce the number of improper payments in Federal programs with the highest dollar value of improper payments.

- **Improper Payments Elimination and Recovery Act (IPERA) of 2010**[2] – enacted on July 22, 2010, amended the IPIA by strengthening agency reporting requirements and redefining "significant improper payments." For Fiscal Year[3] 2014 and beyond, significant is defined as gross annual improper payments. The gross annual improper payments is the total amount of overpayments plus underpayments made in the program during the fiscal year reported that a) exceeded both 1.5 percent of program outlays and $10 million of all program or activity payments or b) exceeded $100 million at any percent of program outlays.

- **Improper Payments Elimination and Recovery Improvement Act (IPERIA) of 2012**[4] – enacted on January 10, 2013, further expanded agency improper payment requirements to foster greater agency accountability. Like Executive Order 13520,[5] the IPERIA

[1] Pub. L. No. 107-300, 116 Stat. 2350.
[2] Pub. L. No. 111-204, 124 Stat. 2224.
[3] Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
[4] Pub. L. No. 112-248, 126 Stat. 2390.
[5] Exec. Order No. 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs* (Nov. 2009).

requires the OMB Director to identify a list of high-priority Federal programs. For those high-priority programs, the IPERIA requires agencies to develop additional or supplemental measures for tracking progress in reducing improper payments and submit an annual report to the Inspector General of the agency on the steps the agency has taken and plans to take to recover past and prevent future improper payments. The report is also required to be posted on a website accessible to the public.

On October 20, 2014, the OMB issued revisions to Circular A-123 Appendix C, *Requirements for Effective Estimation and Remediation of Improper Payments*. Circular A-123 Appendix C provides agencies and Inspectors General with guidance on the implementation of the IPIA as amended by the IPERA, IPERIA, and Executive Order 13520. According to the OMB, the revised Appendix C creates a more unified, comprehensive, and less burdensome improper payment compliance framework. For example, agencies now have the flexibility to combine the various improper payment reporting requirements into one document, the Agency Financial Report.[6] In addition, the Inspectors General also have the flexibility to conduct one review to assess their respective agency's compliance with the various improper payment requirements.

Process to identify IRS programs for improper payment risk assessment

The Department of the Treasury (Treasury) identifies the programs that the IRS must assess for the risk of improper payments. For Fiscal Year 2016, the Treasury selected 20 IRS program fund groups. These funds were selected for assessment based on each fund groups' materiality to the IRS financial statements. Appendix V provides a list of the IRS programs identified for an improper payment risk assessment for Fiscal Year 2016. On March 20, 2014, the OMB issued additional supplemental improper payment guidance[7] to the Treasury clarifying the requirement for annual risk assessments of all refundable tax credits. Specifically, the OMB guidance clarified that *all refundable credits* are subject to IPERA requirements as they represent an additional outlay of funds by the Government.

The IRS used the *Improper Payments Elimination and Recovery Risk Assessment Questionnaire* for Fiscal Year 2016 (hereafter referred to as the Risk Assessment Questionnaire) and related guidance provided by the Treasury to assess the level of risk for each identified program. In response to concerns raised in prior Treasury Inspector General for Tax Administration (TIGTA)

[6] The Agency Financial Report presents the Treasury's financial and performance information for the fiscal year with comparative prior year data, where appropriate.
[7] OMB guidance applies to all refundable credits in effect at the time the guidance was provided. The OMB and Treasury will work together to determine how best to address the Premium Tax Credit and any refundable credits enacted subsequent to the guidance.

reports[8] the Risk Assessment Questionnaire was updated for Fiscal Year 2016 in an attempt to provide a more accurate assessment of the risk associated with the programs the Treasury identified. The Risk Assessment Questionnaire computes a risk score for each program based on the IRS's response to the questions it contains. The risk score determines whether there is a low, medium, or high risk of improper payments in a program. The Treasury establishes the level of risk for a program's improper payments. Based on the risk score, different actions are required by agencies:

- *Low risk program* – Risk score of 0 to 28 requires agencies to monitor those programs annually through the risk assessment.
- *Medium risk program* – Risk score of 29 to 44 requires agencies to review payment controls for improvement opportunities.
- *High risk program* – Risk score of 45 and greater requires agencies to establish a corrective action plan.

The IRS is required to forward the results and documentation supporting the risk assessments performed to the Treasury. For any program identified as having a high risk for improper payments, the IRS must also provide the following information to the Treasury for inclusion in its annual Agency Financial Report:

- The rate and amount of improper payments.
- The root causes of the improper payments.
- Actions taken to address the root causes.
- Annual improper payment reduction targets.
- Discussion of any limitations to the IRS's ability to reduce improper payments.

It should be noted that the OMB has previously identified the Earned Income Tax Credit (EITC)[9] as a high-risk program and, as such, the annual risk assessment is not required to be performed for this program. The EITC is currently the only IRS high-risk program and the only one with information included in the Department of the Treasury's Agency Financial Report. The IRS

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[8] TIGTA, Ref. No. 2014-40-093, *Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments* (Sept. 2014); TIGTA, Ref. No. 2015-40-044, *Assessment of Internal Revenue Service Compliance With the Improper Payment Reporting Requirements in Fiscal Year 2014* (Apr. 2015); and TIGTA, Ref. No. 2016-40-036, *Without Expanded Error Correction Authority, Billions of Dollars in Identified Potentially Erroneous Earned Income Credit Claims Will Continue to Go Unaddressed Each Year* (Apr. 2016).

[9] Congress originally passed the EITC legislation in 1975 in part to offset the burden of Social Security taxes and to provide an incentive to work. The EITC is a refundable tax credit that offsets income tax owed by low-income taxpayers. Refundable tax credits can be used to reduce a taxpayer's tax liability to zero. Any excess of the credit beyond the tax liability can be refunded to the taxpayers.

estimates that 24 percent ($16.8 billion) of EITC payments made in Fiscal Year 2016 were improper payments. The EITC continues to be the only IRS program that the OMB has identified as a high-priority program.

A prior TIGTA review identified that annual risk assessments do not accurately reflect the risks associated with refundable credits

In April 2016, we reported that although the IRS completed the risk assessments of the required funds, the risk assessment process continued to not provide a valid assessment of improper payments associated with refundable credits. The methodology the IRS used to conduct the risk assessments continued to provide an inaccurate assessment of the risk of improper payments.[10] For example, based on its materiality to the IRS's financial statements, the Treasury selected the Additional Child Tax Credit (ACTC)[11] and American Opportunity Tax Credit (AOTC)[12] as two of the revenue program funds for which the IRS must perform an improper payment risk assessment. The IRS conducted risk assessments of the ACTC and AOTC as required and rated the risk of improper payments associated with the ACTC and AOTC as low. The low-risk rating was despite the IRS's own National Research Program (NRP)[13] and compliance data which support that the ACTC and AOTC improper payment rates were similar to that of the EITC.

Using the IRS's own compliance data, TIGTA estimated that the potential ACTC improper payment rate for Fiscal Year 2015 was 24.2 percent, with potential improper payments totaling $5.7 billion.[14] TIGTA estimated that the potential improper payment rate for the AOTC was 30.7 percent, with potential improper payments of $1.8 billion.[15] The OMB defines a program as having significant improper payments when improper payments exceed both 1.5 percent of program outlays and $10 million of all program or activity payments made during the fiscal year reported or exceed $100 million at any percent of program outlays.

