

**The Internal Revenue Service Processed
Most Estate and Gift Tax Returns Accurately,
but Some Estates Did Not Receive the
Maximum Tax Credit**

August 2000

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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.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

August 8, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in cursive script that reads "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Processed
Most Estate and Gift Tax Returns Accurately, but Some Estates
Did Not Receive the Maximum Tax Credit

This report presents the results of our review of the processing of Tax Year (TY) 1999 estate and gift tax returns. The audit objective was to determine whether estate and gift tax returns were processed in accordance with tax law changes effective for TY 1999.

In summary, we found that most estate and gift tax returns were processed in accordance with tax law changes. However, approximately one percent of TY 1999 estate tax returns filed during the period of our review were submitted on outdated forms that showed a lower unified credit than allowable. Internal Revenue Service (IRS) processing procedures were not designed to identify and adjust the understated credit.

Management's response was due on July 31, 2000. As of August 2, 2000, management had not responded to the draft report.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may call Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

**The Internal Revenue Service Processed Most Estate and Gift Tax Returns
Accurately, but Some Estates Did Not Receive the Maximum Tax Credit**

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The Internal Revenue Service Processed Most Estate and Gift Tax Returns Accurately, but Some Estates Did Not Receive the Maximum Tax Credit

Executive Summary

The Internal Revenue Service (IRS) processed most Tax Year (TY) 1999 estate and gift tax returns¹ in accordance with the provisions of the Taxpayer Relief Act of 1997.² However, approximately 1 percent (197) of the 18,184 TY 1999 estate tax returns³ processed by the IRS from November 1999 through March 2000 were filed on outdated forms that showed a lower unified credit than allowable. IRS processing procedures were not designed to identify and correct the understated credit and the resulting \$1.8 million in miscalculated estate tax. If corrective actions had not been initiated, we estimate that 1 percent of approximately 125,000 TY 1999 estate tax return filers may have overpaid \$11.6 million in tax.

An estimated 428,000⁴ estate and gift tax returns are expected to be filed for taxpayers that either died or gave gifts in 1999. The Taxpayer Relief Act of 1997 changed various exemptions, limitations, and exclusions associated with TY 1999 estate and gift taxes. Implementation of these tax law changes required revisions to forms, instructions, publications and computer programs.

Prior to 1999, the maximum unified credit amount was pre-printed on the estate tax return.⁵ The latest version of the estate tax return does not contain a pre-printed unified credit amount. Rather, the executor of the decedent's estate must enter the appropriate maximum allowable unified credit as determined by the taxpayer's date of death.

The objective of this audit was to determine whether the IRS processed estate and gift tax returns in accordance with tax law changes effective for TY 1999.

Results

The IRS put forth significant effort to prepare for the processing of TY 1999 estate and gift tax returns. The IRS ensured that new legislation was effectively implemented during the processing of most estate and gift tax returns, except when estate tax returns were filed on outdated forms.

¹ Estate taxes are paid using the United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) series of returns. Gift taxes are paid using the United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709) series of returns.

² Pub. L. 105-34, 111 Stat. 845, 26 U.S.C.

³ United States Estate Tax Return – United States Citizen/Resident (Form 706).

⁴ Combines the IRS Statistics of Income projections of 125,000 estate tax returns and 303,000 gift tax returns for Calendar Year 1999.

⁵ United States Estate Tax Return–United States Citizen/Resident (Form 706).

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Most Estate and Gift Tax Returns Were Processed in Accordance with Tax Law Changes

The IRS took the actions necessary to ensure that all forms, publications, instructions, and computer programs related to estate and gift tax returns were updated to reflect the appropriate tax law changes. The Internal Revenue Manual instructions were updated to reflect accurate unified credit amounts, limitations, and exclusions.

The Internal Revenue Service Did Not Give Some Estate Tax Return Filers the Maximum Allowable Tax Credit

The Taxpayer Relief Act of 1997 increased the maximum amount of unified credit that could be applied against a taxpayer's estate tax to \$211,300 for taxpayers⁶ who died in 1999. Most estate tax returns were processed accurately, and the correct amount of credit was applied. However, when estate tax returns were filed on outdated versions of the form, the IRS did not always correct the understated amount of unified credit during the processing of the returns.

The IRS' procedures for handling estate tax returns did not cover the processing of older versions of the form with a pre-printed unified credit amount. As a result, when processing TY 1999 estate tax returns, the IRS did not identify and adjust the understatement of unified credit on 197 returns and the resulting \$1.8 million in miscalculated taxes. If corrective actions had not been initiated, approximately 1,250⁷ estates of entitled decedents may have overpaid \$11.6 million in tax. Based on results that we provided to IRS management during the course of this review, they took the necessary actions to eliminate the potential for any future problems with this issue.

Summary of Recommendations

We recommended that the Assistant Commissioner (Forms and Submission Processing) review the applicable documents requesting computer programming changes to the annual exclusion amount in order to rule out a systemic programming problem and study the Code and Edit and Error Resolution instructions in the Internal Revenue Manual to determine the cause of this processing problem.

⁶ United States citizens/residents.

