TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Processing of Carryback Loss Claims Needs to Be Improved to Ensure Taxpayers Receive Accurate Refunds

February 21, 2008

Reference Number: 2008-40-062

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.

Redaction Legend:

1 = Tax Return/Return Information
3(d) = Identifying Information - Other Identifying Information of an Individual or Individuals

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

February 21, 2008

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Processing of Carryback Loss Claims Needs to Be Improved to Ensure Taxpayers Receive Accurate Refunds (Audit # 200740036)

This report presents the results of our review to determine whether taxpayers properly filed and the Internal Revenue Service (IRS) accurately processed carryback loss claims for refunds submitted by individuals on an Application for Tentative Refund (Form 1045) or an Amended U.S. Individual Income Tax Return (Form 1040X). The scope of our review was limited to an assessment of the processes and procedures used by the IRS to ensure a claim was accurate before the refund was issued. This review is part of the Treasury Inspector General for Tax Administration's Fiscal Year 2007 Annual Audit Plan coverage under the major management challenge of Providing Quality Taxpayer Service Operations.

Impact on the Taxpayer

When taxpayers have significant losses from business activities or natural disasters, their deductions may exceed their income for the tax year, resulting in a net operating loss (loss). Taxpayers can file claims to apply (carry back) these losses to income in prior years, which results in refunds of taxes previously paid. The IRS processed 60,865 individual carryback loss refunds totaling approximately $1.2 billion in Fiscal Year 2007. Errors on these claims cause delays in processing and additional work for both taxpayers and the IRS. We reviewed a sample of 84 cases from prior tax years and found 50 percent contained 1 or more errors. Of those with errors, 57 percent were not corrected by the IRS.

Synopsis

The computation of claims for carryback losses can be very complex and may require taxpayers to make several adjustments. This complexity leads to errors on a significant number of taxpayers' claims for carryback loss refunds. While the IRS has processes to review these claims, it does not always identify and correct the errors before the claims are processed and the refunds are paid. We reviewed a statistical sample of 84 claims (43 claims for more than $1 million and 41 claims for $10,000 to $1 million) for carryback loss refunds that posted to the IRS Master File[1] between August 1, 2004, and July 30, 2005, and determined 42 (50 percent) contained at least 1 error. The IRS did not correct the errors on 24 (57 percent) of the 42 claims that had errors, resulting in $732,941 in additional refunds due taxpayers and $1,126,501 in additional tax due the IRS. The majority of the errors on the refund claims fall into three common categories: Alternative Minimum Tax (AMT), charitable contributions deductions, and IRS changes to the originally filed loss year tax return.

Unclear tax form instructions and tax publications appear to be contributing to taxpayer errors. Specifically, the IRS can improve areas in the instructions for both Forms 1045 and 1040X related to the AMT. In addition, the caution in the Form 1045 instructions and the *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts* (Publication 536) that instructs taxpayers not to change their charitable contributions deduction when carrying a loss back to a prior year could be better placed and more visible to taxpayers. Because some of the more common errors involved taxpayers incorrectly changing their charitable contributions deduction, it is possible that they are overlooking the caution.

IRS procedures for working carryback claims are also vague and open to interpretation. We identified two main areas in which the procedures for working carryback claims could be improved: (1) the AMT and (2) resolving differences between taxpayer and Individual Master File figures. In addition, the tool the IRS uses to work carryback claims is not accurate and makes errors in the way it handles charitable contributions and the alternative tax net operating loss deduction. During the course of our review, the IRS modified this tool (Desktop Integration) to correct the problem with charitable contributions.

Recommendations

We recommended the Director, Media and Publications, revise the applicable tax form instructions for claiming the carryback loss as they relate to the charitable contributions deduction and the AMT, and change the instructions for Forms 1045 and 1040X as they pertain to carryback losses to require the taxpayer to attach the AMT–Individuals (Form 6251) for each carryback year. We also recommended the Director, Accounts Management, work with the

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

Office of National Public Liaison to alert the preparer community of the need to be especially aware of issues affecting the AMT and the charitable contributions deduction; revise the procedures for working carryback refunds to improve the identification and resolution of errors before the related refunds are paid; change the procedures for verifying the carryback claim to require employees to ensure a Form 6251 is attached for each carryback year; and work with the Associate Chief Information Officer, Applications Development, to modify the Desktop Integration tool for the alternative tax net operating loss deduction.

Response

IRS management agreed with three of our recommendations, partially agreed with one, and disagreed with two. The Director, Accounts Management, will work with the Office of National Public Liaison to alert the preparer community of the need to be especially aware of the requirement to limit the alternative tax net operating loss deduction and the impact of a carryback loss on the charitable contributions deduction when claiming a carryback loss refund. The Director, Accounts Management, will also update procedures to require that employees verify (to the extent possible) the figures and computations on Form 6251 and the accuracy of the Master File figures before they reject a claim, when differences exist between the figures on the Master File and those on the claim. In addition, the Desktop Integration Tools Section Chief will work with a subject matter expert provided by the Accounts Management function to determine the feasibility of modifying the Desktop Integration tool's AMT worksheet to accurately account for carryback losses. In the interim, an alert will be sent to employees that the Desktop Integration tool for the AMT does not correctly limit the alternative tax net operating loss deduction to 90 percent of a taxpayer's alternative minimum taxable income before the deduction.

The Director, Media and Publications, agreed to revise the instructions for Form 1040X and Form 1045 to indicate that a carryback loss may create a new AMT liability. The Director also agreed to remove references to the Internal Revenue Code from Form 6251 to make the discussion less complex. In addition, the Director highlighted the caution for the charitable contributions deduction in Publication 536 and will make similar changes to Form 1045 in the next revision. However, the Director, Media and Publications, disagreed with our recommendation to move the caution closer to the beginning of the "After Carryback" and "Deducting a Carryback" sections in Form 1045 and Publication 536 stating the caution information belongs appropriately in the "Refiguring your tax" discussion. The charitable contribution deduction is an itemized deduction that is limited by certain percentages of the Adjusted Gross Income. They specifically state which deductions to refigure and state do not refigure your charitable contributions. Although the IRS did not agree to move the caution for the charitable contributions deduction, we agree the actions taken to highlight the caution are sufficient.

The IRS did not agree with our recommendation to require taxpayers to attach Form 6251 for each carryback year regardless of whether the AMT is owed or our related recommendation to modify procedures to require IRS employees to ensure the necessary Forms 6251 are attached to the claim. The IRS stated the Paperwork Reduction Act of 1995 requires agencies to certify that the collection of information is necessary, has practical utility, and reduces to the extent possible the burden on persons required to provide such information. Requiring taxpayers to file Form 6251 when no AMT is owed or no deductions are limited by the tax would impose an unreasonable burden and likely be viewed as a violation of these and other Paperwork Reduction Act requirements. Management's complete response to the draft report is included as Appendix VIII.

Office of Audit Comment

We understand the IRS' concern with unnecessarily increasing the burden on taxpayers and its need to comply with the Paperwork Reduction Act. However, we do not agree our recommendation to require taxpayers filing claims for carryback refunds to attach a Form 6251 for each carryback year would be overly burdensome for the taxpayers affected or significantly increase the amount of paper received by the IRS. As stated in our report, the only additional burden to the taxpayer would be to attach a copy of the Form 6251 for each loss year to his or her carryback claim. Taxpayers are already required to complete the Form 6251 and many voluntarily include it on most of the claims filed. However, the additional Forms 6251 could significantly improve the IRS' ability to determine if the AMT is owed on a claim for carryback refund. Had the IRS corrected the AMT errors we identified, taxpayers filing those claims would have owed approximately $1 million in additional tax. At a minimum, the IRS should revisit its decision to not request the Form 6251 from taxpayers once it has had a chance to evaluate the impact its other corrective actions have on the accuracy of carryback claims.

The IRS' ability to implement our recommendation to request a missing Form 6251, particularly in those instances where the taxpayer claims no AMT is due, was dependent on requiring taxpayers to include a Form 6251 with their claim for each carryback year. Since the IRS disagreed with our recommendation to require the Form, we recognize that it is not possible for the IRS to take our recommended corrective action and agree that the actions taken in Recommendations 3 and 6 will strengthen current controls when a Form 6251 is present. However, the IRS will continue to be unable to verify the AMT liability in those instances where a taxpayer claims no AMT liability and a Form 6251 is missing.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 622-5916.