We again recommended that the IRS revise the ACTC and AOTC improper payment risk assessment process. IRS management agreed with our recommendations and stated that they had already begun to revise processes for both the ACTC and AOTC.

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[10] TIGTA, Ref. No. 2016-40-036, *Without Expanded Error Correction Authority, Billions of Dollars in Identified Potentially Erroneous Earned Income Credit Claims Will Continue to Go Unaddressed Each Year* (Apr. 2016).
[11] The ACTC is intended to reduce the individual income tax burden for families, better recognize the financial responsibilities of raising dependent children, and promote family values.
[12] The AOTC is intended to help offset the costs of higher education for taxpayers, their spouses, and dependents who qualify as eligible students.
[13] The NRP provides the IRS with compliance information that is statistically representative of the taxpayer population. The IRS uses each tax year's NRP results to update the EITC improper payment rate.
[14] We estimate that the potential ACTC improper payment rate for Fiscal Year 2015 is between 21.0 percent and 27.4 percent and the potential improper payment dollars is between $4.9 billion and $6.4 billion.
[15] We estimate that the potential AOTC improper payment rate for Fiscal Year 2015 is between 26.1 percent and 35.3 percent and the potential improper payment dollars is between $1.6 billion and $2.1 billion.

A prior TIGTA review identified that interagency efforts were underway to establish a process to evaluate Premium Tax Credit (PTC)[16] improper payment risk

In April 2016, we also reported that the IRS is not solely responsible for administering the PTC. The Department of Health and Human Services Centers for Medicare and Medicaid Services (CMS) oversees implementation of certain Affordable Care Act provisions related to the Exchanges.[17] For example, the Exchanges have sole responsibility for determining if an individual is eligible to purchase health insurance through the Exchange as well as determining the amount of the Advance Premium Tax Credit (APTC) the taxpayer is eligible to receive, whereas the IRS is responsible for determining the amount of the PTC a taxpayer is entitled to receive. The Affordable Care Act requires all individuals for whom APTC payments were made to an insurer to file a tax return to reconcile the APTC with the actual PTC they are entitled to receive based on the income and family size reported on their tax return.

The IRS must also ensure that individuals who are entitled to an additional PTC amount receive it and those who received more APTC than they were entitled to receive repay the excess. Because the IRS and the Department of Health and Human Services are jointly responsible for the administration of the PTC, improper PTC payments can result from weaknesses in either agency's programs. As a result, the IRS cannot effectively assess the risk of PTC improper payments, estimate the improper payment rate and dollars, or establish corrective actions to address the causes of and reduce improper PTC payments on its own.

The OMB established an interagency working group in Fiscal Year 2015 that included representatives from the IRS, the Treasury, the CMS, and the Department of Health and Human Services. The group was established as a collaborative effort to develop an assessment of improper payment risk across all payments made from the PTC budget fund account. At the working group's request, a third-party vendor conducted a comprehensive review of the PTC. The comprehensive PTC risk assessment was included in the Fiscal Year 2016 Agency Financial Report and rated the PTC at a medium risk for improper payments.

This review was performed with information obtained from the Office of the Chief Financial Officer and the Office of Research, Applied Analytics, and Statistics located at the IRS Headquarters in Washington, D.C., and the Wage and Investment Division's Office of Return Integrity and Compliance Services in Atlanta, Georgia, during the period October 2016 through March 2017. We conducted this performance audit in accordance with generally accepted

[16] The Patient Protection and Affordable Care Act (hereafter referred to as the Affordable Care Act) created a new refundable tax credit, the PTC, to assist eligible taxpayers with paying their health insurance premiums. Patient Protection and Affordable Care Act (Affordable Care Act), Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered section of the Internal Revenue Code and 42 U.S.C.), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.
[17] The Exchange – also known as the Health Insurance Marketplace – is the place for people without health insurance to find information about health insurance options and to purchase health insurance.

government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Results of Review

Assessment of Internal Revenue Service Fiscal Year 2016 Compliance With Improper Payment Reporting Requirements

The IRS provided all required improper payment information to the Treasury for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2016* with the continued exception of not reporting an overall EITC improper payment rate of less than 10 percent. As an alternative, the Treasury and the OMB collaborated on the development of a series of EITC supplemental measures for use in lieu of reduction targets. The OMB approved the supplemental measures on August 27, 2014, and the measures were published in the *Department of the Treasury Agency Financial Report Fiscal Year 2014* as required. The approved EITC improper payment supplemental measures are:

- **The Annual Error Rate** – identifies the percentage of total EITC payments that were improper.
- **The Amount of Revenue Protected** – shows the total value of erroneous payments prevented or recovered through compliance activities.
- **The Amount of Revenue Protected From Paid Preparer Treatments** – shows dollars erroneously or fraudulently claimed by paid tax preparers but not paid out or recovered by the Treasury.
- **The Number of Preparer Due Diligence Penalties Proposed** – reflects the effectiveness of the Treasury efforts to ensure that paid tax preparers are submitting accurate, nonfraudulent EITC claims on behalf of taxpayers.

Figure 1 provides a summary of our evaluation of IRS compliance with the various improper payment reporting requirements including the reporting of supplemental measures.

Figure 1: IRS Compliance With Improper Payment Requirements for the EITC Program for Fiscal Year 2016

Improper Payment Requirement	Source of Requirement	Provided by IRS
Conduct a program-specific risk assessment for each program or activity identified by the Treasury.	IPERA	Yes
Publish an improper payment estimate for the EITC.	IPERA	Yes
Report an improper payment rate of less than 10 percent for the EITC.	IPERA	No

Improper Payment Requirement	Source of Requirement	Provided by IRS
Provide the methodology for identifying and measuring EITC improper payments.	Executive Order	Yes
Publish EITC improper payment supplemental measures in lieu of annual reduction targets for the EITC.	OMB / Treasury	Yes
Provide plans and supporting analysis for meeting the reduction targets for EITC improper payments.	Executive Order	Yes
Publish a programmatic corrective action plan for the EITC.	IPERA	Yes
Report on actions the IRS intends to take to prevent future EITC improper payments.	IPERIA	Yes
Report on efforts taken or planned to recapture EITC improper payments.	IPERA / IPERIA	Yes
Provide plans and supporting analysis for ensuring that the initiatives undertaken do not unduly burden program access and participation by eligible beneficiaries.	Executive Order	Yes
Provide required EITC information for posting to the paymentaccuracy.gov website.	Executive Order IPERIA	Yes
Submit quarterly reports to TIGTA and the Council of the Inspectors General on Integrity and Efficiency and make available to the public a report on EITC improper payments identified by the agency.	Executive Order	N/A[18]

Source: TIGTA's review of IRS EITC information provided to the Treasury for inclusion in the Department of the Treasury Agency Financial Report Fiscal Year 2016.

