

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

September 7, 2023

Report Number: 2023-30-053

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.

HIGHLIGHTS: Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

Final Audit Report issued on September 7, 2023

Report Number 2023-30-053

Why TIGTA Did This Audit

As recently as March 2023, the IRS identified the Fuel Tax Credit (FTC) on its annual "Dirty Dozen" list of the worst tax scams. TIGTA previously recommended that the IRS improve systemic controls over FTC submissions and examine returns with lower FTCs as resources permitted. This audit was initiated to determine whether our prior recommendations were addressed and to evaluate the current FTC screening and examination processes for individual taxpayers claiming the credit.



The IRS processed more than 1 million Forms 1040 with Fuel Tax Credit claims totaling nearly \$800 million.

Impact on Tax Administration

The Federal Government imposes an excise tax on the purchase of certain fuels, including an \$0.184 per gallon tax on gasoline and a \$0.244 per gallon tax on diesel. A refundable credit for these taxes may be claimed for various nontaxable uses of fuel, including off-highway business and farming use. An individual claiming the FTC without a business purpose, being engaged in a business activity that does not qualify for the credit, or filing a tax return with no indication of a business purpose makes the FTC claim questionable. This audit focused on FTC claims made by individuals on Form 4136, *Credit for Federal Tax Paid on Fuels*, attached to Form 1040, *U.S. Individual Income Tax Return*. From January 2018 through December 2021, the IRS processed approximately 1.2 million Forms 1040 with FTC claims totaling \$797 million.

What TIGTA Found

While the IRS has updated its method of screening and examining questionable FTC claims, improvements to FTC compliance processes are needed. For example, of the 1,172,732 Forms 1040 with FTC claims processed from January 1, 2018, through December 31, 2021, 263,522 returns had no business purpose and 24,769 of these returns had FTC claims above the examination threshold. The IRS did not examine 15,779 of the 24,769 returns with \$32.5 million in FTC claims. The IRS considers an FTC claim without a business purpose as a frivolous position and subject to a \$5,000 frivolous filing penalty. The IRS examined 10,026 returns filed by individual taxpayers from October 1, 2017, through December 31, 2021, which had no business purpose indicated on the return. The IRS decreased the FTC on 7,070 returns but assessed a penalty on only 13 returns. The 7,057 remaining returns may have been subject to \$35.3 million in frivolous filing penalties.

The IRS does not require taxpayers to certify on Form 4136 that FTC claims are from use in a vehicle not registered, or required to be registered, for highway use (a requirement of Internal Revenue Code § 6421) and does not examine FTC claims adequately to ensure that taxpayers are engaged in a trade or business. In addition, the IRS Submission Processing function routinely increases problematic FTC claims under certain circumstances but rarely decreases claims due to taxpayer errors. Finally, TIGTA found a disproportionate number of tax returns that claimed an FTC with common tax return characteristics that could indicate unscrupulous filing scheme activity.

What TIGTA Recommended

TIGTA made seven recommendations, with the IRS agreeing to five and partially agreeing to one, including examining additional high-dollar FTC claims, increasing use of the frivolous filing penalty to deter filing improper claims, revising Form 4136 to require certification that the FTC is not claimed for a vehicle registered for highway use, and examining potential FTC schemes with common tax return characteristics.

The IRS did not agree to develop a process to validate FTC claims where the taxpayer completed Form 4136 but did not correctly transfer the claim amount to the Form 1040. TIGTA believes that presuming the validity of the claim is inconsistent with the IRS's placement of the FTC on its "Dirty Dozen" list.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20024

September 7, 2023

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

Heather Hill

FROM: Heather M. Hill
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed (Audit # 202230015)

This report presents the results of our review to determine whether the Internal Revenue Service is adequately considering the Fuel Tax Credit claimed by individual taxpayers and to follow up on past recommendations. This review is part of our Fiscal Year 2023 Annual Audit Plan and addresses the major management and performance challenge of *Increasing Domestic and International Tax Compliance and Enforcement*.

Management's complete response to the draft report is included as Appendix III. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).

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Background

The Federal Government imposes an excise tax on the purchase of certain fuels, including the Federal excise tax at \$0.184 per gallon on gasoline and \$0.244 per gallon on diesel.¹ The Fuel Tax Credit (FTC) is a tax credit that may be claimed for various nontaxable uses of fuel, including farming and off-highway business use. Depending on the taxpayer's situation, the FTC claim is made as an excise claim on either Form 720, *Quarterly Federal Excise Tax Return*, or Form 8849, *Claim for Refund of Excise Taxes*. Amounts not claimed on these forms may be claimed as a refundable income tax credit on a Form 4136, *Credit for Federal Tax Paid on Fuels*, attached to an income tax return.

The FTC for farming requires fuel to be used on a farm for farming purposes.² The FTC for off-highway use requires fuel to be used in a trade or business.³ The FTC for off-highway business use of gasoline does not apply to passenger cars or, generally, to other vehicles that are registered or required to be registered to drive on public highways.⁴ For an individual taxpayer, the business purpose is typically shown by including a Schedule C, *Profit or Loss From Business*, or Schedule F, *Profit or Loss From Farming*, with the Form 1040. Some individuals could receive the FTC from a pass-through activity, like a partnership, shown on a Schedule E, *Supplemental Income and Loss*, submitted with the Form 1040. An individual taxpayer claiming the FTC without a business purpose, or being engaged in a business activity that does not typically qualify for the credit, makes the FTC claim questionable. The amount of fuel in proportion to business activity could also make the FTC claim questionable. For example, a \$1,000 FTC claim would require use of 5,464 gallons of gasoline (at the FTC rate of \$0.183 per gallon) or 4,115 gallons of diesel (at the FTC rate of \$0.243 per gallon).⁵ Business activity in relation to the amount of credit claimed is important in determining a questionable FTC claim. This review focused on individual taxpayers claiming the FTC on Form 4136 attached to Form 1040, *U.S. Individual Income Tax Return*, without a business purpose.

The FTC for off-highway business use of gasoline does not apply to passenger cars or, generally, to other vehicles that are registered, or required to be registered, to drive on public highways.

For the purposes of this review, business activity for an individual taxpayer is indicated by the presence of a Schedule C, E, or F attached to their Form 1040.

¹ Internal Revenue Code (I.R.C.) §§ 4081 and 4041. The tax includes a \$0.001 per gallon tax for the Leaking Underground Storage Tank Trust Fund, which Congress created in 1986 to address petroleum leaks from Federally regulated underground storage tanks. The Leaking Underground Storage Tank Trust Fund provides money for oversight and enforcement of cleanups of petroleum as well as inspections and other prevention activities. I.R.C. § 6430 generally does not allow a credit for the \$0.001 Leaking Underground Storage Tank Trust Fund.

² I.R.C. § 6420(c), where a credit is allowed if the farming activity is carried on as a trade or business.

³ I.R.C. § 6421(e)(2)(A).

⁴ I.R.C. § 6421(e)(2)(A); Internal Revenue Manual 4.19.15.16(2) (Nov. 4, 2019).

⁵ Figures are rounded.

Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

Unscrupulous individuals have been known to file fraudulent tax returns claiming improper FTCs to reduce taxes or receive improper refunds.⁶ The Internal Revenue Service (IRS) regularly identifies the FTC on its annual “Dirty Dozen” list of the worst tax scams. As recently as March 2023, the IRS stated that:

The fuel tax credit is meant for off-highway business and farming use and, as such, is not available to most taxpayers. However, unscrupulous tax return preparers and promoters are enticing taxpayers to inflate their refunds by erroneously claiming the credit.⁷

In March 2019, the IRS noted:

Improper claims for the fuel tax credit generally come in two forms. First, an individual or business may make an erroneous claim on their otherwise legitimate tax return. Second, identity thieves file bogus claims, often as part of a broader fraudulent scheme.

