



*Additional Actions Are Needed to
Ensure That Improper Fuel Tax
Credit Claims Are Disallowed*

September 26, 2014

Reference Number: 2014-30-067

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.

Redaction Legend:

1 = Tax Return/Return Information

2 = Risk Circumvention of Agency Regulation or Statute

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HIGHLIGHTS

ADDITIONAL ACTIONS ARE NEEDED TO ENSURE THAT IMPROPER FUEL TAX CREDIT CLAIMS ARE DISALLOWED

Highlights

**Final Report issued on
September 26, 2014**

Highlights of Reference Number: 2014-30-067 to the Internal Revenue Service Commissioners for the Small Business/Self-Employed and the Wage and Investment Divisions.

IMPACT ON TAXPAYERS

Taxpayers are allowed to claim a fuel tax credit on their individual tax returns to offset the amount of any Federal taxes paid on fuel used for off-highway business purposes, such as farming or commercial fishing. In Processing Years 2011 through 2013, approximately \$694 million in fuel tax credits were claimed by individual taxpayers. A significant number of the claims for these credits are potentially improper. For the past several years, the IRS has included fuel tax credit scams on its annual list of the "Dirty Dozen" tax scams.

WHY TIGTA DID THE AUDIT

This audit was initiated to evaluate whether opportunities exist to improve the return classification and examination processes for individual income tax returns claiming a fuel tax credit.

WHAT TIGTA FOUND

TIGTA's evaluation of data from Processing Years 2011 through 2013 indicates that a total of 4,004 Forms 1040, *U.S. Individual Income Tax Return*, claiming a fuel tax credit at or above the threshold amount for manual screening were not properly coded for review, and credits totaling approximately \$47.2 million may have been erroneously released to taxpayers.

Furthermore, there were 198,395 returns with fuel tax credit claims below the manual screening threshold amount that were questionable because they did not report any business income to support the business use of

the fuel. These lower claim amounts are generally not selected for review due to current IRS policy. As a result, approximately \$120.5 million in questionable fuel tax credit claims may have been allowed in the three years reviewed.

TIGTA's evaluation indicates that a combination of factors caused the questionable claims to be released and that actions can be taken at the processing and examination levels to better ensure that fuel tax credit claims are refunded only when appropriate. Without improved controls and processes to prevent the issuance of questionable refunds, millions of dollars in Federal tax revenue will be lost each year.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS: 1) use systemic controls to ensure that all Forms 1040 claiming a fuel tax credit at the threshold amount or above are manually reviewed prior to refund issuance; 2) if additional auditing resources become available, consider lowering the systemic threshold amount for selecting and reviewing Forms 1040 claiming a fuel tax credit that report only wage income; and 3) provide managers and examiners with additional training and procedures to determine acceptable supporting documentation for fuel tax credit claims as well as to review amended returns when the original return has been adjusted beyond removing the fuel tax credit.

In response to the report, IRS officials agreed with the recommendations and stated that they have taken or plan to take appropriate corrective actions.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 26, 2014

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Additional Actions Are Needed to Ensure That
Improper Fuel Tax Credit Claims Are Disallowed (Audit # 201230024)

This report presents the results of our review to evaluate whether opportunities exist to improve the return classification and examination processes for individual income tax returns claiming a fuel tax credit. This audit is included in our Fiscal Year 2014 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

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 Bryce Kisler, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations).



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Abbreviations

FRP	Frivolous Return Program
FY	Fiscal Year
IMF	Individual Master File
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
IRTF	Individual Return Transaction File
PY	Processing Year
RICS	Return Integrity and Correspondence Services
SSA	Social Security Administration
TIGTA	Treasury Inspector General for Tax Administration



Additional Actions Are Needed to Ensure That Improper Fuel Tax Credit Claims Are Disallowed

Background

The Federal fuel tax on gasoline is 18.4 cents per gallon and, when combined with the taxes imposed by other levels of Government, is the second largest factor contributing to the price motorists pay for gasoline. Other types of fuel are taxed at different rates; for example, the tax on diesel fuel is 24.4 cents per gallon. Because revenues from the Federal fuel tax are used to maintain the Nation's highways, Congress enacted legislation to provide a credit to offset the amount of Federal taxes paid by taxpayers on fuel used for off-highway business purposes, such as for farming or commercial fishing. During Processing Years (PY) 2011 through 2013,¹ individual taxpayers claimed approximately \$694 million in fuel tax credits using Form 4136, *Credit for Federal Tax Paid on Fuels*.

Congress typically establishes tax credits to encourage certain activities or to provide assistance to taxpayers in certain situations. Unlike an income tax deduction, which reduces the amount of income subject to tax, a tax credit reduces the amount of taxes owed dollar for dollar. This makes a tax credit more valuable than a tax deduction of the same dollar amount for those seeking to minimize their tax liabilities. Moreover, some tax credits, such as the Earned Income Tax Credit and fuel tax credits, are refundable in certain situations, meaning that they are paid out even if there is no tax liability or the credit exceeds the amount of any income tax due.

***For the past several years,
the Internal Revenue Service
has included fuel tax credit
scams on its annual list of
“Dirty Dozen” tax scams.***

Unscrupulous individuals and criminals have been known to file fraudulent tax returns claiming improper fuel tax credits to reduce taxes and/or receive improper refunds. For the past several years, the Internal Revenue Service (IRS) has included fuel tax credit scams on its annual list of “Dirty Dozen” tax scams; for example, the IRS news release for the 2014 list states:²

Additionally, some taxpayers are filing excessive claims for the fuel tax credit. Farmers and other taxpayers who use fuel for off-highway business purposes may be eligible for the fuel tax credit. But other individuals have claimed the tax credit although they were not eligible. Fraud involving the fuel tax credit is considered a frivolous tax claim and can result in a penalty of \$5,000.

Overall responsibility for the Federal Fuel Tax Program area falls under the Excise Tax Program of the IRS's Small Business/Self-Employed Division. The Small Business/Self-Employed

¹ See Appendix VI for a glossary of terms.

² IRS News Release 2014-16, *IRS Releases the “Dirty Dozen” Tax Scams for 2014; Identity Theft, Phone Scams Lead List* (Feb. 19, 2014).



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Division's Excise Tax Program covers fuel taxes as well as other excise taxes. The Small Business/Self-Employed Division's Fuel Tax Program is responsible for conducting a wide variety of fuel-related examinations, inspections, and compliance reviews for the taxes on different types of fuel (*e.g.*, gasoline, diesel, kerosene, biodiesel, and ethanol), primarily at refineries, fuel terminals, and other approved facilities, as well as the monitoring of untaxed, dyed fuels.³

However, the IRS's Wage and Investment Division's Submission Processing function is responsible for identifying individual returns claiming fuel tax credits on Form 4136 and referring questionable returns for further examination before the refunds are issued. IRS computer programs identify Forms 1040, *U.S. Individual Income Tax Return*, claiming fuel tax credits at or above a threshold amount during the processing of the returns, based on criteria provided by the Examination function. These returns are flagged with an action code requiring manual screening to determine whether the claim is appropriate or the return should be selected for audit. If the return is selected for audit, an unallowable code is assigned to the return to freeze the portion of the refund attributable to a fuel tax credit. The audits are generally performed using correspondence by general examiners at an IRS campus or by examiners assigned to the Frivolous Return Program (FRP). As a matter of policy, the IRS does not specifically scrutinize Forms 1040 claiming a fuel tax credit below an established threshold amount.

