# The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply With the Improper Payments Elimination and Recovery Act

**March 31, 2014**

**Reference Number: 2014-40-027**



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**THE INTERNAL REVENUE SERVICE FISCAL YEAR 2013 IMPROPER PAYMENT REPORTING CONTINUES TO NOT COMPLY WITH THE IMPROPER PAYMENTS ELIMINATION AND RECOVERY ACT**

# Highlights

**Final Report issued on March 31, 2014**

Highlights of Reference Number: 2014-40-027 to the Internal Revenue Service Chief Financial Officer.

## IMPACT ON TAXPAYERS

The Improper Payments Elimination and Recovery Act (IPERA) of 2010 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 Agency Financial Report.* The IRS estimates that 22 to 26 percent of EITC payments were issued improperly in Fiscal Year 2013. The dollar value of these improper payments was estimated to be between $13.3 billion and $15.6 billion.

## WHY TIGTA DID THE AUDIT

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 assess the IRS's compliance with the IPERA. The scope of this review included an assessment of EITC information the IRS provided for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2013* and a review of the IRS's progress on previous recommendations.

## WHAT TIGTA FOUND

The IRS continues to not provide all required IPERA information to the Department of the Treasury for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2013*. For the third consecutive year, the IRS did not publish annual reduction targets or report an improper payment rate of less than 10 percent for the EITC.

IRS management has indicated that the IRS and the Department of the Treasury are in continued discussions with the Office of Management and Budget to obtain its approval to develop supplemental measures that are appropriate to gauge the impact of EITC compliance and outreach efforts in lieu of developing error reduction targets.

Finally, although risk assessments were performed for each of the programs that the Department of the Treasury required the IRS to assess, the risk assessment process still may not provide a valid assessment of improper payments in tax administration. As such, the EITC remains the only revenue program fund to be considered at high risk for improper payments.

## WHAT TIGTA RECOMMENDED

TIGTA made no recommendations in this report.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

March 31, 2014

**MEMORANDUM FOR** CHIEF FINANCIAL OFFICER

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

**SUBJECT:** Final Audit Report – The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply With the Improper Payments Elimination and Recovery Act (Audit # 201440018)

This report presents the results of our annual review of the Internal Revenue Service's (IRS) compliance with the requirements of the Improper Payments Elimination and Recovery Act (IPERA) of 2010[1] for Fiscal Year 2013. The IPERA requires the Treasury Inspector General for Tax Administration (TIGTA) to review annually the IRS's compliance with these requirements. This audit is included in our Fiscal Year 2014 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 V. Subsequent to our audit testing, the IRS received and provided to TIGTA official guidance from the Office of Management and Budget approving the establishment of supplemental measures for use in evaluating the incremental reduction in Earned Income Tax Credit improper payments. As noted in the IRS management response, the development of these supplemental measures is ongoing. As such, the guidance does not affect the IRS's compliance with Fiscal Year 2013 IPERA reporting requirements. We plan to evaluate the establishment and use of these supplemental measures in subsequent annual reviews of improper payments.

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

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[1] Pub. L. No. 111-204, 124 Stat. 2224

# *Table of Contents*

# *Abbreviations*

| | |
|---|---|
| EITC | Earned Income Tax Credit |
| IPERA | Improper Payments Elimination and Recovery Act of 2010 |
| IRS | Internal Revenue Service |
| NRP | National Research Program |
| TIGTA | Treasury Inspector General for Tax Administration |

# *Background*

Generally, an improper payment is defined as a payment that should not have been made or that was made in an incorrect amount or to an ineligible recipient. Improper payments by Federal Government agencies have been an issue for many years. Various ways have been put forth to identify, measure, and reduce them, including laws specifically addressing improper payments, an executive order, and guidance by certain oversight agencies such as the Office of Management and Budget. In addition, agency Inspectors General serve a role by evaluating agency information related to improper payments.

The Improper Payments Information Act 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 the agency is taking to reduce improper payments. It 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 Improper Payments Elimination and Recovery Act of 2010 amended the Improper Payments Information Act of 2002***

The President signed the Improper Payments Elimination and Recovery Act (IPERA) of 2010[2] into law on July 22, 2010. The IPERA amends the Improper Payments Information Act of 2002 by strengthening agency reporting requirements and redefining "significant improper payments." Significant is defined as gross annual improper payments (*i.e.*, the total amount of overpayments plus underpayments) made in the program during the fiscal year[3] reported that exceeded (a) both 2.5 percent of program outlays and $10 million of all program or activity payments or (b) $100 million. The IPERA requires the Treasury Inspector General for Tax Administration (TIGTA) to annually review the IRS's compliance with the IPERA reporting requirements.