The IRS has stepped up efforts to improve Fuel Tax Credit compliance. IRS processing systems, including new identity theft screening filters, are now stopping a significant number of questionable Fuel Tax Credit refund claims.

Fraud involving the Fuel Tax Credit is considered a frivolous tax claim and can result in a penalty of \$5,000.⁸

Taxpayers submitted approximately 640 million individual returns to the IRS during Processing Years (PY) 2018 through 2021, which included approximately 1.2 million returns claiming a total of \$797 million in the FTC.⁹ Figure 1 provides the approximate number of individual income tax returns submitted by processing year and those with FTC claims. Most of the returns with FTC claims were electronically submitted to the IRS, with 117,200 (10 percent) submitted by paper.

Figure 1: Individual Income Tax Returns Submitted During PYs 2018 Through 2021 and Those With FTC Claims

PY	All Individual Returns	Individual Returns With FTC Claims	Total Amount of FTC Claims
2018	155 million	290,000	\$134 million
2019	155 million	289,000	\$233 million
2020	163 million	296,000	\$199 million
2021	167 million	298,000	\$231 million
Total	640 million	1.2 million	\$797 million

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of data from the IRS’s Individual Return Transaction File (IRTF).¹⁰

⁶ *U.S. v. St. Jean*, 122 American Federal Tax Reports 2d 2018-5601 (N.D. Ga. 2018) and *U.S. v. Demesmin* 123 American Federal Tax Reports 2d 2019-553 (M.D. Fla. 2019), in which tax return preparers who submitted false FTC claims were enjoined by the Government from preparing tax returns due to fraudulent claims; and *U.S. v. Bates*, 68 F.3d 471 (5th Cir. 1995), in which the defendant filed false FTC claims and when imprisoned, assisted fellow prisoners to file their own false FTC claims.

⁷ IR-2023-55, March 23, 2023.

⁸ IR-2019-42, March 14, 2019.

⁹ A processing year is the calendar year in which a tax return or document is processed by the IRS.

¹⁰ The IRTF is a database maintained by the IRS that contains information on the individual tax returns it receives.

When a Form 1040 is filed, the Wage and Investment (W&I) Division's Submission Processing function reviews the return for completeness and accuracy, including misplaced entries, computations, and missing attachments. Once a return is processed by Submission Processing, it goes through an automated selection system intended to identify returns meeting specific criteria for pre-refund examination. Due to limited examination resources, the criteria to identify questionable FTC returns includes dollar thresholds. If the return is selected for examination, the portion of the refund attributable to the FTC is frozen to prevent payment until conclusion of the examination. The Small Business/Self-Employed (SB/SE) and Large Business and International Divisions can also select the return for a post-refund examination based on selection criteria that may or may not include the FTC claim.

Results of Review

Since TIGTA's last review in Fiscal Year 2014, the IRS has improved its method of identifying and examining individual returns that have questionable FTC claims. However, there are areas where further improvements could be made that include: 1) examining additional high-dollar claims; 2) examining repeat filers of potentially improper claims; 3) increasing the use of the frivolous filing penalty where applicable; 4) ensuring that the FTC for off-highway business use is claimed only for equipment and vehicles not registered, or required to be registered, for highway use; 5) validating the FTC when the amount claimed on the Form 1040 is less than the amount on Form 4136; 6) reducing closure errors by Examination to tax accounts; and 7) examining potential schemes based on common tax return characteristics.

Examinations of Improper Fuel Tax Credit Claims Have Improved

In September 2014, TIGTA reported additional actions were needed to ensure that improper FTC claims are disallowed and recommended that the IRS: 1) create systemic controls to ensure that Forms 1040 claiming an FTC at or above a threshold were reviewed prior to refund issuance; 2) lower the threshold amount for selecting and reviewing Form 1040 returns; and 3) provide training to assist in evaluating acceptable documentation required by taxpayers to claim an FTC.¹¹ As a result of TIGTA's review, the W&I Division implemented a screening process to identify FTC returns above a dollar threshold and review them before issuing a refund. However, the process had difficulty tracking cases, which produced a large number of return reviews that were not productive.

To address these recommendations, the W&I Division updated its screening process for PY 2017 to identify improper FTC claims, which is still used today. In addition, the dollar threshold was lowered to allow more questionable returns to be identified for further review. The SB/SE Division examination process was also updated to use different filtering criteria to consider the presence of a qualified business and analyze business activity relative to the FTC claim. Training was also conducted for consistency among screeners and examiners when accepting proper substantiation of FTC claims.

¹¹ TIGTA, Report No. 2014-30-067, *Additional Actions Are Needed to Ensure That Improper Fuel Tax Credit Claims Are Disallowed* (Sept. 2014).

Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

Our review of the examination results of FTC claims shows higher productivity measures than the overall statistics for individual examinations. Figures 2 and 3 provide a comparison of examination statistics and results for individual returns with FTC claims, individual returns with FTC claims and no business purpose, and all individual returns regardless of the existence of FTC claims examined from October 2017 to December 2021.

Figure 2 addresses examination coverage and the percentage of those returns resulting in no examination changes to the filed return. Productivity statistics for examinations of FTC claims with no business purpose are more favorable than other examinations of individual returns, as measured by the higher percentage of returns examined and lower no-change rate.

Figure 2: Examination Statistics for Individual Returns Submitted During PYs 2018 Through 2021 and Completed From October 2017 to December 2021

Examination Results by Return Type	Examinations Completed	Examination Rate	Examination No-Change Rate
All Individual Returns Regardless of FTC Claim	2.8 million	0.4%	10.2%
Individual Returns with FTC Claim	22,403	1.9%	3.0%
Individual Returns with FTC Claim and No Business Purpose	10,026	3.8%	1.4%

Source: TIGTA analysis of data from the IRS's IRTF and Audit Information Management System (AIMS) for individual returns with FTC claims and IRS Data Book Table 37 and Table 38 for all individual returns.¹²

Figure 3 shows that examination productivity for FTC claims with no business purpose remains high, with fewer hours per return spent on examinations and higher assessment dollars generated per hour of an examination.

¹² AIMS is a system that provides inventory and activity controls of active examination cases. It uses linkage to the Integrated Data Retrieval System to input status changes, adjustments, and case closing actions.

Figure 3: Examination Results of Individual Returns Submitted During PYs 2018 Through 2021 and Completed From October 2017 to December 2021

Examination Results by Return Type	Total Amount of Assessments	Average Hours per Return	Average Assessments per Hour
All Individual Returns Regardless of FTC Claim	\$29.6 billion	6.0	\$1,787
Individual Returns with FTC Claim	\$110.6 million	2.4	\$2,057
Individual Returns with FTC Claim and No Business Purpose	\$35.9 million	1.1	\$3,203

Source: TIGTA analysis of data from the IRS IRTF and AIMS for individual returns with FTC claims and IRS Data Book Table 37 and Table 38 for all individual returns.

The W&I Division conducted the majority of the examinations involving FTC claims. Figure 4 provides a comparison of examination productivity of individual returns with FTC claims among divisions from October 2017 to December 2021. The total amount of assessments in Figure 4 represents assessments of individual returns with FTC claims. Overall, the W&I Division had more productive FTC examinations than the Large Business and International Division or the SB/SE Division when comparing the no-change rate, average hours per return, and average assessments per hour.

