TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Improper Payments Elimination and Recovery Act Risk Assessments of Revenue Programs Are Unreliable

January 31, 2013

Reference Number: 2013-40-015

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IMPROPER PAYMENTS ELIMINATION AND RECOVERY ACT RISK ASSESSMENTS OF REVENUE PROGRAMS ARE UNRELIABLE

Highlights

Final Report issued on January 31, 2013

Highlights of Reference Number: 2013-40-015 to the Internal Revenue Service Chief Financial Officer.

IMPACT ON TAXPAYERS

Improper payments cost taxpayers billions of dollars annually across Federal programs. The IRS estimates it paid $15.2 billion in improper Earned Income Tax Credit payments in Fiscal Year 2011. An improper payment is any payment that should not have been made or that was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirements. Ineffective risk assessment processes can affect Government-wide actions to protect taxpayer dollars from waste, fraud, and abuse.

WHY TIGTA DID THE AUDIT

The Improper Payments Elimination and Recovery Act (IPERA) of 2010 increased agency accountability for reducing improper payments in Federal programs. This audit was initiated because the IPERA requires TIGTA to assess the IRS's compliance with improper payment requirements. The objective of this review was to evaluate the adequacy of the IRS's Fiscal Year 2011 assessment of the risk of improper payments in those programs identified by the Department of the Treasury. The Department of the Treasury identified 12 IRS administrative program funds and 16 revenue program funds for the Fiscal Year 2011 IPERA risk assessment process.

WHAT TIGTA FOUND

The IRS used the Department of the Treasury's Improper Payment Risk Assessment Questionnaire (the Questionnaire) and guidance to complete the Fiscal Year 2011 risk assessment for each designated administrative and revenue program fund. TIGTA determined that the risk assessment process adequately reflects the risk of improper payments in the IRS's administrative program funds.

However, the process does not provide a reliable assessment of the risk of improper payments in the IRS's revenue program funds. The IRS's review process for revenue program fund risk assessments is informal and did not always adhere to required guidelines for performing the assessment. The design of the Questionnaire does not provide an adequate assessment of the risk associated with tax refunds. For example, not all of the questions apply to tax refund payments. Depending on the response to these questions, the program's risk score can be affected. In addition, questions pertaining to other areas of potential risk within tax administration are not included in the Questionnaire.

Moreover, other issues, such as insufficient verification of identity or income, can pose a significant risk for improper payments. Prior TIGTA reports indicate that this risk could be significant. As a result of identity theft, the IRS may have paid $5.2 billion in potentially fraudulent tax refunds. TIGTA also previously found the verification process for Individual Taxpayer Identification Number applications was substantially deficient. More than 481,500 tax returns associated with these applications had claims for the Additional Child Tax Credit totaling more than $916 million.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS work with the Department of the Treasury to better identify the IRS programs to be included in the risk assessments for improper payments and refine the Questionnaire to ensure that all questions are applicable to tax administration and more accurately reflect the risks associated with tax refund payments, develop a formal process for assigning responsibility for the completion of the risk assessments, and develop a process to ensure that the Department of the Treasury guidance is being followed.

The IRS agreed with our recommendations and plans to take the corrective actions suggested.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

January 31, 2013

MEMORANDUM FOR CHIEF FINANCIAL OFFICER

FROM: Michael E. McKenney
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Improper Payments Elimination and Recovery Act Risk Assessments of Revenue Programs Are Unreliable (Audit # 201240011.02)

This report presents the results of our review to evaluate the adequacy of the Internal Revenue Service's Fiscal Year 2011 assessment of the risk of improper payments in the Treasury Fund Accounts identified by the Department of the Treasury as part of the requirements of the Improper Payments Elimination and Recovery Act of 2010.[1] The scope of this review was limited to an analysis of the design of the Fiscal Year 2011 Risk Assessment Questionnaire and an assessment of the actions taken by the IRS to complete the risk assessment. This audit was included in the Treasury Inspector General for Tax Administration's Fiscal Year 2012 Annual Audit Plan and addresses the major management challenge of Fraudulent Claims and Improper Payments.

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

Copies of this report are also being sent to the IRS managers affected by the report recommendations. If you have any questions, please contact me or Augusta R. Cook, Acting Assistant Inspector General for Audit (Returns Processing and Account Services).

[1] Pub. L. 111-204, 124 Stat. 2224.

