The Internal Revenue Service Could Enhance the Process for Implementing New Tax Legislation

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DEPARTMENT OF THE TREASURY
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INSPECTOR GENERAL
for TAX
ADMINISTRATION

March 6, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Could Enhance the Process for Implementing New Tax Legislation

This report presents the results of our review of the Internal Revenue Service's (IRS) scheduled plans to implement legislative changes as they relate to processing tax returns. In summary, we found the process of developing tax forms, instructions, and computer programs to implement new tax legislation was effective, but the IRS could enhance this process if it would:

- Increase emphasis on significant legislative provisions to ensure that all actions necessary to implement these provisions are taken.
- Ensure that all documentation prepared to request computer programming changes needed to implement legislative provisions is accurately completed.
- Identify opportunities to increase customer service and decrease taxpayer burden while implementing the tax provisions.

The IRS has responded to the report and its comments have been incorporated into the text where appropriate. The full text of the comments is included as Appendix VIII. With the exception of the two issues discussed below, we agree with the corrective actions outlined in the IRS' response.

IRS management did not implement our recommendation to notify taxpayers who appeared to be eligible for the Child Tax Credit but did not claim it. Instead, they plan to communicate with taxpayers regarding this credit through outreach programs. We believe the IRS should reconsider notifying taxpayers who appear to have been eligible for the Child Tax Credit but did not claim the credit. Based on an analysis of the IRS' computer files, we estimate there could be as many as 1.7 million taxpayers who qualified for the Child Tax Credit in Tax Year 1998 but did not claim or receive the credit. IRS management also did not implement our recommendation to judiciously use red text to emphasize significant items or changes on tax forms and instructions. They cited negative publicity associated with the IRS' use of additional colors to enhance artwork on the 1995 tax package. In our opinion, the judicious use of red text for a sound business purpose would not be perceived as wasteful and warrants testing.

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 Walter E. Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs), at (770) 455-2475.

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Executive Summary

In 1997, the Congress enacted legislation that was considered the most extensive and complicated legislation the Internal Revenue Service (IRS) faced since the Tax Reform Act of 1986. For example, the Taxpayer Relief Act of 1997[1] contained nearly 300 new provisions. Close to half of these provisions were effective for Tax Year 1998. The IRS also embraced strategies, such as those suggested by Vice President Gore in the task force report entitled, *Reinventing Service at the IRS*, to improve the treatment of taxpayers and customer service availability and accuracy.

We initiated an audit strategy to evaluate the IRS' efforts to ensure that taxpayers would have the information necessary to properly file tax returns and to ensure the IRS would be able to properly process those returns. This audit focused on the IRS' efforts to implement key legislative changes affecting the processing of tax returns for the 1999 filing season, including ensuring that taxpayers had information necessary to properly file returns, and that the IRS would be able to properly process returns. The IRS refers to the first half of any calendar year, when most individual taxpayers file tax returns and the IRS processes those returns, as "the filing season."

Results

Plans to implement legislative changes for the 1999 filing season included hundreds of actions, including: revising existing forms and instructions; developing new forms and instructions; changing computer processing programs; training IRS employees; revising Internal Revenue Manuals; revising or preparing new publications; and issuing revenue procedures and regulations. Submission Processing reported preparing 191 Requests for Information Services (RIS) to request computer programming changes for the 1999 filing season, 80 of which were to implement legislative requirements.

The IRS' process of developing tax forms, instructions, and computer programs to implement new tax legislation was effective, but could be improved to provide IRS management greater assurance that significant actions are taken timely and effectively. In addition, the IRS can increase customer service and decrease taxpayer burden while implementing new tax provisions.

Most of the findings presented in this report were reported to IRS management through Audit memoranda as they were identified. In most instances, the responsible IRS

[1] Taxpayer Relief Act of 1997, 26 U.S.C. § 24

managers initiated immediate corrective action on the findings presented in our memoranda. As a result:

- Over 1.1 million taxpayers avoided delays in the processing of their tax returns.
- Computer generated estimated tax penalties of $237 million were assessed for taxpayers whose estimated tax base minus withholding was $1,000 or more.
- The government avoided losing at least $1.8 million of revenue as taxpayers deducted more student loan interest than was allowable by law.
- Over 1.1 million taxpayers will receive annual reminder notices for the amount of their conversion from a traditional Individual Retirement Account (IRA) to a Roth IRA. Taxpayers need to include the conversion amount in subsequent year tax returns.

The Internal Revenue Service Should Increase Emphasis on Significant Legislative Provisions to Ensure That Actions Necessary to Implement These Provisions Are Taken

The IRS prepared RISs documenting necessary computer programming changes for most of the legislative provisions requiring such programming changes. However, necessary RISs for four significant legislative provisions had not been prepared. These included programming changes to implement provisions for the Roth Individual Retirement Accounts (IRA), the increased Adjusted Gross Income limits on IRAs, the Alternative Minimum Tax for Children, and Farmers Income Averaging. Failure to implement any of these four tax provisions properly could result in improper processing of tax returns.

The Internal Revenue Service Should Ensure That Requests for Information Services Needed to Implement Legislation Are Accurately Completed

There were 11 legislative provisions which we considered to be significant based on the number of taxpayers affected, the anticipated revenue effect, and other complexities. RISs prepared by Submission Processing to implement six of these legislative provisions, and one additional RIS related to another legislative provision, contained inaccurate programming instructions and/or were missing some programming instructions.

The IRS had no documentation indicating that RISs went through a review process to ensure that each aspect of a legislative provision was completely and accurately addressed in the RIS.

The Internal Revenue Service Can Increase Customer Service and Decrease Taxpayer Burden While Implementing New Tax Provisions

The IRS had a number of opportunities to assist taxpayers when implementing the 1997 legislation. The IRS could have notified certain affected taxpayers of the Child Tax Credit early in 1998 and reminded them of their option to start recognizing its benefits by adjusting their withholding allowances. Also, the IRS could have planned to send reminder notices to taxpayers who converted traditional IRAs to Roth IRAs and elected to spread the taxable income over four years. There were also instances where the IRS could have used additional colors of print and shading on tax returns to highlight important tax changes. However, the IRS did not take full advantage of these opportunities.

Summary of Recommendations

To ensure that increased emphasis is placed on significant legislative changes, the implementation process should contain procedures to ensure that IRS executives are made aware of critical actions that are overdue. This important control element could be accomplished by having the Chief Operations Officer assign each key legislative provision to an IRS executive. Also, a quality review should be performed on RISs developed to implement tax legislation.

The IRS could improve its customer service by notifying taxpayers who may qualify for the Child Tax Credit, but did not claim it, of their eligibility. The IRS should also consider the judicious use of colored text and shading on tax forms to emphasize significant items or changes.

<u>Management's Response</u>: IRS management agreed that increased emphasis should be placed on highly significant legislative provisions. As part of its charter to transition the IRS' National Office into the modernized structure, the Communications and Liaison Modernization Team developed a process for implementing new legislation in the new structure. The team leader was very familiar with the implementation process used for the IRS Restructuring and Reform Act of 1998[2] and took this process into account in developing a new process.

IRS' Submission Processing function will issue new procedures and initiate a review process to ensure that all aspects of legislative provisions are fully and accurately designed and implemented.

IRS management did not implement our recommendation to notify taxpayers who appeared to be eligible for the Child Tax Credit on their 1998 income tax return but did not claim it. They expressed concern that taxpayers receiving such a notice would lower their withholding in response to the notice but find when they completed their subsequent

[2] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685

tax returns that they were not eligible for the credit. Instead, they plan to continue to communicate with taxpayers regarding this credit through outreach programs. IRS management also did not implement our recommendation to judiciously use red text to emphasize significant items or changes on tax forms and instructions. They cited negative publicity associated with the IRS' use of additional colors to enhance artwork on the 1995 tax package. However, the IRS will reevaluate the effective use of a second color and will explore more effective use of shading, tints, and other graphic treatments.