Figure 4: Examinations Within IRS Divisions Completed From October 2017 to December 2021 of Individual Returns With FTC Claims Submitted During PYs 2018 Through 2021

IRS Division	Number of Examinations Completed	Examination No-Change Rate	Total Amount of Assessments	Average Hours per Return	Average Assessments per Hour
LB&I	63	7.9%	\$6.8 million	46.8	\$2,288
SB/SE	2,500	7.6%	\$19.2 million	12.3	\$625
W&I	19,840	2.4%	\$84.6 million	1.0	\$4,216

Source: TIGTA analysis of data from the IRS's IRTF and AIMS for individual returns with FTC claims. LB&I = Large Business and International.

Not All Fuel Tax Credit Claims Above the Threshold Are Examined

Although the IRS lowered the FTC claim threshold for W&I Division examinations, TIGTA identified FTC claims above the threshold that were not being examined. Of the 1,172,732 individual returns with FTC claims submitted during PYs 2018 through 2021, 263,522 had no business purpose, which included a total of 24,769 returns with FTC claims above the W&I Division examination threshold. Of these, our analysis found 15,779 returns with FTC claims totaling \$32.5 million that had no examination activity. Figure 5 provides our analysis for examinations of individual returns without a business purpose and with FTC claims above the W&I Division Examination threshold.

Figure 5: Examination Activity From October 2017 to December 2021 of Individual Returns Without a Business Purpose and With FTC Claims Above the W&I Division Examination Threshold Submitted During PYs 2018 Through 2021

Examination Activity	Number of Returns	Amount of FTC Claims
Completed Examination	7,057	\$20.5 million
In-Process Examination	1,703	\$10.3 million
Selected but Closed Before Examination	230	\$0.5 million
No Examination Activity	15,779	\$32.5 million
Total	24,769	\$63.8 million

Source: TIGTA analysis of data from the IRS's IRTF and AIMS for individual returns with FTC claims.

Individual returns with FTC claims are identified for review if the return meets certain criteria and the FTC amount is above the threshold. The 15,779 questionable returns above the threshold

Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

that were not selected for examination put \$32.5 million at risk for revenue lost due to improper FTC claims. Even though the IRS does not have the resources to examine every return, those with higher FTC claim amounts that are not examined represent potentially greater losses of revenue. For example, if the IRS had examined 955 additional returns (out of the 15,779 questionable returns) with the highest FTC claims the additional examinations would have covered \$10.7 million (out of \$32.5 million) in FTC claims. Based on historic productivity results discussed previously, such as the no-change rate of 1.4 percent, not examining the 955 highest dollar returns without a business purpose puts \$10.6 million of tax revenue at risk.¹³ IRS representatives stated that higher dollar FTC claims without a business purpose may not have been examined because once the volume of cases selected for examination meets the planned number of cases during a particular cycle, no additional cases are selected for examination. This lack of flexibility inhibits the IRS’s ability to work additional productive FTC cases.

Repeated FTC claims with no business purpose are not being addressed

TIGTA’s analysis of the 1,172,732 individual income tax returns with FTC claims that were submitted during PYs 2018 through 2021 also identified 297,183 taxpayers who submitted a return for two or more of the tax years from 2017 to 2020.¹⁴ Making repeated FTC claims is not questionable by itself unless those claims are not associated with a business purpose. Figure 6 shows examination activity of taxpayers who filed individual returns for multiple years that claimed FTC amounts above the threshold without a business purpose.

Figure 6: Examination Activity From October 2017 to December 2021 for Taxpayers Who Filed Individual Returns During PYs 2018 Through 2021 for Multiple Years Without a Business Purpose and Claimed the FTC Above the W&I Division Examination Threshold

Tax Years 2017 Through 2020	Taxpayers	Number of Returns Filed	Amount of Improper FTC Claims
No examination activity	923	2,026	\$4.4 million
Only one examination for multiple years	733	1,528	\$1.5 million

Source: TIGTA analysis of data from the IRS’s IRTF and AIMS for individual returns with FTC claims.

The 923 taxpayers with repeated FTC claims without a business purpose and no examination activity are putting \$4.4 million of tax revenue at risk due to improper FTC claims. The 733 taxpayers with repeated FTC claims without a business purpose and only one return being examined are putting an additional \$1.5 million of tax revenue at risk for revenue lost due to improper FTC claims. In addition to the potential revenue lost due to improper FTC claims, the failure to address repeated tax law violations will tarnish the public’s view of tax fairness and could encourage more improper FTC claim activity.

¹³ Accounting for 1.4 percent no-change rate: \$10.7 million multiplied by 98.6 percent = \$10.6 million.

¹⁴ A tax year is 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.

Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

The W&I Division conducts the majority of FTC claim examinations, and its procedures do not require consideration of subsequent year returns submitted by the taxpayer for related noncompliance. In addition, W&I Division examination selection criteria does not consider prior improper FTC claims as a potential indication of noncompliance.

The Commissioner, W&I Division, should:

Recommendation 1: Ensure that the FTC examination workplan maintains flexibility to address higher dollar FTC claims without a business purpose. In addition, the W&I Division should perform ongoing analysis for high-dollar questionable FTC claims that are not being selected for examination to determine if the selection process should be adjusted.

Management's Response: The IRS agreed with this recommendation and is preparing an enterprise-wide workplan to forecast business needs, determine how best to use IRS resources, and provide needed compliance coverage to other areas of interest. The Examination workplan was revised to include high-dollar questionable FTC claims that will be selected continually throughout the year.

Recommendation 2: Require all examinations that identify improper FTC claims to check prior year taxpayer returns for additional improper FTC claims. In addition, future examination selection criteria should include repeated filers with improper FTC claims who continue to submit returns with FTC claims.

Management's Response: The IRS agreed with this recommendation and will request programming changes to revise the selection process to include repeat FTC claimants.

The Frivolous Filing Penalty Is Not Being Used for Improper Fuel Tax Credit Claims

The IRS assessed the frivolous filing penalty on only a limited number of taxpayers who submitted returns with FTC claims and no business purpose. Of the 1,172,732 individual income tax returns with FTC claims submitted during PYs 2018 through 2021, there were 263,522 returns with no business purpose. The IRS completed 10,026 examinations involving returns with FTC claims without a business purpose and decreased the claimed FTC on 7,070 returns. However, the frivolous filing penalty was assessed on only 13 returns. The 7,057 returns that had the FTC decreased and were not assessed a \$5,000 frivolous filing penalty could be subject to approximately \$35.3 million in penalties.

Taxpayers who do not meet their tax obligation may owe a penalty. An FTC claim without a business purpose is a frivolous position, as listed in IRS Notice 2010-33. A frivolous position is subject to a \$5,000 frivolous filing penalty.¹⁵ As discussed previously, the IRS most recently mentioned the FTC and the frivolous filing penalty in its annual list of "Dirty Dozen" tax scams in March 2023.

The IRS is not using the frivolous filing penalty as a deterrent to prevent the submission of improper FTC claims. Over the last several years, the W&I Division's Return Integrity Verification Program Management function stated that it has considered procedures to screen FTC claims

¹⁵ I.R.C. § 6702.

for frivolous filing penalty application but does not have them in place. Taxpayers can attempt to file improper FTC claims every year with no repercussions other than having the claim disallowed in an examination. Penalties are used to deter unacceptable behavior. IRS resources used for examining FTC claims could be used elsewhere if taxpayers submitted fewer improper FTC claims.

Recommendation 3: The Commissioner, W&I Division, should develop and implement procedures to assess the frivolous filing penalty, where applicable, as a deterrent for filing improper FTC claims without a business purpose.

