TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Improper Payment Rates for Refundable Tax Credits Remain High

May 10, 2021

Report Number: 2021-40-036

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Final Audit Report issued on May 10, 2021 Report Number 2021-40-036

Why TIGTA Did This Audit

This audit was initiated because TIGTA is required to assess the IRS's compliance with the reporting requirements contained in the Payment Integrity Information Act of 2019 and Executive Order 13520. The objective of this review was to determine whether the IRS complied with the annual improper payment reporting requirements for Fiscal Year 2020.

Impact on Taxpayers

The Office of Management and Budget defines an improper payment as any payment that should not have been made, was made in an incorrect amount, or was made to an ineligible recipient. In Fiscal Year 2020, the Office of Management and Budget determined that the Earned Income Tax Credit, Additional Child Tax Credit, and American Opportunity Tax Credit are high-priority programs that are susceptible to significant improper payments. Although error rates for each of these credits remain high, the IRS attributes these refundable tax credit overclaims to their statutory design and the complexity taxpayers face when self-certifying eligibility for the refundable tax credits and not to internal control weaknesses, financial management deficiencies, or reporting failures.

What TIGTA Found

The IRS provided all required improper payment information for these refundable tax credits to the Department of the Treasury for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2020*. The IRS has not reduced overall improper payment rates for the Earned Income Tax Credit, the Additional Child Tax Credit, or the American Opportunity Tax Credit to less than 10 percent; however, an exception to the annual reduction target reporting requirement has been approved. The IRS described five barriers to reducing refundable tax credit improper payments: complexity and lack of data to verify statutory eligibility requirements, lack of correctable error authority, high turnover of eligible taxpayers, unscrupulous and/or incompetent tax return preparers, and fraud.

The IRS did not calculate the dollar amount and percentage rate of improper payments for its fourth high-risk program – the Net Premium Tax Credit. IRS management stopped working on this calculation, citing delays stemming from significant demands placed on the Department of the Treasury and the IRS in connection with the Coronavirus Disease 2019 crisis as well as delays working with the Department of Health and Human Services and the Centers for Medicare and Medicaid Services to develop a joint methodology for assessing improper payment risk for the Premium Tax Credit.

Finally, the IRS implemented a prior TIGTA recommendation and modified its procedures to address eligibility for the Additional Child Tax Credit when a tax return claiming the Earned Income Tax Credit is selected for review. Management expects to protect $6.3 million for Tax Year 2019 tax returns by following these procedures. This is a significant increase over the $3.2 million protected for Tax Year 2018 tax returns.

What TIGTA Recommended

TIGTA did not make any recommendations.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

May 10, 2021

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

Michael E. McKenney

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Improper Payment Rates for Refundable Tax Credits Remain High (Audit # 202140001)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) complied with the annual improper payment reporting requirements for Fiscal Year 2020. This review is part of our Fiscal Year 2021 Annual Audit Plan and addresses the major management and performance challenge of *Reducing Fraudulent Claims and Improper Payments*.

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

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, Assistant Inspector General for Audit (Returns Processing and Account Services).

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Background

The Office of Management and Budget (OMB) defines an improper payment[1] as any payment that should not have been made, was made in an incorrect amount, or was made to an ineligible recipient. Agency Inspectors General are responsible for evaluating agency information related to improper payments. The Improper Payments Information Act of 2002[2] requires Federal agencies, including the Internal Revenue Service (IRS), to estimate the amount of improper payments and report to Congress annually on the causes of and the steps taken to reduce improper payments. The Improper Payments Information Act also requires agencies to address whether they have the information systems and other infrastructure needed to reduce improper payments. The annual report must also describe steps the agency has taken to ensure that agency managers are held accountable for reducing improper payments.

On March 2, 2020, the Payment Integrity Information Act of 2019 (PIIA)[3] repealed several improper payment laws[4] but set forth similar improper payment reporting requirements. For example, agencies must conduct a program-specific risk assessment for each program or activity identified by the agency, provide the methodology for identifying and measuring improper payments, and report on actions the agency intends to take to prevent future improper payments. In addition, the following Executive Order and OMB Circular remain in effect:

- Executive Order 13520, *Reducing Improper Payments*, signed by the President on November 20, 2009, increased Federal agencies' accountability for reducing improper payments while continuing to ensure that Federal programs serve and provide access to intended beneficiaries. It requires Federal agencies to provide agency Inspectors 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.
- OMB revised Circular A-123 Appendix C, *Requirements for Payment Integrity Improvement,* issued June 26, 2018. Appendix C provides agencies and Inspectors General with guidance on improper payment determinations and reporting. According to the OMB, the goal of the revised Appendix C is to transform the improper payment compliance framework to create a more unified, comprehensive, and less burdensome set of requirements. For example, agencies must report their compliance with most improper payment reporting requirements in the Agency Financial Report (AFR).[5] Every year, each agency Inspector General must review its agency's improper payment reporting in the agency's AFR and any accompanying material, such as that provided on www.paymentaccuracy.gov, to determine if the agency complies with improper payment legislation and OMB guidance.

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[1] See Appendix IV for a glossary of terms.

[2] Pub. L. No. 107-300, 116 Stat. 2350.

[3] Pub. L. No. 116-117, 134 Stat. 113.

[4] *Improper Payments Information Act of 2002; Improper Payments Elimination and Recovery Act of 2010,* Pub. L. No. 111-204, 124 Stat. 2224; *Improper Payments Elimination and Recovery Improvement Act of 2012,* Pub. L. No. 112-248, 126 Stat. 2390; *Fraud Reduction and Data Analytics Act of 2015,* Pub. L. No. 114-186, 130 Stat. 546.