This review was performed at the Wage and Investment Division's Submission Processing function in Austin, Texas, and the Small Business/Self-Employed Division offices in Louisville, Kentucky; Philadelphia, Pennsylvania; and Ogden, Utah, during the period August 2012 through March 2014. 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.

³ Dyed fuels are used for nontaxable off-road purposes, such as in refrigeration units on trailers, off-road equipment, and home heating. Undyed fuels may be sold tax free for use on a farm for farming purposes or to a political subdivision of a State or the District of Columbia.



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Results of Review

Although the IRS's screening filters are preventing a significant amount of questionable fuel tax credit claims from being processed, additional efforts are needed to prevent the issuance of millions of dollars in refunds from questionable claims. In PYs 2011 and 2012, the IRS's existing systems and processes prevented the issuance of approximately \$208 million in questionable fuel tax credits claimed on Forms 1040 during return processing. During the same period, approximately \$133 million in potentially questionable fuel tax credit claims were not detected, and potentially fraudulent refunds were paid to taxpayers.

The Wage and Investment Division implemented new identity theft screening filters in September 2012 that, in addition to improving the detection of potential identity theft fraud, also improved the IRS's ability to identify questionable fuel tax credit claims during return processing. For PY 2013, the IRS's systems and processes, including the newly implemented filters, prevented the issuance of \$33 million in questionable fuel tax credit claims during return processing; however, approximately \$35 million in potentially questionable claims were still not detected. Also, when questionable returns were identified and referred for further review, examiners did not always make correct decisions when allowing the fuel tax credit claims. If the IRS does not adequately detect and prevent questionable fuel tax credit claims, millions of dollars in improper refunds may continue to be erroneously released to taxpayers.

The Internal Revenue Service Did Not Always Identify Questionable Fuel Tax Credit Claims

To determine the number of individual tax returns with questionable fuel tax credit claims being processed by the IRS, we developed and reviewed a database⁴ of 1,152,278 Forms 1040 claiming a fuel tax credit during PYs 2011 through 2013.⁵ As shown in Figure 1, our analysis found that approximately \$168 million (24 percent) of the \$694 million in fuel tax credit claims for the three years were questionable based on the fact that the individuals reported no farming or other business income to support their claims. A total of 202,399 (18 percent) of the 1,152,278 returns with fuel tax credit claims of ***2*** or more filed in PYs 2011 through 2013 were questionable. The Internal Revenue Manual (IRM) states that an action code will be generated during processing that requires a manual review of any tax return filed by an individual taxpayer claiming a fuel tax credit on Form 4136 at or above a fixed threshold amount before a refund is issued; however, exception criteria provided by Examination allowed some returns to avoid identification by the action code process.

⁴ The database consists of data from the IRS's Individual Return Transaction File and Individual Master File.

⁵ See Appendix V for detailed statistical tables.



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**Figure 1: Total Form 1040 Fuel Tax Credit Filings
and Questionable Filings for PYs 2011–2013⁶**

PY	Total Form 1040 Filings With Fuel Tax Credit Claims			
	Total Claims		Questionable Claims	
	Number	Amount (millions)	Number	Amount (millions)
2011	343,666	\$166	47,413	\$46.6
2012	499,959	\$382	113,115	\$86.6
2013	308,653	\$146	41,871	\$34.6
Total	1,152,278	\$694	202,399	\$167.8

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of the IRS's individual taxpayer account information as of December 31, 2013.

**Returns with questionable fuel tax credit claims at the manual screening
threshold amount or above are not being selected for screening**

As shown in Figure 2 below, our analysis identified \$47.2 million in allowed fuel tax credit claims on 4,004 tax returns for the three-year period that were not identified for review by IRS computer systems based on the programming criteria in use. These returns were questionable because they*****2*****⁷ and no other business income that would qualify the filer to claim a fuel tax credit. These 4,004 returns claimed a fuel tax credit at or above the threshold amount that otherwise should have been selected for manual screening before the refunds were issued, but they were not selected. For example, in PY 2013, taxpayers filing Forms 1040 *****2*****and claiming a fuel tax credit reported an average gross cash income of almost \$14,000 with no other types of income on the return. However, these taxpayers also claimed an average fuel tax credit of over \$11,000, which, assuming an average cost of \$2 per gallon,⁸ would be the equivalent of spending over \$121,000 on fuel for the year. As a result of not identifying and reviewing all questionable fuel

⁶ Dollar amounts are rounded.

⁷ *****2*****
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⁸ We will use this figure throughout this report because the IRS training manual uses \$2 per gallon as the average cost of fuel.



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tax credit claims at or above the threshold amount, we estimate that a total of \$68.2 million in questionable claims may be paid for a total of five years.⁹

Figure 2: Form 1040 Fuel Tax Credit Filings and Questionable Filings at or Above Screening Threshold for PYs 2011–2013¹⁰

PY	Form 1040 Filings With Fuel Tax Credit Claims at or Above the Threshold			
	Total Claims		Questionable Claims	
	Number	Amount (millions)	Number	Amount (millions)
2011	11,171	\$74	1,360	\$20.0
2012	25,927	\$187	1,692	\$16.7
2013	8,720	\$63	952	\$10.5
Total	45,818	\$324	4,004	\$47.2

Source: TIGTA analysis of the IRS's individual taxpayer account information as of December 31, 2013.

Our discussions with IRS officials revealed that some of these returns were not coded for manual screening based on the criteria used in the IRS computer programs. IRS officials agreed that the programming criteria permitted some questionable claims to avoid the initial review, and they indicated that programming and processes have been changed to prevent similar exceptions during the 2015 Filing Season.

Millions of dollars in questionable fuel tax credit claims below the threshold amount were paid on Forms 1040 reporting only wage income

As seen in Figure 3, we identified \$120.5 million in fuel tax credit claims on 198,395 PYs 2011 through 2013 returns that reported *****2*****
r*****2*****
*****2***** but claimed fuel tax credits of at least ***2*** but below the threshold amount. The fuel tax credit is intended for taxpayers' use of fuel for an off-highway business purpose, such as for farm equipment or for commercial fishing boats.

⁹ See Appendix IV. The forecasted portion of the total assumes, among other considerations, that economic conditions and tax laws do not change.

¹⁰ Dollar amounts are rounded.



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**Figure 3: Form 1040 Fuel Tax Credit Filings and Questionable Filings
of at Least ***2** but Below the Screening Threshold for PYs 2011–2013¹¹**

PY	Form 1040 Filings With Fuel Tax Credit Claims of at Least ***2** but Below the Threshold			
	Total Claims		Questionable Claims	
	Number	Amount (millions)	Number	Amount (millions)
2011	195,870	\$86	46,053	\$26.5
2012	337,824	\$188	111,423	\$69.9
2013	173,903	\$78	40,919	\$24.0
Total	707,597	\$352	198,395	\$120.5

Source: TIGTA analysis of the IRS's individual taxpayer account information as of December 31, 2013.

In November 2012, we provided the Small Business/Self-Employed Division with information on 17,782 returns claiming a fuel tax credit in PYs 2011 and 2012 that were selected using our analysis. Of these returns, 10,694 were for taxpayers who reported only wage income, with no business income to support the fuel tax credit claim. As examination resources have become available, the IRS has opened over 6,000 examinations to date using our information and has assessed nearly \$17 million in additional taxes for the first 1,928 cases closed.