Management's Response: The IRS agreed with this recommendation and will develop procedures to identify the returns meeting selection conditions after an FTC claim is examined and fully disallowed.

Taxpayers Claiming the Fuel Tax Credit for Off-Highway Business Use Are Not Required to Affirm Whether the Fuel Was Used in Vehicles Registered or Required to Be Registered for Use on Public Highways

As noted previously, the regulations state that the FTC for off-highway business use cannot be claimed for vehicles that are registered, or required to be registered, for use on public highways. The instructions for Form 4136, used by individual taxpayers to document their FTC claim, state that the nontaxable use of gasoline claimed for the FTC must have been used "for a business use other than in a highway vehicle registered (or required to be registered) for highway use." The Form 4136 instructions for claiming the FTC for the use of undyed diesel fuel also prohibits use in a diesel-powered highway vehicle registered, or required to be registered, for use on public highways.

Figure 7 shows that Part 1 of the Form 4136 does not require the taxpayer to specify the type of vehicle or at least certify that the vehicle was not registered, or required to be registered, for use on public highways while using the fuel for a non-taxable purpose.

Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

Figure 7: Portions of Form 4136 Used to Claim the FTC for Nontaxable Use of Gasoline

Form 4136 Department of the Treasury Internal Revenue Service	Credit for Federal Tax Paid on Fuels Go to www.irs.gov/Form4136 for instructions and the latest information.	OMB No. 1545-0162 2022 Attachment Sequence No. 23			
Name (as shown on your income tax return)		Taxpayer identification number			
<p>Caution: Claimant has the name and address of the person who sold the fuel to the claimant and the dates of purchase. For claims on lines 1c and 2b (type of use 13 or 14), 3d, 4c, and 5, claimant has not waived the right to make the claim. For claims on lines 1c and 2b (type of use 13 or 14), claimant certifies that a certificate has not been provided to the credit card issuer.</p>					
1 Nontaxable Use of Gasoline		Note: CRN is the credit reference number.			
	(a) Type of use	(b) Rate	(c) Gallons	(d) Amount of credit	(e) CRN
a	Off-highway business use	\$.183			
b	Use on a farm for farming purposes	.183			
c	Other nontaxable use (see Caution above line 1)	.183		\$	
d	Exported	.184			411
} 362					
} 411					
3 Nontaxable Use of Undyed Diesel Fuel					
Claimant certifies that the diesel fuel did not contain visible evidence of dye.					
Exception. If any of the diesel fuel included in this claim did contain visible evidence of dye, attach an explanation and check here <input type="checkbox"/>					
	(a) Type of use	(b) Rate	(c) Gallons	(d) Amount of credit	(e) CRN
a	Nontaxable use	\$.243			
b	Use on a farm for farming purposes	.243		\$	360
c	Use in trains	.243			353
d	Use in certain intercity and local buses (see Caution above line 1)	.17			350
e	Exported	.244			413

Source: IRS Form 4136 (2022).

If the FTC claim is selected for examination, the substantiation form sent by the IRS in most cases requires the taxpayer to list the vehicles and equipment used in the off-highway business. However, because the Form 4136 has no information on the type of equipment or vehicle using the fuel, the IRS cannot determine whether taxpayers are in compliance with the requirements for claiming the FTC without initiating an examination. If required to attest that the nontaxable fuel was used for equipment, or a vehicle that was not registered for use on public highways, taxpayers would be educated on the requirements of the law and the IRS could more easily identify and correct noncompliant claims. Precedent exists for requesting taxpayers to provide specific information on tax returns to reduce improper claims and tax deductions. For example, Congress has noted that the requirement to provide a Social Security Number for children claimed as dependents on individual tax returns significantly reduced the improper claiming of dependents.¹⁶

Recommendation 4: The Commissioner, W&I Division, should revise Form 4136 to require the taxpayer to certify that the FTC for off-highway business use is being claimed for equipment or a vehicle that was not registered, or required to be registered, for use on public highways.

Management's Response: The IRS partially agreed with this recommendation and will consider updating Form 4136 to require the taxpayer, when applicable, to certify that the

¹⁶ H.R. Rep. No. 103-826(I) (1994).

Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

FTC for off-highway business use is being claimed for equipment or a vehicle that was not registered, or required to be registered, for use on public highways. However, the IRS also stated that claims for the FTC are already made under penalties of perjury, whereby the taxpayer declares the return and accompanying schedules and statements were examined, and to the best of their knowledge and belief, are true, correct, and complete.

Office of Audit Comment: This recommendation is intended to provide additional confirmation that the amounts relate to claims for off-highway business use because the current Form 4136 has no information on the type of equipment or vehicle using the fuel. We believe the recommended modification would reduce erroneous FTC claims.

Thousands of Fuel Tax Credit Claim Amounts Were Increased During Processing

Of the \$797 million in FTC claims by individual taxpayers during PYs 2018 through 2021, Submission Processing accepted \$687 million (86 percent) as filed. Submission Processing also decreased FTC claim amounts on 3,415 returns. However, Submission Processing increased the FTC claim amounts on 5,269 returns from \$239,585 to more than \$3 million. Figure 8 shows the actions taken by Submission Processing for FTC claims.

Figure 8: Submission Processing Actions for FTC Claims Submitted During PY 2018 Through 2021

Submission Processing Action	Individual Returns With FTC Claims	FTC Claims by Taxpayer	FTC Claims Accepted by the IRS
Accepted FTC claim	1,164,048	\$683,360,456	\$683,360,456
Accepted but increased FTC claim	5,269	\$239,585	\$3,061,352
Accepted but decreased FTC claim	291	\$716,498	\$180,260
Fully Disallowed FTC claim	3,124	\$112,498,850	\$0
Total	1,172,732	\$796,815,388¹⁷	\$686,602,068

Source: TIGTA analysis of data from the IRS's IRTF.

Almost all of the Submission Processing changes shown in Figure 8 involved paper-submitted returns. Some claims were disallowed because Form 4136 was not attached to Form 1040 as support for the claim. Some increases or decreases in FTC claims occurred when the Form 4136 amount did not match the amount on Form 1040. Another mismatch involved returns that did not have an FTC amount on the Form 1040 but had an attached Form 4136 with an FTC amount. With these mismatches, Submission Processing changed the Form 1040 amount to match the Form 4136 support amount.

¹⁷ Does not total due to rounding.

Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

If Form 4136 is not attached, Submission Processing will request the taxpayer provide the form before the credit is allowed.¹⁸ For cases where the Form 4136 does not match the Form 1040, the taxpayer is notified of the change and is provided the opportunity to respond to the notice. However, when Form 4136 contains a greater amount than shown on Form 1040, the adjustment increases the claim and potential refund to taxpayers. This may occur when an FTC calculation is present on Form 4136 but not shown on the actual Form 1040. Submission Processing will resolve the error in the taxpayer's favor and move the credit to the Form 1040 to continue processing the FTC claim. While Submission Processing will notify the taxpayer that the credit has been increased due to the mismatching forms, it does not have to verify the correct amount. Submission Processing stated that assessment authority under Internal Revenue Code (I.R.C.) § 6201(a)(1) allows it to increase a credit filed on a Form 1040. I.R.C. § 6201 authorizes the IRS to make inquiries, determinations, and assessments of all taxes. Increasing an FTC claim without validating the correct amount raises the risk of improper payments to taxpayers. Although Submission Processing might have the authority to increase an FTC claim, it would be prudent to take additional steps to validate the credit before increasing the amount claimed on Form 1040, given that this credit is included in the "Dirty Dozen" list of the worst tax scams.