⁷ This is a conservative estimate based on IRS Statistics of Income Calendar Year Projections for 1999 through 2001. The IRS receives estate tax returns for any 1 tax year during 3 calendar years. This is because the returns are due 9 months after the taxpayer's death. With an extension, the estate tax return for a taxpayer dying near the end of the calendar year might not be filed until 2 calendar years later. (1 percent of 125,000 = 1,250)

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Management's Response to Office of Audit Memorandum: IRS management provided an adequate, detailed response to our memorandum dated March 24, 2000 (see Appendices V and VI). The documents requesting computer programming changes were reviewed, and it was determined that the requirements were written and documented correctly. Processing procedures were revised to ensure that all versions of estate tax returns are coded and forced into the Error Resolution System when the unified credit amount is not appropriate for the tax period of the return. Management also stated that a different notice code would be used to allow tax examiners to provide a specific explanation of the change to the decedent's estate.

Management's Response to the Draft Report: Management's response was due on July 31, 2000. As of August 2, 2000, management had not responded to the draft report.

The Internal Revenue Service Processed Most Estate and Gift Tax Returns Accurately, but Some Estates Did Not Receive the Maximum Tax Credit

Objective and Scope

The Taxpayer Relief Act of 1997 changed various exemptions, limitations, and exclusions associated with estate and gift taxes.

The Taxpayer Relief Act of 1997¹ changed various exemptions, limitations, and exclusions associated with estate and gift taxes. The objective of this audit was to determine whether the Internal Revenue Service (IRS) processed estate and gift tax returns² in accordance with the tax law changes effective for Tax Year (TY) 1999.

In order to achieve our objective, we reviewed computer extracts for 29,498 TY 1999 estate³ and gift tax returns processed by the IRS from November 1999 through March 2000.⁴ We performed additional research and reviewed returns when processing data indicated a potential difference from tax law provisions.

We performed this audit in accordance with *Government Auditing Standards* from October 1999 through April 2000. The audit was conducted at the National Office and the Brookhaven IRS Center. Data and cases reviewed were selected from estate and gift tax returns processed nationwide.

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

¹ Pub. L. 105-34, 111 Stat. 845, 26 U.S.C.

² Estate taxes are paid using the United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) series of returns. Gift taxes are paid using the United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709) series of returns.

³ United States Estate Tax Return—United States Citizen/Resident (Form 706). We also reviewed processing data for 41 Nonresident Alien Estate Tax Returns (Form 706-NA). This report renders no decision regarding the processing of Forms 706-GST and 706-GSD due to the small number (14) of these returns filed during the period of our review.

⁴ TY 1999 estate tax returns were processed by the IRS when received because the due date is based on the decedent's date of death. However, regardless of when TY 1999 gift tax returns were received, the IRS processed them after January 1, 2000, because they were not due until April 17, 2000.

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Background

Processing returns and implementing the provisions of tax law changes were included on the list of the top 10 management issues facing the IRS. Implementation of tax law changes affecting the processing of approximately 428,000⁵ estate and gift tax returns of taxpayers who died or gave gifts in 1999 required revisions to forms, instructions, publications, and computer programs.

The Taxpayer Relief Act of 1997 provided for gradual increases to the maximum amount of unified credit that can be applied against a taxpayer's estate and/or gift tax. For taxpayers who died or gave gifts in 1999, the maximum allowable amount of unified credit was \$211,300.

The Taxpayer Relief Act of 1997 provided for gradual increases to the maximum amount of unified credit that can be applied against a taxpayer's estate and/or gift tax. For taxpayers who died⁶ or gave gifts in 1999, the maximum allowable amount of unified credit was \$211,300.⁷ This amount is scheduled to increase until it reaches \$345,800 in 2006.

A credit is an amount that eliminates or reduces tax. A unified credit applies to both the gift tax and the estate tax. The unified credit is subtracted from any gift tax that a taxpayer owes. Any unified credit the taxpayer applied to his/her gift tax in one year reduces the amount of credit that can be applied to his/her gift tax in a later year. If a taxpayer does not use the entire maximum allowable unified credit during his or her lifetime, the estate can use the remainder to eliminate or reduce estate tax upon the taxpayer's death.

If the correct amount of unified credit was not used on an estate and/or gift tax return and was not corrected by IRS return processing procedures, the tax, refund, account balance, and penalty and interest calculations would be incorrect. Further, erroneous notices would be generated and sent to some taxpayers.

⁵ Combines IRS Statistics of Income projections of 125,000 estate tax returns and 303,000 gift tax returns for Calendar Year 1999.

⁶ United States citizens/residents.

⁷ Estates of nonresident aliens were entitled to a maximum credit of \$13,000 (line 7 on Form 706-NA).

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The executor of a decedent's estate uses an estate tax return form to figure the estate tax imposed by the Internal Revenue Code.⁸ The estate return must be filed within nine months of a taxpayer's date of death.

In order to accommodate the future increases to the unified credit amount, the IRS revised the 1999 estate tax return.⁹ Prior to 1999, the return had a maximum unified credit amount appropriate for that particular tax year pre-printed on line 11. However, for TY 1999, line 11 was left blank to accommodate the anticipated changes to the unified credit over the next few years. The executor of the decedent's estate must enter the appropriate maximum allowable unified credit, which is determined by the taxpayer's date of death.