Our evaluation of the IRS's compliance with the IPERA is incorporated into the Department of the Treasury Office of Inspector General's annual assessment of the Department of the Treasury's compliance with the IPERA. Fiscal Year 2013 was the third year Inspectors General were required to assess agencies' compliance with the IPERA. The Treasury Inspector General

[1] Pub. L. No. 107-300, 116 Stat. 2350.
[2] Pub. L. No. 111-204, 124 Stat. 2224.
[3] A 12-consecutive-month period ending on the last day of any month. The Federal Government's fiscal year begins on October 1 and ends on September 30.

is required to issue a report on the annual assessment of the Department of the Treasury's compliance with the IPERA by April 15, 2014.

In addition, Executive Order 13520, *Reducing Improper Payments and Eliminating Waste in Federal Programs*, signed by the President on November 20, 2009, further increases 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. TIGTA's evaluation of this information is published in a separate report, the most recent being in Calendar Year 2013.[4]

## IPERA process to identify IRS programs for improper payment risk assessment

The Department of the Treasury identifies the programs that the IRS must assess for the risk of improper payments. The IRS used the Improper Payments Elimination and Recovery Risk Assessment Questionnaire for Fiscal Year 2013 (the Questionnaire) and related guidance provided by the Department of the Treasury to assess the level of risk for each identified program. The Questionnaire computes a risk score for each program based on the IRS's response 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 the risk score ranges and considers programs with a risk score of 0 to 11 as low risk, 12 to 28 as medium risk, and 29 and greater as high risk.

The IRS is required to forward the results and documentation for all risk assessments to the Department of the Treasury. Appendix IV provides a list of the IRS programs the Department of the Treasury identified for an improper payment risk assessment for Fiscal Year 2013. For any program identified as having a high risk for improper payments, the IRS must provide the following information to the Department of the Treasury for inclusion in the Department's 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.
- A discussion of any limitations to the IRS's ability to reduce improper payments.

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

The Earned Income Tax Credit (EITC) has previously been declared a high-risk program by the Office of Management and Budget; therefore, no risk assessment is required to be prepared for it. The EITC is currently the only IRS high-risk program and the only one with information included in the agency financial report.

## *The IRS uses a statistically valid method to estimate EITC improper payments based on compliance information*

The IRS uses the National Research Program (NRP) as the primary source of data to estimate the annual EITC improper payment rate. The NRP provides the IRS with compliance information that is statistically representative of the taxpayer population. Updated estimates of taxpayer compliance are computed for each tax year.[5] The IRS uses each tax year's NRP results to update the EITC improper payment rate.

Although the NRP process results in a more current estimate of the accuracy of EITC claims than previous methods, the estimated improper payment rate for a given fiscal year is not based on current year data. Because of the time it takes to complete the annual NRP, the IRS's annual estimate of the improper payment rate is based on data that are approximately three years old. For example, EITC improper payment rates for Fiscal Year 2013 are based on information from Tax Year 2009 tax returns that were processed in Calendar Year 2010.

This review was performed with information obtained from the Office of the Chief Financial Officer and the Office of Research, Analysis, and Statistics, both located at the IRS National Headquarters in Washington, D.C., during the period November 2013 through March 2014. The scope of this review included verifying that required risk assessment Questionnaires were completed, verifying that the EITC information the IRS provided for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2013* was accurate, and reviewing the IRS's progress on previous recommendations. 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.

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[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.

# Results of Review

## The Internal Revenue Service Continues to Not Comply With Improper Payments Elimination and Recovery Act Requirements

The IRS continues to not provide all required IPERA information to the Department of the Treasury for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2013*. For the third consecutive year, the IRS did not publish annual reduction targets or report an improper payment rate of less than 10 percent for the EITC. According to the IPERA, continued noncompliance will result in additional reporting requirements as well as a review of Department of the Treasury, and potentially IRS, funding by the Office of Management and Budget. Figure 1 provides a summary of our evaluation of IRS compliance with the IPERA.