Table of Contents

Abbreviations

AMT	Alternative Minimum Tax
IRS	Internal Revenue Service

Background

When taxpayers have significant losses from business activities or natural disasters, their deductions may exceed their income for the tax year, resulting in a net operating loss (loss). Taxpayers can file claims to apply (carry back) these losses to income in prior years. Generally, losses may be carried back up to 2 tax years prior to the loss, although the carryback period for some losses (e.g., natural disasters and farming losses) is longer. The Internal Revenue Service (IRS) processed 60,865 individual carryback loss refunds totaling approximately $1.2 billion in Fiscal Year 2007.

By carrying a loss back to a prior tax year, taxpayers may be entitled to refunds of prior year taxes paid. Taxpayers can claim this carryback refund using the Application for Tentative Refund (Form 1045) or the Amended U.S. Individual Income Tax Return (Form 1040X). A Form 1045 can be filed for multiple carryback years and must be filed within 1 year of the end of the year in which the loss occurred. However, taxpayers must file a separate Form 1040X for each carryback year and generally have 3 years to file a claim using this Form.

The computation of the loss can be complex and may require taxpayers to make several adjustments. For example, the credits and deductions claimed on a taxpayer's originally filed carryback year return may be different after applying the loss because the loss reduces the Adjusted Gross Income.[1] In addition, taxpayers must attach copies of the tax return and certain related tax forms and schedules for the loss year to show how the loss originated. This includes the Alternative Minimum Tax–Individuals (Form 6251), Itemized Deductions (Schedule A), Capital Gains and Losses (Schedule D), and Supplemental Income and Loss (Schedule E) as applicable. There are also additional considerations taxpayers must make if their marital status changes for either the loss or carryback years. This can affect the loss deduction or the amount of the refund for the carryback years. The IRS *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts* (Publication 536) instructs taxpayers on how to compute losses and carrybacks when those circumstances apply.

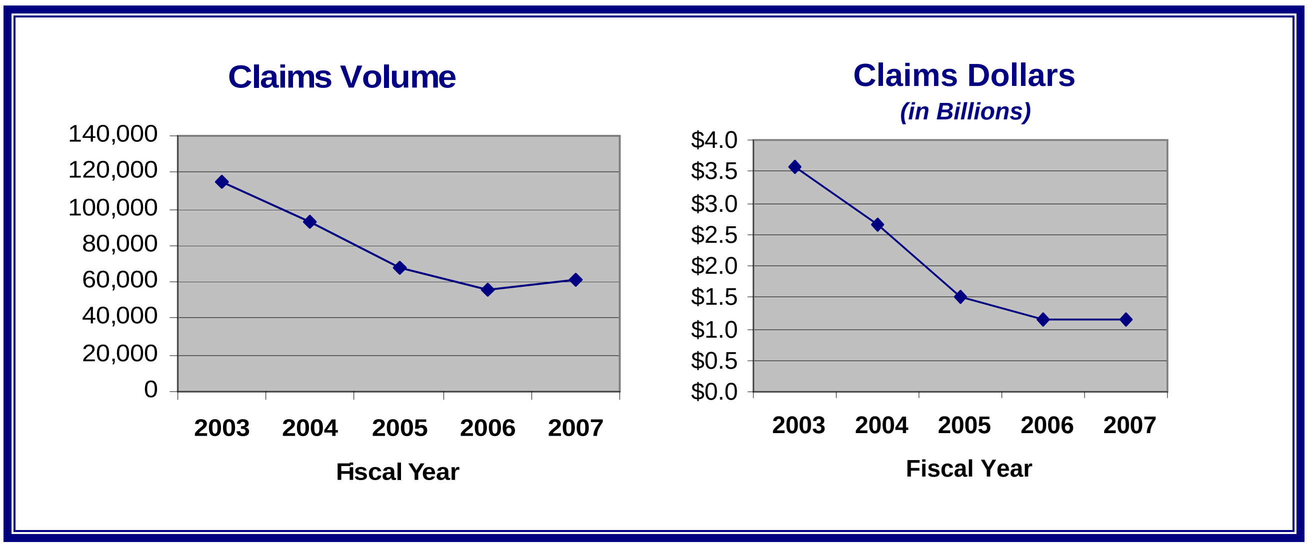
The occurrence of natural disasters and other events affects the number of carryback claims the IRS receives. For example, the tragedy on September 11, 2001, resulted in a significant increase in the number of carryback claims. The aftermath of Hurricanes Katrina, Rita, and Wilma in 2005 will likely create another significant increase in the number of claims filed by both corporations and individuals.

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

The National Hurricane Center[2] estimated that personal damages in the Gulf Coast Region could total almost $100 billion. In response, Congress passed the Katrina Emergency Tax Relief Act of 2005[3] and the Gulf Opportunity Zone Act of 2005[4] to aid the victims of the Hurricanes. These Acts included provisions to eliminate the limitations on personal casualty or theft losses caused by these Hurricanes. The Gulf Opportunity Zone Act of 2005 also allowed certain taxpayers to carry qualified losses back 5 years.

According to IRS data, the number and dollars for carryback refunds had declined through the end of Fiscal Year 2006. This decline coincides with the expiration of the period allowed for victims of the September 11, 2001, tragedy to file carryback claims. The latest data for Fiscal Year 2007 show carryback refunds are beginning to increase (up approximately 9 percent to 60,865). However, the dollars associated with those refunds have remained fairly steady, with only a 0.15 percent increase since Fiscal Year 2006.

Figure 1: Carryback Refund Claims for Fiscal Years 2003 Through 2007



Source: IRS Net Tax Refund Analysis Reports, Fiscal Years 2003-2007.

The IRS could receive claims resulting from the Hurricanes as late as 2010. Taxpayers affected by Hurricane Katrina have as late as April 17, 2010 (Fiscal Year 2010) to file a claim to carry back any qualifying loss to prior tax years.[5] Approximately 673,000 individual returns filed

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[2] The National Hurricane Center is part of the United States Department of Commerce National Oceanic and Atmospheric Administration.
[3] Pub. L. No. 109-73, 119 Stat. 2016 (2005).
[4] Pub. L. No. 109-135, 119 Stat. 2577 (2005).
[5] Victims of Hurricane Katrina were given until April 17, 2007, with properly filed extensions, to file their Tax Year 2005 income tax returns. A taxpayer has 3 years from the date the return was filed, including extensions, to file a Form 1040X to carry back a qualified loss.

between January 1, 2007, and October 20, 2007, reported losses that could result in a claim for carryback refund. An estimated 65,000 of these were for the year the Hurricanes occurred (Tax Year 2005).

This review was performed at the IRS Wage and Investment Division Headquarters in Atlanta, Georgia, in the Office of the Director, Accounts Management, and in the Atlanta, Georgia; Kansas City, Missouri; Fresno, California; and Austin, Texas Campuses during the period February through October 2007. 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 finding and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our finding and conclusions based on our audit objective. The scope of our review was limited to an assessment of the processes and procedures used by the IRS to ensure a claim was accurate before the refund was issued. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Results of Review

Errors on Claims for Carryback Loss Refunds Are Not Being Corrected

The number of taxpayer claims for carryback loss refunds with errors is significant; however, the IRS is not always correcting the errors before processing the claims and paying the refunds. As a result, refunds can be more or less than the amount to which taxpayers are entitled. We reviewed a statistical sample of 84 claims (43 claims for more than $1 million and 41 claims for $10,000 to $1 million) for carryback loss refunds that posted to the IRS Master File between August 1, 2004, and July 30, 2005. Of these 84 claims, 42 (50 percent) contained at least 1 error. Errors can result in additional refunds due taxpayers or additional taxes due the IRS.

The IRS corrected all of the errors on 18 of the 42 claims, resulting in net taxes of $609,106 due the IRS. However, at least 1 error went uncorrected on 24 (57 percent) of the 42 claims, resulting in net taxes of $393,560 due the IRS ($732,941 in additional refunds and $1,126,501 in additional taxes due).

Figure 2: Summary of Case Review Results

Net Result of Error	Claims With Errors	Claims With Errors Corrected	Net Effect of Errors Corrected	Claims With Errors Not Corrected	Net Effect of Errors Not Corrected
Additional Tax Due	17	6	$715,952	11	$1,126,501
Additional Refund	14	5	($106,846)	9	($732,941)
No Tax Effect[6]	11	7	$0	4	$0
Totals	**42**	**18**	**$609,106**	**24**	**$393,560**

Source: Treasury Inspector General for Tax Administration review of net operating loss carryback claims posting to the IRS Individual Master File between August 1, 2004, and July 30, 2005.

