

**Taxpayers and the Internal Revenue Service  
Experienced Problems With Some New  
Tax Provisions**

**March 2000**

**Reference Number: 2000-40-045**

**This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.**

**Redaction Legend:**

- 2a = Law Enforcement Criteria
- 2c = Law Enforcement Tolerance(s)
- 2d = Law Enforcement Technique(s)
- 2e = Law Enforcement Procedure(s)



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

March 20, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

FROM: (for) Pamela J. Gardiner *Scott E. Wilson*  
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

This report presents the results of our review to determine the effectiveness of the Internal Revenue Service's (IRS) efforts to implement new legislation, and to evaluate the actions taken to ensure that tax returns affected by significant new legislative provisions were processed correctly. In summary, we found that the IRS properly processed most tax returns affected by legislative provisions effective for the 1999 filing season. However, taxpayers and the IRS did experience problems with some of the new provisions. The IRS could help alleviate these problems if it would:

- Initiate a post review of tax returns with taxpayer errors related to specific legislative provisions.
- Ensure computer programs necessary to identify taxpayer errors related to two new tax law provisions are completed by the 2001 filing season.
- Ensure that notices issued to taxpayers are more accurate, clear, and informative.
- Consider the feasibility and cost effectiveness of conducting limited computer research to correct inaccurate names and taxpayer identification numbers (TIN) entered on tax returns.

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 XVI. With the exception of the issue discussed below, we agree with the corrective actions outlined in the IRS' response.

IRS management did not implement our recommendation to correct inaccurate names and TINs on returns rather than disallowing credits and exemptions. They expressed

concern that such action would not benefit taxpayers in the long run. Since taxpayers would not be informed of the changes made on their returns, they may continue to use the wrong TINs in the future. The returns would be directed to the Error Resolution function year after year, thus, unnecessarily delaying the processing of all returns.

We believe the IRS should reconsider our recommendation to correct inaccurate names and TINs on returns rather than disallowing credits and exemptions. Correcting a taxpayer's return does not preclude the IRS from issuing a notice to the taxpayer explaining the taxpayer's mistake and encouraging the taxpayer to ensure that the TIN he/she enters on his/her tax returns is correct in succeeding years.

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 contact 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 the Internal Revenue Service (IRS) faced since 1986. Close to half of the 300 new provisions of the Taxpayer Relief Act of 1997<sup>1</sup> were effective for Tax Year 1998. Taxpayers experienced problems preparing 1998 individual income tax returns, and the IRS experienced problems processing tax returns impacted by some of these new provisions.

The objectives of this audit were to evaluate the effectiveness of the IRS' implementation efforts as well as to evaluate actions taken during the filing season<sup>2</sup> to ensure that tax returns affected by significant new legislative provisions were processed correctly.

## **Results**

The IRS put forth significant effort to prepare for the filing season, and has established processes such as the testing of some newly developed forms, by taxpayer focus groups, to ensure that new legislation was effectively implemented. The IRS also conducted functional reviews of Internal Revenue Manual instructions, systems acceptability testing of new computer programs, and training of IRS employees. Overall, these efforts resulted in taxpayers receiving information regarding new tax law provisions necessary to properly file tax returns. The IRS properly processed most tax returns affected by these provisions. However, taxpayers experienced problems understanding some of the new legislative provisions and related forms and instructions. The IRS also experienced problems processing tax returns impacted by some new legislative provisions. This report discusses steps the IRS should take to timely identify and resolve these problems in the future. Recommendations in this report could result in the following:

- The IRS could avoid losing over \$7 million of revenue each year to taxpayers claiming dependent exemptions to which they were not entitled.
- The IRS could also avoid losing over \$33 million of revenue each year to taxpayers receiving tax credits to which they were not entitled.
- The IRS could avoid improperly denying deductions totaling over \$32 million per year for contributions taxpayers made to Individual Retirement Accounts (IRA).

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<sup>1</sup> Taxpayer Relief Act of 1997, 26 U.S.C. § 24 (1999).

<sup>2</sup> The IRS refers to the first half of the calendar year, when most individual taxpayers file their tax returns and the IRS processes those returns, as "the filing season."

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- Burden could be reduced on approximately 900,000 taxpayers if the IRS clarified tax forms and instructions or notices issued to these taxpayers regarding new tax provisions.
- Burden could be reduced on another 239,000 taxpayers if the IRS corrected inaccurate names and taxpayer identification numbers (TIN) on taxpayers' returns rather than disallowing taxpayers' credits and exemptions.
- The IRS could avoid improperly denying the Child Tax Credit to significant numbers of taxpayers, and could avoid improperly allowing the Child Tax Credit to other taxpayers.

### **Within Its Error Resolution Function, the Internal Revenue Service Performs No Regular Post Review of Tax Returns Impacted by Tax Provisions**

As taxpayers' income tax returns are processed by the IRS, computers analyze and recompute information on the returns to identify potential errors. These potential errors are resolved by employees in the Error Resolution function. If the IRS makes changes to figures the taxpayers entered on their returns, employees send taxpayers notices informing them of the changes.