***Figure 1: IRS Compliance With Improper Payment Requirements for the EITC Program for Fiscal Years 2011 Through 2013***

| IPERA Requirement | Provided by the IRS | | |
|---|---|---|---|
| | **Fiscal Year 2011** | **Fiscal Year 2012** | **Fiscal Year 2013** |
| Conduct a program-specific risk assessment for each program or activity that conforms with Section 3321 of Title 31 U.S.C. | Yes | Yes | Yes |
| Publish a programmatic corrective action plan for the EITC. | Yes | Yes | Yes |
| Publish an improper payment estimate for the EITC. | Yes | Yes | Yes |
| Publish annual reduction targets for the EITC and discuss progress toward meeting those targets. | No | No | No |
| Report an improper payment rate of less than 10 percent for the EITC. | No | No | No |
| Report on efforts to recapture EITC improper payments. | Yes | Yes | Yes |

*Source: TIGTA's review of IRS EITC information provided to the Department of the Treasury for inclusion in the Department of the Treasury Agency Financial Reports for Fiscal Years 2011 through 2013.*

As Figure 2 illustrates, the IRS has made little improvement in reducing EITC improper payments since being required by the Improper Payments Information Act of 2002 to report estimates of these payments to Congress.

**Figure 2: Estimated EITC Improper Payments for Fiscal Years 2003 Through 2013**

| Fiscal Year | Minimum Improper Payments[6] Percentage | Maximum Improper Payments Percentage | Minimum Improper Payments Dollars (Billions) | Maximum Improper Payments Dollars (Billions) |
|---|---|---|---|---|
| 2003 | 25% | 30% | $9.5 | $11.5 |
| 2004 | 22% | 27% | $8.6 | $10.7 |
| 2005 | 23% | 28% | $9.6 | $11.4 |
| 2006 | 23% | 28% | $9.8 | $11.6 |
| 2007 | 23% | 28% | $10.4 | $12.3 |
| 2008 | 23% | 28% | $11.1 | $13.1 |
| 2009 | 23% | 28% | $11.2 | $13.3 |
| 2010 | 24% | 29% | $15.3 | $18.4 |
| 2011 | 21% | 26% | $13.7 | $16.7 |
| 2012[7] | 21% | 25% | $11.6 | $13.6 |
| 2013 | 22% | 26% | $13.3 | $15.6 |
| Total | | | $124.1 | $148.2 |

*Source: Department of the Treasury Performance and Accountability Reports for Fiscal Years 2003 through 2010 and Department of Treasury Agency Financial Reports for Fiscal Years 2011 through 2013.*

As we reported in August 2013,[8] the IRS's estimates of Fiscal Year 2012 improper EITC payments were understated. They were based on the assumption that a provision in the American Recovery and Reinvestment Act of 2009 (Recovery Act)[9] that increased the EITC for certain taxpayers would expire at the end of 2010. However, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[10] extended the provision through December 2012. It was later extended through December 2017 by the American Taxpayer

[6] For Fiscal Year 2005 through Fiscal Year 2009, the IRS computed the minimum and maximum improper payment rates (referred to as the upper and lower bounds) using different sets of assumptions concerning the compliance of EITC claimants who fail to show up for the NRP audit.
[7] The Fiscal Year 2012 improper payment estimates were understated. The estimates do not reflect the extension of the additional EITC for families with three or more children.
[8] TIGTA, Ref. No. 2013-40-084, *The Internal Revenue Service Is Not in Compliance With Executive Order 13520 to Reduce Improper Payments* (Aug. 2013).
[9] Pub. L. No. 111-5, 123 Stat. 115 (2009).
[10] Pub. L. No. 111-312,124 Stat. 3299 (2010).

Relief Act of 2012.[11] The IRS's estimates did not take into account the extension of the additional EITC for families with three or more children. As a result, the Fiscal Year 2012 improper payment estimates were understated. The extended EITC provision was correctly included in the IRS's Fiscal Year 2013 estimates of EITC improper payments.

The Fiscal Year 2013 estimates also include EITC underpayments, which have not been included in IRS's estimates in the past. The *Department of the Treasury Agency Financial Report Fiscal Year 2013* states that underpayments increased the overall improper payment rate by less than 0.05 percent. The IRS estimate of $60.3 billion total EITC claims in Fiscal Year 2013 was used to calculate the estimated minimum and maximum EITC improper payment amounts. The estimated improper payment rate and resulting dollar estimates will increase or decrease as the number and/or amount of EITC claims received in a given tax year increases or decreases.

### *Improper payment risk assessments may not provide a reliable assessment of the risk of improper payments in tax administration*

In January 2013, TIGTA reported[12] that the IPERA risk assessment process did not provide a reliable assessment of improper payment risk for IRS revenue program funds.[13] We found that the definition of an IRS program affects the reliability of the risk assessment. 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 (e.g., the verification of one tax credit) may significantly underestimate the risk of improper payments to tax administration.