[5] The AFR presents financial and performance information for the fiscal year with comparative prior year data, where appropriate.

The OMB again updated Circular A-123 Appendix C with guidance directly related to the Inspectors General review, and issued this guidance on March 5, 2021. The guidance is effective starting in Fiscal Year (FY) 2021.

Process to identify IRS programs for improper payment risk assessment

The Department of the Treasury (Treasury Department) identifies the programs that the IRS must assess for the risk of improper payments. For FY 2020, the Treasury Department selected 20 IRS program fund groups. These funds were selected for assessment based on each fund groups' materiality to the IRS financial statements. On March 20, 2014, the OMB issued additional supplemental improper payment guidance to the Treasury Department clarifying the requirement for annual risk assessments for most refundable tax credits. In addition, the OMB's revised guidance allows agencies to conduct improper payment risk assessments at least once every three years for programs that are deemed to be a low risk for susceptibility to significant improper payments. The IRS received approval from the Treasury Department to conduct these risk assessments on a three-year rotational schedule starting in FY 2018. Appendix II provides the list of the seven IRS programs identified for improper payment risk assessments for FY 2020.

To assess the level of risk for each identified program for FY 2020, the IRS used Quantitative Risk Assessment Summaries, Qualitative Risk Assessment Questionnaires, and Treasury Department guidance. A Quantitative Risk Assessment Summary is a review of a sample of disbursements to formulate the overall estimated improper payment rate. A Qualitative Risk Assessment Questionnaire is used to assess a program's internal controls that could lead to susceptible improper payments. The Treasury Department updated the Qualitative Risk Assessment ratings to susceptible or not susceptible.

In FY 2020, the OMB determined that the Earned Income Tax Credit (EITC), Additional Child Tax Credit (ACTC), and American Opportunity Tax Credit (AOTC) are high-priority programs that are susceptible to significant improper payments. As a result, separate risk assessments for these programs are not required because their deliverables in the AFR fulfill improper payment requirements. For any program identified as susceptible to significant improper payments (hereafter referred to as a high-risk program), the IRS must also provide the following information for the Treasury Department's annual AFR in the following fiscal year:

- The rate and amount of improper payments.
- The root causes of the improper payments.
- The actions taken to address the root causes.
- The annual improper payment reduction targets.
- A discussion of any limitations to the IRS's ability to reduce improper payments.

The Treasury Department and the IRS have requested relief from reporting erroneous refundable tax credit claims under the PIIA

In their *Business Case to Eliminate Redundant Reporting of Refundable Tax Credits*, dated October 30, 2020, the Treasury Department and IRS informed the OMB that the tax system is primarily a collection system and not a payment program. The business case states that, while the refundable portions of refundable tax credits are considered outlays and currently fall under the scope of payments under the PIIA, the Treasury Department and IRS do not believe that refundable tax credits meet the definition of payments in the traditional sense and, therefore, should be reported only under the Tax Gap framework that comprehensively assesses the tax collection system. The business case provides the following reasons:

- The refundable portion of tax credits, or outlays, should not be considered separately from the rest of the credit because the IRS and Treasury Department need to view any errors to address them effectively.
- Tax credits are embedded into and affected by other provisions of the Federal tax system. Tax Gap estimates and other comprehensive compliance analyses are more effective in helping the IRS identify noncompliance and allocate limited resources effectively.
- Tax Gap estimates already effectively monitor changes in refundable tax credit errors over time.
- Improper payment estimates under the PIIA provide no additional information to the IRS as it administers tax credits and addresses noncompliance.
- Refundable tax credit overclaims are largely due to the credits' statutory design and the complexity taxpayers face when self-certifying eligibility for the refundable tax credits, not internal control weaknesses, financial management deficiencies, or reporting failures.
- Tax credits are part of an interrelated tax administration portfolio that the IRS addresses through a comprehensive enterprise risk management program.

On December 1, 2020, officials at the Treasury Department and IRS met with OMB officials to further discuss the business case and request that erroneous claims for refundable tax credits no longer be reported under improper payment requirements. On January 8, 2021, the OMB requested additional information on the business case. The Treasury Department and IRS provided responses on February 9, 2021. The OMB advised on February 10, 2021, that it will provide a response on next steps once the full OMB leadership team is in place.

Results of Review

For FY 2020, the IRS calculated the following dollar amount and percentage rate of improper payments for three of its four high-risk programs:

- EITC – The IRS estimates 24 percent ($16.0 billion) of the total EITC payments of $68.2 billion were improper.
- ACTC – The IRS estimates 12 percent ($4.5 billion) of the total ACTC payments of $39.1 billion were improper.
- AOTC – The IRS estimates 26 percent ($2.3 billion) of the total AOTC payments of $8.9 billion were improper.

However, the IRS did not calculate the dollar amount and percentage rate of improper payments for its fourth high-risk program – the Net Premium Tax Credit (Net PTC).[6] IRS management stopped working on this calculation when the Treasury Department notified the OMB, on

[6] Eligible taxpayers can choose to receive the Advanced Premium Tax Credit (APTC), which helps cover the cost of their health insurance premiums. These APTC payments are paid on the taxpayer's behalf by the Treasury Department. When taxpayers prepare their tax return, they must reconcile the APTC with the amount of the PTC that they are allowed to claim. Taxpayers whose PTC exceeds their APTC have a Net PTC, which reduces their tax liability and, if more than the tax liability, results in a refundable tax credit.