Based on the results of our sample, we estimate 10,891 claims filed during the subject time period could contain at least 1 error and 5,453 of these claims would not have been corrected by the IRS. We estimate these uncorrected errors could result in approximately $46 million in

[6] Some errors resulted in no tax effect. For example, correcting an error in the computation of the Alternative Minimum Tax for the loss carryback year can result in an offsetting adjustment to regular tax in that year.

additional refunds due to taxpayers and approximately $13 million in additional taxes due the IRS. However, because of the high variability in the types and number of errors in our sample, we cannot project these estimates with a high degree of precision. As such, these estimates should be used only as an indication of the potential impact of uncorrected errors on carryback loss claims.

Most of the errors we identified on the refund claims fall into three common categories:

- Alternative Minimum Tax (AMT) – 20 claims (48 percent).
- Charitable contributions deductions – 9 claims (21 percent).
- IRS changes to the originally filed loss year return – 5 claims (12 percent).

Unclear tax form and tax publication instructions appear to be contributing to taxpayer errors

Filing a claim for a carryback loss refund is a complex process. For example, a taxpayer must first figure the correct loss amount to carry back to prior tax years. Then the tax for the oldest carryback year must be recalculated to account for the loss. Once that year's tax has been recomputed, the taxpayer must figure the amount of any unused loss that can be carried to the next year and so on. Of the 84 claims we reviewed, 82 were prepared by tax professionals.

AMT errors

Difficult tax situations, such as the AMT, increase the complexity of the claim process. The individual AMT was designed to ensure no taxpayer with substantial economic income is able to avoid all tax liability by using exclusions, deductions, and credits. Taxpayers who carry a loss back to a prior year must refigure the regular tax for that year and either recalculate the AMT or determine if it is now applicable. We identified two types of AMT errors on the carryback claims. The most common occurred when taxpayers calculated their AMT liabilities for the carryback year. Specifically, taxpayers must limit the amount of the alternative tax net operating loss deduction that they can apply against their AMT tax liabilities.[7] We also determined that taxpayers who did not originally owe the AMT in the carryback year now owe it as a result of the loss carryback but were not reporting it.

The instructions for Forms 1045 and 1040X do not advise taxpayers to consider the possibility that the AMT may be due for a prior tax year as a result of the carryback loss even if the taxpayer was not originally liable for the AMT in the prior year. The Form 1045 instructions advise taxpayers only that a carryback may affect their AMT. The Form 1040X instructions advise taxpayers only that refigured forms and schedules for the carryback year, including

[7] The Gulf Opportunity Zone Act of 2005 (Pub. L. No. 109-135, 119 Stat. 2577 (2005)) suspended the limit on the alternative tax net operating loss deduction for qualified losses incurred by taxpayers living in the Gulf Opportunity Zone.

Form 6251, must be attached to Form 1040X when it is used for a carryback claim. This could leave the impression that a taxpayer has to consider computing the AMT only if it was originally due.

The Form 6251 instructions for calculating the alternative tax net operating loss and the alternative tax net operating loss deduction are also difficult to understand. Many tax form instructions are written in common language and make limited references to the tax code. However, the Form 6251 instructions for the alternative tax net operating loss and the alternative tax net operating loss deduction point taxpayers to the tax code but offer little in the way of common language explanations of how to compute these items. Appendix VI provides an example of the Form 6251 instructions for these items.

Charitable contributions deduction errors

We also identified a number of errors with the charitable contributions deduction. Normally, this deduction is limited to a percentage of the taxpayer's Adjusted Gross Income. As a result, a taxpayer generally has to refigure the charitable contributions deduction when an adjustment to his or her return changes the Adjusted Gross Income. The exception to the rule is a carryback loss. According to the Internal Revenue Code, a taxpayer who carries a net operating loss back to a prior tax year should not refigure the charitable contributions deduction to account for the related change in Adjusted Gross Income.[8] However, taxpayers are incorrectly changing their deductions when computing their carryback loss refunds.

Form 1045 instructs taxpayers not to change their charitable contributions deductions when carrying a loss back to a prior tax year. However, the caution in the Form's instructions is in regular type and is listed near the end of the "After Carryback" instructions. The Form 1040X instructions for carrybacks refer taxpayers to Publication 536. However, this Publication also places the caution near the end of the "Deducting a Carryback" instructions. It is possible taxpayers are overlooking the caution when figuring their carryback loss claims.

Recommendations

Recommendation 1: The Director, Media and Publications, should revise the applicable tax form instructions for claiming carryback losses to ease the burden on taxpayers and reduce the number of errors on claims. Specifically, the Director should:

- Revise the Form 1045 and Form 1040X instructions to more clearly indicate that a carryback loss may create a new AMT liability in the carryback year when one did not previously exist.
- Revise the Form 6251 instructions to more clearly describe the computations necessary to figure the alternative tax net operating loss and alternative tax net operating loss

[8] 26 U.S.C. § 170(b)(1)(G) (2006).

deduction. The instructions should be written in common language and offer references to applicable Internal Revenue Code sections only as needed.

- Consider putting in bold or otherwise highlighting the caution for the charitable contributions deduction and moving it closer to the beginning of the "After Carryback" and "Deducting a Carryback" sections in the respective Form 1045 and Publication 536 instructions.

Management's Response: IRS management agreed with most of this recommendation. Management agreed to revise the instructions for Form 1040X and Form 1045 to indicate that a carryback loss may create a new AMT liability. The IRS also agreed to remove references to the Internal Revenue Code from Form 6251 to make the discussion less complex. On December 28, 2007, the IRS highlighted the caution for the charitable contributions deduction in Publication 536, and it will be making similar changes to Form 1045 in the next revision. Management did not agree to move the charitable contributions deduction caution closer to the beginning of the "After Carryback" and "Deducting a Carryback" sections in Form 1045 and Publication 536. It stated the caution was appropriate where it is currently located. The charitable contribution deduction is an itemized deduction that is limited by certain percentages of the Adjusted Gross Income. They specifically state which deductions to refigure and state do not refigure your charitable contributions.

Office of Audit Comment: Although the IRS did not agree to move the caution for the charitable contributions deduction, we agree the actions taken to highlight the caution are sufficient.

Recommendation 2: The Director, Accounts Management, should work with the Office of National Public Liaison to alert the preparer community of the need to be especially aware of the requirement to limit the alternative tax net operating loss deduction and the impact of a carryback loss on the charitable contributions deduction when claiming a carryback loss refund.

Management's Response: IRS management agreed with this recommendation. Management will work with the Office of National Public Liaison to alert the preparer community of the need to be especially aware of the requirement to limit the alternative net operating loss deduction and the impact of a carryback loss on the charitable contributions deduction when claiming carryback refunds. The Director, Accounts Management, will also provide a subject matter expert to assist the Office of National Public Liaison with the carryback information necessary to alert the preparer community.

IRS procedures and tools for validating carryback claims do not ensure taxpayer errors are identified

In general, IRS procedures for working carryback claims are vague and open to interpretation. The procedures require employees to verify all the figures on Forms 1040X and 1045 for each year. However, they do not specify which figures should be verified, whether figures on related forms should be verified, or how to perform the verification. This could be contributing to the inconsistencies we found in the way claims were worked. For the sample cases we reviewed, employees either used the procedures as guidelines and verified more than the procedures required to ensure a claim was accurate, followed the letter of the procedures, or did not follow portions of the procedures at all. We identified two main areas in which the procedures for working carryback claims could be improved: (1) the AMT and (2) resolving differences between taxpayer and Individual Master File figures.

Approximately 48 percent (20 of 42) of the claims we reviewed involved some type of AMT error, and 60 percent (12 of 20) of those were not corrected. The two most common errors involved the computation of the alternative tax net operating loss deduction and taxpayers incorrectly claiming no AMT.

IRS procedures instruct employees to ensure a taxpayer claiming the AMT has attached a Form 6251 to the claim for each carryback and to verify the figures on Forms 1045 and 1040X with those on Forms 6251. However, the procedures do not instruct employees how to verify the figures or how to handle a claim when the taxpayer does not claim the AMT but it appears the AMT may be due. Our review of the claims and discussions with IRS employees showed that claims with a potential AMT liability were not being handled consistently. Some employees were accepting the taxpayer's AMT figures and processing the refund. However, others were verifying, to the extent possible, the computations on the attached Form 6251 and making adjustments to the claim to resolve any errors. If the IRS had corrected the AMT errors it missed, the taxpayer would have either owed the AMT or had it changed in 9 of the 12 claims, for a net tax effect of approximately $1,091,000 in additional taxes due the IRS.