In addition, we reported that risk assessments were not performed in compliance with Department of the Treasury guidelines. 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. However, the IRS assigned completion of some of the risk assessments to individual employees who were not always knowledgeable about the program fund being assessed. In addition, the IRS did not maintain adequate documentation to support its assessment.

Finally, we reported that the Questionnaire did not effectively address risks associated with tax refund payments. We found that the Questionnaire contained questions that did not apply to the IRS's revenue program funds, yet an answer to these questions was required. Specifically, for those questions that applied to tax administration, the Questionnaire required a yes or no

[11] Pub. L. No. 112-240,126 Stat. 2319 (2013).
[12] TIGTA, Ref. No. 2013-40-015, *Improper Payments Elimination and Recovery Act Risk Assessments of Revenue Programs Are Unreliable* (Jan. 2013).
[13] The IRS's custodial activity includes revenues collected and refunds disbursed. However, in this report the general term "revenue" is used in place of "custodial." The revenue program funds for which the IRS performed risk assessments generally represent specific individual tax credits or refund payments.

response to these questions. Depending on the response to these questions, the program's risk score could be affected. We 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.

In response to our audit recommendations, the IRS met with the Department of the Treasury to revise the risk assessment Questionnaire for revenue funds. In addition, the Office of the Chief Financial Officer provided the business units with Fiscal Year 2013 IPERA guidance from the Department of the Treasury that included a required documentation retention period of five years. The Office of the Chief Financial Officer worked with the business unit executives to ensure that the appropriate subject matter experts were identified and participated in the review process. Following Department of the Treasury guidance, the business units developed risk assessment teams with the knowledge and experience to ensure the accuracy of the risk assessment of the revenue programs. However, no changes were made to how IRS programs were identified to be assessed for improper payment risk pending the result of ongoing discussions among the IRS, Department of the Treasury, and the Office of Management and Budget regarding which IRS programs are to be evaluated under improper payment legislation. As such, the Department of the Treasury still selects the fund groups for evaluation based on each fund groups' materiality to the IRS financial statements rather than by significant broad-based IRS program activities.

***Documentation was provided to support IRS 2013 risk assessments; however, the risk assessment process still may not provide a valid assessment of improper payments in tax administration.***

During the course of this review, we were provided with documentation showing that risk assessments were performed for each of the programs that the Department of the Treasury required the IRS to assess. For Fiscal Year 2013, the Department of the Treasury selected 25 program fund groups for review—six administrative program funds and 19 revenue program funds.[14] However, the process still may not provide a valid assessment of improper payments in tax administration. The EITC remains the only revenue program fund to be considered at high risk for improper payments; there is no effective process to address the continued risks associated with improper tax refund payments resulting from other refundable tax credits[15] and tax refund fraud. According to IRS management, the IRS and the Department of the Treasury are continuing to meet with the Office of Management and Budget to determine the best way to

[14] See Appendix IV. Note: The EITC Program has been declared a high-risk program for improper payments by the Office of Management and Budget; therefore, no formal risk assessment is required for it.
[15] 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.

address improper tax refunds, including which revenue refund accounts to include in the annual risk assessment process. Currently, improper EITC payments are addressed under the IPERA, with improper tax refunds addressed as part of the IRS's efforts to reduce the Tax Gap.[16] This is despite the Office of Management and Budget guidance on the IPERA that defines an improper payment as:

> *"…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."*

As such, tax refunds resulting from refundable tax credits and tax refund fraud paid by the IRS in error are an improper payment and the programs that resulted in the erroneous refund should be evaluated under the IPERA. While the IRS has developed a number of initiatives for reducing the Tax Gap, the IPERA is the only mechanism that requires the IRS to evaluate the causes of improper payments, assess whether the IRS has the tools it needs to effectively reduce improper payments, and report to TIGTA and the Office of Management and Budget on the processes and programs it uses or plans to use to reduce improper payments.