Office of Audit Comment: Based on an analysis of the IRS' Individual Masterfile,[3] we estimate there could be as many as 1.7 million taxpayers who qualified for the Child Tax Credit in Tax Year 1998 but did not claim or receive the credit. In our opinion, the IRS should notify these taxpayers that they may be eligible for the credit and advise them of the steps they need to take to amend their 1998 tax returns if necessary.

In our opinion, the judicious use of red text for a sound business purpose would not be perceived as wasteful and warrants testing.

[3] IRS' Individual Masterfile is the IRS database that maintains transactions or records of individual tax accounts.

Objective and Scope

We evaluated the IRS' efforts to implement tax legislative changes.

The overall objective of this audit was to evaluate the Internal Revenue Service's (IRS) efforts to implement key legislative changes affecting the processing of tax returns for the 1999 filing season, including ensuring that taxpayers had information necessary to properly file returns, and that the IRS would be able to properly process returns. The IRS refers to the first half of any calendar year, when most individual taxpayers file tax returns and the IRS processes those returns, as "the filing season."

This audit was conducted prior to the 1999 filing season, from February through December 1998. Audit work was performed at the Ogden Service Center in accordance with *Government Auditing Standards*. The information reviewed was obtained directly from the IRS' National Office.

We also performed an audit during the 1999 filing season. That audit will determine if the actions taken by the IRS to implement the legislation enabled it to accurately and efficiently process tax returns and enabled taxpayers to properly comply with the new legislative provisions.

To accomplish our objective for this audit, we:

- Analyzed tax legislation to identify legislative provisions affecting returns processing for Tax Year 1998.
- Identified 11 legislative provisions affecting individual income tax returns processing, which we considered to be significant based on the number of taxpayers affected, the anticipated revenue effect, and other complexities. Appendix VII contains a list of these provisions.
- Determined if Requests for Information Services (RIS) outlining necessary programming changes were prepared for each of the 11 legislative

provisions and reviewed available documentation regarding the provisions to determine if the RISs fully and accurately addressed all aspects of the provisions.

- Determined whether new forms and instructions, or changes to existing forms and instructions, were planned, as appropriate, for each of the legislative provisions and reviewed available documentation regarding the provisions to determine if tax forms and instructions were accurately prepared and used clear language.

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

Background

For the 1999 filing season, the IRS faced the challenge of implementing complex new legislation, as well as dealing with the Year 2000 Initiative and mainframe computer consolidation.

Three laws were enacted in 1997 that were considered the most extensive and complicated legislation the IRS faced since the Tax Reform Act of 1986. The new legislation included the Taxpayer Relief Act of 1997,[1] the Balanced Budget Act,[2] and the Taxpayer Browsing Act.[3] The Taxpayer Relief Act of 1997 contained nearly 300 new provisions. Close to half of these provisions were effective for Tax Year 1998 and were considered the most complex.

The IRS also embraced strategies to improve the treatment of taxpayers.

The IRS also embraced strategies, such as those suggested by Vice President Gore's task force report entitled, *Reinventing Service at the IRS*, to improve the treatment of taxpayers and increase customer service availability and accuracy. The Vice President's report suggested goals to issue simplified, clear, and concise notices, forms, and instructions and to improve compliance through prevention efforts rather than

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[1] Taxpayer Relief Act of 1997, 26 U.S.C. § 24

[2] Balanced Budget Act of 1997, Pub. L. No. 105-33,111 Stat. 251

[3] Taxpayer Browsing Protection Act of 1997, I.R.C. § 7213A

enforcement efforts. Since our review began, the Congress passed the IRS Restructuring and Reform Act of 1998 (RRA 98),[4] codifying some of the recommendations made in the Vice President's report.

Besides the legislation passed in 1997 and 1998 and the commitments to expanded customer service, the IRS also faced other significant factors affecting the 1999 filing season. These included the Year 2000 computer compliance initiatives and the consolidation of the IRS mainframe computers. Because of this, IRS executives expressed concern that the IRS may have trouble managing all of the changes required for the 1999 filing season.

To address these concerns, the IRS established the 1999 Filing Season Readiness Executive Steering Committee and the Year 2000/99 Filing Season Executive Steering Committee.

The 1999 Filing Season Readiness Executive Steering Committee met regularly, beginning February 1998, to discuss readiness issues and resolve problems that arose. The committee was composed of approximately 20 IRS executives from each of the functions impacted by filing season activities. The Committee met at the end of 1997 and developed an action plan that listed items that needed to be completed to ensure the success of the 1999 filing season. Their plan included action items to implement recommendations made by the Vice President's task force report, and it also included references to some of the legislative provisions. At each meeting, the Committee discussed the status of the action items and worked together to resolve on-going problems.

The Commissioner established the Year 2000/99 Filing Season Executive Steering Committee in November 1997. This Committee was comprised of the Commissioner and 11 senior executives from the IRS,

[4] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685

Treasury Departmental Offices, and the National Treasury Employees' Union. Their mission was to identify risks to the successful completion of the entire IRS Year 2000 and 1999 filing season program, take required actions to reduce risks and eliminate barriers to success, and provide unified communications and direction.

Results

The process of developing tax forms, instructions, and computer programs to implement new tax legislation was effective. However, the IRS should:

- Increase its emphasis on significant legislative provisions to ensure that actions necessary to implement these provisions are taken.
- Ensure that RISs needed to implement legislation are accurately completed.
- Identify opportunities to increase customer service and decrease taxpayer burden while implementing new tax provisions.

Most of the findings presented in this report were reported to IRS management through Audit memoranda as they were identified. In most instances, the responsible IRS managers initiated immediate corrective action on the findings presented in our memoranda. As a result:

- Over 1.1 million taxpayers avoided delays in the processing of their tax returns.
- Computer-generated estimated tax penalties of $237 million were assessed for taxpayers whose estimated tax base minus withholding was $1,000 or more.
- The government avoided losing at least $1.8 million of revenue as taxpayers deducted more student loan interest than was allowable by law.
- Over 1.1 million taxpayers will receive annual reminder notices for the amount of their conversion

from a traditional Individual Retirement Account (IRA) to a Roth IRA that is includable in their subsequent year tax returns.

The Internal Revenue Service Should Increase Emphasis on Significant Legislative Provisions to Ensure That Actions Necessary to Implement These Provisions Are Taken

The IRS' primary controls to ensure necessary actions are taken to implement new legislation are the implementation plans developed by Legislative Affairs.

Legislative Affairs coordinates the IRS-wide implementation of tax law changes using implementation plans. These plans are the IRS' primary control to ensure that necessary actions are taken to implement new legislation. They include the identification of responsible functions, actions to be completed, and target completion dates. The IRS' plans to implement legislative changes for the 1999 filing season contained hundreds of actions, including: revising existing forms and instructions; developing new forms and instructions; changing computer processing programs; training IRS employees; revising Internal Revenue Manuals; revising or preparing new publications; and issuing revenue procedures and regulations. Submission Processing reported preparing 191 RISs for the 1999 filing season, 80 of which were to implement legislative requirements.

RISs had been prepared for most of the applicable legislative provisions included in our review. However, necessary RISs for four important legislative provisions had not been prepared. These included programming changes to implement the provisions for the Roth IRA, the increased Adjusted Gross Income limits on IRAs, and the Alternative Minimum Tax for Children (also known as the Kiddie Tax). Additionally, the RIS necessary to implement an electronic version of Farmers Income Averaging (Schedule J) was overlooked by both the plan developers and the responsible IRS function.

Three of the four missed RISs were for highly significant tax provisions, based on the number of taxpayers affected, the revenue impact, and the sensitivity and complexity of the issue. Failure to properly implement any of the four tax provisions could have prevented taxpayers' returns from being properly processed or otherwise negatively affected taxpayers. Details regarding the missing RISs are contained in Appendix V.

Legislative Affairs' implementation plans may not meet all of their intended purposes.

We were informed that Legislative Affairs is generally responsible for monitoring all actions contained in implementation plans and for identifying and following up on all overdue actions. However, Legislative Affairs' plans did not reflect the three RISs included in the plans as overdue or cancelled even though their due dates had passed. Further, although these RISs were not prepared until after we brought them to the attention of the Assistant Commissioner (Forms and Submission Processing), monitoring reports for each of the RISs reflected them as being prepared ahead of schedule or approximately on schedule.