We also provided IRS's Criminal Investigation with information on 400 returns with questionable fuel tax credit claims to determine if it was tracking any of the returns under any possible fraud schemes. Our sample included 200 returns each from PYs 2011 and 2012. For each year, 100 returns had fuel tax credit claims at or above the threshold amount and 100 returns had fuel tax credit claims that were at least ***2** but below the threshold amount. Criminal Investigation informed us that it was tracking at least 50 percent of the returns we provided with fuel tax credit claims above the threshold amount, but it was tracking less than 10 percent of the returns we provided with fuel tax credit claims under the threshold. However, it was not able to tell us if any of these returns will ultimately be worked because each case is evaluated based on the type of scheme, its complexity, the dollar amount involved, and whether the case impact was sufficient enough to refer to the United States Attorney's Office for prosecution.

¹¹ Dollar amounts are rounded.



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**Recently Implemented Filters Do Not Always Identify Questionable
Fuel Tax Credit Claims**

In Calendar Year 2011, the Wage and Investment Division (which is responsible for processing most individual income tax returns) established the Return Integrity and Correspondence Services (RICS) function to consolidate responsibilities for ensuring revenue protection and refund compliance into one function. In September 2012, the RICS function implemented four new screening filters to allow the IRS to identify potentially questionable fuel tax credit claims by individuals. Although primarily focused on identifying identity theft, the new filter rules also involve determining whether returns with fuel tax credit claims above a screening amount contain the type and amount of income that would make the claim not plausible.

When processing is stopped by the new filters, a letter is sent to the taxpayer requesting that the taxpayer contact the IRS to confirm their identity. If the taxpayer responds to the letter, the processing of the return continues and a refund may be issued. If the taxpayer does not respond, the IRS removes the return from processing to prevent the issuance of a potentially erroneous refund.

As shown in Figure 4 below, our analysis found that the number and dollar amount of potentially questionable fuel tax credit claims not identified during processing was lower in PY 2013, after the IRS's new filters had been in operation for the entire processing year. In PY 2012, the IRS paid approximately \$17 million for 1,692 potentially questionable fuel tax credit claims at or above the threshold amount, while in PY 2013 the IRS paid approximately \$11 million for 952 potentially questionable claims using the same criteria.

The filters also appear to have reduced the number of potentially questionable fuel tax credit claims of at least ****2**** but below the threshold amount. In PY 2012, the IRS paid \$69.9 million for 111,423 potentially questionable fuel tax credit claims in this range. However, in PY 2013, the IRS only paid approximately \$24 million for 40,919 potentially questionable claims using the same criteria.

Figure 4: Effectiveness of the RICS Function's New Fuel Tax Credit Filters

Processing Year	Potentially Questionable Fuel Tax Credit Claims Not Identified			
	At Least **2** but Below the Threshold Amount		At or Above the Threshold Amount	
	Number	Amount (millions)	Number	Amount (millions)
2012	111,423	\$69.9	1,692	\$16.7
2013	40,919	\$24.1	952	\$10.5

Source: TIGTA analysis of the IRS's individual taxpayer database files as of December 31, 2013.



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In March 2014, we provided the Small Business/Self-Employed Division with information on 2,566 returns processed in PY 2013 that appear to be questionable based on our data analysis but were not selected by the IRS's filters. Of these, 952 returns claimed fuel tax credits at or above the threshold amount. More than 1,600 of the 2,566 returns claimed fuel tax credits of at least ***2*** but below the threshold amount, but they reported only wage income with no business or supplemental income reported on Schedule C, Schedule E, or Schedule F. The IRS plans to analyze these returns and open examinations as resources become available.

Some Form 1040 filers claiming fuel tax credits were prisoners or deceased persons

To determine if any fuel tax credit claims were made by prisoners, we matched the IRS's Individual Return Transaction File (IRTF) to the IRS's Prisoner File for PYs 2011 and 2012 and identified approximately \$2 million in refunds for 1,901 questionable fuel tax credit claims on Forms 1040 that were sent to individuals reported to be in prison for the entire year covered by the tax return.¹² We also matched the same IRTF data to Social Security Administration (SSA) data on deceased persons and found refunds totaling \$265,605 from 135 questionable fuel tax credit claims that were sent to individuals who were reported as deceased for the entire year covered by the tax return.

The IRS compiles a Prisoner File from the Federal Bureau of Prisons and State Departments of Corrections. Various IRS offices and functions use the Prisoner File to detect and prevent fraud committed by prisoners, including the filing of fraudulent tax returns. In December 2012, TIGTA reported that, despite increased efforts by the IRS to improve the accuracy of the Prisoner File,¹³ not all prisoner information contained in the file is accurate. In the report, the IRS stated that it was deploying new programming and procedures for the Prisoner File in Calendar Year 2013. Because the recommendations from that report have not been fully implemented or reviewed by TIGTA, we will not make any additional recommendations on the Prisoner File in this report.

The SSA provides a weekly update file of Social Security Numbers, names, dates of birth, and dates of death, among other items. The IRS uses the SSA data to update its computer files to verify the identity of an individual during return processing. If a person has died, the date of death is reflected on the SSA weekly updates. Prior to Calendar Year 2013, when the IRS received a tax return notating that the taxpayer was deceased, the IRS would manually update the taxpayer account with an indicator to reflect that the taxpayer no longer had a filing requirement. This indicator was also added to a taxpayer's account if the IRS was auditing the tax return and discovered that the taxpayer was deceased. However, this process neglected deceased individuals who did not already have a filing requirement (e.g., young individuals and

¹² Account analysis as of September 2012.

¹³ TIGTA, Ref. No. 2013-40-011, *Further Efforts Are Needed to Ensure the Internal Revenue Service Prisoner File Is Accurate and Complete* (Dec. 2012).



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individuals who had little or no income), which allowed identity thieves to use these Social Security Numbers to file false returns to receive tax refunds. IRS officials told us that beginning in Calendar Year 2013, they are no longer solely relying on the manual system to update taxpayer accounts but instead have automated the process using weekly SSA data to update taxpayer accounts with an indicator that may reject a return from processing when there is a date of death appearing on the SSA data.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Use systemic controls to ensure that all Forms 1040 claiming a fuel tax credit at or above the threshold amount are manually reviewed prior to refund issuance.

Management's Response: The IRS agreed with this recommendation and stated that it has updated and revised its processes of identifying tax returns claiming the fuel tax credit for additional review.

Recommendation 2: If additional auditing resources become available, consider lowering the systemic threshold amount for selecting and reviewing Forms 1040 that only report wage income but claim a fuel tax credit.

Management's Response: The IRS agreed with this recommendation and stated that it plans to consider thresholds as an inherent part of the planning process.

Additional Guidance Could Improve Examiner Review of Fuel Tax Credit Claims

Although examiners receive some training and guidance for examining fuel tax credit claims, we found a need for additional guidance and supervision for reviewing amended returns and making a determination on acceptable documentation for supporting fuel tax credit claims. We reviewed examinations conducted during Fiscal Year (FY) 2011 by Campus correspondence examiners for returns with the fuel tax credit project codes as well as returns selected for FRP examinations. For both groups of audits, we found examiners allowed many claims to be processed without adequate supporting documentation and did not always properly review amended returns filed by potential frivolous filers.