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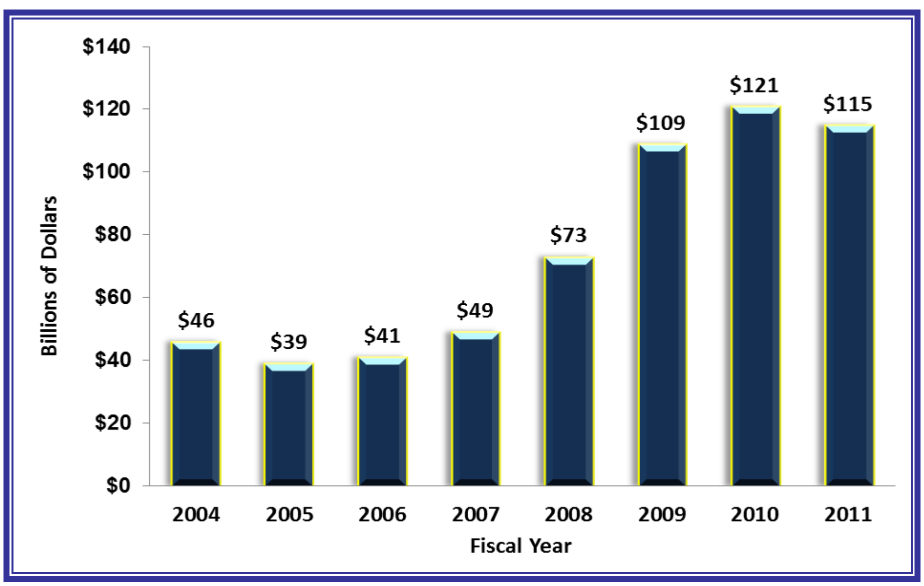
Abbreviations

EITC	Earned Income Tax Credit
IPERA	Improper Payments Elimination and Recovery Act of 2010
IRS	Internal Revenue Service
ITIN	Individual Taxpayer Identification Number
TIGTA	Treasury Inspector General for Tax Administration

Background

In Fiscal Year 2011, Federal agencies reported an estimated $115 billion in improper payments.[1] The Improper Payments Information Act of 2002 (hereafter referred to as the Improper Payments Act)[2] requires Federal agencies to improve the accuracy and integrity of Federal payments and report on their progress. Figure 1 shows the amount of improper payments reported by Federal agencies since Fiscal Year 2004, the first year that Federal agencies Government-wide were required to report improper payment information under the Improper Payments Act.

Figure 1: Federal Improper Payments for Fiscal Years 2004 Through 2011



Source: Government Accountability Office reports included in the Financial Report of the U.S. Government for Fiscal Years 2004 through 2011.

On July 22, 2010, President Obama signed into law the Improper Payments Elimination and Recovery Act of 2010 (IPERA).[3] The IPERA amends the Improper Payments Act by redefining the definition of "significant improper payments" and strengthening agency reporting requirements. The IPERA also made agencies accountable for reducing improper payments.

[1] An improper payment is any payment that should not have been made or that was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirements. Incorrect amounts are overpayments and underpayments made to eligible recipients.
[2] Pub. L. No. 107-300, 116 Stat. 2350.
[3] Pub. L. 111-204, 124 Stat. 2224.

The Department of the Treasury administers the annual improper payment risk assessment for all Treasury bureaus.

The first step in complying with the IPERA is for agencies to conduct an assessment of their risk for significant improper payments. The Department of the Treasury administers the annual risk assessment process for all Treasury bureaus, including the risk assessment performed by the Internal Revenue Service (IRS). It identifies which programs must be included in the IRS's risk assessment for improper payments using bureau funding sources and disbursements referred to as "fund groups." The Department of the Treasury selects the fund groups that are to be assessed based on each fund group's materiality to the IRS financial statements.

The Department of the Treasury identified 12 IRS administrative program funds and 16 revenue program funds for the Fiscal Year 2011 IPERA risk assessment process.[4] Administrative program funds included, for example:

- Payments for information technology investments.
- Business systems modernization.
- Recovery Act administrative expenses.
- Special fund user fees.

The Department of the Treasury identifies the programs that the IRS must assess for the risk of improper payments.

Revenue program funds generally included tax refunds of various tax credits.

The Department of the Treasury also provides its bureaus with an IPERA Risk Assessment Questionnaire (hereafter referred to as the Questionnaire) and related guidance for conducting the risk assessment of each identified program. The Questionnaire automatically computes a risk score for a program based on the IRS's responses to the questions contained in the Questionnaire. The risk score determines whether there is a low, medium, or high risk of improper payments in a program. The Department of the Treasury establishes the level of risk for a program's improper payments based on risk score ranges. For example, the Department of the Treasury considers programs with a risk score of zero to 11 as low risk, 12 to 28 as medium risk, and 29 and greater as high risk. The IRS completed and forwarded the results of the risk assessments for all identified programs to the Department of the Treasury by the end of July 2011.