August 6, 2020, that the Treasury Department's FY 2020 AFR would not include an estimate of the Net PTC improper payments. The Treasury Department's memorandum to the OMB cited delays stemming from significant demands placed on the Treasury Department and IRS in connection with the Coronavirus Disease 2019 (COVID-19) crisis. The memorandum also cited delays working with the Department of Health and Human Services[7] and the Centers for Medicare and Medicaid Services to develop a joint methodology for assessing improper payment risk for the PTC.

Finally, as we continue to report, the IRS has made little progress in reducing improper payments associated with the refundable tax credit programs it administers. However, there are actions that the IRS can take that include more effectively using authorities provided by the Internal Revenue Code. In addition to using these authorities more effectively, Congress could also assist the IRS by expanding the IRS's authority (referred to as correctable error authority or math error authority) to correct tax returns with identified erroneous refundable tax credit claims during processing.

Assessment of Fiscal Year 2020 Compliance With Improper Payment Reporting Requirements

The OMB identified the EITC, ACTC, and AOTC Programs as high-priority programs in FY 2020. As such, the IRS is required to report annually on its efforts to reduce improper payments in these programs. Our review confirmed that the IRS provided all required improper payment information for these refundable tax credits to the Treasury Department for inclusion in the *Department of the Treasury Agency Financial Report Fiscal Year 2020*. The IRS has not reduced the overall improper payment rate to less than 10 percent for these three credits. However, the IRS was approved for an exception to the annual reduction target reporting requirement. As an alternative, the OMB advised that a reduction target may remain constant given the complexities of the program, as long as the complexities are clearly explained in a footnote. Therefore, the IRS included a section in the AFR that describes five barriers to reducing refundable tax credit improper payments. The barriers are 1) complexity and lack of data to verify statutory eligibility requirements, 2) lack of correctable error authority, 3) high turnover of eligible taxpayers, 4) unscrupulous and/or incompetent tax return preparers, and 5) fraud. Figure 1 provides a summary of our evaluation of the IRS's compliance with the various improper payment reporting requirements.

Figure 1: IRS Compliance With Improper Payment Requirements for the EITC, ACTC, and AOTC Programs for FY 2020

Improper Payment Requirement	Source of Requirement	Provided by the IRS
Conduct a program-specific risk assessment for each program or activity identified by the Treasury Department.	PIIA	✓
Publish an improper payment estimate.	PIIA	✓

[7] The Department of Health and Human Services is responsible for determining the amount of the APTC the taxpayer is eligible to receive.

Improper Payment Requirement	Source of Requirement	Provided by the IRS
Report an improper payment rate of less than 10 percent.	PIIA	✗
Provide the methodology for identifying and measuring improper payments.	Executive Order	✓
Publish improper payment reduction targets.[8]	PIIA/Executive Order	✓
Publish a programmatic corrective action plan.	PIIA	✓
Report on actions the IRS intends to take to prevent future improper payments.	PIIA	✓
Report on efforts taken or planned to recapture improper payments.	PIIA	✓
Provide plans and supporting analysis for ensuring that the initiatives undertaken do not unduly burden program access and participation by eligible beneficiaries.	Executive Order	✓
Provide required information for posting to the www.paymentaccuracy.gov website.	PIIA/Executive Order	✓

Source: Treasury Inspector General for Tax Administration's (TIGTA) review of the IRS's compliance with improper payment reporting requirements for FY 2020.

The Risk of Net Premium Tax Credit Improper Payments Is Not Included in the Agency Financial Report

The IRS estimated that 27.4 percent ($540.9 million) of the total Net PTC payments in FY 2019 were improper. This confirms that the improper payments, as defined by OMB guidance, meet PIIA guidelines for rating as a high risk. The OMB defines significant improper payments as gross annual improper payments in a program exceeding both 1.5 percent of program outlays and $10 million of all program or activity payments made during the fiscal year reported, or $100 million in payments regardless of the improper payment percentage of total program outlays.

The Treasury Department is required to begin reporting the estimated total Net PTC improper payments in its FY 2020 AFR. However, as previously stated, the Treasury Department notified the OMB that it will delay reporting this information due to significant demands placed upon the Treasury Department and IRS in connection with the COVID-19 crisis. The IRS continues to collaborate with the Department of Health and Human Services and Centers for Medicare and Medicaid Services to develop a joint methodology for assessing improper payment risk for PTC payments and accurately define the improper payment rate for the PTC that includes both the Advanced PTC (APTC) and the Net PTC. The IRS stated that reporting a rate in the FY 2020 AFR using a separate estimation model without proper coordination with the Department of Health

[8] The IRS is required to submit quarterly scorecards to show the progress made in lieu of reduction targets. In addition, if the reduction target is a constant, a footnote should clearly explain the complexities surrounding the program.

and Human Services and Centers for Medicare and Medicaid Services would be a wasted effort and result in reporting based on a methodology inconsistent with future reporting.

Our analysis of Tax Year 2019 tax returns processed through July 31, 2020, found 4.6 million returns that self-reported nearly $35.9 billion in PTCs that were either received in advance or claimed at the time of filing. A total of $4.3 billion in APTCs claimed by these filers was in excess of the amount of the PTCs to which they were entitled. More than $1.3 billion of the amount of excess APTCs was not required to be repaid because the amount to be repaid is subject to certain limitations.[9] For example, the Patient Protection and Affordable Care Act[10] limits the amount of the APTC that individuals with household income between 100 percent and 400 percent of the Federal Poverty Level have to repay. Figure 2 compares PTC statistics for Tax Years 2017 through 2019, which continues to show the high risk of improper PTC payments.