Examiners allowed fuel tax credit claims without proper supporting documentation

During tax return processing at IRS campuses, examiners screen individual tax returns that meet the dollar threshold criteria and determine if the taxpayers' fuel tax credit claims appear reasonable. For those returns that require further review, an unallowable code is added to the



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return. When a taxpayer is selected for examination, a letter is sent to the taxpayer requesting supporting documentation, such as copies of invoices or receipts for the fuel purchases that show the Federal excise tax was paid, a list of vehicles and equipment used, and the number of gallons and types of fuel used along with the business use of each type of fuel.

During FY 2011, the IRS's Campus Correspondence Examination function conducted two fuel tax credit audit projects: Project Code 0656 (15 audits) and Project Code 0000, Source Code 03 (117 audits).¹⁴ Project Code 0656 used the following criteria to select returns for audit:

- Taxpayer claims credit as a vendor of undyed diesel fuel or kerosene and does not provide the required documentation.
- Taxpayer claims credit for undyed diesel fuel or kerosene used in farming.
- Taxpayer claims credit as a gasoline wholesale distributor.
- Taxpayer claims credit for nontaxable use when there is no obvious reason.
- Sole proprietors claiming credits as Gasohol Blenders or for Train/Intercity Bus User.
- The credit appears to be inflated or excessive.
- The amount of the credit is large for heating oil or liquefied petroleum gas.

Project Code 0000, Source Code 03, selected returns for audit based on the following criteria:

- No allowable business use of the fuel is evident on the return.
- Taxpayer claimed credit for diesel fuel or kerosene use on a farm for farming purposes.
- The credit appears to be excessive for the business activity reported on the return.
- Taxpayer claimed a credit as a gasoline wholesale distributor.
- Taxpayer did not provide the documentation required for a registered vendor of diesel fuel or kerosene with Form 4136.

We reviewed all 15 Project Code 0656 audits and found five cases (33 percent) with total fuel tax credit claims of \$28,411 for which the examiner incorrectly allowed the credit. We reviewed a statistically valid sample of 30 Project Code 0000 (Source Code 03) audits and found 18 cases (60 percent) totaling \$122,810 for which the examiner incorrectly allowed the fuel tax credit.¹⁵ Projecting these results to the sample population of 117 returns, we estimate that a total of

¹⁴ Audits were closed agreed or no-change.

¹⁵ Our sampling criteria included a confidence level of 95 percent and a precision rate of ± 15.38 percent.



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\$478,959 in fuel tax credit claims should not have been allowed.¹⁶ If all fuel tax credit claims had been properly identified and audited, we forecast that a total of \$2,536,850 in questionable claims may be prevented over five years.¹⁷

Both case reviews found instances in which examiners accepted the taxpayer's claimed fuel tax credit with little or no documentation. *****2*****

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*****2*****, the IRS is treating them differently than taxpayers under audit claiming the credit on a Schedule C or Schedule F, who are required to provide receipts to support their fuel tax credit claims. We also found that for those taxpayers who did submit receipts, examiners did not always make the correct determination as to whether the taxpayer's occupation qualified them for the credit or whether the Federal excise tax was paid on the fuel.

IRS management advised us that examiners are trained on fuel tax credit claims as part of training given to all correspondence tax technicians. For guidance, examiners are instructed to review IRM 4.19.15.19, which provides some basic issues to evaluate when reviewing fuel tax credit claims, such as reviewing receipts to determine if the Federal excise tax was imposed on the fuel. The IRM states that further information on fuel tax credit claims can be found in Publication 510, *Excise Taxes (Including Fuel Tax Credits and Refunds)*, and Publication 225, *Farmer's Tax Guide*. However, this information may not provide examiners with a clear understanding of the requirements to evaluate a fuel tax credit claim. *****1*****

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*****1*****
****1***.

Examiners did not always properly review amended returns filed by potential frivolous filers

Some fuel tax credit claims are identified as potentially frivolous by IRS employees during their manual processing of claims at IRS campuses. These claims are first routed to the FRP function at the IRS's Ogden Campus for screening. An IRS notice is sent to the taxpayer stating that the

¹⁶ The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the range of improperly allowed fuel tax credit claims for the 117 Project Code 0000 audits is between \$189,578 and \$768,340.

¹⁷ See Appendix IV. The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.



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tax return is considered frivolous and any tax refund associated with the frivolous claim will not be issued.¹⁸ The notice further advises the taxpayer to file a corrected, nonfrivolous tax return within 30 days from the date of the letter to avoid assessment of a \$5,000 frivolous income tax return penalty. In addition, if the taxpayer does not respond within 30 days from the date of the letter, a notice of deficiency may be issued stating the amount of taxes and penalties owed.

During FY 2011, the Ogden Campus FRP function examined 399 individual tax returns claiming potentially frivolous fuel tax credits.¹⁹ We reviewed a statistically valid stratified sample of 99 closed correspondence audits and found that examiners did not make the correct decision and erroneously allowed the fuel tax credit in 17 of them.²⁰ Because fuel tax credits are refundable, the full amount of the credit can be refunded if the taxpayer does not owe taxes. Based on the examiners' incorrect decisions, we estimate that the IRS may have issued \$98,818 in potentially fraudulent refunds, as shown in Figure 5. Projecting these sample results to the sample population of 399 returns, we estimate that a total of \$198,196 in potentially fraudulent refunds was issued.²¹ Forecasted to the sample population for a five-year period, a total of \$990,978 in potentially fraudulent refunds could be allowed.²²

Figure 5: Results of Review of Fuel Tax Credit FRP Correspondence Audits

FRP Stratum	Population	Sample Size	Errors	Error Percentage	Refunds
Strata 1	12	11	7	63.6%	\$62,297
Strata 2	42	20	4	20.0%	\$18,514
Strata 3	345	68	6	8.8%	\$18,007
Total	399	99	17	N/A ²³	\$98,818

Source: TIGTA review of 99 FY 2011 FRP audits of individual tax returns claiming a fuel tax credit.

For 10 of the audits reviewed, the taxpayers submitted amended returns with Schedules C, reducing their income and increasing their original refunds (and thus collectively avoiding \$43,280 in taxes). For example, taxpayers added Schedules C with losses to the amended returns or adjusted previously submitted Schedules C to increase expenses and decrease profits without supporting documentation. For another six audits, the taxpayers did not provide

¹⁸ Computer Paragraph 72.

¹⁹ This represents a portion of the returns closed as agreed and no-change.

²⁰ Our sampling criteria included a confidence level of 95 percent and a precision rate of ± 9.44 percent.

²¹ The point estimate projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that the range of potentially fraudulent refunds issued is between \$116,919 and \$279,472.

²² See Appendix IV. The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change.

²³ Because this was a stratified sample, a total error percentage is not applicable.



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sufficient documentation or only provided a***2***, collectively avoiding \$52,924 in taxes.

*****1*****
*****1*****
*****1*****.

A review of the 2011 FRP Student and Instructor Guide shows that examiners are instructed to review the return or claim to determine if the amount of the fuel tax credit is so disproportionately excessive to income (normally business income) reported on the individual's return as to be unallowable. An exhibit in the guide instructs the examiner to multiply the number of gallons claimed by \$2 and compare this to the taxpayer's adjusted gross income. It further instructs examiners to review the individual's occupation to determine if it would not generally qualify for off-highway usage. There are no additional instructions to assist the examiner in what documentation is acceptable as proof for the fuel tax credit claim.

First-line managers did not identify incorrect adjustments

First-line managers are an important control component because they are responsible for the quality of work performed by the examiners they supervise. First-line managers use a variety of techniques to ensure that the examiners' work is meeting acceptable standards and procedures are followed in considering, documenting, and assessing penalties. These techniques include observations and discussions with examiners and reviews of work conducted during and after the audits are closed. Through the observations, discussions, and reviews, first-line managers attempt to identify problems so that examiners can take prompt corrective actions.

