

**HEARING BEFORE THE
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEES ON SELECT REVENUE MEASURES AND
OVERSIGHT**

United States House of Representatives

“Energy Tax Policy and Tax Reform”



**September 22, 2011
Washington, D.C.**

**Testimony of
The Honorable J. Russell George
Treasury Inspector General for Tax Administration**

TESTIMONY OF
THE HONORABLE J. RUSSELL GEORGE
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION
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Chairman Tiberi, Chairman Boustany, Ranking Member Neal, Ranking Member Lewis, and Members of the Subcommittees, I thank you for the opportunity to testify on the Internal Revenue Service’s (IRS) administration of energy-related tax credits.

The energy-related tax credits and deductions I address in this testimony are the ones that we have evaluated and reported on this year as part of our evaluation of the IRS’s administration of the tax provisions in the American Recovery and Reinvestment Act of 2009¹ (Recovery Act).

The Recovery Act contained 20 provisions which were applicable to individual taxpayers, including a number of tax credits and deductions. Some of the tax credits were refundable, such as the Making Work Pay Credit and the First-Time Homebuyer Credit, while others were nonrefundable. Refundable credits result in a payment from the government when the amount of the credit exceeds the taxpayers’ liability for tax. A nonrefundable credit can only be used to offset the tax liability and cannot result in a payment from the government for the amount of the credit that exceeds the liability for tax. Refundable credits are at higher risk for fraud and abuse because they result in a payment from the government. These payments can be substantial. For the First-Time Homebuyer Credit, the payment could be up to \$8,000. Nonetheless, all credits and deductions reduce tax liability and are subject to error and abuse.

The energy and motor vehicle provisions in the Recovery Act were nonrefundable credits and deductions to encourage individuals to purchase motor vehicles that operate on clean, renewable sources of energy; encourage the purchase of energy-efficient property for an individual’s principal residence that is designed to reduce heat loss during cold months or heat gain during warm months; encourage the

¹ Pub. L. No. 111-5, 123 Stat. 115 (2009).

purchase of renewable sources of energy for use in a home; and provide an additional deduction for State sales taxes and excise taxes for qualified new motor vehicle purchases.

The Plug-in Electric and Alternative Motor Vehicle Credits provide taxpayers with a credit for the purchase of or conversion to motor vehicles that operate on clean renewable sources of energy. The specific amount of this credit varies by the type of vehicle. Approximately 69,000 individuals who filed electronically claimed \$164 million in plug-in electric and alternative motor vehicle credits during the period January 1 through July 24, 2010.

The Nonbusiness Energy Property Credit allowed individuals to take a credit of 30 percent of the costs paid or incurred in Calendar Year 2009 for energy efficient products for their principal residence with a maximum total credit of \$1,500 for Tax Years 2009 and 2010. The Residential Energy Efficient Property Credit allows individuals to take a credit for investments in alternative energy equipment for their principal residence or secondary residence. This Credit generally equals 30 percent of qualifying alternative energy equipment costs with no dollar limit. Approximately 6.8 million individuals claimed \$5.8 billion in Residential Energy Credits on their Tax Year 2009 tax returns processed through December 31, 2010.

Furthermore, the Qualified Motor Vehicle Deduction provided individuals with an additional deduction for State sales taxes and excise taxes on the purchase of certain motor vehicles. For Tax Year 2009 only, individuals could deduct State sales taxes and excise taxes for qualified motor vehicle purchases after February 16, 2009, and before January 1, 2010. The amount of qualified taxes was limited to the first \$49,500 of the purchase price of the new vehicle. Individuals could take this deduction for more than one vehicle. For Tax Year 2009,² approximately 4.3 million individuals claimed \$7.2 billion in Qualified Motor Vehicle Deductions.

Once tax legislation is enacted, the IRS reviews the law to determine what actions it must take to correctly implement the law to ensure that legislated requirements will be satisfied. Actions the IRS takes in response to new legislation often include creating new tax forms, updating publications, revising internal operating procedures, and updating computer programs for processing tax returns.