Results

The IRS put forth significant effort to prepare for the processing of TY 1999 estate and gift tax returns. It ensured that new legislation was effectively implemented during the processing of most estate and gift tax returns, except when estate tax returns were filed on outdated forms.

Most Estate and Gift Tax Returns Were Processed in Accordance With Tax Law Changes

The IRS took the actions necessary to ensure that all forms, publications, instructions, and computer programs related to estate and gift tax returns were updated to reflect the appropriate tax law changes. Requests for Information Services, the documents submitted to the IRS Information Systems Division requiring programming changes, were submitted timely

⁸ Internal Revenue Code, 26 U.S.C. § 2001.

⁹ United States Estate Tax Return—United States Citizen/Resident (Form 706).

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and reflected the correct dollar amounts, limitations and exclusions. The Internal Revenue Manual processing instructions were updated to reflect accurate unified credit amounts, limitations, and exclusions. Most estate and gift tax returns were processed in accordance with the provisions of the Taxpayer Relief Act of 1997.

The Internal Revenue Service Did Not Give Some Estate Tax Return Filers the Maximum Allowable Tax Credit

Estate tax returns filed on outdated forms showed a lower unified credit than allowable, which IRS processing procedures were not designed to identify and adjust.

Approximately 1 percent (197) of the 18,184 TY 1999 estate tax returns¹⁰ processed by the IRS from November 1999 through March 2000 were filed on outdated forms that showed a lower unified credit than allowable. IRS processing procedures were not designed to identify and correct the understated credit and the resulting \$1.8 million in miscalculated estate tax. If corrective actions had not been initiated, we estimate that 1,250¹¹ estates of entitled decedents may have overpaid \$11.6 million in estate tax.

We reviewed data extracted by specialized computer programs for all TY 1999 estate and gift tax returns (29,498) processed by the IRS from November 1999 through March 2000.

We identified no material problems associated with the processing of 11,314¹² gift tax returns. An in-depth analysis of 58 randomly selected cases confirmed this conclusion.

¹⁰ United States Estate Tax Return-United States Citizens/Residents (Form 706).

¹¹ This is a conservative estimate based on IRS Statistics of Income calendar year projections of estate tax returns filed for 1999 and the error rate identified during our review (125,000 x 1 percent).

¹² The IRS began processing TY 1999 gift tax returns after January 1, 2000, because they were not due until April 17, 2000.

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However, we found that 535 (3 percent) of the 18,184¹³ estate tax returns processed by the IRS were filed on outdated versions of the estate tax return form.¹⁴ These forms showed a lower unified credit than allowable. During processing, these estate tax returns were given the unified credit amount that was pre-printed on line 11, rather than the maximum allowable amount of \$211,300 for taxpayers who died in 1999.

In 197 (1 percent) of the 18,184 cases, the understatement of unified credit resulted in the overpayment of approximately \$1.8 million in estate tax, an average of \$9,329 per return. Since the remaining 338 (2 percent) of the cases had no estate tax due before the application of the credit, there were no tax consequences to the decedent's estate.

Based on IRS Statistics of Income estimates, we calculated that 1 percent (1,250) of the projected 125,000¹⁵ estate tax returns estimated to be filed for Calendar Year 1999, multiplied by the average tax consequence of \$9,329 per return, would equate to approximately \$11.6 million in understated unified credit and miscalculated estate tax.

¹³ Estate tax returns for taxpayers that died in 1999 are processed on an ongoing basis because the due date of the return is based on the decedent's date of death.

¹⁴ United States Estate Tax Return-United States Citizen/Resident (Form 706).

¹⁵ This is a conservative estimate based on IRS Statistics of Income calendar year projections for 1999 through 2001. The IRS receives estate tax returns for any 1 tax year during 3 calendar years. This is because the returns are due 9 months after the taxpayer's death. With an extension, the return for a taxpayer dying near the end of the calendar year might not be filed until 2 calendar years later.

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The Code and Edit and ERS correction procedures for estate tax returns did not cover the processing of older versions of the form with a pre-printed unified credit amount. As a result, most of these estate tax returns were not coded properly and were not routed to the ERS for correction.

At the IRS Centers, the Code and Edit function scans returns and ensures that returns with omissions or errors are directed to the Error Resolution System (ERS) for correction. The Code and Edit and ERS correction procedures for estate tax returns did not provide instructions covering the processing of older versions of the estate tax return form with a pre-printed unified credit amount. As a result, most of these estate tax returns were not coded properly, if at all, and most of the returns were not routed to the ERS for correction.

We found that a small number of estate tax returns that were submitted on an older version of the form were coded in such a manner as to cause them to be routed to the ERS. However, actions taken by ERS tax examiners were insufficient to ensure correct processing. Further, in some instances, their efforts caused the Integrated Data Retrieval System (the IRS' computerized tax account system) to reflect incorrect processing information and generate incorrect and confusing notices to the decedents' estates.

Hypothetical case example

Appendix VII illustrates a hypothetical example of an estate tax return filed on an outdated version (1998) of the form and the most current version of the form (1999).