Recommendation 5: The Commissioner, W&I Division, should develop procedures to validate the FTC claim amount before increasing it on a taxpayer submitted Form 1040.

Management's Response: The IRS disagreed with this recommendation. Specifically, during processing of both paper and electronic tax returns, when programming detects a mismatch between the credit calculated on Form 4136 and the amount carried forward to the credits and payments section of the tax return, I.R.C. § 6201(a)(1) provides general authority to assess tax in an amount determined by the IRS to be correct based on the information reported on a particular return. The IRS considers the amount of credit calculated on Form 4136 to be the amount of credit available to the taxpayer. The IRS resolves inconsistencies in carrying the credit amount to the credits and payment section of the return in favor of the amount shown on Form 4136.

Office of Audit Comment: The IRS should determine whether the amount on the Form 4136 or the Form 1040 is correct before increasing the credit. Considering the FTC's recent inclusion on the IRS's annual "Dirty Dozen" list of the worst tax scams, the IRS should not presume to include the FTC on the Form 1040 when the taxpayer omitted it.

Some Examination Closures Resulted in Erroneous Changes to the Fuel Tax Credit

Of the 22,403 FTC examinations completed through December 31, 2021, TIGTA found that the FTC claim was increased during the examination closure process in 58 instances and was partially decreased in 76 instances. For these examinations, we found a total of 89 closure errors:

¹⁸ Internal Revenue Manual 3.11.3.17.11(1) (Dec. 11, 2020).

Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

- 56 (96.6 percent) of 58 examinations that increased FTC claims had closure errors.
- 33 (43.4 percent) of 76 examinations that partially decreased FTC claims had closure errors.

Examination closures should be free of errors when posted to taxpayer accounts, which supports the IRS's mission of providing quality service and promoting integrity and fairness to all taxpayers. For the 56 examinations with errors that increased the FTC claim, the examination result was to decrease the FTC claim, but employees entered the adjustment amount erroneously as a positive on the examination closing document (Form 5344, *Examination Closing Record*) when the adjustment should have been a negative amount to decrease the FTC claim, resulting in \$381,053 of erroneously allowed claims.¹⁹ For the 33 examinations with errors that partially decreased the FTC claim, the examination result was to decrease the FTC claim, but employees entered an erroneous adjusted FTC amount on the examination closing document. In 18 instances, the taxpayer's FTC claim amount was used instead of Submission Processing's corrected amount from return processing before the examination started, resulting in claims totaling \$15,542 being allowed in error.²⁰ In 15 instances, employees made entry errors, such as typos or transposition of numbers, resulting in \$6,675 of erroneously allowed claims.²¹ Overall, our review found, and the IRS confirmed, that 89 examinations had closure errors that should have decreased FTC claims but erroneously increased FTC claims by a total of \$403,270.²²

The W&I Division examined 52 of the 56 cases with closing errors that increased the FTC claim and has initiated or plans to initiate erroneous refund procedures on all 52 cases. As of June 2022, the IRS began using a different data source for FTC claims that is expected to prevent future errors due to not using the amount of Submission Processing's allowed FTC claim. For closure entry errors, the IRS plans to remind employees to review entries for accuracy and ensure that proper FTC adjustments are reflected during examination closures.

Recommendation 6: The Commissioner, W&I Division, and Commissioner, SB/SE Division, should develop a process to identify and check future FTC examination closure anomalies, such

¹⁹ For the 22,403 completed examinations, the FTC was increased 58 times. Fifty-three of the 58 examination results increased the FTC by the same amount as the FTC claimed on the return. Our review of 12 of these 53 results showed that the FTC was erroneously entered on Form 5344 to increase the claim by the same amount that the examination intended to decrease. Our review of the other five examination results found that three were entered erroneously as increases to FTC on Form 5344 rather than the intended decreases. [REDACTED]

[REDACTED] The IRS confirmed that all 56 returns (53+3) were intended to reduce FTC, but were incorrectly posted on Form 5344, resulting in \$381,053 of erroneous claims.

²⁰ The FTC was partially decreased 76 times in 22,403 completed examinations. Eighteen of the 76 claims were decreased using the amount submitted by the taxpayer and not the amount Submission Processing accepted. A review of seven cases showed that examiners did not adjust the FTC based on the proper Submission Processing amount. The IRS confirmed that that all 18 returns totaling \$15,542 were errors because the Submission Processing amount was not used for examination.

²¹ Fifteen of the remaining 58 partially decreased FTCs appeared to be typos made during the posting of the FTC adjustment on Form 5344. For example, the FTC was filed and processed as \$826 but the examination adjustment was \$8.26. We researched six examples and identified that the IRS intended to fully disallow the FTC claim on five, but the adjustments were incorrectly posted on Form 5344. The Form 5344 posting for the sixth example matched the intended examined FTC claim. The IRS confirmed that all 15 adjustments were intended to reduce FTC by \$6,675 but were incorrectly posted on Form 5344.

²² The 89 confirmed errors of \$403,270 are comprised of the 56 errors of \$381,053, the 18 errors of \$15,542, and the 15 errors of \$6,675.

Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

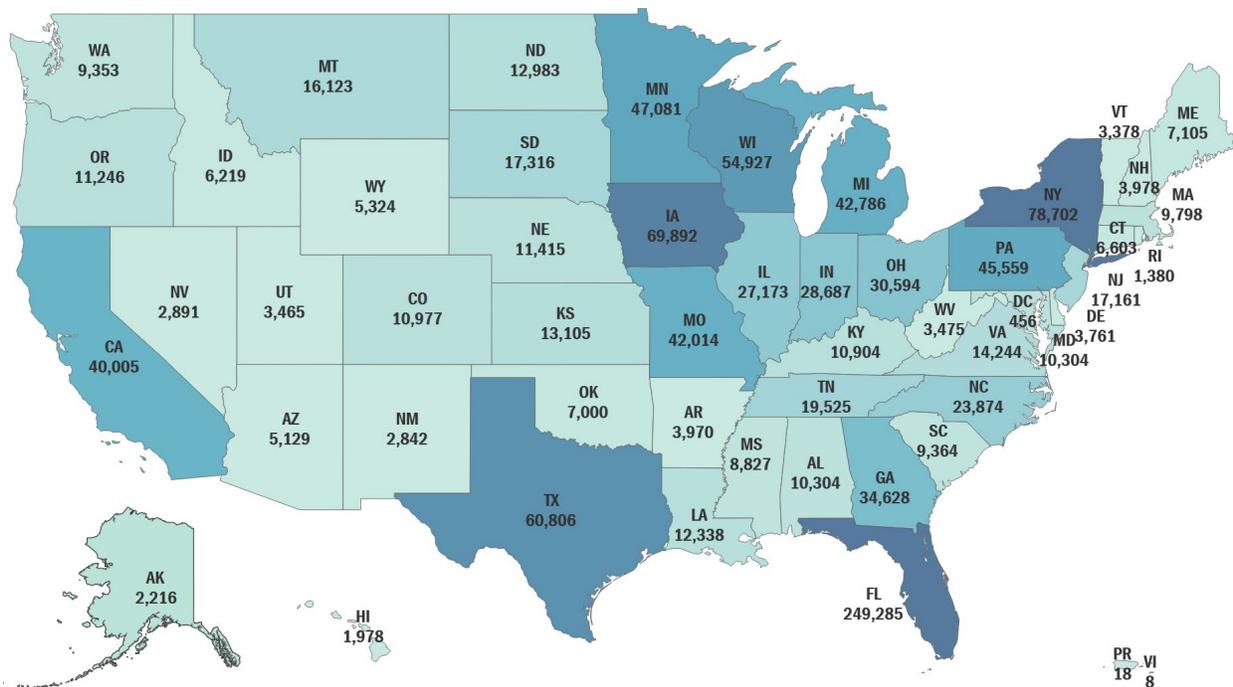
as an increased or partially decreased FTC claim, to ensure that examination adjustments are posting properly to taxpayer accounts.

