Loose Rules Complicate IRS Efforts to Detect Fraud in First-Time Home Buyer Tax Credit

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There may be an unusually high risk of fraud in the first-time home buyer tax credit program despite the best IRS enforcement efforts, according to Tax Analysts interviews with specialists and anecdotal evidence offered by preparers.

The $8,000 first-time home buyer tax credit enacted in 2008 offers qualified taxpayers an attractively large cash payout and eligibility requirements that do not require extensive documentation. As a result, there may be an unusually high risk of fraud in the program despite the best IRS enforcement efforts, according to Tax Analysts interviews with specialists and anecdotal evidence offered by preparers.

The misuse of the new credit -- created to boost homeownership at a time of economic crisis -- may run the gamut from simple taxpayer confusion over eligibility requirements to outright deception from claimants who never even tried to purchase a home, according to preparers interviewed at a recent conference of the National Association of Enrolled Agents.

Some taxpayers have sought enrolled agent assistance in flouting eligibility rules, such as claiming the credit for a home purchase that isn't a primary residence or manipulating the dates of their closing to make the purchase appear to fall within the April 8, 2008, to December 1, 2009, eligibility window.

A spokeswoman for the National Association of Realtors (NAR) said her group had heard about several taxpayers who amended their 2008 returns to claim the credit before they had officially closed on their new home, another violation of the eligibility rules that allow use of the credit only after a taxpayer has closed on a home purchase.

There is no sign that the suspected fraud is taking place on a large scale. The IRS reports that it has charged one preparer with fraud and has opened 24 more investigations. (For a release, see *Doc 2009-17102* [**PDF**]or *2009 TNT 144-5* .)

But a March 2009 interim report from the Treasury Inspector General for Tax Administration found that fraud may be affecting as many as 7 percent of returns claiming the first-time home buyer credit. As of March 6, 2009, the IRS had received 567,685 claims for the credit, worth more than $3.9 billion, TIGTA said, and 38,158 of these claims were made by taxpayers who had already owned a home within the prior three years, making them ineligible for the credit. (For the report, see *Doc 2009-7689* [**PDF**]or *2009 TNT 63-98* .)

"Enforcing a tax provision where the IRS has to have knowledge of people's living situations is difficult," said Roberton Williams, senior fellow at the Urban-Brookings Tax Policy Center and a former Treasury and Congressional Budget Office staffer. But Williams went on to characterize the enforcement challenges presented by the first-time home buyer credit as "standard" for tax programs that try to influence social behavior.

Vulnerabilities in the Program

When the 2008 law was being drafted, the NAR had urged lawmakers to grant the IRS the statutory authority to allow taxpayers to redeem the credit at the settlement meeting when they close their home purchase. This potentially fraud-reducing provision, however, was not included in the final legislation, the association spokeswoman said. That means that many who claim the credit must either amend their 2008 return or wait months for the 2009 filing season for a refund check -- a sizable sum for most taxpayers.

Congress created and then revised the first-time home buyer tax credit, first in the 2008 Housing and Economic Recovery Act of 2008 (passed in July 2008) and then in the American Recovery and Reinvestment Act of 2009 (P.L. 111-05), passed in February. Congress went to great lengths to ensure that the credit would be administered through the tax system and not through, say, the Department of Housing and Urban Development, the realtors spokeswoman said. Allowing taxpayers access to the credit amount at the time of their home purchase would have imposed an enormous administrative burden on the IRS, she said, adding that Congress "couldn't come up with a scheme where the IRS wasn't party to settlement transactions, which is undesirable for all sides."

The resulting vulnerabilities in the credit come in several varieties. Unlike the Obama administration's recent "cash for clunkers" auto industry stimulus, the first-time home buyer credit has unlimited funding available. (The Joint Committee on Taxation estimated that the credit would cost some $14.7 billion in fiscal 2009.) That makes it an ongoing and tempting target for fraud perpetrators.

The credit is also refundable, so the government must write a check to successful claimants who otherwise owe no taxes.