In this example, we assumed the decedent's date of death was February 5, 1999, which would have entitled the estate to a maximum unified credit of \$211,300. However, the 1998 estate tax return has \$202,050 pre-printed on line 11 because that was the maximum allowable amount of unified credit for that particular tax year.

We found that returns filed on an outdated form such as this were usually processed without a correction to the unified credit amount. In this hypothetical example using the incorrect unified credit, the balance due would be \$57,501.

As shown in our illustration, the most current version of the estate tax return (1999) has no pre-printed maximum

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unified credit amount on line 11. Therefore, the executor of the estate would have put \$211,300 on that line and the result would be a correct balance due of \$48,251. This is a difference of \$9,250 from the calculation arrived at when the incorrect version of the form was used. In our example, the decedent's estate would have owed the IRS \$9,250 less than the executor's calculations indicated.

Further, if the return had been filed late, the IRS would have calculated the interest and penalties due on the higher incorrect balance. If the tax had been paid when the return was filed and the error had been corrected upon issuance of a closing letter by the Examination function, the IRS would then have to pay interest to the estate on the \$9,250 difference. This could be up to 18 months after the filing of the estate tax return.

Recommendations

The Assistant Commissioner (Forms and Submission Processing) should:

1. Review the applicable documents requesting computer programming changes to the annual exclusion amount in order to rule out a systemic programming problem.
2. Study the Code and Edit and Error Resolution instructions in the Internal Revenue Manual to determine the cause of this processing problem.

The IRS revised its processing procedures to ensure that all estate tax returns are coded and forced into the ERS when the pre-printed unified credit amount on line 11 is not appropriate for the tax period of the return.

Management's Response to Office of Audit

Memorandum: The Acting Assistant Commissioner (Forms and Submission Processing) provided an adequate, detailed response to our memorandum dated March 24, 2000 (see Appendices V and VI). Processing procedures were revised to ensure that all estate tax returns are coded and forced into the ERS when the pre-printed unified credit amount on line 11 is not appropriate for the tax period of the return. Management also stated that a different notice code would be used to allow tax examiners to provide a specific explanation of the change to the decedent's

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estate. These actions should eliminate the potential for any future problems with this issue.

Management's Response to the Draft Report:

Management's response was due on July 31, 2000. As of August 2, 2000, management had not responded to the draft report.

Conclusion

In general, most estate and gift tax returns were processed accurately and the amount of unified credit applied during processing was correct. However, when estate tax returns were filed on outdated versions of the form, the IRS did not always correct the understated amount of unified credit and miscalculated estate tax during processing.

The number of estate tax returns filed each year is expected to increase 18 percent by the year 2006. The unified credit amount is expected to increase 4 more times before reaching \$345,800 within the same time period. The increasing number of potentially affected returns, combined with the numerous expected changes to the maximum unified credit amount, increase the risk and impact of this processing problem in the foreseeable future. When we brought this issue to IRS management's attention, they took prompt corrective action, which should prevent any future problems with this issue.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall audit objective was to determine whether the Internal Revenue Service (IRS) processed estate and gift tax returns in accordance with the tax law changes effective for Tax Year (TY) 1999. To accomplish our objective, we:

- I. Evaluated the effectiveness of controls in place to ensure the accurate and timely processing of estate and gift tax returns by the IRS in accordance with applicable tax law changes.
 - A. Reviewed recent tax laws and determined the changes applicable to the processing of TY 1999 estate tax returns.
 - B. Reviewed recent tax laws and determined the changes applicable to the processing of TY 1999 gift tax returns.
 - C. Reviewed the National Office Legislative Affairs Action Plan to identify the changes which affected estate and gift tax returns and determined whether all the changes were identified and the responsible individuals named to coordinate the changes.
 - D. Contacted the responsible individuals, held discussions and interviews, and determined whether the necessary changes were made. Determined whether tax forms, instructions, and publications were adequately revised to help taxpayers comply with the new tax laws.
 - E. Determined whether the applicable Requests for Information Services were submitted to Information Services and that computer programs were changed and in place to ensure timely and accurate processing of estate and gift tax returns.
- II. Determined whether estate and gift tax returns were processed in accordance with tax law changes and controls identified above.
 - A. Reviewed data extracted by specialized computer programs developed by the Treasury Inspector General for Tax Administration's Information Technology staff on all TY 1999 estate tax returns processed by the IRS from November 1999 through March 2000:

18,184 United States Estate Tax Return-United States Citizen/Resident (Form 706); 41 Non-resident Alien Estate Tax Return (Form 706-NA);¹ 6 Generation

¹ Forty-one Forms 706-NA were reviewed. These estates were entitled to a maximum credit of \$13,000 (line 7).

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Skipping Transfer Tax Return for Distribution (Form 706-GST); 8 Generation Skipping Transfer Tax Return for Terminations (Form 706-GSD).²

Performed a detailed analysis of 535 (3 percent) cases in which Forms 706 reflected a unified credit discrepancy and determined whether the cases were processed accurately. Performed additional research on 197 of the cases that reflected a tax consequence.

