



G A O

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United States Government Accountability Office
Washington, DC 20548

June 14, 2010

The Honorable Mitch McConnell
Republican Leader
United States Senate

The Honorable Joseph Lieberman
Chairman
The Honorable Susan M. Collins
Ranking Member
Committee on Homeland Security and Governmental Affairs
United States Senate

The Honorable Charles Grassley
Ranking Member
Committee on Finance
United States Senate

The Honorable Edolphus Towns
Chairman
The Honorable Darrell Issa
Ranking Member
Committee on Oversight and Government Reform
House of Representatives

Subject: *GAO Proactive Testing of ARRA Tax Credits for COBRA Premium Payments*

From 2008 to 2009, the U.S. unemployment rate increased significantly from 5.3 percent to 9.2 percent, leaving many Americans jobless and at risk of losing their employer-sponsored health care. Through the American Recovery and Reinvestment Act of 2009 (ARRA)¹ and subsequent amendments,² employees who were involuntarily terminated between September 1, 2008, and May 31, 2010, became eligible to continue their health care coverage for up to 15 months at reduced rates. Previously, the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) allowed certain former employees to maintain health coverage by paying the entire cost of coverage. Under ARRA, former employees pay 35 percent of insurance premiums while employers pay the remaining 65 percent. Employers are reimbursed

¹ Pub. L. No. 111-5 (Feb. 17, 2009).

² Several subsequent acts have extended the original expiration date. Currently, the provision applies to all employees terminated through May 31, 2010. Pub. L. No. 111-157 (April 15, 2010).

through a tax credit against their payroll tax liability or through a tax refund if the credit exceeds their payroll tax liability.

The Congressional Budget Office estimated that the cost of this program to the federal government would be \$25.1 billion. According to the Internal Revenue Service (IRS), as of March 20, 2010, employers had claimed approximately \$2.2 billion in COBRA credits. Employers claiming COBRA credits use quarterly or annual payroll tax returns to report the number of former employees on COBRA and the amount of premiums paid. These returns do not require employers to provide any supporting information about individuals enrolled in COBRA or premiums paid on their behalf, potentially allowing unscrupulous employers to lower their payroll taxes by fraudulently claiming COBRA credits. Based on this potential vulnerability, we performed covert testing of the effectiveness of IRS's internal controls for preventing businesses from submitting fraudulent tax returns to obtain COBRA tax credits and subsidies.

To determine the effectiveness of IRS's internal controls, we performed covert testing to identify what controls, if any, IRS had in place to detect suspicious tax returns. We created five fictitious businesses for tax filing purposes. Because these were new businesses, the fictitious companies had never filed corporate income tax returns with IRS. Thus, our companies filed employer payroll tax returns without any prior records as established businesses. For three of the five businesses, we filed quarterly federal tax returns using IRS form 941 in each of the four quarters of 2009. For the remaining two companies, we filed annual federal tax returns using IRS form 944 in December 2009.³ In several quarters and at the end of the year, we requested refunds of varying amounts for different companies. In some cases, we paid small amounts of monthly payroll taxes to appear legitimate. For companies selected for audit by IRS, we prepared fictitious documentation, including lists of fictitious employee names with no prior tax records on file with IRS, Social Security numbers, and dates of involuntary termination. We used publicly available information, hardware, and software to create fake invoices from an existing health insurance carrier and proof of employer payment of COBRA premiums. At the end of our undercover tests, we interviewed IRS officials to determine what internal controls are in place to detect fraudulent COBRA premium claims and reviewed IRS files related to our five fictitious companies. Our work was limited to testing whether new companies could fraudulently claim COBRA subsidies without being detected. We did not test whether established companies could use COBRA credits to lower their payroll taxes. We conducted our investigative work from June 2009 to June 2010 in accordance with standards prescribed by the Council of Inspectors General on Integrity and Efficiency.