Because credits and deductions have specific objectives and have a significant cost in terms of forgone tax revenue, it is important that the IRS have processes in place to help ensure that associated claims meet the criteria set forth in the law. The

² Through November 12, 2010

IRS uses certain methods to verify the accuracy and eligibility of tax benefits and credits claimed on tax returns. The validation process can occur before a tax return is processed and before funds have been released or after a tax return is processed and after funds have been released. Verifying the accuracy of claims and eligibility for tax deductions and credits before a tax return has been processed and prior to the release of funds is the most efficient and effective approach for the IRS to prevent erroneous or improper claims. These preventive identification efforts include the development of computer programs to detect errors. When errors are detected, the tax returns are rejected and sent back to the transmitter to be corrected. Once a tax return is received (if paper filed) or accepted (if electronically filed) by the IRS, selected information from the tax return is validated and/or verified by the IRS. If a tax return does not pass validation/verification, the tax return is forwarded to the IRS Error Resolution function to be manually reviewed and corrected.

After the IRS has processed a tax return and released funds, it has limited means by which it can validate the accuracy of tax benefits and credits previously claimed. One way the IRS can validate information on the return at this point is by matching third-party documents to information listed on the tax return. In addition, the IRS can perform an audit of the taxpayer's records by a correspondence audit, office audit, or field examination. During these audits, taxpayers are asked to provide the documentation necessary to verify a variety of selected issues that may include certain tax deductions and credits claimed on a tax return.

Our reviews of the effectiveness of IRS processes to identify and prevent erroneous claims for these energy-related credits and deductions identified erroneous claims for millions of dollars in energy credits and qualified motor vehicles deductions. These erroneous claims could have been minimized if the IRS had taken the following actions which would also help minimize erroneous claims for other credits as well:

- Establish effective processes to verify eligibility for these credits up front at the time tax returns are processed.
- Design the tax forms used to claim the credits and deductions to request key information that can be used to verify eligibility.
- Use the data the IRS already has to identify non-qualifying claims.

The President and the Congress announced their commitment to spending Recovery Act dollars with an unprecedented level of transparency and accountability. Five requirements were established for all agencies to follow in order to meet accountability objectives. One of these requirements is that agencies ensure Recovery Act funds are used for authorized purposes and take every step to prevent instances of

fraud, waste, and abuse. We believe that the IRS could have been better positioned to achieve these objectives and mitigate the risk of fraud, waste, and abuse.

A summary of the issues we identified and the associated recommendations that we have made follows. Overall, we made 16 recommendations to help the IRS improve its administration of the Recovery Act energy and motor vehicle credits for individual taxpayers. The IRS agreed to take action on all 16 of these recommendations. If the IRS follows through with these corrective actions, we believe they will be in a better position to administer such tax credits in the future.

Plug-in Electric and Alternative Motor Vehicle Credit – In January 2011, we reported that for paper-filed tax returns with Plug-in Electric and Alternative Motor Vehicle Credit claims, the IRS did not establish processes to record data from the taxpayers' forms into the IRS data files related to the Plug-in Electric Vehicle Credits claimed. As a result, the IRS is unable to track and account for Plug-in Electric Vehicle Credits claimed on paper-filed tax returns. This also prevented the IRS from identifying potentially erroneous claims.

As of July 24, 2010, we identified 12,920 individuals who electronically filed their tax returns and erroneously claimed \$33 million in Plug-in Electric and Alternative Motor Vehicle Credits. IRS processes did not ensure the plug-in electric and alternative motor vehicles claimed met the requirements for vehicle year, placed-in-service date, and make and model. Information was provided on the tax forms used to claim these credits which the IRS could have used to identify and stop these erroneous credits at the time tax returns were processed.

We recommended that the IRS develop procedures to disallow credits for vehicles with nonqualifying years; initiate actions to recover erroneous credits; and either develop a coding system to identify vehicle makes and models or require the Vehicle Identification Number on the forms used to claim Plug-in Electric and Alternative Motor Vehicle Credits. The IRS agreed with the recommendations and plans to update procedures to require a review of the make, model, and date vehicles were placed in service to ensure that credits are being claimed for qualifying vehicles. IRS management plans to add a new line on the forms used to claim the credits to require a Vehicle Identification Number and has requested that e-file software providers implement programming changes to allow taxpayers to select the make, model, and year of qualifying vehicles from a drop-down menu. The IRS also plans to recover erroneous claims by conducting audits.

Residential Energy Credits – In April 2011, we reported that the IRS cannot verify whether individuals claiming Residential Energy Credits are entitled to the credit at the time their tax returns are processed. The IRS does not require individuals to provide any third-party documentation supporting the purchase of qualifying home improvement products and/or costs associated with making energy efficiency improvements and whether these qualified purchases and/or improvements were made to their principal residence. The tax form used to claim these credits does not request specific information that could be used to verify that requirements were met.