AMT carryback loss claims

It is the IRS' policy to not ask a taxpayer to provide information related to his or her tax return unless the form instructions require the information to be attached to the return when the return is filed. For example, U.S. Individual Income Tax Return (Form 1040) instructions do not require a taxpayer to attach Schedule A to the return when he or she chooses to use the standard tax deduction. In this instance, the IRS could not ask the taxpayer to provide a Schedule A because it is not required by the Form 1040 instructions. This policy is consistent with the IRS' commitment to reduce the amount of paper and burden associated with filing a tax return.

Unfortunately, this policy prevents employees who process carryback claims from verifying the accuracy of the AMT computation when the taxpayer indicates no AMT is owed. The AMT is calculated using Form 6251. However, this Form's instructions do not generally require taxpayers to attach the Form to their returns if it indicates no AMT is owed. Without a Form 6251, the IRS cannot ensure taxpayers did not make mathematical errors that would incorrectly result in no AMT being owed when computing their AMT. This is significant because the largest number of errors we identified involved the computation of the alternative tax net operating loss deduction. This deduction reduces or eliminates a taxpayer's AMT liability.

Consistent with IRS policy, procedures for working carryback claims instruct employees to accept the taxpayer's claim of $0 AMT and issue the refund. The only way the IRS can verify the AMT computation for $0 on this type of claim is to suspend the processing of the claim and open an audit. This is inefficient and increases the risk that the IRS will pay interest on the claim.[9] About 29 percent (12 of 42) of the claims we reviewed that had errors involved instances in which the taxpayer did not originally owe the AMT in the carryback year, appears to owe it after the loss, but did not report it. Of these, four claims did not have a Form 6251 for the carryback year attached to the claim. In 3 of the 4 claims, IRS employees took additional steps beyond the requirements of IRS procedures to determine the AMT and assessed a total of approximately $134,000. [redacted]

According to the Form 1040 instructions for the AMT, all taxpayers who file a Form 1040 with a net operating loss should be completing a Form 6251 for that year. As such, the only additional burden to the taxpayer would be to attach a copy of the Form 6251 for each loss year to his or her carryback claim. Furthermore, taxpayers already voluntarily include the Form 6251 on most of the claims filed. Taxpayers received 110 carryback refunds from the 84 claims we reviewed. An analysis of those claims showed taxpayers included 74 Forms 6251 (67 percent) with their claims for the carryback years related to those refunds. The IRS issued 60,865 carryback refunds between October 2006 and September 2007 (Fiscal Year 2007). Based on our review results, we estimate taxpayers would have to attach an additional 19,921 Forms 6251 to their claims if the IRS changed its policy to require the Form. The availability of the Form 6251 significantly improves the IRS' ability to verify the accuracy of taxpayers' claims with regard to the AMT before refunds are issued.

Tax return discrepancies with the Master File

Portions of the procedures the IRS uses to verify the accuracy of carryback claims can actually cause rather than resolve errors. Current IRS procedures instruct employees to compare the figures on the claim to the figures on the Master File. If these figures do not match and the difference is not due to a previous adjustment(s) or assessment(s), employees are instructed to reject the claim. The taxpayer is notified and asked for an explanation of the difference.

However, these procedures may be burdensome and ineffective. The taxpayer would not know why the figures are different because he or she had not received any explanation of the changes from the IRS. In addition, Master File figures are not always accurate. The IRS may have

[9] Generally, the IRS must process a claim for carryback refunds within 45 days of the receipt of the claim or the original due date of the return for the year in which the loss occurred, whichever is later. If this time period is not met, the IRS must pay interest on the refund.

incorrectly transcribed information from the return or edited the return incorrectly. According to the IRS, 24 percent of paper returns contain a taxpayer or an IRS error. Rejecting a claim based on differences between taxpayer and IRS figures can unnecessarily delay the taxpayer's refund or result in an incorrect refund if the claim is eventually processed using incorrect IRS figures.

For example,[10] a taxpayer filed a return claiming a loss of $100,000 and $0 tax due. The IRS identified a $25,000 error in the taxpayer's reported income that reduced the loss to $75,000. However, the error in income did not affect the amount of tax credits the taxpayer was entitled to or the amount of tax the taxpayer owed (still $0). The IRS corrected the income figures and recomputed the loss but did not notify the taxpayer of the changes because they did not affect the tax owed. When a claim was filed to carry the loss back to a prior year, the taxpayer used the figures on his or her copy of the original loss year return to prepare and file the claim for refund. When the IRS receives the claim, it will compare the figures on the claim to the figures on its Master File. Because the figures are different and the difference is not related to a change in tax or tax credits that the IRS can resolve, the IRS may reject the claim. If the claim is rejected, the taxpayer will be notified and asked to explain the difference in the figures. See Appendix V for a detailed example of how changes to a taxpayer's tax return can affect a claim for a carryback loss refund.

Procedures were both inconsistently applied and incomplete. The IRS made a change to the loss year return at the time the return was originally processed in 12 percent (5 of 42) of the claims we reviewed that contained errors. The taxpayers were not notified of the changes because they were not considered math errors and did not affect the overall tax liabilities. When these taxpayers filed their claims for carryback refunds, they used the figures on their copies of the original returns, resulting in differences between taxpayer and the IRS figures. For three of the five claims, there were no indications employees took any steps to verify the Master File figures. If the Master File figures are incorrect in these three cases, two taxpayers would be entitled to larger refunds and one would be entitled to a larger loss amount that could be carried forward. For the other two claims, one error was corrected by the employee (the Master File was in error and the employee used the taxpayer's figures); the other error did not affect the taxpayer's refund.

Desktop Integration tool problems

The tool IRS employees use to validate carryback loss claims (Desktop Integration) could also be more effective. This tool did not accurately apply the rules for the charitable contributions deduction. Employees had to circumvent this problem by entering the charitable contributions deduction on a different line that is not limited to a percentage of the Adjusted Gross Income to prevent it from refiguring a taxpayer's charitable contributions. The Desktop Integration tool

[10] This example is based on hypothetical taxpayer information and our computation of the resulting carryback loss claim to illustrate the effect of not notifying a taxpayer of changes to an originally filed U.S. Individual Income Tax Return (Form 1040).

also provides users with a feature that computes the AMT. However, the feature does not accurately account for the 90 percent limit on the alternative tax net operating loss deduction.

Management Actions: During the course of our review, the IRS modified the Desktop Integration tool to correct the problem with charitable contributions, but the problem with incorrectly computing the 90 percent limit on the AMT still exists.

Recommendations

Recommendation 3: The Director, Accounts Management, should revise the procedures for working claims for carryback loss refunds to improve the identification and resolution of errors before the related refunds are paid. Specifically, the Director should modify the procedures to:

- Require verification of the figures and computations on Form 6251 to the extent possible for the carryback year when the Form is attached to the claim.
- Require employees to verify the accuracy of Master File figures to the extent possible before rejecting a claim when differences exist between figures on the Master File and on the claim.

  Management's Response: IRS management agreed with this recommendation. Management will update procedures to require that employees verify (to the extent possible) the figures and computations on Form 6251 and the accuracy of the Master File figures before they reject a claim when differences exist between the figures on the Master File and those on the claim.

Recommendation 4: The Director, Media and Publications, should change the taxpayer instructions for Forms 1045 and 1040X, as they pertain to carryback losses, to require the taxpayer to attach Form 6251 to the carryback claim for each carryback year to which a loss is being applied.

> ***Management's Response:*** IRS management did not agree with this recommendation. Management does not agree that taxpayers should be required to attach Form 6251 for each carryback year regardless of whether the AMT is owed. The Director, Media and Publications, stated the Paperwork Reduction Act of 1995 requires agencies to certify that the collection of information is necessary, has practical utility, and reduces to the extent possible the burden on persons required to provide such information. Requiring taxpayers to file the Form 6251 when no AMT is owed or no deductions are limited by the tax would impose an unreasonable burden and likely be viewed as a violation of these and other Paperwork Reduction Act requirements.
>
> ***Office of Audit Comment:*** We understand the IRS' concern with unnecessarily increasing the burden on taxpayers and its need to comply with the Paper Reduction Act of 1995. However, we do not agree that our recommendation to require taxpayers filing

claims for carryback refunds to attach a Form 6251 for each carryback year would be overly burdensome for the taxpayers affected or significantly increase the amount of paper received by the IRS. As stated in our report, the only additional burden to taxpayers would be to attach a copy of the Form 6251 for each loss year to his or her carryback claim. Taxpayers are already required to complete the Form 6251 and many voluntarily include it on most of the claims filed. However, the additional Forms 6251 could significantly improve the IRS' ability to determine if the AMT is owed on a claim for carryback refund. Had the IRS corrected the AMT errors we identified, taxpayers filing those claims would have owed approximately $1 million in additional tax. At a minimum, the IRS should revisit its decision to not request the Form 6251 from taxpayers once it has had a chance to evaluate the impact its other corrective actions have on the accuracy of carryback claims.