- B. Reviewed computer extracts of all TY 1999 gift tax returns (11,314) processed by the IRS from January through March 2000 and determined whether they were processed accurately. No discrepancies were noted, but we selected a judgmental sample of TY 1999 gift tax returns (58 cases) and determined whether they were processed in accordance with recent tax law changes.
- C. Selected and reviewed samples of outgoing notices that involved estate and gift tax returns. Determined from Integrated Data Retrieval System (IDRS)³ research if the notice was accurate and clearly explained the issue involved to the taxpayer.

² This report renders no decision regarding the processing of Forms 706-GST and Forms 706-GSD due to the small number of these returns filed during the period of our review.

³ The IDRS enables IRS employees to have instantaneous visual access to certain taxpayer accounts. Some capabilities of the system include researching account information and requesting returns, entering transactions and collection information, and the automatic generating of notices, collection documents, and other outputs.

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Appendix II

Major Contributors to This Report

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Joseph Butler, Computer Specialist

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Appendix III

Report Distribution List

Deputy Commissioner Operations C:DO
Commissioner, Large and Mid-Size Business Division LM
Commissioner, Small Business and Self-Employed Division S
Chief Information Officer IS
Chief Operations Officer OP
Assistant Commissioner (Customer Service) OP:C
Assistant Commissioner (Forms and Submission Processing) OP:FS
National Director, Customer Service Compliance, Accounts and Quality OP:C:A
Director, Customer Account Services, Small Business and Self-Employed Division
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis M:O
Office of Management Controls M:CFO:A:M
Office of the Chief Counsel CC
National Taxpayer Advocate C:TA
Audit Liaisons:
 Deputy Commissioner Operations C:DO
 Assistant to the Deputy Commissioner Operations C:DO
 Assistant Commissioner (Customer Service) OP:C
 Assistant Commissioner (Forms and Submission Processing) OP:FS:S:Q:S
 Chief Operations Officer OP
 Director, Legislative Affairs
 Office of the Chief Counsel CC
 National Taxpayer Advocate C:TA

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective action will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Finding and recommendations:

The Internal Revenue Service (IRS) did not give some estate tax return filers the maximum allowable tax credit. The Taxpayer Relief Act of 1997¹ provided for a maximum unified credit of \$211,300 to be applied against the estate tax of taxpayers² who died in 1999, if the credit had not already been applied towards gift tax during their lifetime. We found that 1 percent (197) of the 18,184 Tax Year (TY) 1999 estate tax returns processed by the IRS from November 1999 through March 2000 were filed on outdated forms that showed a lower unified credit than allowable. IRS processing procedures were not designed to identify and correct the understated credit and the miscalculated estate tax during processing. As a result, these estates overpaid their estate tax by \$1.8 million. If corrective actions had not been taken, we estimate that 1 percent (1,250) of approximately 125,000 TY 1999 estate tax return filers may have overpaid \$11.6 million in estate tax.

We recommended that the Assistant Commissioner (Forms and Submission Processing) review the applicable documents requesting computer programming changes to the annual exclusion amount in order to rule out a systemic programming problem and study the Code and Edit and Error Resolution instructions in the Internal Revenue Manual to determine the cause of this processing problem.

Type of Outcome Measure:

Taxpayer rights and entitlements

Value of the Benefit:

The estates of 197 taxpayers who died in 1999 overpaid \$1.8 million in estate tax by submitting their TY 1999 estate tax returns on outdated forms. If the percentage and average dollar of error cases identified in the sample remain the same, we estimate that if corrective actions had not been taken, 1 percent (1,250) of approximately 125,000 TY 1999 estate tax return filers may have overpaid \$11.6 million in estate tax during the processing of their returns.

¹ Pub. L. 105-34, 111 Stat. 845, 26 U.S.C.

² United States Estate Tax Return—United States Citizen/Resident (Form 706).

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Methodology Used to Measure the Reported Benefit:

We reviewed data extracted by specialized computer programs for all 18,184 TY 1999 estate tax returns³ processed by the IRS from November 1999 through March 2000. We performed Integrated Data Retrieval System research and requested data for all the returns where the unified credit amount differed from the maximum credit allowed for taxpayers who died in 1999.

We found that 535 (3 percent) of the 18,184⁴ estate tax returns processed by the IRS were filed on outdated versions of the estate tax return form.⁵ These forms showed a lower unified credit than allowable. During processing, these estate tax returns were given the unified credit amount that was pre-printed on line 11, rather than the maximum allowable amount of \$211,300 for taxpayers who died in 1999.

In 197 (1 percent) of the 18,184 cases, the understatement of unified credit resulted in the overpayment of approximately \$1.8 million in estate tax, an average of \$9,329 per return. The remaining 338 (2 percent) of the cases had no estate tax due before the application of the credit and there were no tax consequences to the decedents' estates.

Based on IRS Statistics of Income estimates, we calculated that 1 percent (1,250) of the projected 125,000 estate tax returns estimated to be filed for Calendar Year 1999, multiplied by the average tax consequence of \$9,329 per return, would equate to approximately \$11.6 million in understated unified credit and miscalculated estate tax that may have been overpaid.