Figure 2: PTC Statistics for Tax Years 2017 Through 2019

	Tax Year 2017 Tax Returns Processed as of May 3, 2018	Tax Year 2018 Tax Returns Processed as of May 2, 2019	Tax Year 2019 Tax Returns Processed as of July 30, 2020[11]
Total Tax Returns With PTC or APTC	**4.9 million**	**4.8 million**	**4.6 million**
Sum of APTC and PTC Claimed at Filing In Excess of the APTC	$27.0 billion	$37.7 billion	$35.9 billion
Total APTC Amount	$25.6 billion	$36.4 billion	$34.6 billion
Total PTC Claimed at Filing in Excess of the APTC	$1.4 billion	$1.3 billion	$1.3 billion
Tax Returns With Excess APTC Payments – *(taxpayer receives more APTC payments than the PTC amount to which they are entitled)*			
Total Tax Returns	2.7 million	2.6 million	2.4 million
Total PTC Amount	$9.8 billion	$13.5 billion	$12.8 billion
Total APTC Amount	$13.5 billion	$18.0 billion	$17.1 billion
Total APTC Reported in Excess of the PTC	$3.7 billion	$4.5 billion	$4.3 billion
Total APTC Above the Repayment Limit (individuals are not required to repay)	$1.0 billion	$1.3 billion	$1.3 billion
Total APTC Below the Repayment Limit (individuals are required to repay)	$2.7 billion	$3.2 billion	$3.1 billion

Source: TIGTA's analysis of Individual Master File. Totals may not add due to rounding.

[9] TIGTA, Ref. No. 2017-43-022, *Affordable Care Act: Verification of Premium Tax Credit Claims During the 2016 Filing Season* p. 4, (Mar. 2017).

[10] Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of the U.S. Code), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.

[11] Tax Year 2020 returns selected through July 30, 2020, due to the IRS extending Filing Season 2020 to July 15, 2020.

IRS management stated that the Department of Health and Human Services and Centers for Medicare and Medicaid Services do not plan to report their portion of improper payment rates for the PTC until FY 2022. Because the IRS's discussions and collaboration with these agencies is ongoing, we are not making a recommendation.

The IRS Reported the Status of All Unimplemented Recommendations to Congress As Required

On December 20, 2019, Congress enacted the Consolidated Appropriations Act, 2020.[12] Pursuant to that act, the IRS was directed to make the elimination of improper payments an utmost priority. Further, the IRS is to implement, within 270 days of enactment of this Act, all open and unimplemented recommendations from TIGTA and the Government Accountability Office that address improper payments or report on impediments to implementation of each open recommendation. This report shall include the dollar value of improper payments, as estimated by TIGTA or the Government Accountability Office, which would be avoided through implementation of each recommendation. On January 5, 2021, the IRS reported two unimplemented Government Accountability Office recommendations to Congress, as required.

Authorities Provided by the Internal Revenue Code Are Not Effectively Used to Address Erroneous Refundable Tax Credit Payments

In February 2020, we reported[13] on the results of our audit to evaluate the IRS's use of available tools to deter taxpayers from repeatedly claiming erroneous or fraudulent refundable tax credits. Our review identified that the IRS does not use the tools provided by Congress to the maximum extent possible to address erroneous credit payments. For example:

- **The erroneous refund penalty[14] is not being assessed on the majority of taxpayers with reduced or disallowed refundable tax credit claims.** For example, for Tax Years 2015, 2016, and 2017, the IRS disallowed more than $1.7 billion in refundable tax credit claims but did not assess more than $341 million in erroneous refund penalties. Congress provided the IRS with this penalty as a tool to deter aggressive claims for tax refunds and credits by increasing the cost to individuals who attempt to claim erroneous refunds. IRS management stated that the erroneous refund penalty may not be applicable for all cases in which taxpayers' refundable tax credit claims are disallowed, and starting in Processing Year 2021, the erroneous refund penalty will be proposed on the population of taxpayers with more egregious behavior.
- **The majority of taxpayers who are recertified[15] are not verified by the IRS.** Our review identified 311,883 tax returns for which the taxpayers' tax accounts had a

[12] Pub. L. No. 116-93, 133 Stat. 2317.

[13] TIGTA, Ref. No. 2020-40-008, *Authorities Provided by the Internal Revenue Code Are Not Effectively Used to Address Erroneous Refundable Credit and Withholding Credit Claims* (Feb. 2020).

[14] The Small Business and Work Opportunity Tax Act of 2007 provides the IRS with the ability to assess the erroneous claim for refund or credit penalty (referred to as the erroneous refund penalty).

[15] The Internal Revenue Code requires individuals whose EITC, ACTC, or AOTC claim has been reduced or disallowed to recertify their eligibility before they can receive the credit again.

recertification indicator that either were processed during Calendar Year 2018[16] or had an examination that was closed during FY 2018. We identified 289,059 (93 percent) returns for which the IRS did not verify the taxpayers' eligibility before recertifying them to receive a refundable tax credit. These taxpayers received more than $532 million in refundable tax credits. IRS management stated that, to determine whether a taxpayer is eligible to again claim a tax credit after it was disallowed on a prior tax return, an audit must be conducted. Moreover, the absence of an audit does not mean that the taxpayers were not entitled to claim the credit.

- **Bans are not being used effectively to address refundable tax credit noncompliance and ensure efficient use of limited examination resources.** Our analysis of 1.9 million taxpayers who claimed the EITC, the ACTC, or the AOTC in Tax Year 2017 and did not have a ban on their tax accounts identified 3,934 taxpayers[17] who were allowed to claim more than $12.9 million in credits despite having the same credit disallowed in the two prior tax years (Tax Years 2015 and 2016). We estimate it costs the IRS nearly $1.1 million to audit taxpayers who had already been denied the EITC, the ACTC, or the AOTC in two prior audits. IRS management stated that, starting in Processing Year 2021, systemic processes will assess the two-year ban for the ACTC.