Revised Risk Assessments Still Do Not Provide a Valid Assessment of Improper Payments Associated With Refundable Tax Credits

Our review found that the IRS, in response to TIGTA recommendations, revised its Fiscal Year 2016 Risk Assessment Questionnaire for the ACTC and AOTC. However, our review of the revised risk assessments finds that they continue to provide an inaccurate assessment of improper payment risk. For example, the revised risk assessment methodology still does not include the use of available NRP and IRS compliance data to quantify erroneous payments. As such, the IRS concluded that the ACTC and AOTC present a medium risk of improper payments

[18] Effective for Fiscal Year 2014 forward, the dollar threshold for which agencies are required to report quarterly high-dollar improper payments is $25,000 per individual. Because the maximum EITC an individual can receive is well below the $25,000 threshold, the IRS would not be required to report any quarterly high-dollar payments for Fiscal Year 2014 forward.

for Fiscal Year 2016. It should be noted that risk assessments for the ACTC and AOTC prior to Fiscal Year 2016 rated the risk of improper payments as low.

The medium-risk rating is contrary to the IRS's own compliance data, which continues to show that both the ACTC and AOTC programs present a high risk of improper payments. As a result of not correctly rating these programs as high risk, the IRS is not required to report an annual estimate of improper payments or fulfill any of the other improper payment reporting requirements for programs determined to have a high improper payment risk. Using the IRS's own compliance data, we computed the Fiscal Year 2016 potential estimated improper payment rate for the ACTC and AOTC. Our analysis of ACTC and AOTC improper payment rates draws from the same data sources and methodologies the IRS uses to compute the potential improper payment rate for the EITC.[19] We estimate the potential estimated ACTC and AOTC improper payment rates for Fiscal Year 2016 are as follows:

- ACTC – We estimate that 25.2 percent ($7.2 billion) of ACTC payments made during Fiscal Year 2016 were improper.[20] This includes all ACTC claims for which the IRS disallowed some portion of the ACTC regardless of whether there was a change to the Child Tax Credit (CTC). We estimate that the improper payment rate for only those ACTC claims for which no reclassification to the CTC[21] occurred is 13.8 percent, resulting in an estimated $3.9 billion in potential improper payments.[22]

- AOTC – We estimate that 24.1 percent ($1.1 billion[23]) in AOTC payments made during Fiscal Year 2016 were improper.[24]

Our computation of the potential estimated improper payments for the ACTC and AOTC shows that both exceed the IPERA criteria for a significant risk of improper payments and as such should be identified as a high-risk program. Per the OMB, any program that has gross annual improper payments that a) exceed both 1.5 percent of program outlays and $10 million of all program or activity payments or b) exceed $100 million at any percent of program outlays is considered a significant risk.

[19] See Appendix VI.
[20] We estimate that the potential ACTC improper payment rate for Fiscal Year 2016 is between 22.7 percent and 27.8 percent and the potential improper payment dollars is between $6.5 billion and $7.9 billion.
[21] A reclassification of the ACTC to the CTC occurs when, as a result of an audit, the IRS determines that the taxpayer could have claimed more CTC and should have claimed less ACTC.
[22] We estimate that the potential improper payment rate for cases with no reclassification to the CTC is between 11.7 percent and 16.0 percent and the potential improper payment dollars is between $3.3 billion and $4.5 billion.
[23] TIGTA's estimate of improper AOTC payments was calculated using the outlay portion reported in the Fiscal Year 2017 Federal budget. This estimate would be greater if the calculation was completed using both tax expenditures and the outlay portion.
[24] We estimate that the potential AOTC improper payment rate for Fiscal Year 2016 is between 19.6 percent and 28.7 percent and the potential improper payment dollars is between $900 million and $1.3 billion.

The revised risk assessment would result in an incorrect rating of the EITC as medium risk

To further demonstrate that the revised risk assessments do not provide an accurate assessment of the risk of improper payments associated with the ACTC and AOTC risk assessment, we used the methodology to evaluate the EITC improper payment risk. Using the IRS's revised assessment, the risk of EITC improper payments would be a medium risk. This is despite the OMB designating the EITC as a high-risk program for improper payments. The IRS estimates that $16.8 billion or 24 percent of EITC payments made in Fiscal Year 2016 were paid in error.

The incorrect ratings result from the fact that the revised risk assessment does not include the use of available NRP and IRS compliance data to quantify erroneous payments. In addition, the weights assigned to the risk categories in the revised risk assessment do not accurately reflect the overall risks associated with these credits. For example, a program that has little or no risks in other categories in the revised risk assessments that is given the highest score available in "Internal Controls Activities, Monitoring, and Compliance", (*i.e.*, the program did not have internal controls activities, monitoring, and compliance) will still be rated a medium risk using the IRS's revised risk assessments. The Government Accountability Office places such a high priority on the need to have an effective internal control system that it developed internal control standards for Federal entities. According to the Government Accountability Office, internal controls help organizations run their operations efficiently and effectively, report reliable information, and comply with applicable laws and regulations. Monitoring is one of the five components in an effective internal control system identified by the Government Accountability office.

Recent legislation recognizes the significance of ACTC and AOTC improper payments

Congress enacted the Protecting Americans from Tax Hikes (PATH) Act[25] on December 18, 2015, which includes program integrity provisions specifically intended to reduce fraudulent and improper EITC, CTC, ACTC, and AOTC payments. According to the House Committee on Ways and Means, these integrity provisions are projected to save roughly $7 billion over 10 years by reducing fraud, abuse, and improper payments in refundable credit programs. For example, one of the PATH Act's provisions is intended to ensure that the IRS has the information and time needed to verify the earned income of individuals claiming the EITC and ACTC before the related refund is issued. According to the IRS, approximately $1 billion (6 percent) of improper EITC payments are from program design limitations. These errors relate to certain income misreporting, tiebreaker errors, and joint return errors of qualifying children. Figure 2 provides a summary of key PATH Act provisions.

[25] Consolidated Appropriations Act of 2016, Pub. L. No. 114-113, Div. Q (2015).

Figure 2: Key Integrity Provisions of the PATH Act

Provision	Description of Provision	Effective Date
Section 201: Modification of filing dates of returns and statements relating to employee wage information and nonemployee compensation to improve compliance.	- Modifies the due dates of Forms W-2, *Wage and Tax Statement*, and 1099-MISC, *Miscellaneous Income (Info Only)*, to January 31. - Provides additional time for the IRS to review refund claims based on the EITC and the ACTC in order to reduce fraud and improper payments. No credit or refund shall be made to a taxpayer before February 15 if the taxpayer claimed the EITC and/or ACTC on the tax return.	January 1, 2016 (2017 Filing Season[26])
Sections 204-206: Prevention of retroactive claims.	- Prevents retroactive claims for the EITC after issuance of a Social Security Number and prevents retroactive claims for the CTC/ACTC and the AOTC after the issuance of a Social Security Number, Individual Taxpayer Identification Number,[27] or Adoption Taxpayer Identification Number.[28] Taxpayers cannot file an amended tax return or original tax return for prior years to claim credits if the Social Security Number, Individual Taxpayer Identification Number, or Adoption Taxpayer Identification Number were not issued prior to the return due date.	December 18, 2015 (2016 Filing Season)
Section 207: Procedures to reduce improper claims.	- Expands the paid preparer due diligence requirements to cover the CTC/ACTC and the AOTC as well as the EITC, including the associated per-credit penalty for failure to comply.[29] - Requires the IRS to study the effectiveness of the current due diligence procedures and whether these procedures should apply to other methods of tax filing. The report showing the study results for the EITC was due on December 18, 2016, and the report for the CTC/ACTC and AOTC is due on December 18, 2017.	January 1, 2016 (2017 Filing Season)

[26] The period from January through mid-April when most individual income tax returns are filed.
[27] An Individual Taxpayer Identification Number is issued by the IRS to individuals who are required to have a Taxpayer Identification Number for tax purposes but do not have or are not eligible to obtain a Social Security Number.
[28] An Adoption Taxpayer Identification Number is a temporary identification number issued by the IRS for a child in a domestic adoption when the adopting taxpayers do not have or are unable to obtain the child's Social Security Number.
[29] The penalty is $510 for Tax Year 2016. The penalty amount is indexed for inflation and will be adjusted each year.