³ United States Estate Tax Return—United States Citizen/Resident (Form 706).

⁴ TY 1999 estate tax returns are processed on an ongoing basis because the due date of the return is based on the decedent's date of death.

⁵ United States Estate Tax Return—United States Citizen/Resident (Form 706).

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Appendix V

Memorandum: Processing of Estate Tax Returns



INSPECTOR GENERAL
OF TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 24, 2000

Response Date
April 10, 2000

MEMORANDUM FOR ASSISTANT COMMISSIONER (FORMS AND SUBMISSION PROCESSING)

FROM: Gordon C. Milbourn III *Gordon C. Milbourn*
Associate Inspector General for Audit (Small Business and Corporate Programs)

SUBJECT: Processing of Estate Tax Returns

This memorandum contains conditions we identified during our audit of the processing of estate and gift tax returns by the Internal Revenue Service (IRS). We discussed an advanced draft of this memorandum with your staff. This issue will be included in an audit report later this year.

Our audit team has been reviewing the processing of United States Estate Tax Returns (Forms 706) filed for decedents who died during 1999. The executor of a decedent's estate uses Form 706 to figure the estate tax imposed by the Internal Revenue Code, 26 U.S.C. § 2001. The estate return must be filed within nine months of the date of death. The Taxpayer Relief Act of 1997, Pub. L. 105-34, 111 Stat. 788, 26 U.S.C. § 501, provided for a unified credit of \$211,300 to be applied against the estate tax of decedents dying during calendar year 1999. Any amount of this unified credit not previously used against a decedent's gift tax during his or her lifetime can be applied against the estate tax due.

Our preliminary research indicates that some estate tax returns are not being given the maximum allowable unified credit amount of \$211,300 during processing. When the unified credit claimed on these returns is not corrected during processing, the estate tax is inaccurate. We estimate that over \$11.6 million in unified credit will not be properly applied during processing of Tax Year 1999 estate tax returns.

While we are still working on developing the root cause of this problem, it appears as if the affected returns were filed on outdated Forms 706. Prior year forms had a pre-printed unified credit amount appropriate for that particular tax year. Because the

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unified credit amount is being gradually adjusted upward over the next few years, the latest version of the Form 706 does not contain a pre-printed unified credit amount.

We found that approximately 3% of estate tax returns were filed on the outdated forms. We determined this by reviewing a computer extract of all estate tax returns processed in IRS centers during a ten week period. We reviewed all cases where there was a difference in the amount of unified credit allowed by law and the amount allowed by the IRS.

We believe that certain actions need to be taken immediately because when a decedent's estate return is not credited with the allowable unified credit during processing:

- The refund or balance due is not correct.
- The IRS will owe interest on the difference.
- The taxpayers are sent incorrect notices.

The number of estate tax returns filed each year is expected to grow 56% by the year 2008. In addition, the maximum unified credit amount will increase each year until it reaches \$345,800 in 2006. The multitude of changes combined with the increasing number of potentially affected returns multiplies the risk of processing problems in the foreseeable future.

We have contacted the IRS National Office Submissions Processing/Error Resolution Program Analysts to discuss this issue. We suggested that they:

- review the applicable Request for Information Services that contained the required changes to the annual exclusion amounts;
- review the corresponding Functional Specification Package to rule out a systemic programming problem; and
- study the applicable Code and Edit and Error Resolution Internal Revenue Manuals to determine the cause of this processing problem.

Please advise us within 15 calendar days of any actions taken to alleviate these conditions. If you have any questions, please call me at (202) 622-3837, or your staff may contact Richard J. Dagliolo, Director of Audit, Submission Processing at (516) 654-6028, or Robert K. Irish, Audit Manager, at (516) 447-4976.

The Internal Revenue Service Processed Most Estate and Gift Tax Returns Accurately, but Some Estates Did Not Receive the Maximum Tax Credit

Appendix VI

Management's Response to the Memorandum

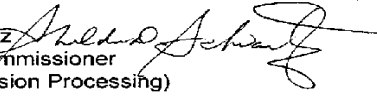


ASSISTANT COMMISSIONER
(FORMS AND SUBMISSION
PROCESSING)

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

MAY 9 2000

MEMORANDUM FOR ASSOCIATE INSPECTOR GENERAL FOR AUDIT (SMALL BUSINESS AND CORPORATE PROGRAMS)

FROM: Sheldon D. Schwartz 
Acting Assistant Commissioner
(Forms and Submission Processing)

SUBJECT: Processing of Estate Tax Returns

In your memorandum dated March 24, 2000, you discussed conditions identified during your audit of the processing of Estate Tax Returns. Your audit team raised concerns about Estate Tax Returns filed on prior year versions of Forms 706 for decedents who died during 1999. Thank you for raising these concerns to my attention.

During your review you found that some taxpayers were not claiming or receiving the 1999 maximum allowable unified credit amount of \$211,300. The allowable credit amount, which was lower in previous years, was pre-printed on prior revisions of Form 706. Although your research was not yet conclusive, it appears that many taxpayers who used the prior revision were not aware that they were entitled to a greater credit than was printed on the form, so they claimed only the lower, pre-printed amount. We were allowing the amount of credit claimed by the taxpayer rather than increasing it to the 1999 maximum amount. We have now changed our procedures. When the pre-printed amount is not the appropriate amount for the tax period of the return and Schedule T is not attached, the return will be forced to Error Resolution (ERS) for correction.