The ineffective use of the various authorities provided in the Internal Revenue Code is a contributing factor in the high rate of improper payments. These tools include the authority to assess the erroneous refund penalty and require taxpayers to recertify that they meet refundable tax credit eligibility requirements for credits claimed on a return filed subsequent to disallowance of a credit and the ability to apply two-year or 10-year bans on taxpayers who disregard credit eligibility rules. However, the IRS does not use these tools to the fullest extent possible to address erroneous credit payments.

TIGTA made eight recommendations to the IRS Commissioner, Wage and Investment Division, in its February 2020 report. The IRS agreed or partially agreed with five recommendations. The IRS did not agree to examine all tax returns with a recertification indicator, modify systemic processes to apply the two-year ban after two audits result in the disallowance of a refundable tax credit, or develop a plan to obtain and use information from the Social Security Administration on individuals who admit to falsely reporting self-employment income to receive refundable tax credits.

Increased Correctable Error Authority Could Reduce the Number of Potentially Erroneous Refundable Tax Credit Payments

To give the IRS the ability to identify improper refundable tax credit claims based on incorrect income reporting, Congress included provisions in the Protecting Americans From Tax Hikes Act of 2015[18] that changed the date for third parties to file Form W-2, *Wage and Tax Statement*, and report nonemployee income on Form 1099-MISC, *Miscellaneous Income*, to January 31. The Act

[16] As of July 31, 2018.

[17] The 3,934 taxpayers are limited to those taxpayers whom the IRS audited at least twice during Tax Years 2015 through 2017, and two or more of the audits were closed with a status other than undeliverable, *i.e.*, the taxpayer received the audit letter.

[18] Pub. L. No. 114-113, 129 Stat. 2242 (2015).

also prohibits the IRS from issuing tax refunds prior to February 15 when the tax return includes the EITC or the ACTC to provide adequate time to verify income reported on these returns. However, this Act did not provide the IRS with expanded correctable error authority to address refundable tax credit claims with identified income discrepancies.

Without this authority, the IRS must still audit each tax return to prevent or recover the unsupported refundable tax credits. As a result of limited resources, the majority of refundable tax credit claims with income discrepancies are not addressed. This, in turn, contributes to the IRS's inability to make any significant reduction in improper refundable tax credit payments via the use of earlier reporting of income information. For example, as of July 30, 2020, our analysis of Tax Year 2019 tax returns identified more than 1.9 million tax returns with an income discrepancy of $1,000 or greater between the amount reported on the tax returns and the amount reported on Forms W-2. However, the IRS did not select these returns for further review.

Refunds associated with these 1.9 million tax returns totaled more than $9 billion, which included nearly $4.9 billion in EITCs and more than $2.3 billion in ACTCs. For 182,048 of the tax returns, we identified that the IRS received no third-party Forms W-2 supporting the wages reported on the returns (for which more than $757 million in EITCs and ACTCs was paid). Figure 3 shows the number of Tax Years 2017 through 2019 tax returns that claimed the EITC and the ACTC and did not have Forms W-2 to support the reported wages.

Figure 3: Tax Years 2017 Through 2019 Returns Without Forms W-2 to Support Wages Reported on the Returns

Tax Year	Number of Returns	EITC/ACTC Claimed
2017[19]	278,174	$1.0 billion
2018[20]	963,618	$3.3 billion
2019	182,048	$757 million
Totals	**1,423,840**	**$5.1 billion**

Source: Previous TIGTA audit reports and our analysis of Individual Master File, Information Returns Master File, and Form W-2 data for tax returns processed as of July 30, 2020.

In Processing Year 2019, the IRS implemented a systemic process to suspend all tax returns identified as potentially fraudulent to provide the IRS with additional time to receive third-party income documents, *e.g.*, Forms W-2. For those tax returns for which a third-party income document is received, the IRS will determine if the return has good income and withholding or will send the return for further review if the income and withholding do not match. Tax returns for which the IRS receives no third-party income document by June 15 are selected for a fraud review.

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[19] TIGTA, Ref. No. 2019-40-039, *Some Refundable Credits Are Still Not Classified and Reported Correctly as a High Risk for Improper Payment by the Internal Revenue Service* (May 2019).

[20] TIGTA, Ref. No. 2020-40-025, *Improper Payment Reporting Has Improved; However, There Have Been No Significant Reductions to the Billions of Dollars of Improper Payments* (Apr. 2020).

The IRS also continues to request additional authority that would allow it to correct tax returns claiming a refundable tax credit with an income discrepancy. The IRS requested this authority to address returns during processing when the information provided by the taxpayer does not match the information contained in Government databases, *e.g.*, income information reported on the tax return does not match Form W-2 information the IRS receives from the Social Security Administration.

Recent legislation allows the IRS to use math error authority in limited instances

Section 211 (c)(1) of the Taxpayer Certainty and Disaster Tax Relief Act of 2020[21] authorizes the use of math error authority for tax returns on which a taxpayer elects to use prior year earned income to calculate the EITC or ACTC but the prior year earned income reported by the taxpayer is incorrect. Specifically, the IRS has math error authority to make the following corrections:

- If an individual elects to use Tax Year 2019 earned income on the Tax Year 2020 tax return to compute either credit but the Tax Year 2019 earned income amount shown on the Tax Year 2020 return is different than the earned income amount shown on the Tax Year 2019 tax return, the IRS can use math error authority to compute the credit(s) using the earned income amount shown on the Tax Year 2019 tax return.
- If the taxpayer's Tax Year 2019 earned income is, in fact, *not* greater than the earned income for Tax Year 2020, the election could be disallowed using math error authority resulting in both credits being calculated on the basis of Tax Year 2020 earned income.