The IPERA requires Federal agencies to estimate improper payments for all programs with significant improper payments. The IPERA defines a program as having significant improper payments when improper payments exceed both 2.5 percent of program outlays and $10 million of all program or activity payments made during the fiscal year reported or $100 million (at any

[4] See Appendix IV.

percent of program outlays).[5] If an agency determines that significant improper payments exist in a program, the agency must report to the Office of Management and Budget the amount of improper payments, the causes of the improper payments, the actions taken to address the causes, and the agency's plans for reducing improper payments. The Department of the Treasury requires its bureaus, including the IRS, to provide the required information for inclusion in the Department of the Treasury Annual Financial Report.

The only program the IRS has designated as high risk for improper payments is the Earned Income Tax Credit (EITC) Program. The IRS first reported EITC improper payments under the Improper Payments Act in Fiscal Year 2004. Both the IRS and the Department of the Treasury agree that the EITC Program continues to be at high risk for significant improper payments. As such, the Department of the Treasury did not require the IRS to complete a Fiscal Year 2011 risk assessment of the EITC Program.

The only program the IRS has designated as high risk for improper payments is the EITC Program.

The IPERA requires the agency Inspector General to assess the agency's compliance with the IPERA requirements. The scope of our review was to determine whether the IRS's IPERA risk assessment process provides a reasonable assessment of the level of risk associated with the IRS programs evaluated. This review was performed at the IRS Headquarters in the Office of the Chief Financial Officer in Washington, D.C., the IRS Beckley Finance Center in Beckley, West Virginia, and the IRS Wage and Investment Division Office in Atlanta, Georgia, during the period December 2011 through September 2012. We conducted this performance audit in accordance with generally accepted 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.

[5] Beginning in Fiscal Year 2013, improper payments will be deemed significant if improper payments exceed both 1.5 percent and $10 million of all program or activity payments made during the fiscal year reported or $100 million at any percent of program outlays.

Results of Review

Improper Payments Elimination and Recovery Act Risk Assessments of Revenue Program Funds Are Unreliable

The IRS completed a Fiscal Year 2011 risk assessment for each administrative and revenue program fund designated by the Department of the Treasury as required by the IPERA. The risk assessment process resulted in a reasonable assessment of the risk of improper payments for the IRS administrative programs. However, the results of the risk assessment may not accurately reflect the risk of improper payments in the IRS's revenue program funds.

A review of a judgmental sample of three of the 12 administrative program funds designated for review by the Department of the Treasury indicates the risk assessment process for administrative programs is reliable.[6] The risk assessments for these funds were completed by a team of reviewers at the IRS Beckley Finance Center with the necessary expertise to address the payment risks of each administrative fund. In addition, the IRS Beckley Finance Center provided adequate documentation to support its assessment of those risks. The IRS Beckley Finance Center determined all of the IRS's administrative program funds had a low risk of significant improper payments.

However, a review of a judgmental sample of seven of the 16 revenue program funds designated for review by the Department of the Treasury identified the following deficiencies in the IRS's risk assessment process:

- Programs selected for evaluation were defined based on fund groups rather than by significant broad-based activities.
- The Questionnaire does not effectively address risks associated with tax refund payments.
- Risk assessments were not performed in compliance with Department of the Treasury guidelines.

The IRS determined that the 15 revenue program funds it assessed had a low risk for improper payments.[7] However, prior Treasury Inspector General for Tax Administration (TIGTA) reports

[6] A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population.
[7] The Department of the Treasury identified 16 revenue program funds for risk assessment. However, the IRS was not required to complete a risk assessment of the EITC Program.

indicate that the risk of improper payments for some of the programs the IRS evaluated could be significant. For example, in September 2011, we reported that the IRS may have erroneously allowed approximately $3.2 billion in American Opportunity Tax Credits.[8] In February 2012, we reported that the IRS erroneously allowed First-Time Homebuyer Credits totaling approximately $23.21 million.[9] We also reported the IRS paid an estimated $11 million in erroneous Adoption Credits during Processing Year 2011.[10]

In Fiscal Year 2011, Federal agencies reported $115 billion in estimated improper payments. The IPERA increases agencies' accountability for identifying the causes of improper payments, reducing improper payments, and recovering payments made in error. However, an agency's efforts to reduce improper payments depends on the effectiveness of the processes used to identify programs and activities that present the greatest risk of improper payments to the Federal government. Ineffective risk assessment processes can affect the Government-wide actions to protect taxpayer dollars from waste, fraud, and abuse.

The definition of an IRS program affects the reliability of the risk assessment of improper payments

The Department of the Treasury identified IRS programs based on the fund groups associated with the Department's annual budget. However, the IRS administers the tax law by establishing broad programs focused on helping taxpayers meet their tax responsibilities, *i.e.*, processing tax returns and enforcing the law to ensure that everyone meets their obligation to pay taxes. Limiting the assessment of the risk of improper payments to fund groups, for example, verification of one tax credit, may significantly underestimate the risk of improper payments to tax administration.