Recommendation 5: The Director, Accounts Management, should change the procedures for verifying the accuracy of carryback refund claims to require employees to ensure a Form 6251 for each carryback year is attached to the claim. The procedures should also require employees to either correspond with the taxpayer for the missing Forms or reject the claim. To the extent possible, Forms 6251 for each carryback year should then be verified for accuracy of the AMT computation before the claim is allowed.

Management's Response: IRS management did not agree with this recommendation. Management stated in the response to Recommendation 4 that it does not agree that taxpayers should be required to attach Form 6251 for each carryback year regardless of whether the AMT is owed. However, as stated in its response to Recommendation 3, management indicated its procedures will be revised to require verification of the figures and computations on Forms 6251 where there is a change to the AMT and the Form 6251 is attached. Also, management will determine the feasibility of implementing changes to the Desktop Integration tool for the AMT as stated in its response to Recommendation 6.

Office of Audit Comment: The IRS' ability to implement this recommendation was dependent on its implementation of Recommendation 4. Since the IRS disagreed with Recommendation 4, we recognize that it is not possible for the IRS to take our recommended corrective action and agree actions taken in Recommendations 3 and 6 will strengthen current controls when a Form 6251 is present. However, the IRS will continue to be unable to verify the AMT liability in those instances where a taxpayer claims no AMT liability and a Form 6251 is missing.

Recommendation 6: The Director, Accounts Management, should work with the Associate Chief Information Officer, Applications Development, to determine if the Desktop Integration tool can be modified to enable it to accurately account for carryback losses in the computation of the AMT, including the ability to compute the alternative tax net operating loss and the alternative tax net operating loss deduction. In the interim, the Accounts Management function should alert employees that the Desktop Integration tool for the AMT does not correctly limit the alternative tax net operating loss deduction to 90 percent of a taxpayer's alternative minimum taxable income before the deduction.

Management's Response: IRS management agreed with this recommendation. The Desktop Integration Tools Section Chief will work with a subject matter expert provided by the Accounts Management function to determine the feasibility of modifying the worksheet to accurately account for carryback losses. In the interim, an alert will be sent to employees that the Desktop Integration tool for the AMT does not correctly limit the alternative tax net operating loss deduction to 90 percent of a taxpayer's alternative minimum taxable income before the deduction.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether taxpayers properly filed and the IRS accurately processed carryback loss claims for refunds submitted by individuals on an Application for Tentative Refund (Form 1045) or an Amended U.S. Individual Income Tax Return (Form 1040X). The scope of our review was limited to an assessment of the processes and procedures used by the IRS to ensure a claim was accurate before the refund was issued. To accomplish this objective, we:

I. Determined whether controls in the Wage and Investment Division Accounts Management function will ensure carryback claims are processed accurately and correct refunds are issued to taxpayers.

A. Reviewed IRS tax law provisions, forms, instructions, and publications pertaining to net operating losses and carrybacks. We also reviewed the Internal Revenue Manual and any training materials related to the processing of carryback claims filed by individuals to determine the verifications employees are required to make to ensure the claims are accurate.

B. Interviewed personnel in the Wage and Investment Division Headquarters Office, Customer Account Services Accounts Management function regarding the carryback procedures and quality review process used to ensure the accuracy of carryback adjustments. We also obtained any supplemental materials used to train employees on carrybacks or any reviews of the quality of claims.

C. Conducted walkthroughs of the carryback claim process at the Kansas City, Missouri, and Atlanta, Georgia, Campuses[1] and obtained any local procedures and/or training materials. We also contacted the Accounts Management functions in the Fresno, California, and Austin, Texas, Campuses to discuss their procedures. We evaluated the local procedures obtained to determine whether any could be considered "best practices" and evaluated whether local procedures addressed any errors found during our case review. In addition, we met with IRS Program Analysis System function personnel in the Kansas City and Atlanta Campuses to discuss the Program Analysis System review process for carryback adjustments.

D. Obtained information about the Wage and Investment Division's Lean Six Sigma project on the processing of carrybacks conducted in the Kansas City Campus to

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

ensure any ongoing efforts to improve the processing were identified and considered during our review.

II. Determined whether the IRS is accurately processing carryback claims filed by individuals and issuing accurate refunds.

A. Reviewed 84 claims for carryback refunds (Forms 1045 and 1040X) that had posted to the IRS Master File between August 1, 2004, and July 30, 2005.

An analysis of the total population of claims posting during our time period (79,426 claims) indicated a high percentage of the dollars paid were on carryback claims with refunds paid of more than $10,000. As a result, we reviewed only those claims where refunds paid were at least $10,000. We stratified these claims into 2 categories: claims with refunds for more than $1 million and claims with refunds for at least $10,000 but not more than $1 million.

We selected for review all 99 claims with refunds for more than $1 million and a statistically valid sample of 400 claims for at least $10,000 but not more than $1 million. We used a 95 percent confidence level, 15 percent average error rate, and ±5 percent precision level to determine our sample size. The sample was selected using a random number generator.

For each claim meeting our dollar criteria, we used the Integrated Data Retrieval System to validate that it had posted to the individual taxpayer's account for the amount listed in our data files.

We employed the stop-and-go sampling review method and determined no additional benefit would be gained by reviewing the full sample. We reviewed 43 claims with refunds for more than $1 million and 41 claims for at least $10,000 but not more than $1 million.

B. Reviewed each claim selected in Step II.A. to determine whether the carryback refund claim was accurately filed by the taxpayer and processed by the IRS.

1. Obtained information from the Integrated Data Retrieval System, related paper adjustment documents, and/or information from the Correspondence Imaging System.

2. Determined whether the taxpayer complied with the statutory guidelines for filing a carryback claim.

3. Determined whether the information on the claim agreed with the information on the Master File, including whether any changes had occurred in the taxpayer's filing status that would require allocation schedules be attached to the claim. For any errors identified, we determined whether the IRS identified the error and took appropriate actions to either correct the error or reject the claim if necessary.

4. Determined whether the net operating loss, carryback, and refund amounts were computed correctly. We also determined whether the IRS had identified and corrected any errors we identified or had rejected the claim back to the taxpayer if necessary.
5. Determined whether any reversals were made to the carryback amounts allowed and, if so, determined why the reversals occurred.
6. Computed the estimated total number of claims received by the IRS that contained at least one error and the estimated net tax effect of those errors. All estimates were computed using a two-sided, 95 percent confidence interval. We estimated 10,891 claims contained at least 1 error. Estimates were based on an error rate of 43.95 percent and a precision level of ±15.31 percent. We also estimated 5,453 claims contained at least 1 error that was not corrected by the IRS. This estimate was computed using a 22 percent error rate and a precision level of ±12.77 percent. Finally, we estimated the dollar effect of the errors that were not corrected. Because errors can result in additional refunds due or additional taxes due, we computed two estimates. We estimated $46 million should have been refunded to taxpayers. The estimate was computed using a precision of ±$2,468. We estimated $13 million in additional taxes should have been paid to the IRS. The estimate was computed using a precision of ±$613. However, the uncertainty associated with the types of errors that may occur reduces the precision of our estimates. As a result, these estimates should be used only as a general indication of the potential impact of uncorrected errors on carryback loss claims.

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs)
Scott A. Macfarlane, Director
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Appendix III

Report Distribution List

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Office of the Commissioner – Attn: Acting Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
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Associate Chief Information Officer, Applications Development OS:CIO:AD
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Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Senior Operations Advisor, Wage and Investment Division SE:W:S

Appendix IV

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:

- Taxpayer Rights and Entitlements – Actual; uncorrected errors on 9 carryback refund claims resulted in $732,941 in additional refunds that should have been issued to taxpayers (see page 4).

Methodology Used to Measure the Reported Benefit:

We reviewed 84 claims for carryback refunds and found 42 (50 percent) contained at least 1 error. The IRS did not correct at least 1 error on 24 of the 42 claims (57 percent). Our analysis of these 24 claims showed 9 contained uncorrected errors that resulted in $732,941 in additional refunds that should have been issued to taxpayers.

We selected for review all 99 claims with refunds paid for more than $1 million and a statistical sample of 400 claims with refunds paid for at least $10,000 but not more than $1 million. This sample was selected using a 95 percent confidence level with an average error rate of 15 percent and a precision level of ±5 percent. To select the cases, we identified all individual taxpayer carryback refund claim transactions[1] posting to the Master File between August 1, 2004, and July 30, 2005. These transactions were for tax years up to and including Tax Year 2003. We then used a random number generator to select our sample.