Management's Response: The IRS agreed with this recommendation and has updated guidance for reviewing examination closing reports for accuracy. The IRS is reviewing recent closures at each campus to evaluate the effectiveness of the guidance and ensure that the adjustments are posting correctly. Additionally, the IRS will remind SB/SE Division managers, reviewers, and employees of the importance of ensuring the accuracy of FTC adjustments.

Potential Fuel Tax Credit Claim Schemes Are Not Being Addressed

Generally, a fraudulent multi-return scheme could have common return characteristics like location, amounts, preparer, and submission method. Figure 9 provides the number of FTC claim returns submitted during PYs 2018 through 2021 by State.

Figure 9: Number of FTC Claim Returns by State Submitted During PYs 2018 Through 2021



Source: TIGTA analysis of data from the IRS's IRTF.

For example, TIGTA found that Florida residents filed significantly more FTC claims than the larger populated states of California and Texas, both of which are heavily involved in agriculture. This discrepancy could indicate the general location of possible fraudulent claim schemes.

TIGTA analyzed the 1,172,732 individual income tax returns with FTC claims that were submitted during PYs 2018 through 2021 and identified 11 potential FTC claim schemes involving 18,032 returns that included common characteristics such as location, amounts, preparer, and submission method. Of these returns, 8,108 included FTC claims totaling \$6.9 million that had no business purpose listed. Six potential FTC schemes involved 9,715 returns submitted on

Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

paper tax returns (as opposed to electronic submission) and did not have a return preparer listed, which could indicate a possible “ghost” preparer.²³ The other five potential FTC schemes involved 8,317 returns that were prepared by the same eight tax return preparers.²⁴ Most of the returns within these potential schemes have addresses in Florida. Based on our preliminary analysis on potential schemes, we believe the IRS could adopt a more data-driven approach to identifying and addressing potential FTC schemes.

The IRS makes it known to the public that it reviews for schemes through its publication of the annual “Dirty Dozen” list, which included FTC claims as recently as March 2023. Addressing schemes supports the IRS mission to enforce the law with integrity and fairness to all. The 11 potential FTC claim schemes involved 18,032 returns with FTC claims totaling \$15.3 million, of which 16,215 (89.9 percent) received FTC claims of \$13.2 million (86.2 percent), as of December 31, 2021.²⁵ Examinations were started for 2,289 potential FTC claim scheme returns, of which 2,029 examinations have been completed and resulted in decreasing FTC claims by approximately \$2 million. Only 15 completed examinations resulted in no changes to returns. The remaining 15,743 potential FTC scheme returns were not selected for examinations as of December 31, 2021. In addition to the revenue lost due to improper FTC claims, the lack of tax law enforcement to address schemes could affect the public’s view of tax fairness and could encourage more noncompliant filings.

The IRS has a process to analyze FTC claims for scheme characteristics like location, amounts, and return preparers. However, the returns analysis is limited by criteria that includes an FTC claim threshold that is higher than the amount used by Examination for its case selection. The returns for the 11 potential FTC claim schemes we identified do not meet the current criteria to be included in the IRS’s analysis for scheme identification. However, the total dollar amounts of the large number of potential FTC claim schemes below the threshold potentially put millions of dollars of tax revenue at risk.

Recommendation 7: The Commissioner, W&I Division, should lower the threshold criteria for FTC claim scheme analysis to expand the scope of returns considered, particularly to identify schemes with large numbers of returns below the IRS’s compliance threshold. Analysis should also focus on preparer misconduct schemes committed by unscrupulous tax return preparers and ghost preparers.

Management’s Response: The IRS agreed with this recommendation and will ensure that the established procedures for FTC scheme analysis include lower thresholds to expand the scope of returns considered and allow focus on the most unscrupulous tax return preparers.

²³ From these 9,715 returns filed, taxpayers received \$7.2 million in FTC on 8,011 returns. A ghost preparer is someone who prepares tax returns but does not sign the tax returns prepared.

²⁴ From these 8,317 returns filed, taxpayers received \$6.0 million in FTC claims on 8,204 returns.

²⁵ The \$7.2 million in FTC claims taxpayers received on 8,011 returns filed from the first six potential schemes and the \$6 million received on 8,204 returns filed from the additional five schemes total \$13.2 million that taxpayers received from the 11 potential schemes on 16,215 returns. TIGTA’s review of possible scheme activity did not include an examination threshold. Of the \$13.2 million on 16,215 returns, \$6.2 million on 5,483 returns were over the threshold and the remaining \$7 million on 10,732 returns were below the threshold. In order to not overstate the measurable benefits of potential tax revenue protection, the potential scheme amounts of \$6.2 million on 5,483 returns are included in the \$32.5 million on 15,779 returns that were not examined over the threshold (see earlier section of this report).

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS is adequately considering the FTC claimed by individual taxpayers and to follow up on past recommendations. To accomplish our objective, we:

- Identified and documented the policies, procedures, and training related to selecting FTCs claimed by individual filers for examination, including Form 4136, Form 8849, and Form 720. In addition, we reviewed the IRS's implementation of recommendations proposed during TIGTA's FTC audit in Fiscal Year 2014.
- Assessed the effectiveness of the IRS's selection process, based on system controls, for identifying questionable FTCs for further analysis from the total population of FTC claims filed by individuals. We obtained information and held discussions with the IRS on processing returns and enhancements made in the selection process.
- Assessed the effectiveness of reviewing individual taxpayer returns with FTCs that were selected for examination. We reviewed examination metrics including hours spent examining FTC returns, assessments per hour spent examining FTC returns, and no-change rates on examined FTC returns. We reviewed examination coverage, identified posting errors on closed examinations, and assessed the frequency of applying the frivolous filing penalty. We evaluated the risk for fraud, waste, and abuse of closed examinations and non-examined returns to obtain reasonable assurance that widespread improprieties do not exist. We identified potential unscrupulous filing scheme activity and taxpayers who repeatedly filed returns with questionable FTC claims.

Performance of This Review

This review was performed with information obtained from the W&I and SB/SE Divisions located in Washington, D.C.; Austin, Texas; and Ogden, Utah, during the period November 2021 through February 2023. 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 Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations); Robert Jenness, Director; John Park, Audit Manager; Kenneth Krause, Lead Auditor; Aaron Foote, Senior Auditor; and Julia Woods, Applied Research and Technology Data Analyst.

Validity and Reliability of Data From Computer-Based Systems

We performed tests to assess the reliability of data from the IRS's IRTF, AIMS, and the Individual Master File (IMF) for individual taxpayer-filed returns (Form 1040) with FTC claims. We accessed

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these files through TIGTA's Data Center Warehouse (DCW).¹ We evaluated the data by 1) performing electronic testing of required data elements, 2) reviewing existing information about the data and the system that produced them, 3) reviewing selected judgmental samples to validate against IRS source data using the Integrated Data Retrieval System, and 4) interviewing agency officials knowledgeable about the data.² 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: IRS policies, procedures, and practices for processing and examining returns filed by individual taxpayers claiming the FTC. We evaluated these controls by reviewing source materials, having discussions with management and staff, and reviewing closed examination cases.