The revenue program funds that the Department of the Treasury selected for review generally represent specific individual credits or payments (line items on the tax returns).[11] While refundable tax credits[12] increase the tax refund a taxpayer can receive, other issues concerning tax administration, such as the verification of income or the issuance of Taxpayer Identification Numbers,[13] can pose a significant risk for improper payments.

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[8] TIGTA, Ref. No. 2011-41-083, *Billions of Dollars in Education Credits Appear to Be Erroneous* (Sept. 2011).
[9] TIGTA, Ref. No. 2012-41-013, *The Internal Revenue Service Disallowed Erroneous First-Time Homebuyer Credits Totaling $1.6 Billion; However, Its Examination Resources Could Have Been Used More Effectively* (Feb. 2012).
[10] TIGTA, Ref. No. 2012-40-065, *Processes to Address Erroneous Adoption Credits Result in Increased Taxpayer Burden and Credits Allowed to Nonqualifying Individuals* (June 2012).
[11] See Appendix IV.
[12] A refundable credit is not limited to the amount of an individual's tax liability and can result in a Federal tax refund that is larger than the amount of a person's Federal income tax withholding for that year.
[13] A nine-digit number assigned to taxpayers for identification purposes. Depending upon the nature of the taxpayer, the Taxpayer Identification Number is an Employer Identification Number, a Social Security Number, or an Individual Taxpayer Identification Number.

In July 2012, the TIGTA completed two audits which reported the following:

- The IRS did not have the information it needed to timely verify the income and withholding reported on individual tax returns.[14] As a result, the IRS may have paid $5.2 billion in potentially fraudulent tax refunds on 1.5 million tax returns in Tax Year[15] 2010. We estimated the IRS could pay $21 billion in questionable tax refunds over the next five years. Yet the IRS's program for verifying withholding was not identified by the Department of the Treasury for assessment because the Department does not have a fund group specifically for the payment of refunds of withholding in the annual budget.
- The Individual Taxpayer Identification Number (ITIN) application review and verification process is so deficient that there is no assurance that ITINs are not being assigned to individuals submitting questionable applications.[16] The amount of Federal funds individuals have access to once they have an ITIN assigned is substantial. For example, in Processing Year[17] 2011, claims for the refundable credit known as the Additional Child Tax Credit by ITIN filers totaled $4.2 billion. For the ITINs assigned in Processing Year 2011, we identified more than 481,500 (71 percent) of the tax returns associated with the ITIN application had claims for the Additional Child Tax Credit totaling more than $916 million. However, the IRS's program for reviewing and verifying the requests for ITINs was not identified by the Department of the Treasury for risk assessment of improper payments.

Had the IRS assessed the risk of improper payments in its income and withholding verification program or the ITIN program, it may have been required to report on the improper payments made in the programs in the Department of the Treasury's Annual Financial Report. The IPERA requires agencies to report on any program with potential improper payments of more than 2.5 percent of program outlays and $10 million of all program payments or $100 million in improper payments. The amount of potential improper payments we identified significantly exceeds this threshold.

The IPERA requires agencies to assess all programs for the risk of improper payments, and the Office of Management and Budget defines a program as any activity or set of activities recognized as a program by the public, the Office of Management and Budget, or Congress. How agencies categorize or define their programs can affect the reliability of the annual

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[14] TIGTA, Ref. No. 2012-42-080, *There Are Billions of Dollars in Undetected Tax Refund Fraud Resulting From Identity Theft* (Jul. 2012).
[15] The 12-month period for which tax is calculated. For most individual taxpayers, the tax year is synonymous with the calendar year.
[16] TIGTA, Ref. No. 2012-42-081, *Substantial Changes Are Needed to the Individual Taxpayer Identification Number Program to Detect Fraudulent Applications* (Jul. 2012).
[17] The calendar year in which the tax return or document is processed by the IRS.

improper payment risk assessment and undermine the intent of the Federal Government's efforts to reduce improper payments Government-wide.

For example, had the IRS been required to report on improper payments in its income and withholding verification and ITIN programs, the IRS would have had to provide the following information to the Department of the Treasury for inclusion in its Annual Financial Report.

- The root causes of the improper payments and actions taken to address the root causes.
- The IRS's annual goal for reducing improper payments and its plans for achieving the goal.
- Efforts to recover improper payments.
- The sufficiency of the agency's information systems and other infrastructure in reducing improper payments to agency target levels.
- Statutory or regulatory barriers that limit corrective actions to reduce improper payments and the actions taken to overcome these barriers.