Provision	Description of Provision	Effective Date
Section 208: Restrictions on taxpayers who improperly claimed credits in a prior year.	- Expands the EITC two-year and 10-year ban to the CTC/ACTC and the AOTC, barring individuals from claiming these credits if it has been determined that the credits were claimed with reckless or intentional disregard or claimed fraudulently. - Adds math error authority, which permits the IRS to disallow improper credits without a formal audit if the taxpayer claims the credit in a period during which he is barred from doing so due to fraud or reckless or intentional disregard. - Expands the EITC requirement for taxpayers to recertify the next time they claim the credit when it was disallowed to the CTC/ACTC and AOTC.	January 1, 2016 (2017 Filing Season)

Source: PATH Act of 2015.

Recommendation

Recommendation 1: The Chief Financial Officer and the Commissioner, Wage and Investment Division, should revise the methodology used to conduct the Annual Improper Payment Risk Assessment for refundable tax credits to include a quantitative assessment using available NRP and IRS compliance data.

Management's Response: The IRS disagreed with this recommendation. The IRS responded that it developed the refundable tax credit program risk assessment framework with Treasury and in accordance with both OMB Circular A-123 Appendix C and Treasury implementation guideline requirements. As TIGTA has acknowledged, the IRS properly conducted a qualitative risk assessment of the programs and the governing internal controls. The IRS and Treasury continue to work with OMB on a process for reporting compliance analytics for these refundable credits. The IRS also intends to report on refundable credits in the Annual Financial Report as part of a broader discussion on the Tax Gap, tax burden, and refundable tax credit compliance independent of the risk assessment process, which will remain focused on program integrity and internal controls.

Office Audit Comment: OMB Circular A-123 Appendix C, Part I Section A,[30] requires agencies to institute a systemic method to identify programs susceptible to significant improper payments. The guidance states "*This systematic method could be a quantitative evaluation based on a statistical sample or a qualitative method (e.g., a risk-assessment questionnaire).*" In addition, the OMB guidance provides an example of how

[30] OMB Circular A-123 Appendix C, Part I Section A, Item 9.

a quantitative analysis may be used to evaluate improper payment risk. Our review of the IRS's revised risk assessments found that the IRS continues to erroneously classify the improper payment risk associated with refundable credits by not including a quantitative analysis of its NRP and compliance data in its risk assessment methodology similar to the analysis we performed. Because the IRS continues to not rate these programs as high risk, it is able to avoid disclosing in the Annual Financial Report that these programs result in significant improper payments and it avoids the requirement that it establish a corrective action plan to reduce improper payments.

Using NRP and compliance data and the same methodology the IRS uses to quantify EITC improper payments, we estimate that the IRS potentially issued $7.2 billion in improper ACTC payments and $1.1 billion in improper AOTC payments in Fiscal Year 2016. The dollar value of these estimated improper payments alone meets the OMB definition of a program at significant risk for improper payments.

Additional Tools to Reduce Refundable Credit Improper Payments Did Not Expand Error Correction Authority

As we reported in April 2016, the PATH Act provides the IRS with additional tools to reduce refundable credit improper payments but does not provide the IRS with expanded error correction authority. As such, the IRS would have to audit each return identified as questionable. The IRS has developed processes to verify income on all tax returns, including those with an EITC or ACTC claim. IRS management informed us that all EITC and ACTC claims that have unsupported income will flow through the Return Review Program Systemic Verification program.

IRS management indicated that all returns identified as potentially fraudulent will be addressed as part of the IRS's fraud prevention programs. All of the remaining returns with an income discrepancy will be addressed as part of the IRS's overall Questionable Refund Program.[31] Specifically, management stated that these returns will be referred to the Examination or Automated Questionable Credit programs.[32] However, management indicated that only those returns with a refund greater than an established dollar tolerance will be selected for review by the Examination or Automated Questionable Refund programs. Our review of IRS internal guidelines confirms that not all returns that have an income discrepancy are referred to or reviewed by the IRS Examination function. As a result, only those EITC and ACTC claims that

[31] The Questionable Refund Program is a nationwide multifunctional program designed to identify fraudulent returns, to stop the payment of fraudulent refunds, and to refer identified fraudulent refund schemes to Criminal Investigation field offices.
[32] Tax examiners in the Automated Questionable Credits program review tax accounts and determine if appropriate documentation exists for the credit(s) claimed.

contain an income discrepancy and have a refund above the established dollar tolerance will be subject to additional review before the refund is paid.

The IRS, in conjunction with the Assistant Secretary of the Treasury for Tax Policy, has put forth a legislative proposal requesting additional error authority. The IRS requested math error authority as part of its Fiscal Year 2017 budget submission. Under this proposal, the Treasury would have regulatory authority to permit the IRS to correct errors in cases in which:

- The information provided by the taxpayer does not match the information contained in Government databases (*e.g.*, income information reported on the tax return does not match Forms W-2 from the Social Security Administration). According to the IRS, reliable Government data sources include information obtained from the Social Security Administration, the Department of Health and Human Services, the Federal Bureau of Prisons, and the States' Departments of Corrections.
- The taxpayer has exceeded the lifetime limit for claiming a deduction or credit.
- The taxpayer has failed to include documentation with his or her return that is required by statute.

However, as of March 2017, the law does not provide this authority. We have multiple audits ongoing to review the IRS's implementation of the PATH Act provisions.

Assessment of the Risk of Premium Tax Credit Improper Payments May Not Be Reliable

The interagency PTC improper payment working group, established in Fiscal Year 2015, worked with an outside vendor to complete a comprehensive risk assessment for the PTC for use in Fiscal Year 2016. Using this assessment, the IRS determined that the PTC has a medium risk of improper payments. However, we found that the PTC risk assessment may not be reliable. Specifically, we found that:

- No formal agreement has been reached among the IRS, Treasury, Department of Health and Human Services, and CMS as to the definition of a PTC improper payment. In addition, IRS management has not defined the types of errors that result in a PTC improper payment.
- The PTC risk assessment methodology does not include a quantitative assessment of improper payment risk.

As of June 30, 2016, the IRS processed more than 5.2 million tax returns for which taxpayers received approximately $20.3 billion in the PTC received in advance or claimed at the time of filing.