### *The regulation of paid tax return preparers was previously cited as the IRS's most promising initiative to reduce EITC improper payments; however, Federal courts have ruled that the IRS does not have this regulation authority*

The IRS announced a plan in January 2010 to register, license, and create enforcement tools that would impact the paid return preparer community more broadly. IRS management expected the new return preparer program (consisting of registration, testing, education, and enforcement) to have a positive impact on overall paid preparer compliance. These activities were to be implemented over a three-year period. In a February 2011 TIGTA report,[17] the IRS noted that its efforts to regulate tax return preparers would drive increased EITC compliance, decrease fraud, and reduce the improper payment rate. IRS management stated that the tax return preparer initiative was the IRS's most promising avenue to substantially reduce erroneous EITC payments. The IRS further indicated that evidence suggests that unscrupulous preparers contribute to overall improper EITC claims. Paid return preparers assisted in the preparation of approximately 66 percent of all EITC claims in Tax Year 2008.

However, on January 18, 2013, a Federal Court enjoined the IRS from enforcing the regulatory requirements for registered tax return preparers. The IRS appealed the Federal Court's decision. On February 11, 2014, the Federal Appeals Court ruled that the IRS does not have the authority to regulate tax preparers by requiring them to pay an annual fee, pass a qualifying exam, and take

[16] The Tax Gap is the estimated difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time
[17] 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).

annual continuing education. Although the IRS has a number of programs to monitor and address tax return preparer EITC compliance, these programs require IRS resources to investigate and assist tax return preparers in becoming compliant. As a result, the effectiveness of these programs is limited to the availability of resources. The February 2014 Federal Appeals Court ruling means that the IRS can no longer prevent tax return preparers who do not meet minimum proficiency requirements from filing tax returns on behalf of taxpayers, including those claiming the EITC.

The Court ruling materially affects the basis on which the IRS planned to establish a baseline for meaningful reduction targets as previously indicated. The IRS indicated in its response to our 2012 report[18] that Fiscal Year 2011 was the first year of a three-year ramp-up of this initiative. IRS management indicated that after the program is fully established, the IRS will have a baseline against which it can set meaningful reduction targets. However, the IRS can no longer implement the most beneficial aspects of the tax return preparer initiative.

The IRS did not provide the Department of the Treasury or TIGTA with quantifiable improper payment reduction targets for the EITC as required by the IPERA for a third consecutive year. IRS management has indicated that the IRS and the Department of the Treasury are in continued discussions with the Office of Management and Budget to obtain its approval to develop supplemental measures that are appropriate to gauge the impact of EITC compliance and outreach efforts in lieu of developing error reduction targets. As part of these discussions, the IRS and the Department of the Treasury should also obtain input from the Office of Management and Budget as to an acceptable baseline against which improvement can be measured. The IRS has not provided us with documentation detailing the content of the discussions of those meetings or with a time frame for the development of the supplemental measures.

[18] 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).

**Appendix I**

# Detailed Objective, Scope, and Methodology

The overall objective of this review was to assess the Internal Revenue Service's (IRS) compliance with the requirements of the Improper Payments Elimination and Recovery Act (IPERA) of 2010[1] for Fiscal Year 2013. The IPERA requires TIGTA to review annually the IRS's compliance with the IPERA reporting requirements. 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 2013* and a review of the IRS's progress on previous recommendations. To accomplish our objective, we:

I. Determined if certain conditions identified in prior TIGTA audits still exist. We reviewed the Department of the Treasury's Joint Audit Manager Enterprise System reports, discussed the IRS's corrective actions with management, and determined if the previous recommendations and goals had been implemented.

II. Determined if the information the IRS provided for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2013* complied with the IPERA reporting requirements. We compared the information contained in the agency financial report to the IPERA reporting requirements outlined in the Office of Management and Budget Circular A-123, *Management's Responsibility for Internal Control*, guidance on improper payment reporting. We also compared the information provided by the IRS to the Department of the Treasury with the information contained in the agency financial report to ensure that the information was accurately reflected in the report. We evaluated the accuracy of the IRS's estimate of the EITC improper payment rate and the associated dollar projections.

## ***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 reporting requirements established in the IPERA. We tested these controls by reviewing and analyzing relevant documents, data, and calculations related to preparation of IPERA improper payment estimate information.