For the RRA 98, the IRS developed a new process for monitoring the implementation of the legislative provisions.

The RRA 98 was controlled differently. For this Act, the IRS developed a list of the most significant provisions. The status of the implementation of the most significant provisions, as well as any other provisions that were significantly behind schedule, was discussed at the IRS' Executive Steering Committee meeting. IRS executives were assigned ownership of provisions and were responsible for their complete implementation. The IRS' implementation plan was automated and updated regularly by responsible functions. However, we were informed by the Chief, Legislative Analysis Branch, that this process would be in effect for the RRA 98 only and would not be used for more routine tax legislation.

Recommendation

1. The Chief Operations Officer should develop a process which ensures that actions necessary to implement a legislative act are completed timely. The process should ensure that IRS executives are timely made aware of critical actions that are overdue for implementing tax legislation.

Increased emphasis should be placed on highly significant legislative provisions. For each act, the Chief Operations Officer should identify the key provisions, assign each of those key provisions to an IRS executive, and ensure that overdue actions are reported to affected executives and/or to a steering committee. The process the IRS used to implement the RRA 98 could serve as a model for this process.

Management's Response: IRS management agreed that increased emphasis should be placed on highly significant legislative provisions. As part of its charter to transition the IRS' National Office into the modernized structure, the Communications and Liaison Modernization Team developed a process for implementing new legislation in the new structure. The team leader was very familiar with the implementation process used for RRA 98 and took this process into account in developing a new process. The new process uses techniques and technology developed by Taxpayer Treatment and Service Improvements and requires a database specialist.

The Internal Revenue Service Should Ensure That Requests for Information Services Needed to Implement Legislation Are Accurately Completed

We identified 11 legislative provisions which we considered to be highly significant based on the number of taxpayers affected, the anticipated revenue effect, and other complexities or issues that could result in negative publicity for the IRS if not handled properly. We reviewed available documentation to determine whether RISs prepared for each of these provisions accurately reflected the legislative provision.

Submission Processing was reportedly responsible for preparing 191 RISs to facilitate implementation of legislation, as well as other routine processing changes for the 1999 filing season.

RISs prepared to implement seven legislative provisions contained inaccurate and/or incomplete programming instructions.

RISs prepared by Submission Processing to implement six highly significant legislative provisions, and one additional RIS related to another legislative provision, contained inaccurate programming instructions and/or were missing some programming instructions. These RISs were for the following legislative provisions:

- De Minimus Threshold for Underpayment of Estimated Tax
- Estimated Tax Safe Harbor
- Education Loan Interest Deductions
- Earned Income Tax Credit (EITC) Changes to Calculations of Modified Adjusted Gross Income and Earned Income
- EITC Recertification
- IRA Phaseout Range for Married Taxpayers Filing Jointly
- Dependents Standard Deduction

We brought each of these issues to IRS management's attention during the audit and they committed to take appropriate corrective action.

During the clearance process, RISs are circulated to allow other areas to comment or suggest changes.

The IRS needs to improve the process used to ensure the quality of RISs. The process used to provide oversight for prepared RISs is the clearance process. During this process, RISs are circulated to allow other areas to comment or suggest changes. All of the inaccurate RISs we identified had been signed off, but no one had identified the errors. There was no documentation indicating that these RISs went through any review process where they were compared with legislation to ensure that each aspect of a legislative provision was completely and accurately addressed in the RIS.

Many of the legislative provisions for which proper programming was not requested were highly publicized or sensitive issues. Failure to implement them properly could have resulted in improper processing of tax returns.

Recommendation

2. The Assistant Commissioner (Forms and Submission Processing) should ensure that a quality review is performed for RISs developed to implement tax legislation. Reviewers should compare the RISs, amendments, and Information Systems' responses to the RISs with the legislative provisions to ensure that each provision is completely and accurately addressed.

Management's Response: The Assistant Commissioner (Forms and Submission Processing) will issue new procedures and initiate a review process to ensure that all aspects of legislative provisions are fully and accurately designed and implemented.

The Internal Revenue Service Can Increase Customer Service and Decrease Taxpayer Burden While Implementing New Tax Provisions

The IRS could have notified potentially qualified taxpayers of the Child Tax Credit early in 1998

The IRS could have notified taxpayers of the credit and the option to adjust their withholding.

The IRS had the opportunity to provide a significant service to taxpayers and to proactively address the desires of lawmakers by providing information to specific taxpayers expected to receive significant benefits from the Child Tax Credit provision of the Taxpayer Relief Act of 1997. This provision allowed eligible taxpayers a credit of $400 per qualifying child in Tax Year 1998.

The version of the Act passed by the United States (U.S.) House of Representatives provided that the Secretary of the Treasury submit a notice to all taxpayers of the passage of the Child Tax Credit. In addition, it directed the Secretary to modify the withholding tables for certain taxpayers (single taxpayers claiming more than one exemption and married taxpayers claiming more than two exemptions).

(Neither of these requirements was included in the final Act. However, their passage in the House version indicates that lawmakers wanted the IRS to make sure taxpayers were aware of the credit.) The IRS included the new Child Tax Credit in the worksheet for the 1998 Employee's Withholding Certificate (Form W-4) and in Is My Withholding Correct for 1998? (Publication 919). During our fieldwork, the National Director, Communications Division, was working with a contractor to develop a communication strategy to inform individual taxpayers of the Child Tax Credit and other pertinent provisions in the Act.

To determine the feasibility of mailing information to taxpayers who were significantly affected by the Act, we obtained a computer extract of those taxpayers filing refund returns in 1996, claiming three or more children with birthdays after 1981, and falling within the adjusted gross income criteria necessary to qualify for the Child Tax Credit. Based on our computer analysis, a postcard-type notice could have been sent to approximately 1.6 million taxpayers at an estimated cost of $425,000. Our computer listing contained the taxpayers' names and addresses that could have been used by the IRS to send this notice.

Notices could have been sent to approximately 1.6 million taxpayers for an estimated cost of $425,000.

The National Director, Communications Division, advised us that a mail-out (while not the least expensive option) would be the most effective method of reaching taxpayers. Besides encouraging taxpayers to adjust their withholding, it could also serve as a reminder to taxpayers to take the credit when they file their tax returns.

The IRS decided not to take the action. We raised this issue with the IRS in a memorandum dated April 21, 1998. To allow taxpayers the greatest opportunity to immediately begin recognizing the benefits of the Child Tax Credit, the IRS would have needed to expedite its actions. Therefore, we offered to provide our computer list for its use in providing notices to taxpayers. However, the National Director, Customer Service Telephone Operations and Systems Division, verbally expressed concern with taxpayers changing their withholding because their financial situations could have changed since 1996 (the year used to develop our list).

In August 1998, the National Director, Customer Service Telephone Operations and Systems Division, issued a response to our memorandum stating that notices would not be sent. The response stated that for taxpayers to have received the maximum benefit of this new legislation, it would have been necessary for them to have been notified to adjust their withholding earlier in the year. The response also voiced concerns regarding the criteria for identifying those taxpayers who would be notified of the credit and stated that efforts to effectively communicate with all taxpayers regarding the new credit should be through outreach programs.

Recommendation

The IRS should develop a computer routine to identify taxpayers who may have qualified for the credit but did not claim it.

3. Since a notice was not issued, and in order to meet lawmakers' desires, the Assistant Commissioner (Customer Service) should request a computer routine to identify taxpayers who may qualify for the Child Tax Credit but did not claim it on their 1998 income tax return. These taxpayers should be sent an informational notice similar to the notice which has been used to inform taxpayers that they may qualify for the EITC.

Management's Response: IRS Management expressed continued concern that taxpayers receiving such a notice would lower their withholding in response to the notice but find when they completed their subsequent tax returns that they were not eligible for the credit. The IRS will continue to communicate with taxpayers regarding this credit through outreach programs.