No agreed-upon definition of a PTC improper payment has been developed

While the OMB agreed that CMS is responsible for reporting on improper payments for the APTC and the IRS for reporting on improper payments for the PTC program, there is currently no formal agreement on the definition of an improper PTC payment. In the absence of an agreed-upon definition, the IRS defines an improper PTC payment as an error in net PTC. The IRS defines net PTC as the total PTC a taxpayer is entitled to receive less APTC paid to insurers on the taxpayer's behalf. Taxpayers' may be entitled to receive additional PTC or may have to repay APTC paid in excess of allowable PTC. Taxpayers compute net PTC on Form 8962, *Premium Tax Credit (PTC)*. Taxpayers who are entitled to additional PTC claim the credit on line 69 on Form 1040, *U.S. Individual Income Tax Return*. Taxpayers who receive more APTC than allowable PTC report the amount of APTC that must be repaid, if any, on line 46 of the Form 1040.

In addition, while the IRS has defined a PTC improper payment as errors in net PTC, IRS management indicated that they are currently developing the types of net PTC errors that result in an improper PTC payment. Without a formal agreed-upon definition of a PTC improper payment, the IRS cannot reasonably assess the extent to which improper payments will occur.

Erroneous APTC payments increase the risk of improper PTC payments

The Exchanges have sole responsibility for determining if an individual is eligible to purchase health insurance as well as determining the amount of the APTC an individual is eligible to receive. Once the Exchange determines the amount of the APTC an individual is entitled to receive, the individual elects the actual amount to be sent to the insurer on a monthly basis. Individuals can elect to send all, a portion, or none of the APTC to which they are entitled. The IRS is responsible for determining the total PTC a taxpayer is entitled to receive based on the income and family size reported on his or her tax return. Taxpayers who received the APTC must file a tax return to reconcile any APTC payments that were made to an insurer on their behalf with total allowable PTC.

Taxpayers who are entitled to more PTC than was received in advance receive the additional credit as a refund on their tax returns. However, taxpayers who received more PTC in advanced payments than they were entitled to receive must repay the excess when filing their tax return. The amount required to be repaid is subject to certain limitations because the Affordable Care Act limits the amount of APTC that individuals with income between 100 percent and 400 percent of the Federal Poverty Level[33] will have to repay. Figure 3 shows the limits for Tax Year 2015 on repayment of excess APTC.

[33] The Federal Poverty Level is a measure of income level issued annually by the Department of Health and Human Services and is used to determine eligibility for certain programs and benefits. More information on the Federal Poverty Level can be found at https://www.healthcare.gov/glossary/federal-poverty-level-FPL.

Figure 3: Limit on Repayment – Individuals Receiving Excess APTC for Tax Year 2015

Household Income Percentage of the Federal Poverty Level	Repayment Limit – Filing Status Single	Repayment Limit – Filing Status Other Than Single
- Less Than 200%	$300	$600
- 200% but Less Than 300%	$750	$1,500
- 300% but Less Than 400%	$1,250	$2,500
- 400% or More	No Limit	No Limit

Source: Treasury Regulation Section (§) 1.36B-4.

With the Exchanges responsible for the APTC, we do not believe the IRS can effectively evaluate the risk that an improper PTC payment occurred without also considering the risk that the APTC received by taxpayers was paid in error. For example, an error in the computation of the APTC an individual is entitled to receive can result in a taxpayer receiving more in PTC payments than they are entitled to receive.

Our review of Tax Year 2015 tax returns filed as of June 30, 2016, found that approximately 2.9 million taxpayers received nearly $3.8 billion in excess APTC (*i.e.*, the APTC exceeded total allowable PTC).[34] Further analysis of the 2.9 million taxpayers found that 803,961 taxpayers had their APTC repayment limited as previously discussed. As a result, these taxpayers received the benefit of $1.4 billion[35] in excess APTC payments to which they were not entitled and that was not required to be repaid. Given the interdependency of the APTC and PTC, we believe the IRS and CMS would benefit from working together to develop an overall assessment of PTC improper payments that includes the risk of error in both APTC and PTC payments. In addition, a collaborative risk assessment would enable both agencies to evaluate all potential causes of PTC improper payments and develop a more comprehensive strategy for reducing improper APTC and PTC payments.

The methodology to assess the risk of the PTC does not include a quantitative analysis

Our analysis of the risk assessment methodology used to evaluate the risk of PTC improper payments for Fiscal Year 2016 found the methodology does not include a quantitative

[34] TIGTA, Ref. No. 2017-43-022, *Affordable Care Act: Verification of Premium Tax Credit Claims During the 2016 Filing Season* (Mar. 2017).

[35] Our analysis of Processing Year 2016 statistics includes tax returns with APTCs in excess of $25,000 that posted to the taxpayer's account on the IRS Master File. These figures are consistent with information reported in TIGTA Ref. No. 2017-43-022.

assessment of PTC improper payment risk. As such, we believe the IRS may have incorrectly determined the PTC to have a medium improper payment risk despite indications that the risk of improper payments in the PTC program may be significant. For example, in March 2017, we reported that 80,005 taxpayers potentially received $128.7 million more in the PTC than they were entitled to receive for Tax Year 2015.[36]

- 63,463 tax returns for which the IRS had no Exchange Periodic Data[37] or Form 1095-A, *Health Insurance Marketplace Statement.* These returns received PTCs totaling $123.4 million.
- 167 tax returns for which a blank Form 8962 was included with the tax return. Even though the Form 8962 was blank, the IRS treats the tax return the same as if the Form 8962 included actual amounts. The IRS performed no review of these claims because the PTC discrepancies were below the IRS dollar tolerance for selection. Had the IRS treated these taxpayers the same as taxpayers who did not file a Form 8962, the IRS would have identified these 167 returns for additional review. As a result, these taxpayers received $87,580 more in the PTC than they were entitled to receive. All of the $87,580 in PTC payments were received by the taxpayer in advance of filing.
- 16,375 taxpayers potentially received approximately $5.2 million more in the PTC than they were entitled to receive due to programming errors which caused the IRS to incorrectly compute the allowable PTC amount.

Per the OMB, any program that has gross annual improper payments that a) exceed both 1.5 percent of program outlays and $10 million of all program or activity payments or b) exceed $100 million at any percent of program outlays is considered as having significant risk.

Recommendations

The Chief Financial Officer and the Commissioner, Wage and Investment Division, should:

Recommendation 2: Work with the CMS to develop a collaborative strategy to assess the comprehensive risk of improper PTC payments, including the risk of APTC improper payments.

> ***Management's Response:*** The IRS disagreed with this recommendation. The IRS responded that the interagency workgroup involving the IRS, Treasury, CMS, and Department of Health and Human Services concluded, after evaluating the merits of an end-to-end risk assessment process, that evaluating APTC risk and PTC risk separately

[36] TIGTA, Ref. No. 2017-43-022, *Affordable Care Act: Verification of Premium Tax Credit Claims During the 2016 Filing Season* (Mar. 2017).

[37] Internal Revenue Code § 36B(f)(3) requires the Federal Exchange and State Exchanges to report enrollment data to the IRS. Treasury Regulation § 1.36B–5, *Information Reporting by Exchanges*, issued May 7, 2014, requires this information to be reported both monthly (by the 15th of each month) as well as annually (by January 31). The monthly data are referred to as Exchange Periodic Data.

was the most appropriate approach. The OMB approved this approach in Fiscal Year 2016. The IRS believes this structure is more advantageous because the specific responsibilities of the CMS and IRS for the APTC and PTC, respectively, provide a logical basis with which to evaluate the program risks. A separate risk assessment process also reduces the likelihood that improper payments will be double-counted when risk assessments are conducted, resulting in artificially inflated risk. However, both the IRS and CMS will continue to work together to understand the intricacies of the APTC and PTC programs and look for opportunities to strengthen controls and improve its ability to detect and prevent fraudulent and erroneous payments.