¹ The DCW is a collection of IRS databases containing various types of taxpayer accounts and IRS and TIGTA employee information that is maintained by TIGTA for the purpose of analyzing data for ongoing audits.

² The Integrated Data Retrieval System is an IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records. A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.

Appendix II

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 Measure:

- Revenue Protection – Potential; \$32.5 million on 15,779 questionable returns received during PYs 2018 through 2021 with FTC claims above the threshold that were not examined through December 31, 2021 (see Recommendation 1).

Methodology Used to Measure the Reported Benefit:

We extracted data using the IRTF and AIMS from TIGTA's DCW to identify 1,172,732 individual income tax returns (Form 1040) filed during PYs 2018 through 2021 that claimed the FTC. In addition, these FTC returns were matched to the IMF to obtain FTC postings to taxpayer accounts. The various data extracts were combined into one record for each FTC return. Of the 1,172,732 individual returns, 263,522 questionable returns had no business purpose based on the lack of a Schedule C, E, or F included with the Form 1040. FTC amounts for these 263,522 returns were assigned dollar ranges that identified 24,769 returns with the FTC above the W&I Division's examination threshold. Of these 24,769 returns, we determined that 15,779 returns were not examined as of December 31, 2021. The total FTC amount of the 15,779 returns not examined was \$32,493,447.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$35.3 million on 7,057 tax returns that had the FTC claim decreased and were not assessed a \$5,000 frivolous filing penalty under I.R.C. § 6702 (see Recommendation 3).

Methodology Used to Measure the Reported Benefit:

We extracted data using the IRTF and AIMS from TIGTA's DCW to identify 1,172,732 individual income tax returns (Form 1040) filed during PYs 2018 through 2021 that claimed the FTC. In addition, these FTC returns were matched to the IMF to obtain FTC postings to taxpayer accounts and frivolous filing penalty activity. Of the 1,172,732 individual returns, 263,522 questionable returns were identified that had no business purpose based on the lack of a Schedule C, E, or F included with Form 1040. Of the 263,522 returns, 10,026 returns were examined and 7,070 of these returns had FTC amounts decreased. However, only 13 returns with decreased FTC claims were assessed the frivolous filing penalty. The remaining 7,057 returns may be subject to the \$5,000 frivolous filing penalty per filing under I.R.C. § 6702, providing \$35,285,000 in potential revenue (7,057 returns multiplied by the \$5,000 penalty per return).

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$381,053 on 56 examinations completed through December 31, 2021, in which the examinations showed the FTC adjustment was entered as a positive amount to increase the credit on the examination closing document when it should have been entered as a negative amount to decrease the FTC claim. This erroneously gave taxpayers FTC refunds of \$381,053 (see Recommendation 6).
- Revenue Protection – Potential; \$15,542 on 18 examinations completed through December 31, 2021, in which the taxpayers' filed claim amounts were used by examiners instead of Submission Processing's accepted amounts. This erroneously gave taxpayers FTC refunds of \$15,542 (see Recommendation 6).
- Revenue Protection – Potential; \$6,675 on 15 examinations completed through December 31, 2021, in which employees made typographic errors or transposed numbers on the examination closing document. This erroneously gave taxpayers FTC refunds of \$6,675 (see Recommendation 6).

Methodology Used to Measure the Reported Benefit:

We extracted data using the IRTF and AIMS from TIGTA's DCW to identify 1,172,732 individual income tax returns (Form 1040) filed during PYs 2018 through 2021 that claimed the FTC. In addition, these FTC returns were matched to the IMF to obtain FTC postings to taxpayer accounts. The various data extracts were combined into one record for each FTC return. Of the 1,172,732 individual income tax returns submitted, the IRS completed 22,403 examinations as of December 31, 2021. Of the 22,403 completed examinations, the FTC was increased only 58 times. Of the 58 examinations, 53 had the FTC increased through examination by exactly the same amount as the taxpayer claimed on the return. We researched 12 examples using the IRS's Correspondence Examination Automation Support (CEAS) system and found the FTC adjustment was entered as a positive amount to increase the credit on the examination closing document when it should have been entered as a negative amount to decrease the FTC claim.¹ Five of the 58 examinations had the FTC increased by an amount different than the taxpayer claimed amount on the return. TIGTA researched these five examinations using the CEAS system and determined that three of the five examinations intended to decrease the FTC. The amounts were posted incorrectly on the closing document. [REDACTED]

[REDACTED] The 56 returns (53 where the FTC appeared to be increased by the same amount of the credit taken on the returns and three other questionable increases) were sent to the IRS to review, and the IRS confirmed that all 56 returns were intended to reduce the FTC but were incorrectly posted on the examination closing document, resulting in \$381,053 of erroneously allowed claims.

Of the 22,403 completed examinations, the FTC was partially decreased 18 times by the amount submitted by the taxpayer and not by the amount Submission Processing accepted, *i.e.*, the examination disallowed the incorrect FTC amount. We researched seven examples on the CEAS system and found that the examiners adjusted the taxpayer's filed FTC and not the accepted

¹ The IRS's CEAS system is a suite of web-based applications developed to enhance the examination process. The application also enables case assignment and transfer between examination groups and batch groups. It facilitates universal view of the campus examination case inventory records and also allows the display of client-generated tax reports and letters associated with the examination case.

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Submission Processing amount. The 18 returns were sent to the IRS to review, and the IRS confirmed that the 18 returns contained errors totaling \$15,542 because the accepted Submission Processing amount was not used for the examination.

Of the 22,403 completed examinations, the FTC was partially decreased 58 times. A visual review found that 15 of the 58 adjustments appeared to be typos made during the posting of the FTC adjustment on the examination closing document resulting in an incorrect amount. For example, the FTC was filed and processed as \$826 but the examination adjustment was \$8.26. We researched six examples on the CEAS system and identified that the IRS intended to fully disallow the FTC claim on five returns, but the adjustments were incorrectly posted on the closing document. The examination adjustment posted for the sixth return matched the intended examined FTC claim. The 15 returns were sent to the IRS to review, and it confirmed that all 15 returns were intended to reduce FTC but were incorrectly posted on the examination closing document leading to \$6,675 of erroneously allowed claims.

The IRS confirmed that 89 examinations (56 + 18 + 15) had closure errors that should have decreased FTC claims but erroneously increased FTC claims by a total of \$403,270 (\$381,053 + \$15,542 + \$6,675).

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$7.0 million on 10,732 returns possibly involved in schemes (see Recommendation 7).

Methodology Used to Measure the Reported Benefit:

We extracted data using the IRTF and AIMS from TIGTA's DCW to identify 1,172,732 individual income tax returns (Form 1040) filed during PYs 2018 through 2021 that claimed the FTC. In addition, these FTC returns were matched to the IMF to obtain FTC postings to taxpayer accounts. We reviewed common tax return characteristics from the population of 1,172,372 returns, including location, FTC amounts, preparer, and submission method (paper versus electronic filing) and found 11 potential FTC schemes. Six of the 11 potential schemes involved 9,715 returns that were filed using paper forms, had a common filing location, had common FTC amounts, and had no preparer listed. From these filings, taxpayers received \$7,169,301 in FTC on 8,011 returns. The remaining five schemes involved eight tax preparer firms listed on 8,317 returns that had common claim amounts. From these filings, taxpayers received \$6,014,984 in FTC claims on 8,204 returns. The \$7,169,301 in FTC received by taxpayers on 8,011 returns filed from the first six potential schemes and the \$6,014,984 received on 8,204 returns filed from the additional five schemes total \$13,184,285 that taxpayers received from the 16,215 returns involved in the 11 potential schemes.