A review of the case files showed managerial reviews by a first-line manager in two of the 45 fuel tax credit project examinations we reviewed and 31 of the 99 FRP examinations we reviewed. IRM 1.4.17.2.3.2, *Compliance Workload Reviews*, states that workload reviews are performed primarily to make an objective assessment of an employee's performance, protect the rights of customers, and identify training needs. However, the IRM only requires that workload reviews for each employee be performed a minimum of two times per quarter.

We also found several instances in which a manager or technical lead reviewed a case that was also in our sample as an exception, but the manager or lead did not identify the incorrect adjustments. Of the 23 fuel tax credit project examinations for which the examiner did not make the correct adjustment, only two were reviewed. Similarly, six of the 17 not properly adjusted FRP examination cases were reviewed. Because no supporting documentation was provided for the changes, the reviewer in each case should have questioned the examiner's conclusion and subsequent actions.

Recommendation

Recommendation 3: The Director, Campus Reporting Compliance, Small Business/Self-Employed Division, and the Director, Reporting Compliance, Wage and Investment Division, should provide managers and examiners with additional training and procedures to



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(a) determine acceptable supporting documentation for claiming a fuel tax credit and (b) review amended returns when the original return has been adjusted beyond removing the fuel tax credit.

Management's Response: The IRS agreed with this recommendation and plans to assess its procedures and the training needs of examiners and managers with regard to the examination of fuel tax credit claims and the review of related amended tax returns.



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Appendix I

Detailed Objective, Scope, and Methodology

The objective of this review was to evaluate whether opportunities exist to improve the return classification and examination processes for individual income tax returns claiming a fuel tax credit.¹ To accomplish this objective, we:

- I. Determined the policies and procedures related to identifying for examination individual tax returns claiming questionable fuel tax credits and the policies, procedures, and training provided to help guide examiners.
 - A. Researched the IRM and met with IRS officials to determine the current criteria and systematic filters and computer codes (Action Code 300) used for identifying returns with potential fuel tax credit issues, including claims over the threshold amounts.
 - B. Visited the IRS Austin Campus, which processes individual returns with fuel tax credit claims, and created a flowchart of the process.
- II. Determined filing trends of individual returns with a fuel tax credit.
 - A. Obtained IRS IRTF data for PYs 2011 through 2013.
 - B. Analyzed the number and amount of fuel tax credit filings for PYs 2011 through 2013.
- III. Assessed the effectiveness of the initial screening of returns with fuel tax credits at IRS campuses.
 - A. Used a combination of IRTF and IRS Individual Master File (IMF) data to identify fuel tax credit returns in PYs 2011 through 2013 that should have been selected for examination before refund issuance based on the fuel tax credit being above the threshold amount.
 - B. Provided PYs 2011 and 2012 sample cases identified in Step III.A to appropriate IRS personnel for review to obtain agreement that these cases should have been selected.
- IV. Identified and selected FY 2011 examinations for the PY 2010 population of individual returns with fuel tax credits.
 - A. Used a combination of PY 2010 fuel tax credit and the FY 2011 closed correspondence examination file to identify the various fuel tax credit audit project examinations.

¹ See Appendix VI for a glossary of terms.



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- B. Identified 117 PY 2010 returns claiming a fuel tax credit that had closed correspondence examinations in FY 2011 under fuel tax Project Code 0000 and 15 PY 2010 returns with closed examinations under fuel tax Project Code 0656, all with agreed or no-change decisions.
- C. Selected a statistically valid sample of 30 closed examination cases from the population of 117 cases identified from Step IV.B. Our sampling criteria included a confidence level of 95 percent, a desired precision rate of ± 15.69 percent, and an estimated error rate equal of 50 percent. We used a statistical sample so that we could project the results to the population.
- D. Identified 399 PY 2010 returns claiming a fuel tax credit that had closed audits in the FY 2011 correspondence examination file under the FRP project code with agreed or no-change decisions.
- E. Selected three statistically valid stratified samples consisting of 11, 20, and 68 for a total of 99 closed examination cases from Step IV.D. Our sampling criteria included a confidence level of 95 percent, a desired precision rate of ± 9.44 percent,² and an estimated error rate of 50 percent for each of the stratum. We used a statistical sample so that we could project the results to the population.
- F. Projected outcome measures from closed case reviews of fuel tax credit audit projects and the FRP examinations.
- G. Used TIGTA's contract statistician to ensure the accuracy of sample designs, projections, and forecasts.
- V. Conducted data validation for computer coding files (Action Code 300), IRTF fuel tax credit filings, and the IMF.
 - A. For Steps II and III, randomly selected 20 records for PYs 2011 and 2012 from the computer coding file (Action Code 300) and validated them to the Integrated Data Retrieval System. We determined that the data were sufficiently reliable for the purposes of this report.
 - B. For Steps II and III, randomly selected 20 records each for PYs 2011 through 2013 from the IRTF for returns claiming a fuel tax credit and validated against the Integrated Data Retrieval System. We determined that the data were sufficiently reliable for the purposes of this report.
 - C. For Steps II and III, randomly selected 20 records each for PYs 2011 through 2013 from the IMF for returns claiming a fuel tax credit and validated against the

² Our initial statistically valid stratified samples consisted of 12, 20, and 68 for a total of 100 returns to be reviewed. However, we received only 11 of 12 returns in the first stratum.



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- Integrated Data Retrieval System. We determined that the data were sufficiently reliable for the purposes of this report.
- D. For Step IV, randomly selected 20 records for PY 2010 from the IRTF for returns claiming a fuel tax credit and validated against the Integrated Data Retrieval System. We determined that the data were sufficiently reliable for the purposes of this report.
 - E. For Step IV, compared the FY 2011 closed correspondence examination file totals to the IRS Data Book for FY 2011 for data validation. We determined that the data were sufficiently reliable for the purposes of this report.

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: IRS policies, procedures, and practices (*i.e.*, systemic filters, file matching, *etc.*) for the processing and examination of individual returns claiming the fuel tax credit. We evaluated these controls by reviewing source materials, interviewing management, and reviewing samples of closed examination cases.



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Appendix II

Major Contributors to This Report

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Todd Anderson, Senior Auditor
Carole Connolly, Senior Auditor
Brian Hattery, Information Technology Specialist



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Wage and Investment Division SE:W
Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS
Director, Communications, Liaison and Disclosure, Small Business/Self-Employed Division
SE:S:CSO
Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, Return Integrity and Correspondence Services, Wage and Investment Division
SE:W:RICS
Director, Campus Reporting Compliance, Small Business/Self-Employed Division
SE:S:CCS:CRC
Director, Exam Policy, Small Business/Self-Employed Division SE:S:E:EP
Director, Exam Planning and Delivery, Small Business/Self-Employed Division SE:S:E:EPD
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:
 Commissioner, Small Business/Self-Employed Division SE:S
 Commissioner, Wage and Investment Division SE:W



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Appendix IV

Outcome Measures

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

Type and Value of Outcome Measures:

Total potential revenue protection of \$68.2 million in questionable fuel tax credits¹ claimed on 5,908 tax returns over five years, as shown below.