We used the stop-and-go method to review the claims associated with the transactions selected. We reviewed the claims in random order based on the availability of documents provided by the IRS. Factors such as the number of claims reviewed, time involved to review all selected claims, and added benefit gained by reviewing all the selected claims were considered when determining if our review should be discontinued. Based on these factors, we discontinued our review of the sampled claims after reviewing 43 claims with refunds for more than $1 million and 41 claims with refunds for at least $10,000 but not more than $1 million.

[1] Abatement of Prior Tax Assessment With Interest Computation Date (Transaction Code 295) and Abatement of Prior Tax Assessment Interest Computation Date (Transaction Code 299).

The value of the refunds due was computed using the actual tax change that would have resulted if the IRS had corrected the errors we identified during our review of the sample of carryback refund claims.

Type and Value of Outcome Measure:

- Revenue Protection – Actual; uncorrected errors on 11 carryback refund claims resulted in $1,126,501 in additional taxes that should have been paid to the IRS (see page 4).

Methodology Used to Measure the Reported Benefit:

We reviewed 84 claims for carryback refunds and found 42 (50 percent) contained at least 1 error. The IRS did not correct at least 1 error on 24 (57 percent) of the 42 claims. Our analysis of these 24 claims showed 11 contained errors that resulted in $1,126,501 in additional tax that should have been paid to the IRS.

The value of the additional tax due was computed using the actual tax change that would have resulted if the IRS had corrected the errors we identified during our review of the sample of carryback refund claims.

Appendix V

Detailed Explanations of Issues Identified: Alternative Minimum Tax and Errors on Loss Year Returns

AMT

Tax laws give special treatment to certain income types and allow special deductions and credits for some kinds of expenses. Taxpayers who benefit from the laws may have to pay the AMT[1] on these benefits, which are known as tax preferences and adjustments. In addition, the carryback of a net operating loss (carryback loss) may result in an AMT liability when none existed before the carryback. For example, a taxpayer may be able to significantly reduce or eliminate his or her regular income tax due to a carryback loss. However, the taxpayer may now owe the AMT because the AMT liability exceeds the taxpayer's reduced or eliminated regular tax. An individual taxpayer uses Alternative Minimum Tax–Individuals (Form 6251) to determine if the AMT is owed. While the AMT can be complex and difficult to calculate, carryback losses require additional calculations and further complicate the process. The taxpayer must calculate the alternative tax net operating loss and the alternative tax net operating loss deduction when carrying a loss back to a prior tax year.

Using Form 6251, the taxpayer must first determine his or her alternative minimum taxable income. This calculation begins with the Adjusted Gross Income reduced by itemized deductions, if claimed, and adjusted for certain deductions and tax preference items including the carryback loss. A taxpayer with a carryback loss is allowed to use the alternative tax net operating deduction to reduce alternative minimum taxable income. The computation of the deduction is very complex and open to mistakes. In addition, the deduction is generally limited to 90 percent of the taxpayer's alternative minimum taxable income before the deduction is applied. Once the net alternative minimum taxable income (less the alternative tax net operating loss deduction) has been calculated, the taxpayer can claim a tax exemption. The exemption is based on the taxpayer's filing status but may be reduced or eliminated if the alternative minimum taxable income exceeds a certain level. After taking the exemption, the tentative minimum tax is generally computed based on a rate of 26 percent for the first $175,000, with any excess taxed at 28 percent. This tentative minimum tax is compared with the regular tax. The AMT is the amount that exceeds the regular tax. If the taxpayer determines no AMT is due, he or she is not

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

required to include Form 6251 for the carryback year with the claim for a carryback refund if no AMT was originally reported for the carryback year.

We determined many of the AMT errors taxpayers made resulted from their failing to limit the alternative tax net operating loss deductions to 90 percent. By not limiting the alternative tax net operating loss deductions, taxpayers were able to reduce their alternative minimum taxable income below the level at which the AMT would be due. However, once the 90 percent limitation was correctly applied, these taxpayers owed the AMT. For example,[2] a taxpayer with a carryback loss exceeding $2 million eliminated his or her previously reported income and regular tax for the prior tax year. If the alternative minimum taxable income prior to application of the alternative tax net operating loss deduction was $1.8 million and the taxpayer incorrectly claimed the entire deduction, regular tax would be eliminated and no AMT would be due. However, if the deduction was properly limited to 90 percent of the minimum taxable income ($1,620,000), the taxpayer would be liable for the AMT of approximately $32,500.[3]

Errors on Loss Year Returns

The IRS has a number of controls and processes to ensure individual income tax returns are accurately filed and processed so the correct amounts of tax are assessed and the refunds or balances due are accurate. If the IRS determines during processing that a return has a math error, it corrects the error. The taxpayer is notified of the change and provided information about the amounts on the return that were adjusted. This notification tells the taxpayer about the changes made to his or her return and gives the taxpayer a chance to question those changes. It is possible some changes the IRS makes to tax returns are the result of an IRS error that went undetected during processing.

While the IRS notifies taxpayers about math errors, it does not have an effective process to notify the taxpayer when the error on the return does not result in a change to the tax or credits (non-math errors). This weakness affects the taxpayer when he or she files a carryback claim. The return for the loss year would have no tax due. Therefore, changes to the loss year return would generally be a non-math error resulting in no tax due. The IRS would not notify the taxpayer of these changes.

When a taxpayer files a claim for a carryback refund, he or she has to provide the tax return information for both the loss year and the prior tax year(s) before the carryback loss is applied. The IRS verifies the return information included on the claim to the information on the Master File before it processes the claim. Because the taxpayer used the figures on his or her copy of the returns, the figures will not match. The IRS determines whether there any math errors that

[2] This example is based on hypothetical taxpayer information for the purposes of illustrating the effect of an incorrectly computed alternative tax net operating loss deduction.
[3] The example is computed using the Married Filing Jointly exemption. The estimate of the AMT is based upon the exemption amounts in effect for Tax Year 2006.

the taxpayer may not have accounted for when completing the claim form. If a math error exists, the IRS corrects the discrepancy and processes the claim.

If a non-math error exists, the IRS may reject the claim and ask the taxpayer to explain the difference. This is burdensome--the taxpayer would not be aware of the reason for the difference because he or she did not receive an explanation from the IRS. For example,[4] a taxpayer files a return showing a loss and no tax due. During processing, the IRS determines the return contains a $75,000 non-math error. The error does not change the credits or tax due, so the IRS does not notify the taxpayer that it changed his or her return. The taxpayer later files a claim to carry $200,000 of the loss back to a prior tax year. When the IRS processes the carryback claim, it determines the Master File indicates the loss should be $125,000 because of the $75,000 error on the original loss year return. The IRS rejects the carryback claim and asks the taxpayer to explain the difference. This $75,000 difference could have a significant effect on the carryback refund due the taxpayer.

Taxpayer's Computation of Carryback Refund

	Before Carryback		After Carryback
Taxable income	$400,000		$200,000
Income tax[5]	$113,251		$45,982
Tax reduction/refund		**$67,269**	

The IRS' Computation of Carryback Refund

	Before Carryback		After Carryback
Taxable income	$400,000		$275,000
Income tax	$113,251		$70,732
Tax reduction/refund		**$42,519**	

Unfortunately, the taxpayer cannot explain the difference between the figures used to compute the carryback refund because he or she was unaware a change had been made to the loss year return or why it was made. The taxpayer will likely contact the IRS for further explanation.

[4] This example is based on hypothetical taxpayer information for the purposes of illustrating the impact of not notifying taxpayers of changes to their originally filed U.S. Individual Income Tax Return (Form 1040).
[5] Income tax was computed using the income tax rate for Tax Year 2006 and a filing status of Married Filing Jointly. The computation assumed no other taxes or credits were applicable for this example. Income tax was rounded to whole dollar amounts.

Appendix VI

Alternative Minimum Tax–Individuals (Form 6251) Instructions: Alternative Tax Net Operating Loss and Alternative Tax Net Operating Loss Deduction

Difficult tax situations, such as the AMT,[1] only increase the complexity of the carryback loss claim process. The individual AMT was designed to ensure no taxpayer with substantial economic income is able to avoid all tax liability by using exclusions, deductions, and credits. Taxpayers who carry a loss back to a prior tax year must refigure the regular tax for that year and either recalculate the AMT or determine if the AMT is now applicable.