Reintroducing the nonemployee compensation form will assist the IRS in determining eligibility for refundable tax credits

The IRS is reintroducing Form 1099-NEC, *Nonemployee Compensation*, for reporting nonemployee compensation and can use the data on these forms while determining eligibility for refundable tax credits. Businesses should issue Form 1099-NEC if the following four conditions are met:

- Payment is made to someone who is not an employee.
- Payment for services is made in the course of the trade or business.
- Payment is made to an individual, partnership, estate, or in some cases, a corporation.
- Payment is made to the payee for at least $600 during the year.

However, similar to the IRS's use of Forms W-2 to identify refundable credit claims with income discrepancies, the IRS was not given the authority to adjust, at the time of processing, claims based on Form 1099-NEC income discrepancies. As such, the IRS will have to audit tax returns with Form 1099-NEC income discrepancies. As previously stated, the majority of refundable tax credit claims with income discrepancies will not be addressed because of limited IRS resources.

[21] Pub. L. No. 116-260, Division EE.

Revising the Nonwork Social Security Number Case Selection Increased the Revenue Protected

In July 2017,[22] we reported that the IRS had not established processes to prevent individuals who have a nonwork Social Security Number (SSN) from receiving the EITC.[23] In response, the IRS initiated a pilot program to identify 500 tax returns with EITC claims during processing for which claimants were issued a nonwork SSN and, as such, did not qualify for the EITC. Claimants are asked to provide documentation that they no longer have a nonwork SSN (now have one that is valid for work) and, therefore, qualify for the EITC claimed. If the claimant cannot provide the documentation or fails to respond to the notice, the IRS will disallow the credit. Figure 4 provides a breakdown of the number of returns filed by nonwork SSN individuals for Tax Years 2017 and 2018 that the IRS selected for review, the number of the returns with reversed EITC, and the amount of revenue protected associated with the erroneous returns.

Figure 4: Returns With Nonwork SSNs Selected by the IRS

Tax Year	Number of Returns Selected	Number of Returns With Reversed EITC	Revenue Protected
2017	500	341	$1.3 million
2018	1,142	782	$3.2 million
Totals	**1,642**	**1,123**	**$4.5 million**

Source: Return Integrity and Compliance Services function management. The 2018 Filing Season data are as of October 27, 2018, and the 2019 Filing Season data are as of May 30, 2019.

The Tax Cuts and Jobs Act,[24] enacted in December 2017, changed the requirements for the ACTC to require an SSN that is valid for work for each qualifying dependent. As such, similar to EITC claims, ACTC claims for which dependent(s) were issued a nonwork SSN do not qualify for the ACTC. In a prior report,[25] we recommended that the IRS systemically identify and evaluate tax returns filed by individuals who have nonwork SSNs to prevent erroneous refunds of the EITC and the ACTC. The IRS agreed with this recommendation.

Our current review identified that the IRS modified its procedures to address eligibility for the ACTC when a tax return claiming the EITC is selected for review. The Automated Questionable Credit Program identifies and processes these questionable returns. This processing includes the IRS issuing Letter 4800C, *Questionable Credit 30 Day Contact Letter*, informing the taxpayer of a proposed tax deficiency or disallowed claim for refund. If the taxpayer does not respond to this letter within 30 days, the IRS sends Letter 3219C, *Statutory Notice of Deficiency*, allowing

[22] TIGTA, Ref. No. 2017-40-042, *Processes Do Not Maximize the Use of Third-Party Income Documents to Identify Potentially Improper Refundable Credit Claims* (July 2017).

[23] The Personal Responsibility and Work Opportunity Reconciliation Act of 1996, enacted August 22, 1996, requires individuals claiming the EITC to have an SSN that is valid for work and authorizes the IRS to deny claims to those individuals who file using an invalid SSN.

[24] Pub. L. No. 115-97, 131 Stat. 2054.

[25] TIGTA, Ref. No. 2019-40-039, *Some Refundable Credits Are Still Not Classified and Reported Correctly as a High Risk for Improper Payment by the Internal Revenue Service* (May 2019).

the taxpayer 90 days to petition the Tax Court for relief. If the taxpayer does not petition the court within 90 days or respond to Letter 3219C, the IRS will disallow the EITC/ACTC claim.

The IRS selected for review 1,819 Tax Year 2019 tax returns filed by individuals with a nonwork SSN who claimed the EITC or ACTC. The IRS is in the process of issuing 450 Letters 4800C. The IRS also reversed the EITC/ACTC on 88 returns and protected about $450,000 in revenue through January 9, 2021. However, the IRS was unable to resolve the remaining 1,281 cases due to suspension of Tax Court operations and the IRS placing a moratorium on tax assessments due to COVID-19. Management stated that resolving these cases, after the moratorium is lifted, is expected to result in $6.3 million in protected revenue. This is a significant increase over the $3.2 million protected for Tax Year 2018 tax returns.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the IRS complied with the annual improper payment reporting requirements for FY 2020. To accomplish our objective, we:

- Determined if the IRS complied with the improper payment reporting requirements for FY 2020.
- Reviewed the information the IRS provided to the Treasury Department for inclusion in the AFR to determine if sufficient information was provided to satisfy the reporting requirements.
- Reviewed information that the IRS provided to the Treasury Department for posting to the www.paymentaccuracy.gov website.
- Determined if the information included in the FY 2020 Treasury AFR relative to EITC improper payments accurately reflects the underlying information from the IRS and was posted to www.paymentaccuracy.gov or other Internet locations as required.
- Evaluated the adequacy of the IRS's methodology to calculate the ACTC and AOTC improper payment rate and dollar amounts.
- Determined the potential ACTC and AOTC improper payment rate for FY 2020. We ensured that the IRS's determination of improper payment risk was consistent with the potential improper payment rate.
- Determined the potential PTC improper payment rate for FY 2020. We ensured that the IRS's determination of the improper payment risk was consistent with the potential improper payment rate. We assessed the IRS's efforts to evaluate the risk of PTC improper payments.
- Evaluated the adequacy of the IRS's FY 2020 risk assessment for the Treasury Department's identified revenue program funds.
- Followed up on select prior audit findings to ensure that the IRS has taken the agreed upon action to resolve the issues.
- Determined if the IRS has taken action to analyze the available nonwork SSN data and evaluate its usefulness to identify potentially fraudulent EITC claims.
- Determined if the IRS has taken actions to use third-party income documents to identify discrepancies to prevent the issuance of EITC and ACTC claims when the income reported on the tax return is not supported by Forms W-2 on the Information Return Master File.

Performance of This Review

This review was performed with information obtained from the Office of the Chief Financial Officer and the Office of Research, Applied Analytics, and Statistics located at the IRS Headquarters in Washington, D.C., and the Office of Return Integrity and Correspondence Services in Atlanta, Georgia, during the period October 2020 through February 2021. 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.

Major contributors to the report were Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services); W. Allen Gray, Director; Paula W. Johnson, Audit Manager; Edgar L. Moon Jr., Lead Auditor; and Audrey M. Graper, Auditor.

Validity and Reliability of Data From Computer-Based Systems

During this review, we relied on data received from the IRS for the National Research Program on the ACTC, the AOTC, the PTC, and the EITC for Tax Year 2016. We also obtained extracts from the IRS's Individual Master File and the Individual Return Transaction File databases for Processing Year 2020 that were available on TIGTA's Data Center Warehouse. We evaluated the data by 1) performing electronic testing of required data elements, 2) reviewing existing information about the data and the systems that produced them, and 3) interviewing agency officials knowledgeable about the data. We determined that the data were sufficiently reliable for 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 that the following internal controls were relevant to our audit objective: the controls in place to ensure that the IRS met the annual improper payment reporting requirements established in the PIIA and Executive Order 13520. We tested these controls by reviewing and analyzing relevant documents, data, and calculations related to the preparation of EITC improper payment estimate information.

Appendix II

IRS Programs Identified for Improper Payment Risk Assessments

The following IRS programs were identified by the Treasury Department for improper payment risk assessments for FY 2020.

IRS Program	Type of Program	Level of Risk Identified	Total Non-Federal Disbursements
Headquarters Disbursement Earned Income Credit	Revenue	High	$59.2 billion
Additional Child Tax Credit	Revenue	High	$28.9 billion
American Opportunity Credit[1]	Revenue	High	$2.9 billion
Premium Tax Credit[2]	Revenue	High	$58.4 billion
Health Care Credit	Administrative	Low	$24.3 million
Refund – Corporations	Revenue	Low	$8.2 billion
Refund Collection – Interest	Revenue	Low	$2.0 billion

Source: IRS Office of the Chief Financial Officer.

[1] The EITC, ACTC, and AOTC have been declared high-priority programs for improper payments by the OMB; therefore, no formal risk assessment is required for these revenue funds.

[2] A risk assessment was required; however, the IRS was granted an exemption for reporting an estimate for the PTC for FY 2020, as implementing COVID-19 programs was determined to be a priority.

Appendix III

Management's Response to the Draft Report

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

CHIEF FINANCIAL OFFICER

April 23, 2021

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Teresa R. Hunter
Chief Financial Officer

Teresa R. Hunter
Digitally signed by Teresa R. Hunter
Date: 2021.04.20 13:35:17 -04'00'

SUBJECT: Response to Draft Audit Report – Improper Payment Rates for Refundable Tax Credits Remain High (Audit #202140001)

Thank you for the opportunity to review and comment on your draft audit report entitled *Improper Payment Rates for Refundable Tax Credits Remain High*. The programs examined in this report are refundable tax credits (RTC) designed to achieve specific economic and social objectives, such as reducing poverty and increasing the affordability of higher education. Programs with RTC present challenges of administering complex social benefit programs, such as the Earned Income Tax Credit, the American Opportunity Tax Credit, the Additional Child Tax Credit, and the Premium Tax Credit component of the Affordable Care Act through the tax administration system. These, and other social programs, have been expanded and will continue to require education, oversight, and compliance activities going forward to ensure the correct taxpayers receive the correct benefits.

Concerning the summary of the *Business Case to Eliminate Redundant Reporting of Refundable Tax Credits* (pages 2 and 3), we are continuing discussions with the Office of Management and Budget to eliminate redundant RTC reporting. RTC overclaims are largely due to their statutory design and complexity taxpayers face when self-certifying RTC eligibility, not internal control weaknesses or reporting failures. The tax system is primarily a collection system and not a payment program. While the refundable portions of RTCs are considered outlays and currently fall under the scope of payments under the Payment Information Integrity Act of 2019, we do not believe that RTCs meet the definition of payments. Accordingly, RTC overclaims are more effectively remediated in the Tax Gap Estimate Program, where they can be prioritized relative to all other types of tax noncompliance identified by this enterprise risk approach.