Office of Audit Comment: Based on an analysis of the IRS' Individual Masterfile[5] near the end of the 1999 filing season, we estimate there could be as many as 1.7 million taxpayers who qualified for the Child Tax Credit in Tax Year 1998 but did not claim or receive the credit. In our opinion, the IRS should notify these taxpayers that they may be eligible for the credit and advise them of the steps they need to take to amend their 1998 tax returns if necessary. Concerns regarding whether these taxpayers will subsequently reduce their withholding should not deter the IRS from performing this customer service.

The IRS had not planned to send reminder notices to taxpayers who converted traditional IRAs to Roth IRAs

The IRS did not have plans for gathering the information needed for implementation of the new Roth IRA provisions or to send reminder notices to taxpayers who elected to spread their taxable gains from the conversions of traditional IRAs to Roth IRAs. The new Roth IRA provision allowed taxpayers to roll amounts from traditional IRAs into Roth IRAs and elect to spread the resulting income over four years. Actions necessary to capture essential information and send reminder notices were on the implementation plan but were not pursued.

We recommended that the IRS send reminder notices to taxpayers who defer income taxes when converting to Roth IRAs.

In a May 1998 memorandum to the Chief, Taxpayer Service, and the Acting Chief Compliance Officer, we recommended that the IRS send reminder notices to taxpayers who defer income from such roll-overs to the subsequent three years' taxes. This would comply with the goals of the IRS to provide better service to taxpayers, to provide important tax information to taxpayers when and where they need it, and to prevent tax violations before they occur.

[5] IRS' Individual Masterfile is the IRS database that maintains transactions or records of individual tax accounts.

In response to our memorandum, the Chief Operations Officer took corrective action to address this issue. A RIS was submitted to request transcription of the information necessary to support this taxpayer service and compliance effort. The National Director, Education, Walk-in, Correspondence Improvement, has developed another RIS to facilitate mailing the notices and planned to have the RIS implemented by October 4, 1999.

<u>The IRS could have used additional colors on the tax forms and instructions to highlight important changes</u>

In our opinion, the IRS should have used colored text or shading on tax forms and instructions to highlight significant issues that directly affect taxpayers or the processing of their tax returns. For example, highlighting the new Child Tax Credit lines with red text would bring this credit to taxpayers' attention and help them identify where to claim the credit. Taking this action could have reduced taxpayer burden and processing costs by eliminating many taxpayer errors.

Industry literature suggests using color to emphasize information.

Industry literature suggests using color to emphasize information in a document. It suggests that red be used for warnings and critical items. The IRS currently uses two colors of ink for each of the Individual Income Tax Return (Form 1040) series of returns packages (1040 – blue/black, 1040A – red/black, 1040EZ – green/black, Telefile – purple/black).

The National Director, Multimedia Production, stated that tax packages are generally produced on presses that have the capability to print four colors. The cost of using a third or fourth color is negligible. However, the IRS has not used more than two colors in tax packages since the 1995 packages.

The IRS should have considered red printing to highlight changes to tax forms and instructions.

In an Audit Memorandum dated July 29, 1998, we recommended that consideration be given to using red printing to highlight at least the following three changes to return filing procedures:

- Removing Social Security Numbers (SSN) from pre-printed labels included in tax packages and the need for taxpayers to provide their SSNs on the form.
- Having taxpayers enclose checks with their returns without stapling them to the returns.
- Having taxpayers make checks payable to the U.S. Treasury (rather than the IRS).

In response to our memorandum, the National Director, Tax Forms and Publications, inserted the following text on the same page as the taxpayers' label in the package: "**Important**: Your **SSN(s)** is not on this label. You **must** enter your SSN (and, if married, your spouse's) in the space provided on your return." In addition, this information is the lead message on the covers and the "What's New" page of the tax package.

The IRS has shied away from additional colors because of previous criticism.

The Assistant Commissioner (Forms and Submission Processing) disagreed with our recommendation to test the limited use of colored text and highlighting. He cited the negative publicity received when the IRS used multiple colors on the cover of the 1995 tax packages.

Beginning with the 1995 tax packages, and in every tax package since, the IRS has used one other color in addition to black throughout the tax package to highlight some information. The same color has also been used throughout the tax package for aesthetic purposes, which lessens its effectiveness in drawing taxpayers' attention to specific issues. In addition, the color is only used for backshading on the tax form and is not used to highlight significant items or changes to the form.

Two additional colors were used on the 1995 tax packages but only to enhance the artwork on the cover of the package, not to highlight significant items or changes on the tax forms or in the tax packages.

Recommendations

4. The Assistant Commissioner (Forms and Submission Processing) should solicit input from

customers (Tax Forms and Publications, Submission Processing, Customer Service, etc.) and should review tax legislation to identify significant items or changes on tax forms and instructions which warrant highlighting with an additional color.

5. The Assistant Commissioner (Forms and Submission Processing) should use red ink on tax forms and tax package instructions (a different color should be used for Form 1040A) to emphasize significant items or changes which taxpayers should be aware of. The colored text should be used judiciously to increase its effectiveness and to avoid the perception of waste.

Management's Response: The Assistant Commissioner (Forms and Submission Processing) did not implement our recommendation to judiciously use red ink. He stated that in 1995, the IRS requested and received permission from the Government Printing Office to use more than two colors of ink on its tax packages. The resulting negative publicity revealed a strong preference for unelaborate, direct tax products and reinforced the conservative use of color.

The IRS continually searches for effective methods of highlighting material in tax forms and publications. This year, for instance, a contract with an outside consultant that focused primarily on materials for the EITC has generated design elements and concepts that have been incorporated throughout other pages of the tax packages. As an example, a new "caution" icon has been developed and used to highlight troublesome items.

The IRS currently uses a color other than black to backshade important information. The IRS will reevaluate the effective use of the second color and will explore more effective use of shading, tints, and other graphic treatments that might be used in lieu of a third color to highlight important changes.

Office of Audit Comment: In our opinion, the judicious use of red text for a sound business purpose would not be perceived as wasteful and warrants testing.

Conclusion

The IRS' process of developing tax forms, instructions, and computer programs to implement new tax legislation is effective but could be improved to provide management greater assurance that significant actions are taken timely and effectively. In addition, the IRS can increase customer service or decrease taxpayer burden while implementing new tax provisions.

Taking the actions recommended in this report will decrease taxpayer burden and decrease costs to the IRS.

Taking the actions recommended in this report will:

- Decrease taxpayer burden by avoiding delays in refunds and preventing unnecessary notices caused by incomplete or inaccurate computer programs and by making taxpayers aware of significant tax provisions that directly affect them.
- Decrease costs by reducing taxpayer errors requiring research or correspondence to correct.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to evaluate the Internal Revenue Service's (IRS) efforts to implement key legislative changes affecting the processing of tax returns for the 1999 filing season, including ensuring that taxpayers had information necessary to properly file returns, and that the IRS would be able to properly process returns. Our review emphasized key legislative provisions affecting individual income tax returns processing. Our review included evaluating the IRS' scheduled plans for implementation of the tax-related legislative changes and determining if all necessary forms, instructions, and Requests for Information Services (RIS) outlining programming changes were prepared. For key legislative provisions identified in Appendix VII, we determined if the RISs fully and accurately addressed all aspects of the tax law provision and if tax forms and instructions were accurately prepared and used clear language.

I. We reviewed legislation created by the Taxpayer Relief Act of 1997[1] and the IRS Restructuring and Reform Act of 1998.[2]

   A. Identified all new provisions of these Acts that took effect during the 1998 tax year and, therefore, affected the 1999 filing season.

   B. Considered each new provision and identified the key provisions based on the dollar and taxpayer impacts as well as the sensitivity and complexity of the issue.

   C. Monitored technical corrections and other legislative actions that might affect returns and instructions relevant to the 1999 filing season.

II. We secured copies of the plans prepared by Legislative Affairs for implementation of the legislation.

   A. Analyzed the provisions and determined if the plans considered all steps necessary for the IRS to fully implement the provisions.

      1. Assessed whether the new provisions would require development of new or revised forms, schedules, instructions, or publications.