What's more, the document used by taxpayers to claim the credit, Form 5405, does not require the filer to verify a claim through third-party documentation, such as a closing statement from the mortgage issuer. Home buyers who use the credit for 2009 also do not have to repay it unless the home they purchase ceases to be their primary residence within three years of the purchase date. (Home purchases in 2009 are subject to rules that differ from those for home purchases in 2008. In the latter, taxpayers may claim a $7,500 credit that amounts to an interest-free loan that must be repaid.)

Additional challenges for IRS enforcement, according to the Treasury auditors, is the Service's inability to efficiently verify dates of purchase. The value of the credit varies depending on the purchase date: $7,500 for purchases in 2008, and $8,000 for purchases in 2009.

Finally, several return preparers spoke of parents who wished to buy homes for their young adult children and claim the credit for themselves, or spouses who wanted to file separately so that the partner who did not appear on the title of their current home would be entitled to the credit for the purchase of a new home. Under the law, taxpayers who acquired their home from a "related person" are ineligible for the credit; the IRS defines "related persons" as spouses as well as lineal ancestors and decedents such as children, grandchildren, parents, and grandparents.

Searching for a Solution

TIGTA in last spring's report said the IRS was scrambling to implement a process to verify the closing dates reported by taxpayers. IRS spokespersons declined to address Tax Analysts' inquiries on the Service's overall response. Other sources confirmed, however, that the IRS already has in place its Electronic Fraud Detection System, an automated system that checks electronic and some paper returns against thousands of criteria to sift out those returns most likely to be fraudulent. But the timing of the two laws creating the home buyer credit may not have given the IRS adequate time to upload the necessary criteria and deploy the system to effectively monitor Form 5405, the sources said.

In response to an inquiry from syndicated housing columnist Kenneth Harney, IRS spokesman Terry Lemons declined to discuss the criminal investigations of taxpayers claiming the home buyer credit, but he did say the investigations involved individuals as well as return preparers. "We don't want to discourage people from taking advantage of the credit," Lemons said. The IRS wants taxpayers to be certain they've read through the eligibility rules so they don't end up with audits, back taxes, and late-filing penalties, he said.

Detailed and current data on fraud in the program may not be available for some time. According to the NAR, "the IRS hasn't even begun to collect the data on who is claiming the credit. It's maintained on systems that do a weekly input, and that input has not been collated." Also, the NAR spokeswoman said, "Amended returns will be filed throughout the year, and the IRS doesn't start auditing until a tax year has closed."

As a stopgap solution to the taxpayers' problem of having to wait through the tax season to receive a check for the credit, the spokeswoman pointed to Credit Advancement Loan Programs, an approach her group pressed on HUD to support. Those programs grant Federal Housing Authority-approved lenders the authority to make "bridge loans" to home buyers who wish to have the credit amount for which they qualify available at closing. Participation in the programs is voluntary for creditors, and each state administers them through the state housing agency. As with refund anticipation loans, borrowing taxpayers are charged interest that they must repay in addition to the amount of the credit.

According to the National Council of State Housing Agencies, 15 state housing finance agencies have created bridge loan programs: Colorado, Delaware, Idaho, Illinois, Kentucky, Massachusetts, Missouri, Nebraska, New Jersey, New Mexico, Ohio, Pennsylvania, Texas, Tennessee, and Virginia.

Meanwhile, the IRS has the authority to take a simple step to improve its own efforts to improve fraud detection, Williams said. "If the IRS required filers to submit proper documentation showing the closing on a house, [enforcement] would be more straightforward," he said. "The IRS already asks for a lot of documentation; it wouldn't be a stretch for the IRS to ask people to submit closing documents." That would likely reduce both fraud and the error rates, he added.

Others think the fault in the tax credit lies with Congress. Chris Edwards, an economist and tax policy studies director at the Cato Institute, said, "Tax-side programs that rely on people honestly reporting their income open the IRS up to big-time cheating. Whenever you get subsidy programs, you get fraud," Edwards said, citing examples from programs as diverse as Medicare and the school lunch program. Edwards added, "That particular credit is a wrong-headed approach to try to pump up the housing bubble again. Haven't we learned that subsidizing housing is not a good idea?"