Although the IRS did not select the programs for the Fiscal Year 2011 risk assessment, the IRS has a responsibility under the Department of the Treasury guidance to ensure that the programs selected most accurately reflect the IRS's programs and activities. The Department of the Treasury instructed its bureaus to review the inventory of programs selected for the improper payment risk assessment to determine if the groupings best represent the programs within each bureau. Had the IRS proposed an alternative grouping of programs, the risk assessment process would have resulted in a more reliable depiction of the risk of improper payments in tax administration.

The IRS Chief Financial Officer indicated that the Office of Management and Budget has exempted tax refunds from the improper payment reporting requirements. However, the IRS was unable to provide us with a copy of the exemption. In addition, the Department of the Treasury required the IRS to complete a Fiscal Year 2011 improper payment risk assessment of revenue program funds associated with tax refunds. Such a requirement is not consistent with management's assertion that tax refunds are exempted from the improper payment reporting requirements.

The IPERA Questionnaire did not effectively evaluate risks associated with tax refund payments

To evaluate the effectiveness of the Questionnaire used to estimate the level of improper payment risk, we completed the Questionnaire for the EITC Program.[18] The Department of the Treasury did not require the IRS to complete a Fiscal Year 2011 risk assessment of the

[18] The Questionnaire was completed using auditor knowledge of the EITC Program.

EITC Program. Our evaluation resulted in a risk score of 12, rating the EITC Program a medium risk (using the Department of the Treasury's 12 to 28 points rating). Therefore, the IRS would not have had to estimate EITC improper payments based on the Questionnaire's risk score. This is despite the EITC Program having a reported improper payment rate of 23.5 percent and an estimated $15.2 billion in improper payments; it ranked third on the Federal Government's list of improper payments reported in Fiscal Year 2011.

A review of the Questionnaire found that it contains questions that do not apply to the IRS's revenue program funds. Yet an answer to these questions is required. Specifically, for those questions that do apply to tax administration, the Questionnaire requires a yes or no response to these questions. Depending on the response to these questions, the program's risk score can be affected. Based on our review, the IRS Chief Financial Officer recognized that not all of the questions on the Fiscal Year 2011 Questionnaire applied to tax administration. The Chief Financial Officer requested that the Questionnaire be modified to allow a response of "not applicable" on 12 of the 62 questions in the Questionnaire. The Department of the Treasury subsequently modified the Fiscal Year 2012 Questionnaire to allow a response of "not applicable" for the questions the IRS identified.

The Fiscal Year 2011 Questionnaire contained questions that did not apply to IRS revenue program funds.

However, more needs to be done to ensure that the Questionnaire provides a valid assessment of the risk of improper tax refund payments. Specifically, the Questionnaire does not address the specific risks most commonly associated with the verification of taxpayer claims for tax refunds and credits. For example, the Questionnaire does not ask if the IRS has the information it needs to validate a taxpayer's claim for a tax refund at the time the tax return is filed and the tax refund is paid. TIGTA has repeatedly identified weaknesses in the IRS's verification of taxpayers' claims for refundable tax credits at the time tax returns are processed.[19]

Office of Management and Budget guidance states that when an agency is unable to determine if a payment is proper because of insufficient or lack of documentation, the payment is to be considered an improper payment. By not including questions to specifically assess the sufficiency of documentation in the Questionnaire, the Department of the Treasury may be systemically underestimating the amount of potential improper payments in the IRS's revenue programs.

The IRS did not follow Department of the Treasury guidance

Department of the Treasury guidance states that the risk assessments should be conducted by a team of reviewers knowledgeable in the types of payments for each of the program fund groups. This includes being knowledgeable in the requirements that need to be met to authorize the payments and the financial and administrative controls for the processing of the payments.

[19] See Appendix V for a list of TIGTA reports issued between June 2010 and June 2012.

A review of seven Fiscal Year 2011 revenue fund risk assessments identified that the IRS did not always:[20]

- Use a team of reviewers to conduct the improper payment risk assessments, but rather assigned individual IRS employees to conduct the assessments. We found that a team of reviewers was not used for three of the risk assessments.
- Ensure that the risk assessment was completed by the IRS function or employees who possessed sufficient knowledge of the types of payments, requirements that need to be met to authorize the payment, or financial and administrative controls for processing the payments. One risk assessment of a refundable credit was assigned to the wrong IRS function for completion. Two of seven risk assessments were completed by a program analyst who did not have sufficient knowledge to respond to more than 30 percent of the questions on the Questionnaire. In addition, individuals in one IRS function indicated they would have answered several questions on two Questionnaires differently based on their knowledge of the programs.
- Maintain adequate documentation to support its responses on the Questionnaires. Department of the Treasury guidance states that its bureaus and offices are to maintain the results and documentation of all risk assessments for five years. The IRS was unable to provide adequate documentation to support responses on three of the risk assessments.