In summary, IRS controls were successful in identifying all five fictitious companies that fraudulently applied for COBRA credits and tax refunds based on those credits. IRS's internal controls prevented our fictitious companies from obtaining \$8,900 of the \$9,182 in refunds we requested. While the IRS paid three small refunds, ranging

³ Most employers are required to report wages, tips, and withholding for their employees on a quarterly basis using form 941, even if they have no taxes to report. Form 944 allows the smallest employers (those whose annual liability for Social Security, Medicare, and withheld federal income taxes is \$1,000 or less) to file and pay these taxes only once a year instead of every quarter.

from \$38 to \$145, it denied our other requests and began investigating all five of our companies. IRS investigators used a variety of sources to determine that our companies were fictitious, and ultimately linked four of our five companies to the same fraud scheme. While the fifth company was not identified as part of this scheme, IRS had determined that its claims were potentially fraudulent and was preparing to refer it for investigation.

The COBRA premium subsidy program may still be vulnerable to fraud, but we did not attempt to determine the extent to which companies use COBRA credits to commit fraud. The scenarios we used in our undercover tests had obvious indicators of fraud, including companies that had never filed income or payroll tax returns requesting refunds based on COBRA credits. However, we have previously noted that real businesses facing economic hardship may choose to reduce costs by failing to pay taxes.⁴ The COBRA premium credit provides an opportunity for unscrupulous businesses to fraudulently lower their payroll taxes by claiming several thousand dollars of fictitious COBRA payments. IRS officials told us their controls were effective at identifying fraudulent COBRA claims. Because of the sensitive nature of these controls for tax enforcement, IRS did not provide specific information about the controls that would have allowed us to evaluate their claim. In addition, three of our companies received a small refund, despite an ongoing fraud investigation into each of them. IRS officials told us that if a payroll tax return successfully passes its audit filters, a refund is automatically issued. For civil investigations, IRS does not have the capability to place a hold on a company's tax return before it is processed to prevent a refund from being issued. IRS Criminal Investigation Division has this capability, but officials told us that our companies had not yet been referred to the division at the time the refunds were issued. IRS's inability to place all future returns for an entity on hold until a civil investigation is resolved creates a risk that companies defrauding the government will continue to receive refunds. We did not evaluate how frequently companies under investigation receive refunds or the cost of implementing this type of hold on tax returns.

Background

Under ARRA, employees eligible for the COBRA premium subsidy must (1) have been involuntarily terminated between September 1, 2008, and December 31, 2009; (2) not be eligible for another group health plan, such as Medicare or a group plan offered through a spouse's employer; and (3) have a modified adjusted gross income below \$145,000 if single or \$290,000 if married and filing a joint tax return.⁵ In December 2009, coverage was extended from 9 months to 15 months and eligibility was extended to individuals who were involuntarily terminated up to February 28, 2010. The eligibility period for this program was extended in March and April 2010, and currently covers employees terminated up to May 31, 2010. Employers with 20 or more employees in the prior year are required to offer employees the opportunity to continue their coverage. According to IRS, as of March 31, 2010, it had received 331,280 returns claiming COBRA credits. As of March 20, 2010, IRS had issued \$718,885,818 in refunds to employers based on COBRA credits.

⁴GAO, *Tax Compliance: Businesses Owe Billions in Federal Payroll Taxes*, [GAO-08-617](#) (Washington, D.C.: July 25, 2008).

⁵Employees with a modified adjusted gross income between \$125,000 and \$145,000 (or between \$250,000 and \$290,000 for joint returns) are only eligible for a partial subsidy.

We reported in February 2010 that IRS had instituted a number of prepayment checks, such as looking for irregularities in COBRA claims and in the dollar value of subsidies.⁶ According to IRS, from the start of the program through the first quarter of 2010, 11,716, or 3.6 percent, of COBRA claims were stopped by prepayment checks and submitted for further review. However, we also reported that in an effort to reduce employer burden, IRS did not require employers to submit lists of all people receiving COBRA. As a result, the agency did not know who received the COBRA subsidies, limiting its ability to determine if an employee was qualified to receive a subsidy and to ensure that employers did not receive the credit for ineligible individuals. Employers are required by IRS to keep records of the COBRA assistance, including the names and Social Security numbers of covered employees, but IRS would only obtain this information during tax examinations. We also reported that while individuals have a financial incentive to terminate their high-cost COBRA coverage when other options exist, employers may have an incentive to continue claiming the credit even when former employees are no longer eligible. IRS agreed with our recommendation that it determine whether individuals or employers were exceeding the 15-month limit and, if so, issue letters reminding employers of the COBRA eligibility requirements and instructing them to correct erroneous claims.