We also updated the ERS instructions to ensure that the maximum credit is allowed when a Form 706 is filed on a return with a prior year's pre-printed credit amount. We will send a notice to the taxpayer to explain why we lowered their tax. Since the wording of the established notice codes would be confusing in this situation, we have instructed the ERS examiners to use notice code 90, which allows for a write-in explanation that will be tailored to the specific situation.

As you requested in your memorandum and as we have since discussed with your staff, we also reviewed the Requests for Information Services and the Functional Specifications Package to ensure that the changes related to the annual exclusion

**The Internal Revenue Service Processed Most Estate and Gift Tax Returns
Accurately, but Some Estates Did Not Receive the Maximum Tax Credit**

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amount were made correctly. We found that the requirements were written and documented correctly.

If there are any questions regarding this matter, please call me at (202) 622-2875 or a member of your staff may contact Harry Anderson at (202) 283-0539.

cc: Executive Officer for Service Center Operations

The Internal Revenue Service Processed Most Estate and Gift Tax Returns Accurately, but Some Estates Did Not Receive the Maximum Tax Credit

Appendix VII

Hypothetical Case Example

OUTDATED VERSION OF FORM 706

Form **706** United States Estate (and Generation-Skipping Transfer) Tax Return
 (Rev. July 1998) Estate of a citizen or resident of the United States (see separate instructions). To be filed for decedents dying after December 31, 1997, and before January 1, 1999.
 Department of the Treasury Internal Revenue Service For Paperwork Reduction Act Notice, see page 1 of the separate instructions. DMB No. 1545-0015

Part 1—Decedent and Executor

1a Decedent's first name and middle initial (and maiden name, if any) 1b Decedent's last name 2 Decedent's social security no.

3a Legal residence (domicile) at time of death (county, state, and ZIP code, or foreign country) 3b Year domicile established 4 Date of birth 5 Date of death 2/5/99

6a Name of executor (see page 2 of the instructions) 6b Executor's address (number and street including apartment or suite no. or rural route; city, town, or post office; state; and ZIP code)

6c Executor's social security number (see page 2 of the instructions)

7a Name and location of court where will was probated or estate administered 7b Case number

8 If decedent died testate, check here and attach a certified copy of the will. 9 If Form 4768 is attached, check here

10 If Schedule R-1 is attached, check here

Part 2—Tax Computation

1	Total gross estate less exclusion (from Part 5, Recapitulation, page 3, item 12)	1	864,980.00
2	Total allowable deductions (from Part 5, Recapitulation, page 3, item 23)	2	22,434.00
3	Taxable estate (subtract line 2 from line 1)	3	842,546.00
4	Adjusted taxable gifts (total taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts that are includable in decedent's gross estate (section 2001(b)))	4	0.00
5	Add lines 3 and 4	5	842,546.00
6	Tentative tax on the amount on line 5 from Table A on page 10 of the instructions	6	284,393.00
7a	If line 5 exceeds \$10,000,000, enter the lesser of line 5 or \$17,184,000. If line 5 is \$10,000,000 or less, skip lines 7a and 7b and enter -0- on line 7c.	7a	0
	b Subtract \$10,000,000 from line 7a	7b	0
	c Enter 5% (.05) of line 7b	7c	0.00
8	Total tentative tax (add lines 6 and 7c)	8	284,393.00
9	Total gift tax payable with respect to gifts made by the decedent after December 31, 1976. Include gift taxes by the decedent's spouse for such spouse's share of split gifts (section 2513) only if the decedent was the donor of these gifts and they are includable in the decedent's gross estate (see instructions)	9	0.00
10	Gross estate tax (subtract line 9 from line 8)	10	284,393.00
11	Maximum unified credit against estate tax	11	202,050.00
12	Adjustment to unified credit. (This adjustment may not exceed \$6,000. See page 7 of the instructions.)	12	0.00
13	Allowable unified credit (subtract line 12 from line 11)	13	202,050.00
14	Subtract line 13 from line 10 (but do not enter less than zero)	14	82,343.00
15	Credit for state death taxes. Do not enter more than line 14. Figure the credit by using the amount on line 3 less \$60,000. See Table B in the instructions and attach credit evidence (see instructions)	15	24,842.00
16	Subtract line 15 from line 14	16	57,501.00
17	Credit for Federal gift taxes on pre-1977 gifts (section 2012) (attach computation)	17	0.00
18	Credit for foreign death taxes (from Schedule(s) P). (Attach Form(s) 706-CE.)	18	0.00
19	Credit for tax on prior transfers (from Schedule O)	19	0.00
20	Total (add lines 17, 18, and 19)	20	0
21	Net estate tax (subtract line 20 from line 16)	21	57,501.00
22	Generation-skipping transfer taxes (from Schedule R, Part 2, line 10)	22	0
23	Total transfer taxes (add lines 21 and 22)	23	57,501.00
24	Prior payments. Explain in an attached statement.	24	0.00
25	United States Treasury bonds redeemed in payment of estate tax	25	0.00
26	Total (add lines 24 and 25)	26	0.00
27	Balance due (or overpayment) (subtract line 26 from line 23)	27	57,501.00

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than the executor) is based on all information of which preparer has any knowledge.