      2. Analyzed each provision and determined whether a RIS should be developed.

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[1] Taxpayer Relief Act of 1997, 26 U.S.C. § 24

[2] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685

B. Ensured that all the necessary steps were included in the implementation plans with respect to RISs, forms, and instructions.

C. Determined how the implementation plans were used to monitor the IRS' implementation of the legislative provisions.

III. We secured copies of draft forms, schedules, and instructions related to the key legislative provisions.

A. Determined whether the forms and schedules complied with legal provisions of the new laws.

B. Determined whether the forms and schedules would provide necessary information for up-front or down-stream compliance efforts.

C. Determined whether the forms and instructions were clearly written and easily understood.

IV. We secured copies of all RISs, RIS amendments, and RIS responses related to the key legislative provisions.

A. Determined whether all RISs needed to implement the key provisions were planned and prepared.

B. Determined whether the RISs complied with legal provisions of the new laws.

C. Evaluated the effectiveness of the control used to ensure that RISs contain adequate and accurate information necessary to properly prepare required programs.

V. We determined whether the IRS had made plans to implement significant recommendations from Vice President Gore's task force report, *Reinventing Service at the IRS.*

A. Analyzed the task force report to identify significant issues impacting the 1999 filing season.

B. Compared issues identified above to the 1999 Filing Season Readiness Executive Steering Committee Action Plan and the Service Improvement Action Items.

C. Determined whether the 1999 filing season issues required a RIS and, if so, whether the RISs were included in the Action Plan.

Appendix II

Major Contributors to This Report

Walter E. Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs)
Maurice Moody, Associate Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)
Mary Baker, Deputy Director
Kyle Andersen, Audit Manager
L. Jeff Anderson, Auditor
Kyle Bambrough, Auditor
George Burleigh, Auditor
Annette Hodson, Auditor
John Phillips, Auditor
Bill Russell, Auditor
Greg Schmidt, Auditor
Eric Guthrie, Computer Specialist
Don Meyer, Computer Specialist
Kevin O'Gallagher, Computer Specialist

Appendix III

Report Distribution List

Chief Operations Officer OP
Assistant Commissioner (Customer Service) OP:C
Assistant Commissioner (Electronic Tax Administration) OP:ETA
Assistant Commissioner (Forms and Submission Processing) OP:FS
National Director, Customer Service Compliance, Accounts & Quality OP:C:A
National Director, Customer Service Telephone Operations & Systems OP:C:T
National Director, Electronic Program Operations OP:ETA:E
National Director, Multimedia Production OP:FS:M
National Director, Submission Processing OP:FS:S
National Director, Tax Forms and Publications OP:FS:FP
National Director for Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis M:OP
Office of Management Controls M:CFO:A:M
Office of the Chief Counsel CC
Audit Liaisons:

- Chief Operations Officer OP
- Assistant Commissioner (Customer Service) OP:C
- Assistant Commissioner (Electronic Tax Administration) OP:ETA
- Assistant Commissioner (Forms and Submission Processing) OP:FS

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 the Congress.

Finding and recommendation:

Necessary Requests for Information Services (RIS) for four important legislative provisions had not been prepared. These included requests for programming to implement the provisions for the Roth Individual Retirement Accounts (IRA), the increased Adjusted Gross Income limits on IRAs, the Alternative Minimum Tax for Children (also known as the Kiddie Tax), and an electronic version of Farmers Income Averaging (Schedule J).

The Office of Audit issued memoranda recommending the necessary programming be accomplished for these four provisions. In addition, this report recommends that increased emphasis be placed on significant legislative changes. To accomplish this, the implementation process should contain procedures to ensure that Internal Revenue Service (IRS) executives are made aware of critical actions that become overdue. This important control element could be accomplished by having the Chief Operations Officer assign each key legislative provision to an IRS executive. If the IRS had increased emphasis on significant legislative changes and ensured that executives were made aware of critical actions that became overdue, as we are recommending, they could have identified the missing RISs for the four legislative provisions discussed in this report. After being informed of the missing RISs, the IRS did prepare most of them. (See pages 5 – 7.)

Type of Outcome Measure:

Reduced taxpayer burden

Value of the Benefit:

Taxpayer burden will be reduced for the following numbers of taxpayers. Some will receive reminders, such as the Roth conversion notices, and others will avoid delays in processing refunds by avoiding the IRS error correction routines that slow processing.

- Over 1.1 million taxpayers will receive annual reminder notices for the amount of their conversion from the traditional IRA to a Roth IRAs that is includable in their subsequent year returns.

- As many as 38,591 single taxpayers less than 14 years old filing 1998 tax returns with an Alternative Minimum Tax (Form 6251) attached and an adjusted gross income which exceeds earned income by more than $1,400 will avoid processing delays. We cannot determine the exact number because some of the taxpayers who filed Form 6251 had no tax liability and because information on Form 6251 necessary to determine what portion of the $5,000 exemption was used was not available on our data source. Returns would have been routed to Error Resolution, causing delays in processing the returns, possible requests for additional information, and possible unnecessary notices.
- Because so few taxpayers claiming IRA deductions and participating in an employer-sponsored retirement plan could be computer-identified by the IRS, we determined the measurable benefit achieved by programming the increased adjusted gross income limits on IRAs was very limited. We found that few farmers who had previously filed electronically had sufficient income to take advantage of the Schedule J provisions and that measurable benefits for this outcome were also limited.

<u>Methodology Used to Measure the Reported Benefit</u>:

- We performed a computer analysis of the IRS' Individual Masterfile[1] to identify all 1998 individual income tax returns, as of July 3, 1999, reporting a conversion to a Roth IRA on Nondeductible IRAs (Form 8606) and leaving the check box on line 17 blank (averaging the taxable income over four years).
- The Alternative Minimum Tax exemption amount for children under age 14 was increased from $1,400 to $5,000. We performed a computer analysis of the IRS' Individual Masterfile to identify all 1998 individual income tax returns, as of July 3, 1999, filed by dependent children under age 14 which included Forms 6251 and had adjusted gross income which exceeded earned income by more than $1,400.

<u>Finding and recommendation</u>:

There were 11 legislative provisions we considered significant based on the number of taxpayers affected, the anticipated revenue effect, and other complexities. RISs prepared by Submission Processing to implement six of these legislative provisions, and one additional RIS related to another legislative provision, contained inaccurate programming instructions and/or were missing some programming instructions. The legislative provisions with inaccurate and/or missing programming instructions included:

- De Minimus Threshold for Underpayment of Estimated Tax

[1] IRS' Individual Masterfile is the IRS database that maintains transactions or records of individual tax accounts.

- Estimated Tax Safe Harbor
- Education Loan Interest Deductions
- Earned Income Tax Credit (EITC) Changes to Calculations of Modified Adjusted Gross Income and Earned Income
- EITC Recertification
- IRA Phaseout Range for Married Taxpayers Filing Jointly
- Dependents Standard Deduction

The Office of Audit issued memoranda recommending the programming instructions be corrected for these legislative provisions. In addition, this report recommends that the IRS perform a quality review on RISs developed to implement tax legislation. If the IRS had performed a quality review of the RISs developed to implement tax legislation, they could have identified the inaccurate and/or missing programming instructions. After being informed of the problems with the RISs, the IRS corrected the programming instructions or developed manual workaround procedures. (See pages 7 – 9.)

<u>Type of Outcome Measure</u>:

Increased revenue, revenue protection, and reduced taxpayer burden

<u>Value of the Benefit</u>:

We determined the following outcomes:

- Computer-generated estimated tax penalties of $237 million were assessed for taxpayers whose estimated tax base minus withholding was $1,000 or more.
- The amount (over $1,000) of student loan interest deductions claimed by taxpayers having more than one exemption was over $12 million. At 15 percent, the lowest tax rate, this would equate to $1.8 million in reduced tax revenue.
- Approximately 29,000 single taxpayers claimed student loan interest deductions of $100 or more with modified adjusted gross income of between $50,000 and $55,000. These returns would have been routed to the Error Resolution function had the IRS not corrected the RIS. This could have resulted in delayed or inaccurate refunds and improper notices.
- There were 16,771 taxpayers who filed for the EITC and had an amount shown as tax-exempt interest on their return. Our sample review of 50 of these cases, although not statistically valid, found that 34 percent of these returns would have been routed to the Error Resolution function had the IRS not corrected the RIS. This projects to 5,072 returns that could have been delayed or had inaccurate refunds or improper notices.
- Over 1.1 million taxpayers who were claimed as dependents on other returns had earned and unearned income amounts that would have resulted in their returns being

routed to the Error Resolution function had the IRS not corrected the RIS. This could have resulted in delayed or inaccurate refunds and improper notices.