Because of missing or insufficient documentation, we are unable to determine the impact of the IRS's noncompliance with the Department of the Treasury's guidance on the program fund risk assessment scores.

The IRS Chief Financial Officer assigns each program fund selected for a risk assessment to a responsible IRS executive for completion. However, there is no prescribed process to determine which IRS executive or function is best qualified to complete the risk assessment. There is also no prescribed process for determining who within the assigned IRS functions will work on the team that should be convened to complete the risk assessments. As a result, the IRS cannot ensure that the risk assessments are being completed by the individuals who are most knowledgeable about the individual program funds.

The Federal Government is focused on ensuring that the right payment in the right amount is provided to the right recipient. The annual improper payment risk assessment is one of the steps in the Federal Government's efforts to reduce improper payments. Without a strong assessment tool and process, the IRS may be significantly underestimating the amount of improper payments in tax administration. In addition, the IRS will have minimal accountability under the Improper Payments Act or the IPERA for reducing improper payments in those programs.

[20] Each risk assessment may contain more than one error condition.

Recommendations

The Chief Financial Officer should:

Recommendation 1: Work with the Department of the Treasury, Office of the Deputy Chief Financial Officer, Risk and Control Group, to better identify the IRS programs to be assessed for improper payment risk and refine the Questionnaires to ensure that all questions are applicable to tax administration and more accurately reflect the risks associated with tax refund payments.

> **Management's Response:** IRS management agreed with this recommendation. The Chief Financial Officer will work with the Department of the Treasury, Office of the Deputy Chief Financial Officer, Risk and Control Group, and the affected IRS business executives to identify the IRS programs that should be assessed for improper payment risk and will refine the Questionnaires that do not appropriately address applicable tax administration and tax refund payment risks.
>
> **Office of Audit Comment:** Although the IRS agreed with the recommendation, in its response the IRS stated that the documentation provided to us does confirm the Office of Management and Budget decision that the EITC is the only IRS tax program that should be reported under the IPERA. This decision was based on the fact that payments from tax refunds are included in the Tax Gap estimates in the overclaim rates and should continue to be reported and addressed as part of the overall plan for reducing the Tax Gap. However, the documentation provided to us shows that the Office of Management and Budget agrees tax refunds should be part of the IRS's Tax Gap efforts; it does not support that the Office of Management and Budget has determined that the EITC is the only IRS tax program subject to the IPERA.

Recommendation 2: Establish a formal process for assigning responsibility for the completion of the annual risk assessments for the selected IRS programs to the appropriate IRS executive.

> **Management's Response:** IRS management agreed with this recommendation. The Chief Financial Officer will establish a more formalized process with IRS business executives for assigning responsibility and completing the annual risk assessments for the selected programs. The Chief Financial Officer will maintain oversight of the process to ensure that the annual risk assessments are completed timely and accurately.

Recommendation 3: Develop a process to ensure that the Department of the Treasury guidance regarding the performance of risk assessments is being followed. The process should (1) ensure that the members of the team completing the risk assessment collectively possess knowledge of all aspects of the IRS program being reviewed, (2) include the type of documentation to be relied upon when completing the assessment, and (3) ensure that documentation is maintained for five years.

Management's Response: IRS management agreed with this recommendation. The Chief Financial Officer will work with the appropriate IRS business executives to develop internal guidance to ensure that the Department of the Treasury guidance for performing the annual risk assessments is being followed and ensure that those completing the risk assessments have the proper knowledge of the programs being reviewed. The guidance will also ensure that the appropriate program documentation is being relied on to determine the associated risks and that it will be maintained for five years.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate the adequacy of the IRS's Fiscal Year 2011 assessment of the risk of improper payments in the Treasury Fund Accounts identified by the Department of the Treasury as part of the requirements of the IPERA.[1] The scope of this review included an analysis of the IPERA Risk Assessment Questionnaire for Fiscal Year 2011 used to assess the risk within the identified fund accounts and an assessment of the actions taken by the IRS to complete the risk assessments. To accomplish our objective, we:

I. Assessed the effectiveness of the IRS's risk assessment process used to identify programs that are susceptible to improper payments and provide a reasonable assessment of the level of risk associated with those programs.

   A. Met with the IRS Chief Financial Officer and obtained an understanding of the risk assessment process used to identify programs susceptible to improper payments, including the categorization of programs included in the assessment process.

   B. Determined if the risk assessment process used by the IRS adequately identifies programs that are susceptible to improper payments and provides a reasonable assessment of the level of risk associated with those programs.