Office of Audit Comment: We requested documentation detailing the definition of a PTC improper payment and approach for evaluating the risk of improper payments. In addition, we requested that the IRS provide the OMB's approval of the agreed-upon approach. The IRS was unable to provide us with this information.

Recommendation 3: Ensure that the methodology used to conduct the PTC improper payment risk assessment includes a quantitative assessment of available IRS compliance data, including NRP data, once available.

Management's Response: The IRS disagreed with this recommendation. The IRS responded that it properly conducted a qualitative risk assessment of the PTC program and its governing internal controls. The IRS intends to report on PTCs in the Annual Financial Report as part of a broader discussion on the Tax Gap, tax burden, and refundable tax credit compliance independent of the risk assessment process, which will remain focused on program integrity and internal controls. In addition, any quantitative analysis of PTCs using NRP program data will not be available until 2018.

Office of Audit Comment: OMB Circular A-123 Appendix C, Part I Section A, requires agencies to institute a systemic method to identify programs susceptible to significant improper payments. The guidance states "*This systematic method could be a quantitative evaluation based on a statistical sample or a qualitative method (e.g., a risk assessment questionnaire).*" In addition, the OMB guidance provides an example of how a quantitative analysis may be used to evaluate improper payment risk. Similar to the method used to assess the risk of ACTC and AOTC payments, we found that the method the IRS used to assess PTC risk does not accurately reflect improper payments we identified as a result of our ongoing audit work on the IRS's implementation of the PTC.

In its response to our report, the IRS indicated that data for the PTC will be available in the NRP in 2018. As such, the IRS should revise its PTC improper payment risk assessment methodology to include an assessment of this data once available.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS complied with the annual improper payment reporting requirements for Fiscal Year[1] 2016. This review evaluated the IRS's compliance with the reporting requirements contained in the IPERA of 2010;[2] Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*;[3] and the IPERIA of 2012.[4] The scope of this review included an assessment of the information that the IRS provided for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2016.* To accomplish our objective, we:

I. Reviewed the *Department of the Treasury Agency Financial Report Fiscal Year 2016* published on November 15, 2016, to determine if the IRS was in compliance with the improper payment reporting requirements for Fiscal Year 2016. We compared the information contained in the Agency Financial Report to the improper payment reporting requirements outlined in the OMB Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control*, guidance on improper payment reporting.

   A. Determined if the IRS was in compliance with IPERA reporting requirements.

   B. Determined if the IRS was in compliance with IPERIA reporting requirements.

   C. Determined if the IRS was in compliance with Executive Order 13520 reporting requirements.

   D. Reviewed information that the IRS provided to the Treasury for posting to the paymentaccuracy.gov website.

   E. Determined if the information included in *Department of the Treasury Agency Financial Report Fiscal Year 2016* relative to EITC improper payments accurately reflects the underlying information from the IRS and was posted to paymentaccuracy.gov or other Internet locations as required.

[1] Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
[2] Pub. L. No. 111-204, 124 Stat. 2224.
[3] Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs* (November 20, 2009).
[4] Pub. L. No. 112-248, 126 Stat. 2390.

II. Assessed the accuracy of the IRS's computation of the EITC improper payment rate and dollar amount.

   A. Determined if the IRS revised the methodology used to compute the EITC improper payment rate and/or dollar amount since Fiscal Year 2016.

   B. Determined if the IRS revised the methodology used to compute the EITC supplemental measures for Fiscal Year 2016.

III. Evaluated the adequacy of the IRS's risk assessments of the Treasury-identified revenue program funds.

   A. Ensured that the required Risk Assessment Questionnaire was completed for each revenue program fund and identified the risk level for each.

   B. Determined the potential ACTC improper payment rate for Fiscal Year 2016. We ensured that the IRS determination of improper payment risk is consistent with the potential improper payment rate. We used data from the IRS's NRP 1040 Study for Tax Year[5] 2012 and the OMB budget report and compiled the data needed to update the ACTC improper payment rate for Fiscal Year 2016.

      1. Used the contract statistician to compute the potential ACTC improper payment rate using the same methodology used to compute the Fiscal Year 2015 estimated improper payment rate.

      2. Using the same methodology as was used for Fiscal Year 2015, computed the total potential ACTC improper payment amount for Fiscal Year 2016.

   C. Determined the potential AOTC improper payment rate for Fiscal Year 2016. We ensured that the IRS determination of improper payment risk is consistent with the potential improper payment rate. We used data from the IRS's NRP 1040 Study for Tax Year 2012 and the OMB budget report and compiled the data needed to update the AOTC improper payment rate for Fiscal Year 2016.

      1. Used the contract statistician to compute the potential AOTC improper payment rate by identifying the claims for the AOTC that were partially or fully disallowed by the IRS in the NRP study of Tax Year 2012 returns and computed the potential improper payment rate for Fiscal Year 2016.

      2. Identified the claims for the AOTC that were partially or fully disallowed by the IRS in the NRP study of Tax Year 2012 returns and computed the potential improper payment amount for Fiscal Year 2016.

[5] A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

IV. Evaluated the IRS's efforts to evaluate the risk of PTC improper payments.

A. Obtained information regarding the OMB interagency working group's progress on defining PTC improper payments and assessing their risk including the timeline for finalizing the definition and assessing risk based on that definition.

B. Determined the steps the IRS took to assess the risk of PTC improper payments for Fiscal Year 2016 including the risk of improper APTC payments. We determined if the process used provided a reasonable assessment of the risk of improper PTC payments for Fiscal Year 2016.

Data validation methodology

During this review, we relied on data received from the IRS for the NRP on the ACTC, the AOTC, and the EITC for Tax Year 2012. We also obtained extracts from the IRS's Returns Transaction File[6] databases that were available on the TIGTA's Data Center Warehouse.[7] Before relying on the data, we ensured that each file contained the specific data elements we requested. In addition, we selected random samples of each extract and verified that the data in the extracts were the same as the data captured in the IRS's Integrated Data Retrieval System.[8] We also performed analysis to ensure the validity and reasonableness of our data such as ranges of dollar values, transaction dates, and tax periods. Based on the results of our testing, we believe that the data used in our review were reliable.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: controls in place to ensure that the IRS met the annual improper payment reporting requirements established in the IPERA, Executive Order 13520, and the IPERIA. We tested these controls by reviewing and analyzing relevant documents, data, and calculations related to the preparation of EITC improper payment estimate information.

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[6] An IRS database containing transcribed tax returns for individuals that includes most forms and schedules.
[7] A TIGTA repository of IRS data.
[8] IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner
Office of the Commissioner - Attn: Chief of Staff
Deputy Commissioner for Operations Support
Deputy Commissioner for Services and Enforcement
Commissioner, Wage and Investment Division
Director, Office of Legislative Affairs
Director, Office of Program Evaluation and Risk Analysis
Director, Office of Research
Director, Office of Research, Analysis, and Statistics
Director, Return Integrity and Compliance Services, Wage and Investment Division
Director, Office of Audit Coordination

Appendix IV

Treasury Inspector General for Tax Administration Audit Reports on Improper Payments

TIGTA, Ref. No. 2016-40-036, *Without Expanded Error Correction Authority, Billions of Dollars in Identified Potentially Erroneous Earned Income Credit Claims Will Continue to Go Unaddressed Each Year* (Apr. 2016).