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[1] Pub. L. No. 111-204, 124 Stat. 2224

**Appendix II**

# *Major Contributors to This Report*

Russell P. Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services)
Deann L. Baiza, Director
Roy E. Thompson, Audit Manager
Jane G. Lee, Lead Auditor
Karen C. Fulte, Senior Auditor

## Appendix III

# Report Distribution List

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- Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PEI
- Research, Analysis, and Statistics  RAS

## 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 2013.

| IRS Program | Type of Program | Level of Risk Identified |
|---|---|---|
| Affordable Health Care Program | Administrative | Low |
| Business Systems Modernization | Administrative | Low |
| Federal Highway Administration (FHWA) Allocation Account | Administrative | Low |
| Information Systems | Administrative | Low |
| Tax Law Enforcement | Administrative | Low |
| Taxpayer Services | Administrative | Low |
| Adoption Credit | Revenue | Low |
| Alternative Minimum Tax Credit Refunds | Revenue | Low |
| American Opportunity Credit | Revenue | Low |
| Build America Bonds | Revenue | Low |
| Child (Tax) Credit Payments | Revenue | Low |
| Consolidated Omnibus Budget Reconciliation Act (COBRA) Credit | Revenue | Low |
| Corporation Tax Credit Refunds | Revenue | Low |
| EITC Disbursements[1] | Revenue | High |
| Health Care Credit Payments | Revenue | Low |
| Home Buyers Credit Refunds | Revenue | Low |
| Informant Reimbursement | Revenue | Low |
| Making Work Pay Credit | Revenue | Low |

[1] The EITC Program has been declared a high-risk program for improper payments by the Office of Management and Budget; therefore, no formal risk assessment is required for it.

| IRS Program | Type of Program | Level of Risk Identified |
|---|---|---|
| New Clean Renewable Energy Bonds | Revenue | Low |
| Qualified Energy Conservation Bond | Revenue | Low |
| Qualified Zone Academy Bonds | Revenue | Low |
| Qualified School Construction Bonds | Revenue | Low |
| Refund Collection | Revenue | Low |
| Refund Collection – Interest | Revenue | Low |
| Small Business Health Insurance Tax Credit | Revenue | Low |

*Source: IRS Office of the Chief Financial Officer.*

## Appendix V

# Management's Response to the Draft Report

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

CHIEF FINANCIAL OFFICER

March 27, 2014

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

FROM: Robin L. Canady
Chief Financial Officer

Robin L. Canady

SUBJECT: Draft Audit Report –The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply With the Improper Payments Elimination and Recovery Act (Audit # 201440018)

We have reviewed the draft report titled, *"The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply With the Improper Payments Elimination and Recovery Act"* (IPERA). Our response is provided below.

As you correctly stated in your report, the IRS and the Department of the Treasury (Treasury) were in continued discussions with the Office of Management and Budget (OMB) during your audit testing period to obtain a formal letter from OMB: (1) approving the use of supplemental measures to gauge the impact of Earned Income Tax Credit (EITC) compliance and outreach efforts in lieu of error reduction targets; and (2) determining which non-EITC refunds are required to be reported under IPERA and which will continue to be reported as part of the tax gap. We appreciate TIGTA's collaboration and willingness to give us the opportunity to obtain this letter from OMB prior to the issuance of your report, and we understand that because the letter was received on March 20, 2014, TIGTA was not able to review and determine how OMB's decisions affected the IRS' compliance with IPERA in Fiscal Year (FY) 2013.

We appreciate your acknowledgement that the IRS revised the risk assessment questionnaire for revenue funds, provided the business units with FY 2013 IPERA guidance that included a required documentation retention period of five years, and worked with the business unit executives to ensure that the appropriate subject matter experts were identified and participated in this year's review process, all in response to your audit recommendations. We are also pleased to report that the guidance we received in the OMB letter will resolve the reported non-compliance areas in your report. The OMB letter formally states

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that by IRS establishing supplemental measures and reporting them along with the annual reported improper payment estimates, Treasury and the IRS will fulfill specific requirements found in Executive Order 13520 and IPERA. The IRS is continuing to develop these measures and anticipates meeting with OMB to obtain their concurrence and provide the measures to Treasury, along with our annual EITC error estimates for reporting in the FY 2014 Annual Financial Report.

The OMB letter also states it is reasonable for the IRS to exempt reporting refunds made without relation to any refundable tax credit program (i.e., those payments made for tax withholdings) from improper payments requirements. For the non-EITC refundable credits, OMB states the IRS should continue to perform risk assessments on all IPERA-implicated refundable tax credit programs, but OMB agrees that in cases of returns filed with multiple refundable credits, it is reasonable that non-compliance related to those non-EITC credits will continue to be estimated as part of the tax gap estimation program. OMB suggests that Treasury describe this determination in their Annual Financial Report, including identification of any statutory barriers to meeting requirements.

If you have any questions, please contact me at (202) 317-6400, or a member of your staff may contact John Pekarik, Acting Associate Chief Financial Officer, Corporate Planning and Internal Control, at (202) 317-4038.