      1. Identified the types of payments the risk assessment process evaluates.

      2. Because of limited resources, selected a judgmental sample[2] of three of 12 administrative program funds and seven of 16 revenue program funds. We selected the sample of administrative program funds based on the total disbursements associated with the fund. We selected the sample of revenue program funds based on total disbursements and prior TIGTA audit coverage. We met with the technical individual(s) or team responsible for completing the IPERA Risk Assessment Questionnaire for each of the administrative and revenue program funds selected and obtained copies of the supporting documentation for each of the responses, if available.

      3. Determined if the risk assessment for each of the administrative and revenue program funds selected included enough analysis to evaluate the susceptibility of specific programs to improper payments.

[1] Pub. L. 111-204, 124 Stat. 2224.
[2] A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population.

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 the following internal controls were relevant to our audit objective: controls in place to ensure that the IRS adequately assessed its programs for the risk of improper payments. We evaluated the controls by reviewing the process used to identify IRS programs for assessment. In addition, we reviewed a judgmental sample of completed administrative and revenue program fund risk assessments.

Appendix II

Major Contributors to This Report

Augusta R. Cook, Acting Assistant Inspector General for Audit (Returns Processing and Account Services)
Russell P. Martin, Director
Deann Baiza, Acting Director
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Appendix III

Report Distribution List

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Appendix IV

Internal Revenue Service Programs Identified for Improper Payment Risk Assessments

The following IRS programs were identified by the Department of the Treasury for improper payment risk assessments for Fiscal Year 2011.

IRS Program	Type of Program	Level of Risk
Affordable Health Care Program	Administrative	Low
Department of Transportation Federal Highway Administration Allocation Account	Administrative	Low
Federal Tax Lien Revolving Fund	Administrative	Low
Health Insurance Tax Credit (*Two Funds*)	Administrative	Low
Information Systems	Administrative	Low
Information Technology Investments/ Business Systems Modernization	Administrative	Low
Private Collection Agent Program	Administrative	Low
Recovery Act Administrative Expenses	Administrative	Low
Special Fund User Fees	Administrative	Low
Tax Law Enforcement	Administrative	Low
Taxpayer Services	Administrative	Low
Alternative Minimum Tax Credit	Revenue	Low
American Opportunity Tax Credit	Revenue	Low
Build America Bond Payments	Revenue	Low
Credits for Certain Government Employees	Revenue	Low
Additional Child Tax Credit	Revenue	Low
Consolidated Omnibus Budget Reconciliation Act (COBRA) Insurance	Revenue	Low
Corporation Refunds	Revenue	Low
Earned Income Tax Credit	Revenue	High[1]

[1] The IRS was not required to complete a Fiscal Year 2011 risk assessment for the EITC Program. The EITC Program was previously determined to be high risk for improper payments, and the Department of the Treasury reported on the EITC Program as a high-risk program in its Fiscal Year 2011 Annual Financial Report.

IRS Program	Type of Program	Level of Risk
Grants for Investments in Qualified Therapeutic Projects in Lieu of Tax	Revenue	Low
Health Care Credit	Revenue	Low
Homebuyers Credit	Revenue	Low
Informant Reimbursement	Revenue	Low
Making Work Pay Credit	Revenue	Low
Refund Collection	Revenue	Low
Refund Collection Interest	Revenue	Low
Stimulus Disbursements	Revenue	Low

Source: IRS Office of the Chief Financial Officer.

Appendix V

Treasury Inspector General for Tax Administration Reports Issued on Refundable Tax Credits

The TIGTA issued 12 reports between June 2010 and June 2012 that reported problems with the IRS's processing of refundable tax credits, listed below.

- Ref. No. 2010-41-069, *Additional Steps Are Needed to Prevent and Recover Erroneous Claims for the First-Time Homebuyer Credit* (June 2010).
- Ref. No. 2010-41-128, *Verifying Eligibility for Certain New Tax Benefits Was a Challenge for the 2010 Filing Season* (Sept. 2010).
- Ref. No. 2011-41-002, *Overall the Making Work Pay Credit Was Implemented As Intended by the Congress, but Resulted in Many Taxpayers Owing Taxes With Their Returns* (Nov. 2010).
- 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).
- Ref. No. 2011-40-032, *Interim Results of the 2011 Filing Season* (Mar. 2011).
- Ref. No. 2011-41-035, *Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits* (Mar. 2011).
- Ref. No. 2011-41-061, *Individuals Who Are Not Authorized to Work in the United States Were Paid $4.2 Billion in Refundable Credits* (Jul. 2011).
- Ref. No. 2011-41-083, *Billions of Dollars in Education Credits Appear to Be Erroneous* (Sept. 2011).
- Ref No. 2011-40-128, *The Passage of Late Legislation and Incorrect Computer Programming Delayed Refunds for Some Taxpayers During the 2011 Filing Season* (Sept. 2011).
- Ref. No. 2012-41-013, *The Internal Revenue Service Disallowed Erroneous First-Time Homebuyer Credits Totaling $1.6 Billion; However, Its Examination Resources Could Have Been Used More Effectively* (Feb. 2012).
- Ref. No. 2012-40-036, *Interim Results of the 2012 Filing Season* (Mar. 2012).
- Ref. No. 2012-40-065, *Processes to Address Erroneous Adoption Credits Result in Increased Taxpayer Burden and Credits Allowed to Nonqualifying Individuals* (June 2012).