We appreciate your office's conscientious evaluation of these programs and the IRS's continuing efforts to reduce and eliminate erroneous claims within the structure of the tax administration system. If you have any questions, please contact me at 202-317-4147, or a member of your staff may contact Jonathan Edelson, Acting Associate Chief Financial Officer for Internal Controls, at 202-803-9206.

Appendix IV

Glossary of Terms

Term	Definition
Additional Child Tax Credit (ACTC)	A credit for individuals who receive less than the full amount of the nonrefundable Child Tax Credit. The ACTC may result in a refund even if no tax is owed.
Advanced Premium Tax Credit (APTC)	Payments that help eligible taxpayers cover the cost of insurance premiums, which is reported to the IRS on Form 1095-A, *Health Insurance Marketplace Statement.*
Agency Financial Report (AFR)	Provides financial and performance information of the Treasury Department's operations, accomplishments, and challenges.
American Opportunity Tax Credit (AOTC)	A credit for qualified education expenses paid for an eligible student for the first four years of higher education. Forty percent of the AOTC may be refundable. This means that if the refundable portion of the credit is more than the tax liability, the excess will be refunded.
Data Center Warehouse	The Data Center Warehouse is a TIGTA Office of Information Technology function that obtains and stores numerous IRS data files and makes them available to auditors and investigators via the TIGTA Intranet.
Earned Income Tax Credit (EITC)	A credit for certain low-income individuals who meet earned income, adjusted gross income, and certain other requirements. EITC greater than the tax liability may be refunded.
Excess Advanced Premium Tax Credit	When the APTC is more than the allowed PTC (APTC minus PTC = Excess APTC). This is treated as a tax liability.
Filing Season	The period from January through mid-April when most individual income tax returns are filed.
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.
Fund Group	Programs the Treasury Department identifies that the IRS must assess for the risk of improper payments.
High-Priority Program	Program identified as susceptible to significant improper payments.
Improper Payment	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 (including both overpayments and underpayments).
Improper Payment Rate	Amount in improper payments divided by the amount in program outlays for a given program in a given fiscal year.
Incorrect Amount	An overpayment or underpayment made to an eligible recipient, including payments that are incorrect amounts or duplicate payments.

Term	Definition
Individual Master File	The IRS database that maintains transactions or records of individual tax accounts.
Individual Return Transaction File	This process displays Individual Master File, Individual Return Transaction File, and National Account Profile data by account.
Information Returns Master File	Maintains a master batch file of current tax year information returns and maintains access to nine prior years. Beginning in January of each year, extracts are made from the entire Individual Returns Master File on a weekly basis.
Net Premium Tax Credit	When the PTC exceeds the APTC (PTC minus APTC = Net PTC). Net PTC reduces a taxpayer's tax liability and, if it is more than the tax liability, results in a refundable tax credit.
Non-Federal Disbursements	Outlays to taxpayers (claims on tax returns).
Nonwork Social Security Number	A nonwork SSN is issued to obtain Federal benefits, *e.g.*, Medicaid or food stamps, and is not valid for work. The Social Security Administration has issued almost 8 million "NOT VALID FOR EMPLOYMENT" SSNs since 1972 to individuals who do not have authorization to work in the United States.
Outlay	A payment to liquidate an obligation generally equal to cash disbursements (the measure of Government spending).
Overpayment	Amount of the refundable tax credit paid to taxpayers as a refund.
Payment	Any disbursement or transfer of Federal funds to any non-Federal person, non-Federal entity, or Federal employee, which is made by a Federal agency, contractor, grantee, or a governmental or other organization administering a Federal program or activity.
Premium Tax Credit (PTC)	Refundable tax credit that helps eligible individuals and families cover the premiums for their health insurance purchased through the Health Insurance Marketplace.
Processing Year	The calendar year in which the tax return or document is processed by the IRS.
Program	Activities or sets of activities recognized as programs by the public, OMB, or Congress as well as those that entail program management or policy direction.
Qualitative Risk Assessment	A questionnaire used to assess a program's internal control risks that could lead to susceptibility to significant improper payments.
Quantitative Risk Assessment	A review of a sample of disbursements to formulate the overall estimated improper payment rate for the program.
Significant Improper Payment	Gross annual improper payments (*i.e.*, the total amount of overpayments and underpayments) in the program exceeding 1) both 1.5 percent of program outlays and $10 million of all program or activity payments made during the fiscal year reported <u>or</u> 2) $100 million (regardless of the improper payment percentage of total program outlays).

Term	Definition
Tax Gap	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.
Tax Year	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.
Underpayment	The amount disallowed in processing (and not subsequently allowed prior to the examination) that should have been allowed based on an examination of the taxpayer's books and records.

Appendix V

Abbreviations

ACTC	Additional Child Tax Credit
AFR	Agency Financial Report
AOTC	American Opportunity Tax Credit
APTC	Advanced Premium Tax Credit
EITC	Earned Income Tax Credit
FY	Fiscal Year
IRS	Internal Revenue Service
OMB	Office of Management and Budget
PIIA	Payment Integrity Information Act
PTC	Premium Tax Credit
SSN	Social Security Number
TIGTA	Treasury Inspector General for Tax Administration

To report fraud, waste, or abuse, call our toll-free hotline at:

(800) 366-4484

By Web:

www.treasury.gov/tigta/

Or Write:

Treasury Inspector General for Tax Administration

P.O. Box 589

Ben Franklin Station

Washington, D.C. 20044-0589

Information you provide is confidential, and you may remain anonymous.