Again, because so few taxpayers claiming IRA deductions and participating in an employer-sponsored retirement plan could be computer-identified by the IRS, we determined the measurable benefit achieved by correcting the RIS regarding the IRA phaseout for married taxpayers filing jointly was minimal. We also determined the number of taxpayers affected by the erroneous programming instructions for the estimated tax safe harbor was minimal. The EITC recertification outcomes are being reported as part of a subsequent report of the IRS' 1999 filing season.

<u>Methodology Used to Measure the Reported Benefit</u>:

- The IRS' programming instructions incorrectly stated not to assess the estimated tax penalty when the taxpayer's estimated tax base minus withholding was $1,000 or more. We performed a computer analysis of the IRS' Individual Masterfile to identify all 1998 individual income tax returns, as of October 31, 1999, meeting this criteria that had computer-generated penalties assessed. We excluded amounts where taxpayers determined their own estimated tax penalty because current and prior years' programming instructions state that these amounts are to be accepted. We also performed a statistically valid sample to determine the percentage of these penalties that were subsequently abated and reduced our numbers accordingly.
- The IRS' programming instructions would have incorrectly allowed taxpayers to deduct up to $1,000 of student loan interest per student rather than $1,000 per return. We performed a computer analysis of the IRS' Individual Masterfile to identify all 1998 individual income tax returns, as of July 3, 1999, claiming a student loan interest deduction of more than $1,000 with more than one exemption and calculated the amount over $1,000 of student loan interest deductions claimed by taxpayers on these returns. These amounts would have been allowed had the IRS not taken corrective action to address our issue.
- The IRS' programming instructions incorrectly called for the maximum modified adjusted gross income for single taxpayers claiming a student loan interest deduction to be set at $50,000. The maximum modified adjusted gross income should have been $55,000. We performed a computer analysis of the IRS' Individual Masterfile to identify all 1998 individual income tax returns, as of July 3, 1999, filed by single taxpayers claiming the student loan interest deduction that had modified adjusted gross income between $50,000 and $55,000. These taxpayers would have been denied the deduction if the IRS had not taken corrective action to resolve this issue, and the taxpayers would have had to correspond with the IRS to resolve the issue.
- The IRS' computer programming request overlooked tax-exempt interest when calculating modified adjusted gross income for purposes of determining the EITC. We performed a computer analysis of the IRS' Individual Masterfile to identify, as of

July 3, 1999, all 1998 individual income tax returns reporting tax-exempt interest and a claim for the EITC identified. We reviewed a sample of 50 of these returns to determine whether the amount of earned income these taxpayers reported would result in delayed or inaccurate refunds or improper notices.

- The IRS' computer programming request addressed the new $700 standard deduction for taxpayers who could be claimed as dependents by others but did not address the provision for the standard deduction amount equal to earned income plus $250. We performed a computer analysis of the IRS' Individual Masterfile to identify all 1998 individual income tax returns, as of July 3, 1999, of taxpayers claimed as dependents by others that had more than $450 in earned income and $50 of unearned income but that were still below the normal standard deduction allowance.

<u>Finding and recommendation</u>:

The IRS had a number of opportunities to assist taxpayers when implementing the 1997 legislation. The IRS could have notified certain affected taxpayers of the Child Tax Credit early in 1998 and reminded them of their option to start recognizing its benefits by adjusting their withholding allowance. Also, the IRS could have planned to send reminder notices to taxpayers who converted traditional IRAs to Roth IRAs and elected to spread the taxable income over four years. There were also instances where the IRS could have used additional colors of print and shading on tax forms and instructions to highlight important tax changes. However, the IRS did not take full advantage of these opportunities.

The Office of Audit recommended the IRS improve its customer service by notifying taxpayers who may qualify for the Child Tax Credit (but did not claim it) of their eligibility. We also recommended that the IRS send reminder notices to remind appropriate taxpayers of the need to include their deferred Roth IRA conversion on future tax returns (see missing RISs discussed on page 27). We believe the IRS should also consider the use of colored text and shading on tax forms and instructions to emphasize items or changes. (See pages 9 – 15.)

<u>Type of Outcome Measure</u>:

Reduced taxpayer burden

<u>Value of the Benefit</u>:

- The value of using color on tax forms and instructions cannot be specifically measured. However, this action could reasonably be expected to affect all taxpayers at some point.
- We identified approximately 1.7 million taxpayers filing 1998 individual income tax returns who may have qualified for the Child Tax Credit but did not claim it. Burden

will be reduced on all such taxpayers receiving notification of the credit. The 1.7 million is approximate because the Child Tax Credit amount allowed did not show up on the appropriate line on the IRS database we used until a few weeks into the filing season. And even though we tried to eliminate these cases, some of the early filers we identified might have actually been allowed the credit, thereby overstating our estimate. On the other hand, we were sometimes unable to determine the ages of all the dependents claimed, which understates our total amount.

<u>Methodology Used to Measure the Reported Benefit</u>:

We performed a computer analysis of the IRS' Individual Masterfile, as of October 2, 1999, to determine the number of taxpayers that would be affected by our recommendation to send notices to those who may qualify for the Child Tax Credit but did not claim it. Our criteria included the following:

- No Child Tax or Additional Child Tax Credit claimed and none allowed by the IRS on the 1998 individual income tax return.
- At least one child claimed as an exemption who was under age 17 as of December 31, 1998.
- Adjusted gross income claimed on the return was below the Child Tax Credit or Additional Child Tax Credit phase-out range, taking into consideration the number of qualifying children the taxpayer claimed and the taxpayer's filing status.

We also did the following:

- Eliminated all records where there were only one or two eligible exemptions and the tentative tax per computer was $0.00.
- Eliminated those records with three or more eligible exemptions and with the EITC greater than the Federal Insurance Contribution Act (FICA) amount paid. (We calculated the FICA amount paid using entries for wages, self-employment tax, social security, and medicare tax on tip income not reported to employer.)
- Eliminated those records we identified where the Child Tax Credit had been allowed but did not show on the IRS database we used as our source (RTVUE). These were returns that were processed on or before January 21, 1999 (Julian date 021).

We could not accurately determine the dollar amount of the Child Tax Credit to which all the taxpayers were entitled without reviewing a substantial statistical sample of tax returns.

Appendix V

Requests for Information Services Not Prepared to Implement Legislative Provisions

1. Roth Individual Retirement Accounts (IRA)

Submission Processing's Legislative Action Plan called for Requests for Information Services (RIS) to address this provision. However, we were informed in discussions with Submission Processing, Customer Service, and Compliance that it was determined that no programming was necessary to implement this provision.

The provision allows taxpayers to roll amounts from traditional IRAs into Roth IRAs and spread the resulting taxable income over four years. However, taxpayers can generally make such a rollover only if their adjusted gross income is $100,000 or less.

Programs were necessary to:

- Immediately identify and notify taxpayers who rolled over amounts from their traditional IRAs but did not meet the adjusted gross income requirements.
- Send reminder notices to taxpayers who deferred income from such rollovers to the subsequent three years' taxes.

2. Increased Adjusted Gross Income Limits on IRAs

Submission Processing thought this issue was addressed in RIS TSF-8-0064. However, there was no mention of IRAs in this RIS.

3. Alternative Minimum Tax for Children (also known as the Kiddie Tax)

Submission Processing's original Legislative Action Plan called for a RIS for this provision. However, no RIS had been prepared.