TIGTA, Ref. No. 2015-40-044, *Assessment of Internal Revenue Service Compliance With the Improper Payment Reporting Requirements in Fiscal Year 2014* (Apr. 2015).

TIGTA, Ref. No. 2015-40-009, *The Internal Revenue Service Is Working Toward Compliance With Executive Order 13520 Reporting Requirements* (Dec. 2014).

TIGTA, Ref. No. 2014-40-093, *Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments* (Sept. 2014).

TIGTA, Ref. No. 2014-40-027, *The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply With the Improper Payments Elimination and Recovery Act* (Mar. 2014).

TIGTA, Ref. No. 2013-40-084, *The Internal Revenue Service Is Not in Compliance With Executive Order 13520 to Reduce Improper Payments* (Aug. 2013).

TIGTA, Ref. No. 2013-40-024, *The Internal Revenue Service Was Not in Compliance With All Requirements of the Improper Payments Elimination and Recovery Act for Fiscal Year 2012* (Feb. 2013).

TIGTA, Ref. No. 2012-40-028, *The Internal Revenue Service Is Not in Compliance With All Improper Payments Elimination and Recovery Act Requirements* (Mar. 2012).

TIGTA, Ref. No. 2011-40-023, *Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year* (Feb. 2011).

Appendix V

Internal Revenue Service Programs Identified for Improper Payment Risk Assessments

The following IRS programs were identified by the Treasury for improper payment risk assessments for Fiscal Year 2016.

IRS Program	Type of Program	Level of Risk Identified
Refund Collection	Revenue	Low
Refund Collection – Interest	Revenue	Low
HQ Disbursement Earned Income Credit[1]	Revenue	High
Additional Child Tax Credit	Revenue	Medium
Refund – Corporations	Revenue	Low
American Opportunity Credit	Revenue	Medium
Build America Bond and Recovery Zone Bond	Revenue	Low
Qualified Zone Academy Bonds	Revenue	Low
Qualified School Construction Bonds	Revenue	Low
New Clean Renewable Energy Bonds	Revenue	Low
Qualified Energy Conservation Bonds	Revenue	Low
Premium Tax Credit	Revenue	Medium
Adoption Credit	Revenue	Low
Small Business Insurance Tax Credit	Administrative	Low
Informant Reimbursement	Revenue	Low
Affordable Health Care Program	Administrative	Low
Taxpayer Services	Administrative	Low
Examination and Appeals	Administrative	Low
Operations Support	Administrative	Low
Business Systems Modernization	Administrative	Low

Source: IRS Office of the Chief Financial Officer.

[1] The EITC Program has been declared a high-risk program for improper payments by the OMB; therefore, no formal risk assessment is required for this revenue fund.

Appendix VI

Methodology to Compute Potential Additional Child Tax Credit and American Opportunity Tax Credit Improper Payments

To compute the potential estimated improper rate for the ACTC and AOTC, we used the same data sources and methodologies to the extent possible that the IRS uses to estimate the EITC improper payment rate. For example, we used the results of the IRS's NRP 1040 Study for Tax Year 2012, which is the same study the IRS used to estimate the Fiscal Year 2016 EITC improper payment rate. In addition, we computed the estimated amount of potential ACTC and AOTC improper payments by applying our estimate of the potential improper payment rate to the OMB budget estimates that are consistent with the budget estimates used by the IRS to compute Fiscal Year 2016 EITC improper payments.

Methodology Used to Compute the Potential ACTC and AOTC Improper Payment Rate for Fiscal Year 2016

Potential Improper Payment Rate	**=**	***Improper Payments – Overclaims Recovered*** / ***Total Claims***

Improper Payments – The difference between the amount of the ACTC or AOTC claimed by the taxpayer on his or her tax return and the amount the taxpayer should have claimed based on NRP results for Tax Year 2012. This amount includes overclaims and underpayments. This amount totaled $7.3 billion for the ACTC and $2.2 billion for the AOTC.

Overclaims Recovered – The amount of ACTC or AOTC overclaims that the IRS prevents from being paid through activities such as math error processing and prerefund examinations or recovers after being paid through Automated Underreporter document matching and post-refund examinations.

ACTC Overclaims Recovered – This amount was estimated by applying the ratio of EITC overclaims recovered to EITC improper payments from the IRS's Fiscal Year 2016 EITC improper payment rate calculation. Using the EITC overclaims recovered ratio of 12.99 percent, we estimated the ACTC overclaims recovered to total $945.1 million.

AOTC Overclaims Recovered – We used data provided by the IRS for the amount recovered through prerefund examinations or recovered through Automated Underreporter document matching and post-refund examinations. AOTC overclaims recovered total $65.6 million.

Total Claims – The amount of the ACTC or AOTC claimed on all tax returns based on the NRP results for Tax Year 2012. This amount totaled $25.1 billion for the ACTC and $8.7 billion for the AOTC.

Potential Improper Payment Dollars	=	Estimated Claims[1] X Potential Improper Payment Rate
Estimated Fiscal Year 2016 Improper Payment Dollars – This amount was computed by multiplying the estimated Improper Payment Rate by the estimate of total claims for that year. **ACTC** – The estimate of ACTC Fiscal Year 2016 improper payments is $7.2 billion. **AOTC** – The estimate of AOTC Fiscal Year 2016 improper payments is $1.1 billion.		

Source: TIGTA analysis of Tax Year 2012 1040 NRP ACTC and AOTC data and the IRS's calculation of the Fiscal Year 2016 EITC improper payment rate.

[1] Estimated claims are determined after upward adjustments are made to estimates of tax expenditures and outlays in the Fiscal Year 2017 Federal Budget. For the ACTC, the estimated total claims were $28.5 billion. For AOTC, the estimated claims totaled $4.4 billion and included only the outlay portions reported in the Fiscal Year 2017 Federal Budget.

Appendix VII

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

CHIEF FINANCIAL OFFICER

April 18, 2017

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Ursula S. Gillis
Chief Financial Officer

SUBJECT: Draft Audit Report - Revised Refundable Credit Risk Assessments Still Do Not Provide an Accurate Measure of the Risk of Improper Payments (Audit #201740001)

Thank you for the opportunity to review and comment on your draft audit report entitled, "Revised Refundable Credit Risk Assessments Still Do Not Provide an Accurate Measure of the Risk of Improper Payments." We appreciate your acknowledgement of the inherent challenges in managing refundable tax credit programs effectively, including the Earned Income Tax Credit (EITC), the American Opportunity Tax Credit (AOTC), the Additional Child Tax Credit (ACTC), and the Premium Tax Credit (PTC) component of the Affordable Care Act (ACA). Our risk assessments continue to show that improper payments from refundable credits are not rooted in internal control weaknesses, financial management deficiencies, or financial reporting failures, but instead, from the inherent difficulty of delivering benefits through the tax system.