We identified 362 ineligible individuals who were allowed to erroneously claim \$404,578 in Residential Energy Credits on their tax returns. These individuals were prisoners or were under the age needed to enter into a contract to purchase a residence. The IRS has data that could have been used to identify these erroneous credits at the time the tax return was processed; however, the IRS did not have a process in place for this.

We recommended that the IRS revise the tax form used to claim Residential Energy Credits to request specific information supporting key eligibility requirements; examine the tax returns of the 362 individuals who appeared to be ineligible to claim the credit; and implement processes to identify and review tax returns filed by prisoners or underage individuals to verify whether they qualify for the Residential Energy Credits claimed. IRS officials agreed to revise the tax form and develop processes to identify claims submitted by prisoners or underage individuals and agreed to review the returns of the individuals we identified and audit those returns if warranted.

Qualified Motor Vehicle Deduction – In April 2011, we reported that the IRS cannot verify whether individuals claiming a Qualified Motor Vehicle deduction are entitled to the credit at the time their tax returns are processed. Individuals do not have to provide third-party documentation to support that they actually purchased a qualified motor vehicle and the amount paid in sales and excise taxes.

The IRS implemented controls to identify and freeze refunds of individuals who claim a Qualified Motor Vehicle deduction in excess of a specific dollar amount. Once the freeze is applied, the tax return is sent to the Examination function for review to determine if the deduction is correct. Although the IRS recognized the potential for abuse, the process for identifying and working the potentially abusive deductions was not effective. During the period January 1 through November 12, 2010, we identified 4,257 individuals with more than \$150 million in deductions that met the IRS dollar amount criteria for identifying the deduction as potentially excessive. However, the refunds were not frozen and the tax returns were not sent for review.

In addition, for cases that were identified and sent to the Examination function, the IRS did not request or receive documentation to support the purchase of a qualified motor vehicle before closing these tax returns without reducing the deduction and associated tax refund. As a result, even individuals whose tax returns were examined by the IRS received more than \$73,418 in questionable tax refunds.

Our review of a judgmental sample of 120 of the 944 tax returns reviewed by the Examination function and closed with no reduction to the Qualified Motor Vehicle deduction identified that 53 (44 percent) of 120 tax returns were incorrectly closed without requesting and/or receiving documentation to support the purchase of a qualified motor vehicle. IRS management indicated that tax examiners did not follow the procedures when examining these tax returns.

Finally, we identified 473 cases for which information that the IRS maintains identifies these individuals as ineligible to claim about \$1 million in Qualified Motor Vehicle deductions they were allowed. These individuals were in prison, deceased, or under the age needed to enter into a contract to purchase a motor vehicle. The IRS did not develop procedures to identify these claims for further scrutiny.

The Qualified Motor Vehicle deduction expired on December 31, 2009, and has not been extended by law. If similar legislation is enacted in the future, the IRS should require individuals to provide enough information on their tax returns to support the vehicle deduction. For example, the IRS could require individuals to provide a vehicle identification number or the name and address of the dealer from which the vehicle was purchased. Requesting additional information could serve as a deterrent for those individuals who may intend to claim erroneous vehicle-related credits and/or deductions.

We recommended that the IRS review the excessive Qualified Motor Vehicle deduction claims we identified. In addition, the IRS should review all tax returns with an excessive deduction that met examination criteria but were closed without reducing the amount claimed to ensure tax examiners are taking the correct actions before closing cases. Finally, the IRS should review the tax returns of the 473 individuals who, based on IRS records, appear to be in prison, deceased, or underage to evaluate whether these individuals qualify for the deduction. The IRS agreed with all of the recommendations.

In conclusion, because the IRS has limited resources to examine questionable claims for credits and deductions after the fact, it needs to do a better job of putting processes in place to help verify claims during the processing of tax returns. This

includes designing tax forms to capture information that could be used to validate the claims; recording appropriate information from paper tax returns into its data systems; and using information it already has, such as information from third parties, to help validate eligibility.

Chairman Tiberi, Chairman Boustany, thank you for the opportunity to share my views. I hope my discussion helps the Congress to ensure accountability of the IRS and assists you with your oversight duties.