Computer program changes were necessary to address the increased exemption amount for children under age 14. As part of the change, the minimum exemption amount would be increased from $1,400 to $5,000. According to the current Internal Revenue Manual (3.12.3.65.3.7), the computer would almost always calculate $1,400 for the exemption amount, and returns claiming greater than that amount would be manually reviewed in Error Resolution. To ensure all returns are not routed to Error Resolution, the minimum exemption needed to be raised to $5,000.

4. Electronic Farmer's Income Averaging (Schedule J)

Schedule J was created for the reporting of a provision in the Taxpayer Relief Act of 1997[1] that allows taxpayers in the trade or business of farming to elect to compute their current year's tax liability by averaging farm income over a three-year period. This provision was designed to smooth out the economic disparities they may incur from year to year.

The IRS did not include Schedule J among the forms it will accept electronically, even though it does include Profit or Loss From Farming (Schedule F). The Electronic Tax Administration informed us that when they met with Information Systems to decide what programming could be accomplished for the 1999 filing season, the need for an electronic Schedule J had not been identified. When the need for Schedule J was raised by the Office of Audit, it could not be programmed without dropping other programming work that the Electronic Tax Administration considered to be higher priority.

[1] Taxpayer Relief Act of 1997, 26 U.S.C. § 24

Appendix VI

Requests for Information Services Missing Programming Instructions or Containing Inaccurate Programming Instructions

1. De Minimus Threshold for Underpayment of Estimated Tax

This provision increased the de minimus threshold for underpayment of estimated tax from $500 to $1000. Request for Information Services (RIS) TSF-8-0092 provided programming instructions which stated not to assess the estimated tax penalty when the estimated tax base minus withholding was $1,000 or more. The estimated tax penalty should be assessed in this scenario.

2. Estimated Tax Safe Harbor

This provision modified the estimated tax safe harbor percentage for taxpayers with adjusted gross income in the prior year of over $150,000. RIS TSF-8-0092 applied the safe harbor to taxpayers with adjusted gross income in the prior year of $150,000 or more. An Information Systems analyst informed us that he thought proper programming would be accomplished despite the improper information in the RIS. However, his documented analysis of the RIS did not mention the improper information, and his analysis contained additional inaccuracies.

3. Education Loan Interest Deductions

Submission Processing's RIS contained inaccurate programming instructions and was missing some programming instructions.

The RIS provided a modified adjusted gross income limitation of $50,000 for single taxpayers claiming the deduction. The Taxpayer Relief Act of 1997[1] specified a maximum modified adjusted gross income amount allowed for claiming an education loan interest deduction of $55,000 for single taxpayers and $75,000 for married taxpayers.

The RIS allowed taxpayers to claim an interest deduction of $1,000 per dependent. The Act limited the deduction to a maximum of $1,000 per return.

4. Earned Income Tax Credit (EITC) Changes to Calculations of Modified Adjusted Gross Income and Earned Income

This provision clarified that in computing a worker's modified adjusted gross income for purposes of the EITC phaseout, the following nontaxable items are added back to adjusted gross income for tax years beginning after 1997: (1) tax-exempt interest;

[1] Taxpayer Relief Act of 1997, 26 U.S.C. § 24

(2) nontaxable distributions from pensions, annuities, and individual retirement accounts; and (3) 75 percent of net losses from trades or businesses. RIS TSF-8-0186, EITC Modified Adjusted Gross Income Correction for Tax Year 1998, provided programming instruction but omitted the addition of tax-exempt interest in the calculation of modified adjusted gross income.

5. EITC Recertification

This provision made taxpayers ineligible to receive the EITC if they committed prior acts of recklessness or fraud and required taxpayers to "recertify" their eligibility for future years if they had the EITC denied "in a deficiency procedure" (meaning as a result of an Internal Revenue Service [IRS] audit). Taxpayers recertify by submitting an Information to Claim Earned Income Credit After Disallowance (Form 8862) with their tax returns.

The RIS to implement this provision specified that all returns with a Form 8862 would be coded and forwarded to Examination for review. The coding would suspend any refund until the Examination review was conducted. However, on Tax Year 1997 returns, EITC claims were mostly denied during returns processing using Error Resolution math error procedures rather than Examination deficiency procedures. Most taxpayers may not understand the difference between math error and deficiency procedures. Therefore, taxpayers who had the EITC denied through math error procedures may misunderstand the tax package instructions pertaining to when a Form 8862 must be filed and unnecessarily attach the form when recertification is not required. Under the RIS procedures, these taxpayers' refunds would remain frozen until released by a tax examiner. This could have caused significant refund delays and also resulted in unnecessary use of IRS resources to screen returns for taxpayers who mistakenly filed Form 8862.

6. Individual Retirement Account (IRA) Phaseout Range for Married Taxpayers Filing Jointly

A new IRA provision related to active participants in an employer-sponsored retirement plan set a second adjusted gross income phaseout range related to IRA deductions for married taxpayers filing jointly. This new provision was not considered in the RIS adjusting the existing phaseout range, and could have resulted in valid IRA deductions being eliminated based on the adjusted gross income processing validation requested in the RIS.

7. Dependents Standard Deduction

RIS TSF-8-0064 addressed the new $700 standard deduction but did not address the provision for the standard deduction amount equal to earned income plus $250.

Appendix VII

Key Legislative Provisions Affecting Individual Returns Processing for the 1999 Filing Season

Legislative Provision	Large Dollar	Large Taxpayer Impact	Sensitive	Complex
• **Child Tax Credit**	**Yes**	**Yes**	**Yes**	**Yes**
• **Earned Income Tax Credit Changes To Calculations of Modified Adjusted Gross Income (AGI) and Earned Income**	**No**	**Yes**	**Yes**	**Yes**
• **Credits for Higher Education** (Hope Scholarship and Lifetime Learning Credits)	**Yes**	**Yes**	**Yes**	**Yes**
• **Education Individual Retirement Accounts (IRA)**	**Yes**	**Yes**	**Yes**	**No**
• **Interest on Education Loans**	**No**	**Yes**	**Yes**	**No**
• **Individual Retirement Accounts** Roth IRAs; Increased AGI Limits for Contributions; Contributions to Spouses IRA; Education Expense Withdrawals; First-Time Homebuyer Withdrawals	**Yes**	**Yes**	**Yes**	**Yes**
• **Farmers Income Averaging**	**No**	**No**	**Yes**	**Yes**
• **Filing Threshold for Individuals for Underpayment of Estimated Tax**	**No**	**Yes**	**Yes**	**No**
• **Estimated Tax Safe Harbor**	**No**	**Yes**	**Yes**	**No**
• **Payment of Tax by Credit Cards**	**No**	**Yes**	**Yes**	**Yes**
• **Earned Income Tax Credit Recertification**	**No**	**Yes**	**Yes**	**Yes**

Significance Criteria

Large Dollar: Provisions that have estimated budget effects greater than $1 billion over 10 years. (Estimates based on the House of Representatives' Conference Agreement.)

Large Taxpayer Impact: Provisions that have an estimated effect on over 5 million taxpayers. Our projections were based on research of the "Fall 1997 Statistics of Income Bulletin" and Compliance Research's "Calendar Year Return Projections for the United States and Service Centers: 1997-2004." Data was not available to make estimates on numerous provisions. In those cases, auditors determined whether a high or low number of taxpayers would be affected based on their analysis of the provisions and their best judgement.

Sensitive: Provisions that, if not properly implemented, present a high risk of embarrassment to the Internal Revenue Service (IRS) and could significantly harm the IRS' efforts to provide quality customer service. This includes provisions affecting special interest groups, e.g., low income, elderly, or farmers.

Complex: Provisions that include intricate or involved changes to tax laws and/or provisions that are unique and would present computations that would be difficult and confusing to laypersons.

Appendix VIII

Management's Response to the Draft Report

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

COMMISSIONER

December 21, 1999

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR
TAX ADMINISTRATION

FROM: Charles O. Rossotti
Commissioner of Internal Revenue

SUBJECT: Draft Audit Report — The Internal Revenue Service (IRS) Could Enhance the Process for Implementing New Tax Legislation (Reference No. 19980068)

Thank you for the opportunity to review and comment on your draft report and recommendations based on the implementation of key legislative changes affecting the processing of tax returns for the 1999 filing season. Your report focused primarily on implementation of the Taxpayer Relief Act of 1997 (TRA 97) as it had the most impact on the processing of tax returns for the 1999 filing season.