When a loss is present, the taxpayer must compute the alternative tax net operating loss and the alternative tax net operating loss deduction as part of the AMT computation. However, instructions on the Form 6251 for these items are very difficult to understand. Many tax form instructions are written in common language and make only limited references to the tax code. However, the Form 6251 instructions for the alternative tax net operating loss and the alternative tax net operating loss deduction point taxpayers to the tax code and offer little common language explanations of how to compute these items. The following page is an excerpt from the Form 6251 instructions for Tax Year 2006.

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

Figure the difference between the AMT and regular tax amount for each item. Combine the amounts for all your related adjustments and include the total on line 26. Keep a copy of all computations for your records, including any AMT carryover and basis amounts.

CAUTION *Do not include on line 26 any adjustment for an item you refigured on another line of this form (for example, line 9).*

Example. On your Schedule C (Form 1040) you have a net profit of $9,000 before figuring your section 179 deduction. You do not report any other business income on your return. During the year, you purchased an asset for $10,000 for which you elect to take the section 179 deduction. You also have an AMT depreciation adjustment of $700 for other assets depreciated on your Schedule C.

Your section 179 deduction for the regular tax is limited to your net profit (before any section 179 deduction) of $9,000. The $1,000 excess is a section 179 deduction carryforward for the regular tax.

For the AMT, your net profit is $9,700, and you are allowed a section 179 deduction of $9,700 for the AMT. You have a section 179 deduction carryforward of $300 for the AMT.

You include a $700 negative adjustment on line 26 because your section 179 deduction for the AMT is $700 greater than your allowable regular tax deduction. In the following year, when you use the $1,000 regular tax carryforward, you will have a $700 positive related adjustment for the AMT because your AMT carryforward is only $300.

Line 27—Alternative Tax Net Operating Loss Deduction (ATNOLD)

The ATNOLD is the sum of the alternative tax net operating loss (ATNOL) carryovers and carrybacks to the tax year, subject to the limitation explained below. Figure your ATNOLD as follows.

Your ATNOL for a loss year is the excess of the deductions allowed for figuring AMTI (excluding the ATNOLD) over the income included in AMTI. Figure this excess with the modifications in section 172(d), taking into account the adjustments in sections 56 and 58 and preferences in section 57 (that is, the section 172(d) modifications must be separately figured for the ATNOL). For example, the limitation of nonbusiness deductions to the amount of nonbusiness income must be separately figured for the ATNOL, using only nonbusiness income and deductions that are included in AMTI.

Your ATNOLD may be limited. To figure the ATNOLD limitation, you must first figure your AMTI without regard to the ATNOLD and any domestic production activities deduction. To do this, first figure a tentative amount for line 9 by treating line 27 as if it were zero. Next, figure a tentative total of lines 1 through 26 using the tentative line 9 amount and treating line 27 as if it were zero. Add any domestic production activities deduction to this tentative total. Your ATNOLD limitation is 90% of the result.

However, if an ATNOL that is carried back or carried forward to the tax year is attributable to qualified Gulf Opportunity Zone losses as defined in section 1400N(k)(2), the ATNOLD for the tax year is limited to the sum of:

1. The smaller of:

a. The sum of the ATNOL carrybacks and carryforwards to the tax year attributable to net operating losses other than qualified Gulf Opportunity Zone losses, or

b. Ninety percent of AMTI for the tax year (figured without regard to the ATNOLD and any domestic production activities deduction, as discussed earlier), plus

2. The smaller of:

a. The sum of the ATNOL carrybacks and carryforwards to the tax year attributable to qualified Gulf Opportunity Zone losses, or

b. AMTI for the tax year (figured without regard to the ATNOLD and any domestic production activities deduction, as discussed earlier) reduced by the amount determined under (1), above.

Enter on line 27 the smaller of the ATNOLD or the ATNOLD limitation.

Any ATNOL not used may be carried back 2 years or forward up to 20 years (15 years for loss years beginning before 1998). In some cases, the carryback period is longer than 2 years; see sections 172(b) and 1400N(k) for details. The treatment of ATNOLs does not affect your regular tax NOL.

Note. If you elected under section 172(b)(3) to forgo the carryback period for the regular tax, the election also applies for the AMT.

Line 28—Alternative Minimum Taxable Income

If your filing status is married filing separately and line 28 is more than $200,100, you must include an additional amount on line 28. If line 28 is $325,200 or more, include an additional $31,275. Otherwise, include 25% of the excess of the amount on line 28 over $200,100. For example, if the amount on line 28 is $220,100, enter $225,100 instead—the additional $5,000 is 25% of $20,000 ($220,100 minus $200,100).

Special Rule for Holders of a Residual Interest in a REMIC

If you held a residual interest in a real estate mortgage investment conduit (REMIC) in 2006, the amount you enter on line 28 may not be less than the amount on Schedule E, line 38, column (c). If the amount in column (c) is larger than the amount you would otherwise enter on line 28, enter the amount from column (c) instead and enter "Sch. Q" on the dotted line next to line 28.

Part II—Alternative Minimum Tax

Line 29—Exemption Amount

If line 28 is more than the amount shown for your filing status in the middle column of the chart on line 29, see the worksheet on this page to figure the amount to enter on line 29.

Child Under Age 18

If this form is for a child under age 18, complete the worksheet on this page. A child under age 18 is a child who was born after January 1, 1989, does not file a

Exemption Worksheet—Line 29

Keep for Your Records

Note. If Form 6251, line 28, is equal to or more than: $282,500 if single or head of household; $400,200 if married filing jointly or qualifying widow(er); or $200,100 if married filing separately; your exemption is zero. **Do not** complete this worksheet; instead, enter the amount from Form 6251, line 28, on line 30 and go to line 31.

1. Enter: $42,500 if single or head of household; $62,550 if married filing jointly or qualifying widow(er); $31,275 if married filing separately		**1.**
2. Enter your alternative minimum taxable income (AMTI) from Form 6251, line 28	**2.**	
3. Enter: $112,500 if single or head of household; $150,000 if married filing jointly or qualifying widow(er); $75,000 if married filing separately	**3.**	
4. Subtract line 3 from line 2. If zero or less, enter -0-	**4.**	
5. Multiply line 4 by 25% (.25)		**5.**
6. Subtract line 5 from line 1. If zero or less, enter -0-. If this form is for a child under age 18, go to line 7 below. Otherwise, **stop here** and enter this amount on Form 6251, line 29, and go to Form 6251, line 30		▶ **6.**
7. Child's minimum exemption amount		**7.** $6,050
8. Enter the **child's earned income,** if any (see instructions)		**8.**
9. Add lines 7 and 8		**9.**
10. Enter the **smaller** of line 6 or line 9 here and on Form 6251, line 29, and go to Form 6251, line 30		▶ **10.**

-7-

Appendix VII

Glossary of Terms

Adjusted Gross Income – Gross income less certain deductions and/or expenses.

Alternative Minimum Tax (Individual) – An alternative tax system designed to ensure no taxpayer with substantial economic income is able to avoid all tax liability by using exclusions, deductions, and credits.

Alternative Net Tax Operating Loss – The excess of the deductions (excluding the alternative tax net operating loss deduction) over the income when computing the alternative minimum taxable income. This excess is figured after considering the same modifications used in computing the net operating loss.

Alternative Tax Net Operating Loss Deduction – The sum of the alternative tax net operating loss carryovers and carrybacks to the tax year; it is generally limited to 90 percent of the alternative minimum taxable income computed without regard to the alternative tax net operating loss deduction.

Campus – The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

Correspondence Imaging System – A modern, digital, image-based system for processing taxpayer correspondence.

Integrated Data Retrieval System – The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

Internal Revenue Manual – IRS policies and procedures used to administer the Internal Revenue Code.

Master File – The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

Math Error – An error that results in either an increase or decrease in tax or credits.

Net Tax Effect – The net effect of the errors we identified on taxpayers' tax liabilities. Errors identified can increase and/or decrease taxpayers' overall tax liabilities.

Appendix VIII

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

COMMISSIONER
WAGE AND INVESTMENT DIVISION

RECEIVED
JAN 31 2008

JAN 30 2008

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard Byrd, Jr.
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Processing of Carryback Loss Claims Needs to Be Improved to Ensure Taxpayers Receive Accurate Refunds (Audit # 200740036)

I have reviewed the subject draft report and appreciate your recommendations to improve the accuracy of carryback loss claims. As you are aware, the processing of carryback loss claims can be a complicated process and certain tax situations such as the Alternative Minimum Tax (AMT) can increase the level of difficulty. Therefore, we value your suggestions to make this complex process easier and to increase the accuracy of refunds for taxpayers.