Appendix VI

Management's Response to the Draft Report

CHIEF FINANCIAL OFFICER

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

December 20, 2012

MEMORANDUM FOR MICHAEL E. MCKENNEY
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Pamela J. LaRue
Chief Financial Officer

SUBJECT: Draft Audit Report – Improper Payments Elimination and Recovery Act Risk Assessments of Revenue Programs Are Unreliable (Audit # 201240011.02)

Thank you for the opportunity to review and respond to the draft report titled, "Improper Payments Elimination and Recovery Act Risk Assessments of Revenue Programs Are Unreliable" (Audit # 201240011.02).

We agree with your recommendations on addressing the IPERA process and our proposed corrective actions are discussed in the attachment. However, in your report, you state that *"the IRS Chief Financial Officer indicated that the Office of Management and Budget has exempted tax refunds from the improper payment reporting requirements. However, the IRS was unable to provide us with a copy of the exemption."* While the documentation we provided TIGTA from the Office of Management and Budget (OMB) does not exempt tax refunds from the requirements, it does confirm the decision made by OMB that the Earned Income Tax Credit (EITC) is the only IRS tax program that should be reported under the Improper Payments Elimination and Recovery Act (IPERA). This decision was based on the fact that payments from tax refunds are included in the tax gap estimates in the over-claim rates and should continue to be reported and addressed as part of the overall plan for reducing the tax gap.

If you have any questions, please contact William Maglin, Associate Chief Financial Officer, Financial Management, at (202) 435-5540.

Attachment

Attachment

RECOMMENDATION 1
The IRS CFO should work with the Department of the Treasury, Office of the Deputy Chief Financial Officer, Risk and Control Group, to better identify the IRS programs to be assessed for improper payment risk and refine the Questionnaire to ensure all questions are applicable to tax administration and more accurately reflect the risks associated with tax refund payments.

CORRECTIVE ACTION
The IRS agrees with this recommendation. The CFO will work with the Department of the Treasury, Office of the Deputy Chief Financial Officer, Risk and Control Group, and the impacted IRS business executives to identify the IRS programs that should be assessed for improper payment risk, and will refine the Questionnaires that do not appropriately address applicable tax administration and tax refund payment risks.

IMPLEMENTATION DATE
March 31, 2013

RESPONSIBLE OFFICIAL
Chief Financial Officer

CORRECTIVE ACTION MONITORING PLAN
N/A

RECOMMENDATION 2
The IRS CFO should establish a formal process for assigning responsibility for the completion of the annual risk assessments for the selected IRS programs to the appropriate IRS executive.

CORRECTIVE ACTION
The IRS agrees with this recommendation. The CFO will establish a more formalized process working with the IRS business executives for assigning responsibility and completing the annual risk assessments for the selected programs. The CFO will maintain oversight over the process to ensure the annual risk assessments are completed timely and accurately.

IMPLEMENTATION DATE
April 30, 2013

RESPONSIBLE OFFICIAL
Chief Financial Officer

CORRECTIVE ACTION MONITORING PLAN
N/A

2

RECOMMENDATION 3
The IRS CFO should develop a process to ensure the Department of the Treasury guidance regarding the performance of risk assessments is being followed. The process should (1) ensure that the members of the team completing the risk assessment collectively possess knowledge of all aspects of the IRS programs being reviewed, (2) include the type of documentation to be relied upon when completing the assessments, and (3) ensure documentation is maintained for five years.

CORRECTIVE ACTION
The IRS agrees with this recommendation. The CFO will work with the appropriate IRS business executives to develop internal guidance to ensure the Department of Treasury guidance for performing the annual risk assessments is being followed, and ensure those completing the risk assessments have the proper knowledge of the programs being reviewed. The guidance will also ensure the appropriate program documentation is being relied on to determine the associated risks and that it will be maintained for five years.

IMPLEMENTATION DATE
April 30, 2013

RESPONSIBLE OFFICIAL
Chief Financial Officer

CORRECTIVE ACTION MONITORING PLAN
N/A