IRS's Internal Controls Identified GAO's Fictitious Companies Fraudulently Claiming COBRA Credits

IRS controls were successful in identifying all five fictitious companies that fraudulently applied for COBRA credits and tax refunds based on those credits. For the three fictitious companies that were required to file employment tax returns on a quarterly basis, IRS's internal controls successfully prevented our companies from obtaining \$8,900 of the approximately \$9,000 in refunds we requested. For example, one company claimed \$14,640 in COBRA credits and requested a refund of \$2,232 for the first quarter. IRS sent our fictitious company a letter adjusting the refund to \$0, which the company appealed. IRS also requested supporting documentation to verify the existence of employees and payments to insurance carriers on their behalf, which we created and submitted. Eventually, an IRS examiner approved the COBRA credit based on the fake documentation provided during the appeal process, but the IRS Criminal Investigation Division identified the return as potentially fraudulent and prevented the issuance of the refund. In the four other COBRA tests in which IRS denied our refunds, IRS adjusted our refunds down to \$0 and sent the company a letter requesting supporting documentation, notified the company that it would be reviewed, or simply ignored our refund request with no explanation.

In addition, IRS did not prevent the payment of small refunds for the two fictitious companies that file annual employment tax returns, nor did it prevent the payment of a tax refund on one tax return for one of the three fictitious companies that file quarterly. For these three tax returns, IRS paid our fictitious companies about \$300 in tax refunds.⁷ IRS officials told us that their controls are risk-based, balancing the potential loss to the government against the cost of investigating the potential fraud.

⁶ GAO, *Recovery Act: IRS Quickly Implemented Tax Provisions, but Reporting and Enforcement Improvements Are Needed*, [GAO-10-349](#) (Washington, D.C.: Feb. 10, 2010).

⁷ For example, one fictitious company, in its annual tax return, claimed to have paid \$1,658 in COBRA premiums for two employees and requested a refund of \$145.

We agree that pursuing taxpayers who commit fraud can be costly and time-consuming.

Our undercover tests found that even in cases where a company did not request a refund, IRS targeted the company for investigation based on large COBRA credit claims. For example, in the third quarter, one of our companies claimed to have made \$14,640 in COBRA premium payments. The company did not request a refund and had even paid monthly payroll tax deposits totaling \$160, but IRS sent a letter requesting supporting documentation from the company. Table 1 shows the COBRA credits and refunds claimed by our fictitious companies and IRS’s response.

Table 1: COBRA Credits and Refunds Claimed by GAO’s Fictitious Companies

Quarter	Company	Type of filer	COBRA credits	Refund claimed	Refund received
Q1	One	Quarterly	14,640.00	\$2,232.53	No
	Two	Quarterly	33,672.00	6,221.96	No
Q2	One	Quarterly	16,350.44		
	Two	Quarterly	27,498.80		
	Three	Quarterly	12,312.11		
Q3	One	Quarterly	14,640.00		
	Two	Quarterly	24,814.80		
	Three	Quarterly	11,930.49	316.62	No
Q4	One	Quarterly	1,444.00	97.02	Yes
	Two	Quarterly	4,708.50	37.07	No
	Three	Quarterly	1,710.00	92.43	No
	Four	Annual	1,782.84	38.46	Yes
	Five	Annual	1,657.98	145.54	Yes

Source: GAO.

IRS identified all five of our companies for civil investigation and ultimately linked four of the five companies to the same fraud scheme. IRS officials told us they identified our companies as potentially fraudulent based on factors such as their relatively new employer identification numbers, their lack of previous tax returns, and their large COBRA credit claims relative to their sizes. In two cases, IRS required our companies to submit information about employees benefiting from the COBRA premium subsidy, including Social Security numbers, dates of involuntary termination, proof of employee enrollment in COBRA, proof of employer payments to the insurance carrier and, in one case, proof of employee payments of 35 percent of the premium to employers, such as canceled checks. IRS used this information to determine that our companies were fictitious, including identifying the Social Security numbers we provided as belonging to children or deceased individuals, determining that our company addresses were rental mailboxes, and using IRS data to establish that the companies had not previously paid taxes. Investigators ultimately determined that four of our five companies were part of a single scheme based on similarities between the companies and the type of fraud they were attempting to commit. The fifth company was not identified as part of this scheme, but IRS had determined that its claims were potentially fraudulent and was preparing to refer it for investigation.