The primary process for ensuring that necessary actions are taken to implement new legislation are implementation plans. Despite the shortcomings that you identified with this process for TRA 97 implementation, the report reflects that the process of developing tax forms, instructions, and computer programs to implement new tax legislation was effective.

We were pleased that the report identified that a new process was developed for implementation of the IRS Restructuring and Reform Act of 1998 (RRA 98). We agree that increased emphasis should be placed on implementing highly significant legislative provisions as evidenced by our different approach to RRA 98 implementation. As we continue to move forward to modernize the IRS structure, effective implementation of new legislation has to be addressed. The RRA 98 process will certainly be taken into account in developing a new process that will be effective both during the transition to the modernized structure and after the new structure is fully implemented.

IDENTITY OF RECOMMENDATION/FINDING #1
The Chief Operations Officer should develop a process which ensures that actions necessary to implement a legislative act are completed timely. The process should ensure that IRS executives are timely made aware of critical actions that are overdue for implementing new legislation.

2

Increased emphasis should be placed on highly significant legislative provisions. For each act, the Chief Operations Officer should identify the key provisions, assign each of those key provisions to an IRS executive, and ensure that overdue actions are reported to affected executives and/or to a steering committee. The process the IRS used to implement RRA 98 could serve as a model for this process.

ASSESSMENT OF CAUSE(S)
To facilitate the successful implementation of the RRA 98, the IRS developed a list of the most significant provisions, monitored progress, and discussed any concerns at an Executive Steering Committee meeting. An IRS executive "owned" each provision and was responsible for its implementation. The implementation plan was automated and was regularly updated.

CORRECTIVE ACTIONS
In the new IRS, there will be no Chief Operations Officer and our challenge is to ensure a coordinated process among the four operating divisions. As part of its charter to transition National Office into the modernized structure, the Communications and Liaison Modernization Team (Phase IIB) developed a process for implementing new legislation in the new structure. The team leader was very familiar with the RRA 98 process and took this process into account in developing a new process, which uses techniques and technology developed by Taxpayer Treatment and Service Improvement (TTSI) and requires a database specialist.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL
National Director for Legislative Affairs

IDENTITY OF RECOMMENDATION/FINDING #2
The Assistant Commissioner (Forms and Submission Processing) should ensure that a quality review is performed for Requests for Information Services (RIS) developed to implement tax legislation. Reviewers should compare the RIS, amendments, and Information Systems response to RISs, with the legislative provisions to ensure that each provision is completely and accurately addressed.

ASSESSMENT OF CAUSE(S)
The overall effort to implement the Taxpayer Relief Act of 1997 (TRA 97) was a substantial undertaking. The large number of provisions that were dealt with correctly is a testament to the staff's involvement in implementing the required actions. There were, however, some provisions that were inadequately addressed. As noted in the report, steps were taken to correct the requests upon notification from TIGTA.

The amount of time and resources available for preparing RISs, reviewing completed work and comparing the legislative provisions to the RISs was severely limited due to our efforts to ensure Y2K compliance. Not only was the timeframe for implementation shorter than is usual, but due to the compressed RIS due dates, resources were divided between preparing requests for implementation in 1999, and preparing for and facilitating the successful 1998 filing season. The overall effort and result of the work to implement the vast majority of the provisions was excellent, however, the requests would have benefitted from a more formal review process.

CORRECTIVE ACTIONS
Submission Processing will issue new procedures and initiate a review process to ensure that all aspects of legislative provisions are fully and accurately designed and implemented. Submission Processing Division's legislative coordinator will work with a designated analyst in each section to perform the review and ensure that the necessary actions identified during the review are acted upon to correct any identified shortcomings.

IMPLEMENTATION DATE:
PROPOSED February 1, 2000

RESPONSIBLE OFFICIAL
Assistant Commissioner (Forms and Submission Processing)

CORRECTIVE ACTION MONITORING PLAN
The review will be performed on a regular basis after implementation actions have been identified. When corrections are needed, a control will be issued to ensure timely completion.

IDENTITY OF RECOMMENDATION/FINDING #3
Since a notice was not issued, and in order to meet lawmakers' desires, the Assistant Commissioner (Customer Service) should request a computer routine to identify taxpayers who may qualify for the child tax credit but did not claim it. These taxpayers should be sent an informational notice similar to the notice that has been used to inform taxpayers that they may qualify for the EITC.

ASSESSMENT OF CAUSE(S)
There was discussion, including a provision in an early version of the TRA, of a notice to inform taxpayers of the new child tax credit. A notice was not sent in 1998 because of concern that some taxpayers would lower their withholding in response to the notice but find when they complete their return that they are not eligible for the credit.

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CORRECTIVE ACTIONS
We are still concerned that taxpayers will lower their withholding in response to the notice but find when they complete their return that they are not eligible for the credit. This will result in these taxpayers owing additional taxes that they had not anticipated and are, thus, unable to do so. We will continue our efforts to effectively communicate with all taxpayers regarding this credit through outreach programs.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL
Assistant Commissioner (Customer Service)

CORRECTIVE ACTION MONITORING PLAN
N/A

IDENTITY OF RECOMMENDATION/FINDING #4
The Assistant Commissioner (Forms and Submission Processing) should solicit input from customers (Tax Forms and Publications, Submission Processing, Customer Service, etc.), and should review legislation to identify significant items or changes on tax forms and instructions which warrant highlighting with an additional color.

ASSESSMENT OF CAUSE(S)
TIGTA indicates that the use of an additional color (red in most cases) will assist taxpayers in identifying new and/or important information on their tax forms. TIGTA cites that industry literature suggests using color to emphasize information in a document and suggests red be used for warnings and critical items.

CORRECTIVE ACTIONS
The IRS uses a variety of methods to highlight significant information. We will continue to work with internal and external customers to review tax legislation to identify information that warrants additional emphasis in the printed tax products.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL
Assistant Commissioner (Forms and Submission Processing)

CORRECTIVE ACTION MONITORING PLAN
N/A

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IDENTITY OF RECOMMENDATION/FINDING #5
The Assistant Commissioner (Forms and Submission Processing) should use red ink on tax forms and tax package instructions (a different color should be used for Form 1040A) to emphasize significant items or changes which taxpayers should be aware of. The colored text should be used judiciously to increase its effectiveness and to avoid the perception of waste.

ASSESSMENT OF CAUSE(S)
In 1995, the IRS requested and received permission from the Government Printing Office to use more than two (black plus one other) colors of ink on its tax packages. The resulting negative publicity revealed a strong preference for unelaborate, direct tax products and reinforced the conservative use of color.

The IRS currently uses a color other than black to backshade important information. TIGTA suggests that using red ink to emphasize significant items or changes will reduce taxpayer burden and processing costs by eliminating taxpayer errors. The report points out that industry literature suggests that color be used to emphasize information.

While most effective design concepts do incorporate the use of multiple colors, they also suggest that simply adding an additional color instead of utilizing other effective layout and design elements can be both ineffective and perceived as wasteful, or extravagant. The IRS embraces the use of various design concepts to produce a product that is effective and does not appear wasteful.

CORRECTIVE ACTIONS
The IRS continually searches for effective methods of highlighting material in tax forms and publications. This year, for instance, a contract with an outside consultant that focused primarily on EITC materials, has generated design elements and concepts that have been incorporated throughout other pages of the tax packages. As an example, a new "caution" icon has been developed and used to highlight troublesome items throughout the instructions. We will reevaluate the effective use of the second color, and will explore more effective use of shading, tints, and other graphic treatments that might be used in lieu of a third color to highlight important changes.

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL
Assistant Commissioner (Forms and Submission Processing)

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CORRECTIVE ACTION MONITORING PLAN
N/A

If you have any questions, please call me or a member of your staff may call Sharon Patton at 622-7055.