- Revenue Protection – Potential; \$36.7 million claimed on 3,052 returns for PYs 2011 and 2012 with questionable fuel tax credit claims at or above the screening threshold that were not selected for review during return processing (see page 3).
- Revenue Protection – Potential; \$10.5 million claimed on 952 tax returns for PY 2013 with questionable fuel tax credit claims at or above the screening threshold that were not selected for review during return processing or by the revised filters implemented by the RICS function (see page 3). The three-year forecast is \$31.5 million (2,856 tax returns), computed by multiplying \$10.5 million (952 tax returns) by three years.²

Methodology Used to Measure the Reported Benefits:

We used the IRS's IRTF to identify return filings claiming fuel tax credits on Form 4136, *Credit for Federal Tax Paid on Fuels*. We also obtained return processing data to identify the return filings that received an Action Code 300 and then eliminated these returns from our analysis because they were processed properly. Our intention was to identify only returns that were not selected for examination based on fuel tax credit claims. We then matched the returns to the IMF to eliminate any that were examined, surveyed, or had open examinations. Using the IMF, we further eliminated returns that had the fuel tax credit claims disallowed or otherwise stopped during return processing or had been corrected by taxpayers, assuming that these fuel tax credit claims were also properly addressed. This left us with the total population of tax returns with fuel tax credit claims that were paid without being examined or adjusted/corrected through other processes.

¹ See Appendix VI for a glossary of terms.

² The three-year forecast assumes, among other considerations, that economic conditions and tax laws do not change.



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For fuel tax credits at or above the threshold amount, we further reduced this population to those returns filed with *****2*****³, with no other business income. We computed the fuel expense by dividing the fuel tax credit claimed by 18.3 cents to determine the number of gallons used by each taxpayer and then multiplying the number of gallons by \$2.00.³ We divided the fuel expenses by gross profit cash or total income accrual *****2*****³. In the final population, we determined 4,004 returns with a fuel expense percentage greater than 50 percent of gross profit for PYs 2011 through 2013. See Figure 2, Questionable Claims totals on page 5.

We identified 3,052 questionable fuel tax credit claims at or above the threshold amount for \$36.7 million in PYs 2011 through 2012, and 952 questionable fuel tax credit claims at or above the threshold amount for \$10.5 million in PY 2013, for a total of 4,004 returns for \$47.2 million. We multiplied PY 2013 questionable fuel tax credit claims of \$10.5 million (952 tax returns) by two years (to get the two additional years for our five-year total), which totals \$21 million in fuel tax credits claimed on 1,904 tax returns. The combined five-year total is \$68.2 million (\$36.7 million plus \$10.5 million plus \$21 million) claimed on 5,908 tax returns (3,052 returns plus 952 returns plus 1,904 returns).

Figure 1 provides a summary of these calculations in chart form.

Figure 1: Summary of Revenue Protection Calculations

Fuel Tax Credits At or Above the Threshold (see Figure 2, Questionable Claims totals on page 5)	Returns	Dollars (millions)
PY 2011	1,360	\$20.0
PY 2012	1,692	\$16.7
PY 2013	952	\$10.5
Total PYs 2011–2013	4,004	\$47.2
PY 2013 Totals Projected Over Two Additional Years (PY 2013 totals x 2)	1,904	\$21.0
	5,908	\$68.2

³ There are various types of fuel taxes claimed on Form 4136. To be conservative in our estimate, we used the 18.3 cents per gallon credit for the nontaxable use of gasoline to divide the credit claimed, and multiplied the result by \$2.00.



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Type and Value of Outcome Measure:

Total potential revenue protection from examination operations of \$3,527,828 forecasted over five years,⁴ as shown below.

Campus Correspondence Examination Program:

- Revenue Protection – Potential, Project 0656: \$28,411 for one year; \$142,055 forecasted over five years (see page 9).
- Revenue Protection – Potential, Project 0000: \$478,959 for one year; \$2,394,795 forecasted over five years (see page 9).

FRP Examination:

- Revenue Protection – Potential, \$198,196 for one year; \$990,980 forecasted over five years, (see page 9).

Methodology Used to Measure the Reported Benefit:

Project 0656 = \$28,411

We determined that for five of the 15 cases, examiners should have disallowed an additional \$28,411 in fuel tax credits. The five-year total revenue forecast is $\$28,411 * 5 = \$142,055$.

Project 0000 Source Code 03 = \$478,959 ± \$289,381

We determined that for 18 of the 30 cases reviewed, examiners should have disallowed \$122,810 in fuel tax credits. Projecting this to the population of 117 cases, we are 95 percent confident that an additional 70 cases (± 18 cases) should have disallowed credits totaling \$478,959 ($\pm \$289,381$).⁵ The five-year total revenue forecast is $\$478,959 * 5 = \$2,394,795$.

Project 0310 Frivolous Return Examinations = \$990,980

We determined that for 17 of the 99 cases (claims) reviewed, examiners should have disallowed a total of seven of the 11 claims in stratum 1 with an average claim of \$5,663.36 in fuel tax credits, four of the 20 claims in stratum 2 with an average claim of \$925.66 in fuel tax credits, and six of the 68 claims in stratum 3 with an average claim of \$264.80 in fuel tax credits. Projecting these into total strata populations of 12, 42, and 345, respectively (a combined total population of 399 cases), we are 95 percent confident that an additional 46 cases (± 22 cases) should have disallowed credits totaling \$198,196 ($\pm \$81,276$).⁶ The five-year total revenue forecast is $\$198,196 * 5 = \$990,980$.

⁴ The five-year forecast assumes, among other considerations, that economic conditions and tax laws do not change.

⁵ This projection was made using a 15.38 percent precision rate.

⁶ This projection was made using a 5.44 percent precision rate.



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Appendix V

Selected Statistical Tables

Figure 1 shows that the number of Forms 1040, *U.S. Individual Income Tax Return*, with fuel tax credit¹ claims increased between PYs 2011 and 2012 but decreased in PY 2013, for an overall decrease of 10 percent for the three-year period. The largest decrease is the category of \$20,000 to under \$25,000, which shows a decrease of 81 percent.

Figure 1: Number of Form 1040 Fuel Tax Credit Filings for PYs 2011–2013

Fuel Tax Credit Claims on Forms 1040	Processing Year			Percentage Increase (Decrease)
	2011	2012	2013	Processing Years 2011–2013
Under Threshold Amount	332,488	474,032	299,933	(10)%
Threshold Amount to Under \$5,000	7,143	13,118	6,042	(15)%
\$5,000 to Under \$10,000	1,552	8,649	1,758	13%
\$10,000 to Under \$15,000	1,147	1,371	445	(61)%
\$15,000 to Under \$20,000	746	753	180	(76)%
\$20,000 to Under \$25,000	512	1,028	96	(81)%
\$25,000 or More	78	1,008	199	155%
Total	343,666	499,959	308,653	(10)%

Source: TIGTA analysis of IRTF data for PYs 2011 through 2013.

¹ See Appendix VI for a glossary of terms.



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Figure 2 shows that the amount of fuel tax credits claimed on Forms 1040 decreased by 12 percent between PYs 2011 and 2013. The largest decrease in claimed fuel tax credits was in the category of \$20,000 to under \$25,000, which shows a decrease of 80 percent.