Signature(s) of executor(s) _____ Date _____

Signature of preparer other than executor _____ Address (and ZIP code) _____ Date _____

Cat. No. 20548R

The Internal Revenue Service Processed Most Estate and Gift Tax Returns Accurately, but Some Estates Did Not Receive the Maximum Tax Credit

CURRENT VERSION OF FORM 706

Form 706 (Rev. July 1999)	United States Estate (and Generation-Skipping Transfer) Tax Return Estate of a citizen or resident of the United States (see separate instructions). To be filed for decedents dying after December 31, 1998. For Paperwork Reduction Act Notice, see page 1 of the separate instructions.	OMB No. 1545-0015
Department of the Treasury Internal Revenue Service		

Part 1—Decedent and Executor	1a Decedent's first name and middle initial (and maiden name, if any)	1b Decedent's last name	2 Decedent's Social Security No.
	3a Legal residence (domicile) at time of death (county, state, and ZIP code, or foreign country)	3b Year domicile established	4 Date of birth 5 Date of death 2/5/99
	6a Name of executor (see page 4 of the instructions)	6b Executor's address (number and street including apartment or suite no. or rural route; city, town, or post office; state; and ZIP code)	
	6c Executor's social security number (see page 4 of the instructions)		
	7a Name and location of court where will was probated or estate administered		7b Case number
8 If decedent died testate, check here <input type="checkbox"/> and attach a certified copy of the will. 9 If Form 4768 is attached, check here <input type="checkbox"/>			
10 If Schedule R-1 is attached, check here <input type="checkbox"/>			

Part 2—Tax Computation	1 Total gross estate less exclusion (from Part 5, Recapitulation, page 3, item 12)	1	864,980.00
	2 Total allowable deductions (from Part 5, Recapitulation, page 3, item 23)	2	22,434.00
	3 Taxable estate (subtract line 2 from line 1)	3	842,546.00
	4 Adjusted taxable gifts (total taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts that are includible in decedent's gross estate (section 2001(b)))	4	0.00
	5 Add lines 3 and 4	5	842,546.00
	6 Tentative tax on the amount on line 5 from Table A on page 12 of the instructions	6	284,393.00
	7a If line 5 exceeds \$10,000,000, enter the lesser of line 5 or \$17,184,000. If line 5 is \$10,000,000 or less, skip lines 7a and 7b and enter -0- on line 7c.	7a	0.00
	7b Subtract \$10,000,000 from line 7a	7b	0.00
	7c Enter 5% (.05) of line 7b	7c	0.00
	8 Total tentative tax (add lines 6 and 7c)	8	284,393.00
	9 Total gift tax payable with respect to gifts made by the decedent after December 31, 1976. Include gift taxes by the decedent's spouse for such spouse's share of split gifts (section 2513) only if the decedent was the donor of these gifts and they are includible in the decedent's gross estate (see instructions)	9	0.00
	10 Gross estate tax (subtract line 9 from line 8)	10	284,393.00
	11 Maximum unified credit (applicable credit amount) against estate tax	11	211,300.00
	12 Adjustment to unified credit (applicable credit amount). (This adjustment may not exceed \$6,000. See page 4 of the instructions.)	12	0.00
	13 Allowable unified credit (applicable credit amount) (subtract line 12 from line 11).	13	211,300.00
	14 Subtract line 13 from line 10 (but do not enter less than zero)	14	73,093.00
	15 Credit for state death taxes. Do not enter more than line 14. Figure the credit by using the amount on line 3 less \$60,000. See Table B in the instructions and attach credit evidence (see instructions)	15	24,842.00
	16 Subtract line 15 from line 14	16	48,251.00
	17 Credit for Federal gift taxes on pre-1977 gifts (section 2012) (attach computation)	17	0.00
	18 Credit for foreign death taxes (from Schedule(s) P). (Attach Form(s) 706-CE.)	18	0.00
	19 Credit for tax on prior transfers (from Schedule Q)	19	0.00
	20 Total (add lines 17, 18, and 19)	20	0.00
	21 Net estate tax (subtract line 20 from line 16)	21	48,251.00
	22 Generation-skipping transfer taxes (from Schedule R, Part 2, line 10)	22	0.00
	23 Total transfer taxes (add lines 21 and 22)	23	48,251.00
	24 Prior payments. Explain in an attached statement	24	0.00
	25 United States Treasury bonds redeemed in payment of estate tax	25	0.00
	26 Total (add lines 24 and 25)	26	0.00
	27 Balance due (or overpayment) (subtract line 26 from line 23)	27	48,251.00

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer other than the executor is based on all information of which preparer has any knowledge.

Signature(s) of executor(s)	Date
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Signature of preparer other than executor	Address (and ZIP code)	Date
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Cat. No. 20548R