Our analysis for schemes did not include an FTC examination threshold. Of the \$13,184,285 on 16,215 returns related to the 11 schemes, \$6,188,366 on 5,483 returns are included in the \$32,493,477 on 15,779 returns over the threshold that were not examined as of December 31, 2021. The remaining \$6,995,919 on 10,732 returns are below the threshold and identified as an outcome measure.

Appendix III

Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

August 9, 2023

MEMORANDUM FOR HEATHER M. HILL
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kenneth C. Corbin  Digitally signed by Kenneth C. Corbin
Date: 2023.08.09 10:24:35 -04'00'
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed (Audit # 202230015)

Thank you for the opportunity to review and provide comments on the subject draft report. We are pleased that the report recognizes the steps we have taken to improve identifying and examining individual returns with questionable Fuel Tax Credit (FTC) claims. The improvements include updating and revising the identification procedures for FTC claims meeting or exceeding threshold criteria and providing additional guidance through our correspondence audit training programs.

Improper FTC claims continue to be an important area of focus for IRS. The credit is intended for off-highway business and farming use and, as such, is not available to most taxpayers. The credit is included on our annual "Dirty Dozen" list of the worst tax schemes to increase taxpayer awareness of unscrupulous promoters inducing them to file improper FTC claims for which the taxpayers are not entitled. Individuals not entitled to claim the credit may be subject to a \$5,000 penalty for submitting a frivolous tax return.

Our responses to your specific recommendations are enclosed. If you have any questions, please contact me, or a member of your staff may contact RICS, Director, James P. Clifford, at 470-639-3505

Attachment

Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

Attachment

Recommendations

The Commissioner, W&I Division, should:

RECOMMENDATION 1:

Ensure that the FTC examination workplan maintains flexibility to address higher dollar FTC claims without a business purpose. In addition, the W&I Division should perform ongoing analysis for high-dollar questionable FTC claims that are not being selected for examination to determine if the selection process should be adjusted.

CORRECTIVE ACTION

We are preparing an enterprise-wide workplan to forecast business needs, determine how best to use our resources, and provide needed compliance coverage to other areas of interest. The Examination workplan was revised to include high-dollar questionable Fuel Tax Credit (FTC) claims that will be selected continually throughout the year.

IMPLEMENTATION DATE

December 15, 2023

RESPONSIBLE OFFICIAL

Director, Refundable Credits Program Management, Return Integrity and Compliance 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:

Require all examinations that identify improper FTC claims to check prior year taxpayer returns for additional improper FTC claims. In addition, future examination selection criteria should include repeated filers with improper FTC claims who continue to submit returns with FTC claims.

CORRECTIVE ACTION

We will request programming changes to revise the selection process to include repeat FTC claimants.

IMPLEMENTATION DATE

February 15, 2024

RESPONSIBLE OFFICIAL

Director, Refundable Credits Program Management, Return Integrity and Compliance Services, Wage and Investment Division

Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

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CORRECTIVE ACTION MONITORING PLAN

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

Recommendations

RECOMMENDATION 3:

The Commissioner, W&I Division, should develop and implement procedures to assess the frivolous filing penalty, where applicable, as a deterrent for filing improper FTC claims without a business purpose.

CORRECTIVE ACTION

We will develop procedures to identify the returns meeting selection conditions after an FTC claim is examined and fully disallowed.

IMPLEMENTATION DATE

October 15, 2023

RESPONSIBLE OFFICIAL

Director, Return Integrity Verification Program Management, Return Integrity and Compliance Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

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

RECOMMENDATION 4:

The Commissioner, W&I Division, should revise Form 4136 to require the taxpayer to certify that the FTC for off-highway business use is being claimed for equipment or a vehicle that was not registered, or required to be registered, for use on public highways.

CORRECTIVE ACTION

We will consider updating Form 4136 to require the taxpayer, when applicable, to certify that the FTC for off-highway business use is being claimed for equipment or a vehicle that was not registered, or required to be registered, for use on public highways. It should be noted that claims for the FTC are already made under the jurat that under penalties of perjury, the taxpayer declares the return and accompanying schedules and statements were examined, and to the best of their knowledge and belief, are true, correct, and complete.

IMPLEMENTATION DATE

February 15, 2025

Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

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RESPONSIBLE OFFICIAL

Director, Refundable Credits Program Management, Return Integrity and Compliance Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

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

RECOMMENDATION 5:

The Commissioner, W&I Division, should develop procedures to validate the FTC claim amount before increasing it on a taxpayer submitted Form 1040.

CORRECTIVE ACTION

During processing of both paper and electronic tax returns, programming detects a mismatch between the credit calculated on Form 4136, *Credit for Federal Tax Paid on Fuels*, and the amount carried forward to the credits and payments section of the tax return. Consistent with the provisions of Internal Revenue Code § 6201(a)(1), which provides general authority to assess tax in an amount determined by the Service to be correct based on the information reported on a particular return, the amount of credit calculated on Form 4136 is considered to be the amount of credit available to the taxpayer. Inconsistencies in carrying the credit amount to the credits and payment section of the return are resolved in favor of the amount shown on Form 4136. Taxpayers are informed of the correction of the inconsistency and have the right to ask for its reconsideration.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 6:

The Commissioner, W&I Division, and Commissioner, SB/SE Division, should develop a process to identify and check future FTC examination closure anomalies, such as an increased or partially decreased FTC claim, to ensure that examination adjustments are posting properly to taxpayer accounts.

CORRECTIVE ACTION 1

Guidance has been updated for reviewing examination closing reports for accuracy. We are reviewing recent closures at each campus to evaluate the effectiveness of the guidance and ensure the adjustments are posting correctly.

Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

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IMPLEMENTATION DATE

December 15, 2023

RESPONSIBLE OFFICIAL

Director, Refundable Credits Program Management, Return Integrity and Compliance Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

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

CORRECTIVE ACTION 2

To further strengthen adherence to our existing policies and procedures, Small Business/Self-Employed will remind managers, reviewers, and employees of the importance of ensuring the accuracy of FTC adjustments.

IMPLEMENTATION DATE

February 15, 2024

RESPONSIBLE OFFICIAL

Director, Examination Field and Campus Policy, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

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

RECOMMENDATION 7:

The Commissioner, W&I Division, should lower the threshold criteria for FTC claim scheme analysis to expand the scope of returns considered, particularly to identify schemes with large numbers of returns below the IRS's compliance threshold. Analysis should also focus on preparer misconduct schemes committed by unscrupulous tax return preparers and ghost preparers.

CORRECTIVE ACTION

We will ensure that the established procedures for FTC scheme analysis include lower thresholds to expand the scope of returns considered and allow focus on the most unscrupulous tax return preparers.

IMPLEMENTATION DATE

April 15, 2024

RESPONSIBLE OFFICIAL

Director, Return Integrity Verification Program Management, Return Integrity and Compliance Services, Wage and Investment Division

Actions Have Been Taken to Enhance Fuel Tax Credit Screening and Examination Processes; However, Improvements Are Still Needed

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CORRECTIVE ACTION MONITORING PLAN

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

Abbreviations

AIMS	Audit Information Management System
CEAS	Correspondence Examination Automation Support
DCW	Data Center Warehouse
FTC	Fuel Tax Credit
IMF	Individual Master File
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
IRTF	Individual Return Transaction File
PY	Processing Year
SB/SE	Small Business/Self-Employed
TIGTA	Treasury Inspector General for Tax Administration
W&I	Wage and Investment



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