Though IRS prevented our fictitious companies from receiving nearly all of the requested refunds, the COBRA premium payment assistance program may be vulnerable to fraud. However, we did not attempt to determine the extent to which companies use COBRA credits to commit fraud. The scenarios we used in our undercover tests had obvious indicators of fraud: new companies with large numbers of employees, significant layoffs immediately after the COBRA credit came into effect, companies that paid very high insurance premiums with very low payroll taxes, and companies that never filed corporate income tax returns requesting refunds. To illustrate vulnerabilities in a short time frame, our tests also focused on obtaining a refund rather than simply lowering our payroll tax liability. However, as we have previously reported, businesses facing economic hardship may take advantage of the tax system by ignoring their payroll tax obligations and instead devoting the funds to other uses. Unscrupulous businesses can use COBRA credits to fraudulently lower their payroll taxes. IRS officials told us they have multiple controls that use a variety of factors to detect this type of fraud, particularly amounts of COBRA credits that conflict with other information provided by the company. However, IRS officials told us they cannot guarantee that a company using COBRA credits to reduce its payroll tax liability by a modest amount will be detected. In addition, IRS did not provide us with specific information about their fraud controls because of their sensitive nature for tax enforcement, so we were unable to evaluate their effectiveness in preventing the use of fraudulent or erroneous COBRA credits to reduce payroll tax liabilities.

Three of our companies were able to receive small refunds, despite ongoing fraud investigations into each of them. One company claimed around \$15,000 in COBRA credits in each of the first three quarters, and had been identified by IRS as part of a larger fraud scheme. However, in the fourth quarter, the company claimed \$1,444 in COBRA credits, and the company was issued a refund of \$97. Two other companies that had been identified as part of the same scheme also received refunds. IRS officials told us that if its audit filters identify a payroll tax return as potentially fraudulent, the refund for that quarter is not issued. However, if a tax return successfully passes its audit filters, a refund is automatically issued. For civil investigations, IRS does not have the capability to place a hold on a company's tax return before it is processed to prevent a refund from being issued. IRS Criminal Investigation Division has this capability, but officials told us that our companies had not yet been referred to the division at the time the refunds were issued. IRS's inability to place all future returns for an entity on hold until a civil investigation is resolved creates a risk that companies defrauding the government will continue to receive refunds. However, we did not evaluate how frequently companies under investigation receive refunds or the cost of implementing this type of hold on such companies.

Corrective Action Briefing

We briefed officials from IRS on the results of our investigation. IRS officials stated that typically, tax returns suspected of fraud are audited after a refund has been issued. They noted that controls to screen returns for fraud prior to the issuance of a refund are only implemented for high-risk programs, such as the COBRA credit and other refundable credits. We suggested that IRS modify its system to prevent the issuance of refunds to companies identified for any kind of fraud. IRS said these

kinds of controls are resource-intensive and therefore it had no plans to implement them for all kinds of fraud. In addition, we suggested that IRS allow examiners to place a hold on all future refunds to a company under investigation for fraud. IRS said that its return processing system does not have the capability to place a hold on future returns for companies identified for civil violations, though this capability exists for companies under criminal investigation.

We are sending copies of this correspondence to the Secretary of the Treasury and the Commissioner of the IRS. This correspondence will also be available on the GAO Web site at <http://www.gao.gov>. If you or your staff have any questions concerning this correspondence, please contact Gregory Kutz at (202) 512-6722 or kutz@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this correspondence.

A handwritten signature in blue ink that reads "Gregory D. Kutz". The signature is written in a cursive style with a large initial "G".

Gregory D. Kutz
Managing Director
Forensic Audits and Special Investigations

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