Figure 2: Amount of Form 1040 Fuel Tax Credit Filings for PYs 2011–2013

Amount of Fuel Tax Credit Claimed on Forms 1040	Processing Year			Percentage Increase (Decrease)
	2011	2012	2013	Processing Years 2011–2013
Under Threshold Amount	\$91,960,077	\$194,181,173	\$83,585,516	(9)%
Threshold Amount to Under \$5,000	\$17,016,906	\$29,475,407	\$14,397,465	(15)%
\$5,000 to Under \$10,000	\$11,890,778	\$68,430,561	\$14,179,216	19%
\$10,000 to Under \$15,000	\$15,066,635	\$16,730,780	\$5,383,537	(64)%
\$15,000 to Under \$20,000	\$14,460,648	13,856,615	\$3,146,016	(78)%
\$20,000 to Under \$25,000	\$10,635,771	\$21,664,948	\$2,075,964	(80)%
\$25,000 or More	\$4,988,898	\$37,163,177	\$23,568,633	372%
Total	\$166,019,713	\$381,052,661	\$146,336,347	(12)%

Source: TIGTA analysis of IRTF data for PYs 2011 through 2013.



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Figure 3 shows selected characteristics of Forms 1040 with fuel tax credit claims of less than **2**. For example, 74,527 returns reported no income tax owed, while 33,791 returns also claimed over \$64 million in Earned Income Tax Credits.

**Figure 3: PY 2013 Selected Characteristics of Forms 1040
With Fuel Tax Credit Claims Less Than **2**

Fuel Tax Credit Less Than **2	Selected Return Characteristics	
	Schedule C Less Than - *2	Schedule C Greater Than - *2
Number	30,780	56,067
Amount	\$(598,532,129)	\$1,488,049,909
	Schedule D Less Than - *2	Schedule D Greater Than - *2
Number	23,215	77,496
Amount	\$(54,733,536) ²	\$9,121,006,060
	Schedule E Less Than - *2	Schedule E Greater Than - *2
Number	23,202	74,637
Amount	\$(1,142,623,286)	\$5,613,987,614
	Schedule F Less Than - *2	Schedule F Greater Than - *2
Number	73,673	67,494
Amount	\$(1,566,753,070)	\$2,845,323,592
	Tentative Tax Equal to - *2	Tentative Tax Greater Than - *2
Number	74,527	164,355
Amount		\$4,411,478,305
	Wages Equal to - *2	Wages Greater Than - *2
Number	88,333	150,549
Amount		\$8,119,947,291
	Earned Income Credit Equal to - *2	Earned Income Credit Greater Than - *2
Number	205,091	33,791
Amount		\$64,086,384

Source: TIGTA analysis of PY 2013 IRTF data. Note: Schedule C, Profit or Loss From Business; Schedule D, Capital Gains and Losses; Schedule E, Supplemental Income and Loss; Schedule F, Profit or Loss From Farming.

² This information was updated on November 19, 2015.



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Figure 4 shows that for Form 1040 fuel tax credit claims of ***2*** or more, 31,245 taxpayers reported no taxes owed, while 24,980 taxpayers also claimed nearly \$50 million in Earned Income Tax Credits.

**Figure 4: PY 2013 Selected Return Characteristics
for Returns With Fuel Tax Credits of ***2**or More**

Returns With Fuel Tax Credit ***2*** or More	Selected Return Characteristics	
	Schedule C Less Than -*2*	Schedule C Greater Than -*2*
Number	9,000	19,965
Amount	\$(305,031,928)	\$610,651,722
	Schedule D Less Than -*2*	Schedule D Greater Than -*2*
	Number	7,497
Amount	\$(8,873,045)	\$6,324,415,045
	Schedule E Less Than -*2*	Schedule E Greater Than -*2*
	Number	9,124
Amount	\$(1,268,725,374)	\$4,527,018,268
	Schedule F Less Than -*2*	Schedule F Greater Than -*2*
	Number	6,946
Amount	\$(401,932,712)	\$474,430,171
	Tentative Tax Equal to -*2*	Tentative Tax Greater Than -*2*
	Number	38,512
Amount		\$3,098,631,143
	Wages Equal to -*2*	Wages Greater Than -*2*
	Number	49,285
Amount		\$1,939,816,577
	Earned Income Tax Credit Equal to -*2*	Earned Income Tax Credit Greater Than -*2*
	Number	24,980
Amount		\$49,693,642

Source: TIGTA analysis of PY 2013 IRTF data.



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Figure 5 shows that for Form 1040 fuel tax credit claims at or above the threshold amount in Tax Years 2011 and 2012, 73 percent and 90 percent, respectively, were timely filed, including those with extensions filed. However, 27 percent and 10 percent of the claims in these populations were filed late. The majority of questionable claims were filed late, with 53 percent and 54 percent in the same period.

For fuel tax credit claims of at least ***2*** but below the threshold amount, 85 percent and 93 percent, respectively, were timely filed for Tax Years 2011 and 2012, and 15 percent and 7 percent were filed late (while 12 percent and 9 percent of the questionable claims were filed late).

**Figure 5: Percentage of Tax Year 2011 and 2012 Returns
Claiming the Fuel Tax Credit That Were Timely and Late Filed³**

Tax Year	At or Above the Threshold Amount				At Least ***2*** but Below the Threshold Amount			
	Overall Fuel Tax Credit Returns		Questionable Claims		Overall Fuel Tax Credit Returns		Questionable Claims	
	Timely Filers	Late Filers	Timely Filers	Late Filers	Timely Filers	Late Filers	Timely Filers	Late Filers
2011	73%	27%	47%	53%	85%	15%	88%	12%
2012	90%	10%	46%	54%	93%	7%	91%	9%

Source: TIGTA analysis of IRTF and IMF data for Tax Years 2011 and 2012.

³ For this analysis, a return was deemed late if the return receipt date had passed the normal filing date, including an extension even though there was no late file penalty because of the return generating a refund.



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Figure 6 shows that for Form 1040 fuel tax credit claims at or above the threshold amount, 42 percent and 70 percent were filed using preparers in PYs 2012 and 2013, respectively, while 1.1 percent and 0.3 percent of the questionable claims were filed using preparers for the same periods. For Form 1040 fuel tax credit claims of at least \$2 but below the threshold amount, 85 percent and 83 percent, respectively, used preparers, while 89 percent and 75 percent of the questionable claims used preparers for the same periods.

**Figure 6: Percentage of Fuel Tax Credit Returns
Prepared by Preparers for PYs 2012 and 2013**

Processing Year	At or Above the Threshold Amount		At Least \$2 but Below the Threshold Amount	
	Overall Fuel Tax Credit Returns	Questionable Claims	Overall Fuel Tax Credit Returns	Questionable Claims
2012	42%	1.1%	85%	89%
2013	70%	0.3%	83%	75%

Source: TIGTA analysis of IRTF data for PYs 2012 and 2013.



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Appendix VI

Glossary of Terms

Term	Definition
Action Code	Numeric codes edited in the bottom center margin of a return to reject documents and identify the reason the document has been rejected.
Audit Information Management System	A computer system used to control returns, input assessments/adjustments to the Integrated Data Retrieval System, and provide management reports.
Computer Paragraph	A computer-generated notice resulting from an analysis of the taxpayer's account. It is used to notify the taxpayers of a balance due, refund, or no balance status. It is also used for internal research and review.
Correspondence Examination	A process that is less intrusive than a face-to-face examination, more automated, and conducted by examiners who are trained to address and focus on less complex tax issues.
Earned Income Tax Credit	A refundable Federal tax credit for low-income working individuals and families.
Examiner	Primarily responsible for determining the correct tax liabilities of taxpayers. Examinations of individual taxpayers can range from reviewing their tax returns and resolving questionable items by corresponding with them through the mail to a detailed face-to-face examination of a taxpayer's financial records at his or her place of business.
First-Line Manager	A group manager in the Examination function responsible for supervision of IRS examiners.
Fiscal Year	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.