We have already completed many of your recommended changes to clarify associated forms, publications and Internal Revenue Manuals (IRM) to improve identification of carrybacks and resolve errors before the refunds are paid. In addition, we are speaking to tax preparers at the next Stakeholder Liaison meeting in late February 2008, regarding carryback loss claims. We will alert the preparer community of the need to be aware of the requirement to limit the alternative tax net operating loss deduction and the impact of a carryback loss on the charitable contributions deduction when claiming a carryback loss refund. Furthermore, we have started preliminary work to include this information on IRS.gov and are working with the web page owner for concurrence and correct placement.

During the course of the review, we modified the Desktop Integration (DI) tool to correct the problem with carrybacks and charitable contributions, and are currently working with Modernization Information Technology Services (MITS) to correct the problem with the AMT DI tool.

Finally, we have a Lean Six-Sigma Office project analyzing Form 1040X (Amended U.S. Individual Income Tax Return) for processing improvements. Although the main thrust of the team is to look for efficiencies in processing, the final results may result in improved accuracy. We are closely monitoring the team's progress, and looking forward to receiving the final recommendations.

Attached are our specific comments to your recommendations. We agree with the outcome measures as stated in the report. If you have any questions, please contact me at (404) 338-7060, or members of your staff may contact Peter J. Stipek, Director, Customer Account Services, at (404) 338-8910.

Attachment

Attachment

RECOMMENDATION 1

The Director, Media and Publications, should revise the applicable tax form instructions for claiming carryback losses to ease the burden on taxpayers and reduce the number of errors on claims. Specifically, the Director should:

- Revise the Form 1045 and Form 1040X instructions to more clearly indicate that a carryback loss may create a new AMT liability in the carryback year when one did not previously exist.
- Revise the Form 6251 instructions to more clearly describe the computations necessary to figure the alternative tax net operating loss and alternative tax net operating loss deduction. The instructions should be written in common language and offer references to applicable Internal Revenue Code sections only as needed.
- Consider putting in bold or otherwise highlighting the caution for the charitable contributions deduction and moving it closer to the beginning of the "After Carryback" and "Deducting a Carryback" sections in the respective Form 1045 and Publication 536 instructions.

CORRECTIVE ACTION

We agree with most of this recommendation and our corrective actions are listed below:

a) The instructions for Form 1040X (Amended U.S. Individual Income Tax Return) and Form 1045 (Application for Tentative Refund) were revised to indicate that a carryback loss may create a new AMT liability.

b) The references to the Internal Revenue Code were removed from Form 6251 (Alternative Minimum Tax – Individuals) to make the discussion less complex.

c) We highlighted the caution for the charitable contributions deduction in Publication 536 (Net Operating Losses for Individuals, Estates, and Trusts) for 2007 on December 28, 2007. We will make a similar change to Form 1045 in the next revision.

We disagree with part of the recommendation regarding moving the caution closer to the beginning of the "After Carryback" and "Deducting a Carryback" sections in Form 1045 and Publication 536. The caution information belongs appropriately in the "Refiguring your tax" discussion. The charitable contribution deduction is an itemized deduction that is limited by certain percentages of the AGI. We specifically state which deductions to refigure and state do not refigure your charitable contributions. This is where we added the caution to the already existing instruction to highlight it.

IMPLEMENTATION DATES

a) Completed November 13, 2007
b) Completed December 26, 2007
c) December 15, 2008

RESPONSIBLE OFFICIAL
Director, Media and Publications, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 2
The Director, Accounts Management, should work with the Office of National Public Liaison to alert the preparer community of the need to be especially aware of the requirement to limit the alternative tax net operating loss deduction and the impact of a carryback loss on the charitable contributions deduction when claiming a carryback loss refund.

CORRECTIVE ACTION
We agree with this recommendation and are working with the Office of National Public Liaison (NPL) to alert the preparer community of the need to be especially aware of the requirement to limit the alternative net operating loss deduction and the impact of a carryback loss on the charitable contributions deduction when claiming carryback refunds. We will provide a subject matter expert to assist NPL with the carryback information necessary to alert the preparer community.

IMPLEMENTATION DATE
March 15, 2008

RESPONSIBLE OFFICIAL
Director, Accounts Management, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 3
The Director, Accounts Management, should revise the procedures for working claims for carryback loss refunds to improve the identification and resolution of errors before the related refunds are paid. Specifically, the Director should modify the procedures to:

- Require verification of the figures and computations on Form 6251 to the extent possible for the carryback year when the Form is attached to the claim.
- Require employees to verify the accuracy of the Master File figures to the extent possible before rejecting a claim when differences exist between figures on the Master File and on the claim.

3

CORRECTIVE ACTION
We agree with this recommendation. IRM 21.5.9 will be updated to require verification of the figures and computations on Form 6251 to the extent possible, and to require employees to verify the accuracy of the Master File figures to the extent possible before rejecting a claim when differences exist between Master File and the figures on the claim.

IMPLEMENTATION DATE
February 15, 2008

RESPONSIBLE OFFICIAL
Director, Accounts Management, 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 Director, Media and Publications, should change the taxpayer instructions for Forms 1045 and 1040X, as they pertain to carryback losses, to require the taxpayer to attach Form 6251 to the carryback claim for each carryback year to which a loss is being applied.

CORRECTIVE ACTION
We do not agree with this recommendation. As set out in our responses to Recommendations 1, 2, 3, and 6, we are implementing a number of corrective actions that will improve the accuracy of taxpayer carryback loss claims, as well as our ability to detect and correct taxpayer errors. These changes include, among other things, specific changes to the instructions for Form 1040X and Form 1045 to indicate that a carryback loss may create a new AMT liability. These instructions direct taxpayers to complete a Form 6251 and if there is a change they are required to attach this form to the Form 1040X or Form 1045 they are filing.

We do not agree that taxpayers should be required to attach Form 6251 for each carryback year regardless of whether AMT is owed, as recommended in your report. Generally speaking, the Paperwork Reduction Act of 1995 (PRA) requires agencies to certify that the collection of information is necessary, has practical utility, and reduces to the extent possible the burden on person required to provide such information. Requiring taxpayers to file Form 6251 when no AMT is owed or no deductions are limited by the AMT would impose an unreasonable burden and likely be viewed as a violation of these and other PRA requirements.

4

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A

RECOMMENDATION 5
The Director, Accounts Management, should change the procedures for verifying the accuracy of carryback refund claims to require employees to ensure a Form 6251 for each carryback year is attached to the claim. The procedures should also require employees to either correspond with the taxpayer for the missing Forms or reject the claim. To the extent possible, Forms 6251 for each carryback year should then be verified for accuracy of the AMT computation before the claim is allowed.

CORRECTIVE ACTION
For the reasons noted above, we do not agree with this recommendation. However, as set out in our response to Recommendation 3, where there is a change to the AMT and the Form 6251 is attached, our procedures will be revised to require verification of the figures and computations on these forms. In addition, as noted in our response to Recommendation 6, we will determine the feasibility of implementing changes to the Desktop Integration tool to accurately account for carryback losses in the computation of the AMT.

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A

RECOMMENDATION 6
The Director, Accounts Management, should work with the Associate Chief Information Officer, Applications Development, to determine if the Desktop Integration tool can be modified to enable it to accurately account for carryback losses in the computation of the AMT, including the ability to compute the alternative tax net operating loss and the alternative tax net operating loss deduction. In the interim, Accounts Management should alert employees that the Desktop Integration tool for AMT does not correctly limit

5

the alternative tax net operating loss deduction to 90 percent of a taxpayer's alternative minimum taxable income before the deduction.

CORRECTIVE ACTION

We agree with this recommendation. The DI Tools Section Chief, will work with a subject matter expert provided by Accounts Management to determine the feasibility of modifying the worksheet to accurately account for carryback losses. This will enable MITS, Application Development, to confirm if the scope of the change falls under the yearly maintenance Unified Work Request (UWR) that covers corrections and tax year changes or if a new calculation tool is required that would require a new UWR.

In the interim, an alert will be sent to employees that the DI tool for AMT does not correctly limit the alternative tax net operating loss deduction to 90 percent of a taxpayer's alternative minimum taxable income before the deduction.

IMPLEMENTATION DATE

(a) September 15, 2008 (Determine feasibility of modifying worksheet)

(b) March 15, 2008 (Alert sent to employees)

RESPONSIBLE OFFICIAL

(a) Director, Accounts Management, Wage and Investment Division and Associate Chief Information Officer

(b) Director, Accounts Management, Wage and Investment

CORRECTIVE ACTION MONITORING PLAN

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