It is difficult to administer these programs since errors frequently stem from how Congress structured them, and because the IRS lacks available tools for verifying data or correcting issues identified during filing or through our fraud prevention programs. For example, the IRS lacks the statutory authority to address errors due to misreported income, claims in excess of lifetime limitations, and a lack of required documents at the time a return is filed. As a result, we must go through the lengthy deficiency process in order to address the errors through examinations or document matching. However, the number of returns we can address is limited by resource constraints and the need to balance compliance priorities, which significantly affects the number of returns we can address through these activities. With the majority of erroneous payments stemming from the statutory design of the refundable tax credit programs, and the IRS's limited ability to correct and audit returns, there is little we can do to reduce payment errors in refundable tax credits, absent legislative changes or increased funding.

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We also appreciate your acknowledgement of our efforts to implement the Protecting Americans from Tax Hikes (PATH) Act. The IRS continues to work with the Department of the Treasury to push for expanded error correction authority and other legislative changes beyond those included in the PATH Act and other recent legislation.

While we agree that TIGTA appropriately emphasized our limited ability to address improper refundable tax credit payments because of their statutory design, we disagree with your overall conclusions. Guidance from the Office of Management and Budget (OMB) Circular A-123, Appendix C, allows the use of a qualitative risk assessment for improper payments, including nine key factors that we employed properly per Treasury implementation guidance. Where internal program considerations identified threats to controls, we elevated the risk level consistent with Treasury implementation guidance. As a result of the risk assessment process, we determined that three programs - AOTC, ACTC, and PTC - had a medium risk of improper payments. We appreciate that TIGTA's report did not identify any specific concerns with our program internal controls, nor with our assessment of risk against OMB's nine criteria.

Although TIGTA used data from our National Research Program (NRP) to calculate estimates of potential improper payment rates and amounts for ACTC and AOTC, its methodology differed from the approach used to calculate the FY 2016 EITC improper payment amount. The EITC methodology estimates a value for the entire amount of the credit, not just the portion of the refundable credit that is considered an outlay. The IRS and Treasury continue to work with OMB on a process for reporting compliance analytics for these refundable credits, and we intend to report on refundable credits in the AFR as part of a broader discussion on tax gap, tax burden, and refundable tax credit compliance.

Your report made conclusions about the PTC program with which we disagree. We do not concur with your assessment that no formal agreement concerning the definition of a PTC improper payment exists, as the IRS has defined improper PTC payments as errors in net PTC. This definition was developed by the interagency workgroup involving Treasury, IRS, HHS, and CMS, and was briefed to OMB for their adjudication. OMB approved this approach in FY 2016, and the IRS has used this definition as the basis for our risk assessment and for our analyses since. Should we decide that a quantitative assessment is appropriate, the first opportunity for quantitative analysis using NRP data will be in 2018, following the integration of tax year 2014 data into the NRP.

Your report also concluded that erroneous APTC payments may increase the risk of erroneous PTC payments. We disagree with this conclusion because of the nature of the APTC payment and reconciliation process. When a taxpayer submits to CMS that they are eligible for an APTC payment, CMS is responsible for validating, to the extent possible, the taxpayer's eligibility and the appropriate amount of the APTC to be paid out. An erroneous APTC payment will not necessarily result in an erroneous PTC payment, if one is made at all. While it is true that erroneous APTC payments may result in unrecoverable excess APTC (based on income levels in relation to the Federal

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Poverty Level), that issue is distinct from the PTC process because APTC payments are made solely at the discretion of CMS based on the information they have available at the time.

We appreciate that your audit report did not identify any specific issues with our internal controls. We believe that our internal controls over these programs are strong, and we are committed to ensuring that they remain so. We also continue to advance our fraud detection and prevention capabilities and pursue problematic returns through our compliance processes, despite dwindling resources. However, despite our best efforts, trying to fit refundable tax credits into the framework of improper payments legislation is counterproductive to addressing the root causes of erroneous or fraudulent payments, since the majority of the errors are due to the programs' statutory design and the limited audit resources available to focus on erroneous or fraudulent return filings.

Our comments to your specific recommendations are provided in the attached document. If you have any questions, please contact me at 202-317-6400, or a member of your staff may contact John Pekarik, Associate Chief Financial Officer for Corporate Planning and Internal Control, at 202-803-9151.

Attachment

Attachment

RECOMMENDATION 1

The Chief Financial Officer and the Commissioner, Wage and Investment Division, should revise the methodology used to conduct the Annual Improper Payment Risk Assessment for refundable tax credits to include a quantitative assessment using available NRP and IRS enforcement data.

CORRECTIVE ACTION

The IRS disagrees with this recommendation. We developed the refundable tax credit program risk assessment framework with Treasury and in accordance with both OMB Circular A-123 Appendix C and Treasury implementation guideline requirements. As TIGTA has acknowledged, the IRS properly conducted a qualitative risk assessment of the programs and the governing internal controls. The IRS and Treasury continue to work with OMB on a process for reporting compliance analytics for these refundable credits. We intend to report on refundable credits in the AFR as part of a broader discussion on tax gap, tax burden, and refundable tax credit compliance, independent of the risk assessment process, which will remain focused on program integrity and internal controls.

IMPLEMENTATION DATE

n/a

RESPONSIBLE OFFICIAL

n/a

RECOMMENDATION 2

The Chief Financial Officer and the Commissioner, Wage and Investment Division, should work with the CMS to develop a collaborative strategy to assess the comprehensive risk of improper PTC payments, including the risk of APTC improper payments.

CORRECTIVE ACTION

The IRS disagrees with this recommendation. As part of the efforts of the interagency workgroup, IRS and Treasury jointly evaluated the merits of an end-to-end risk assessment process with CMS and HHS. After considering the advantages and disadvantages of this approach, the interagency workgroup concluded that a risk assessment process that evaluates APTC risk and PTC risk separately was the most appropriate approach. OMB was briefed on this approach and approved it in FY 2016. The IRS believes this structure is more advantageous because the specific responsibilities of CMS and IRS for APTC and PTC, respectively, provide a logical basis with which to evaluate the program risks. A separate risk assessment process also reduces the likelihood that improper payments will be double-counted when risk assessments are conducted, resulting in artificially inflated risk. However, both IRS and CMS have committed to OMB that we will continue to work together to understand the intricacies of the APTC and PTC programs and look for opportunities to strengthen controls and improve our ability to detect and prevent fraudulent and erroneous payments.

IMPLEMENTATION DATE
n/a

RESPONSIBLE OFFICIAL
n/a

RECOMMENDATION 3
The Chief Financial Officer and the Commissioner, Wage and Investment Division, should ensure that the methodology used to conduct the PTC improper payment risk assessment includes a quantitative assessment of available IRS enforcement data, including NRP data, once available.

CORRECTIVE ACTION
The IRS disagrees with this recommendation. As previously stated about the other refundable tax credits, the IRS properly conducted a qualitative risk assessment of the PTC program and its governing internal controls. As with the other credit programs, the IRS intends to report on PTC in the AFR as part of a broader discussion on tax gap, tax burden, and refundable tax credit compliance, independent of the risk assessment process, which will remain focused on program integrity and internal controls. As TIGTA is aware, any quantitative analysis of PTC using NRP program data will not be available until 2018.

IMPLEMENTATION DATE
n/a

RESPONSIBLE OFFICIAL
n/a