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Term	Definition
Frivolous Return Program	Encourages individuals to become compliant with the tax laws, advises taxpayers of the potential consequences for asserting frivolous arguments, and takes action on accounts for which taxpayers do not become compliant.
Fuel Tax Credit	A credit that can be taken for U.S. Federal income tax purposes for certain nontaxable uses of fuels. Final purchasers and, in some cases, vendors of certain types of fuels may be able to claim a refund or credit for the Federal excise tax that applies on the fuel if it is for specific nontaxable uses, such as on a farm; for off-highway business use; for commercial fishing; for use in certain types of intercity, local, and school buses; and for exclusive use by a nonprofit educational organization.
Individual Master File	The IRS database that maintains transactions or records of individual tax accounts.
Individual Return Transaction File	The IRS database that contains information originally filed by the taxpayer and transcribed from Forms 1040 and 1040A, <i>U.S. Individual Income Tax Return</i> , and Form 1040EZ, <i>Income Tax Return for Single and Joint Filers With No Dependents</i> , and their accompanying forms and schedules.
Integrated Data Retrieval System	A computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.
Internal Revenue Manual	An IRS handbook of procedure and law specifically designed to cover one area of processing.
Notice of Deficiency	A legal notice in which the IRS determines the taxpayer's tax deficiency. The notice of deficiency consists of: (1) a letter explaining the purpose of the notice, the amount of the deficiency, and the taxpayer's options; (2) a waiver to allow the taxpayer to agree to the additional tax liability; (3) a statement showing how the deficiency was computed; and (4) an explanation of the adjustments.
Processing Year	The year in which tax returns and other tax data are processed.



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Term	Definition
Project Code	A four-digit code used on the Audit Information Management System to identify a special program to which an examination belongs.
Return Integrity and Correspondence Services Function	Comprised of organizations that strengthen revenue protection and prerefund compliance, administer refundable credits, and provide oversight of content for all notices and letters sent to taxpayers.
Social Security Number	A nine-digit number assigned by the Social Security Administration and used as the account number of a taxpayer on the IMF.
Tax Year	The 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.
Transaction Code	A three-digit code used to identify transactions being applied to (actions being taken on) a taxpayer's account.
Unallowable Code	During return processing, a two-digit unallowable code identifies item(s) that have been disallowed. These can include a taxpayer's deductions, exemptions, items exceeding statutory limitations, items of a questionable nature, or items not supported by the proper information or schedule.



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Appendix VII

Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

SEP 12 2014

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Debra Holland *Debra S. Holland*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Additional Actions Are Needed to Ensure
That Improper Fuel Tax Credit Claims Are Disallowed
(Audit # 201230024)

Thank you for the opportunity to review and respond to the subject draft report. We are pleased that the report describes the actions the IRS has taken in recent years to address both erroneous fuel tax credit claims and instances of suspected identity theft where claims for fuel tax credits are part of the fraudulent scheme. We agree that opportunities exist to remind examiners and managers of their responsibilities for verifying fuel tax credit claims and reviewing audit determinations.

To promote voluntary compliance with the tax laws, the IRS identifies certain deductions and credits that may be susceptible to abuse by individuals improperly claiming them. Criteria is developed to identify those returns that appear to be questionable so they may be carefully reviewed during processing and, when appropriate, referred to our Examination functions for additional scrutiny and review before refunds are issued. During this review, it became apparent that exception criteria had been introduced into the screening process that allowed some returns to avoid an increased level of review.

For the upcoming 2015 Filing Season, we have taken actions to revise the programming and processes to be used in identifying for review those returns claiming fuel tax credits. Limited resources available for balanced administration of the tax system will result in a continued reliance on threshold amounts when determining the appropriate treatment for questionable items; however, we will broaden the identification criteria to ensure a more comprehensive approach is used in selecting returns for review.

Another process described in the report addresses the new identity theft filters installed in September 2012, prior to the start of the 2013 Filing Season. The report states that these filters do not always identify questionable fuel tax credit claims; however, it is



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important to note that the subject filters were placed in use to identify probable identity theft, not questionable claims made by the legitimate owner of the Social Security Number under which the return was filed. The criteria used for evaluating potential identity theft involves the analysis of more return attributes than are considered in the initial return screening for questionable fuel tax credit claims, and includes a substantially lower tolerance for considering the fuel tax credit aspect of the return. Similarly, the treatment for a return identified as fraudulent due to identity theft is significantly different and less resource intensive than addressing a questionable claim filed by the legitimate owner of the Social Security Number. Any returns not stopped by the identity theft filters were still subject to the initial screening process. Also, we note that our various screening filters are periodically evaluated, and then updated and enhanced as needed.

When questioning claims for fuel tax credits, the IRS must follow deficiency procedures to comply with statutory requirements that ensure taxpayers may dispute the IRS determinations and appeal proposed tax increases or credit disallowances to the United States Tax Court prior to the tax assessment or credit denial. Our Examination resources are limited and must be broadly allocated to ensure compliance activities provide balanced support to overall tax administration. To provide balanced administration, the IRS prepares workplans to forecast business needs and determine how limited resources should be deployed. Thresholds are considered when workplans are prepared and are adjusted in response to resource availability. We do not agree with the \$68.2 million Outcome Measure associated with claim screening because it has been applied to processes that are not designed to identify questionable returns.

Attached are our comments to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Ivy McChesney, Director, Customer Account Services, Wage and Investment Division, at (404) 338-8910.

Attachment



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Attachment

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1

Use systemic controls to ensure that all Forms 1040 claiming a fuel tax credit at or above the threshold amount are manually reviewed prior to refund issuance.

CORRECTIVE ACTION

We have updated and revised the process for identifying tax returns claiming the fuel tax credit for additional review. The new programming and procedures will identify all returns meeting or exceeding the threshold criterion.

IMPLEMENTATION DATE

January 15, 2015

RESPONSIBLE OFFICIAL

Director, Submission Processing, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.

Recommendation 2

If additional auditing resources become available, consider lowering the systemic threshold amount for selecting and reviewing Forms 1040 that only report wage income but claim a fuel tax credit.

CORRECTIVE ACTION

The IRS establishes workplans to determine how limited resources should be allocated to provide balanced coverage for tax administration. Threshold amounts are one criterion considered in preparing the workplans, and they are reevaluated as the plans are adjusted when workload or resource levels fluctuate. This is an ongoing process and we will continue to consider thresholds as an inherent part of the planning activity.

IMPLEMENTATION DATE

Implemented

RESPONSIBLE OFFICIAL

Director, Campus Reporting Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

N/A



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Recommendation

Recommendation 3

The Director, Campus Reporting Compliance, Small Business/Self-Employed Division, and the Director, Reporting Compliance, Wage and Investment Division, should provide managers and examiners with additional training and procedures to (a) determine acceptable supporting documentation for claiming a fuel tax credit and (b) review amended returns when the original return has been adjusted beyond removing the fuel tax credit.

CORRECTIVE ACTION

We will assess our procedures and the training needs of examiners and managers with regard to the examination of fuel tax credit claims and the review of related amended tax returns.

IMPLEMENTATION DATE

September 15, 2015

RESPONSIBLE OFFICIAL

Director, Campus Reporting Compliance, Small Business/Self-Employed Division
Director, Reporting Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.