Many changes the IRS made to taxpayers' returns involving four new legislative provisions were incorrect. These errors resulted in significant losses of funds to both the Government and to taxpayers. The IRS did not timely identify and take action to address significant error rates involving the following four new legislative provisions:

- Child Tax and Additional Child Tax Credit
- Farmers Income Averaging
- Changes to the Calculation of Modified Adjusted Gross Income Used to Determine the Earned Income Tax Credit (EITC)
- Increased Adjusted Gross Income Limits for Contributions to an IRA

If reviews had been performed and trended by tax provision, they may also have revealed needed clarifications to tax forms and instructions.

### **The Internal Revenue Service did not Program Computer Checks for Two New Legislative Provisions**

Because of limited programming resources and extensive priority programming requirements, the IRS postponed or cancelled programming to identify potential taxpayer errors relating to two new tax law provisions. (See Appendix V for a detailed discussion of these missing programs.) As a result of these programs not being written, taxpayers

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mistakenly received the benefit from provisions in the tax law or received tax credits that they were not entitled to.

These taxpayers were not informed of their errors and are likely to repeat them. Also, these errors, if later identified by the IRS, could result in significant burden to taxpayers as they could be subject to penalties and interest in addition to any underpaid taxes.

### **The Internal Revenue Service Could Improve Several Taxpayer Notices Related to New Legislative Provisions**

Notices for the following four new tax provisions did not clearly or adequately explain the taxpayers' errors, or the actions necessary:

- Child Tax and Additional Child Tax Credit
- EITC Recertification
- Changes to the Calculation of Modified Adjusted Gross Income for Purposes of Determining the EITC
- Increased Adjusted Gross Income Limits for Contributions to an IRA

If taxpayers do not receive complete, clear notices, they are likely to repeat errors in subsequent years, or to contact the IRS for clarification.

### **The Internal Revenue Service Could Correct Inaccurate Names and Taxpayer Identification Numbers on Returns Rather than Disallowing Credits and Exemptions**

In over 31 percent of 403 notices sampled, the IRS had the correct information elsewhere on its computer system when it sent notices telling taxpayers their Child Tax Credit was disallowed because the name or TIN (usually a social security number) for their child on their 1998 tax return did not match IRS or Social Security Administration records.

If IRS employees performed computer research, the IRS could have prevented significant numbers of notices from being issued, and reduced the related burden to taxpayers. The IRS would experience additional returns processing costs to provide this service. However, some costs would be recovered because fewer taxpayers would need to contact the IRS to resolve their incorrect name or TINs.

### **The Internal Revenue Service Experienced Problems with Its Computer Programs to Implement Earned Income Tax Credit Recertification**

Taxpayers who have been denied the EITC as a result of an IRS audit are not eligible to claim the credit in subsequent years unless they provide information to demonstrate their eligibility on Information to Claim Earned Income Credit After Disallowance (Form 8862).



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Based on the tax return instructions, we anticipated that taxpayers would be confused about when to file Form 8862. The computer programs prepared by the IRS did not take into consideration that some taxpayers would file the form unnecessarily, and would have caused these taxpayers' refunds to be delayed. We reported this issue to the IRS, and it immediately revised its programs. During the filing season, approximately 6,500 taxpayers unnecessarily filed Form 8862. Left uncorrected, the incorrect computer programs would have caused refunds for these taxpayers, totaling approximately \$12.8 million (\$8.8 million of which was the EITC) to be delayed unnecessarily. (See Appendices VIII and IX.)

Early in the filing season, refunds totaling over \$218,000 (\$143,000 of which was the EITC) were issued to 74 taxpayers whose refunds should have been stopped because they were required to recertify with the IRS before they could receive the EITC. Computer programs to stop these refunds were not functioning as intended.

We brought this problem to the IRS' attention in a memorandum and the IRS took immediate corrective action. (See Appendices X and XI.) Left uncorrected throughout the filing season, this programming error would have resulted in approximately 29,000 disqualified taxpayers receiving the EITC totaling over \$50 million.

### **The Internal Revenue Service Unnecessarily Burdened Taxpayers Who Obviously Entered the Child Tax Credit on the Wrong Line**

Taxpayers claimed amounts consistent with the Child Tax Credit on the Child Care Credit or Education Credit line of their tax returns, and did not attach the required schedules for these credits. Although these were obviously misplaced Child Tax Credit entries, the IRS sent these returns back to, or corresponded with, taxpayers and requested that they supply additional schedules.

Taxpayers could have been confused and frustrated when they received their tax returns back or received correspondence requesting additional information to support credits they did not intend to claim.

We brought this issue to the IRS' attention in a memorandum and the IRS took corrective action. (See Appendices XII and XIII.)

### **Summary of Recommendations**

The IRS should take several steps to ensure that legislative changes are properly implemented. Included among these are: initiating a post review of Error Resolution cases impacted by specific legislative provisions; ensuring that computer programming necessary to identify taxpayer errors related to two new tax law provisions (detailed in Appendix V) are completed by the 2001 filing season; and ensuring that notices issued to

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taxpayers are technically accurate, clearly address the taxpayers' errors, and clearly inform taxpayers what to do.

The IRS should also consider the feasibility and cost effectiveness of conducting limited computer research to correct inaccurate names and TINs entered on tax returns.

Management's Response: IRS management agreed to implement our recommended actions to ensure that legislative changes are properly implemented. The Assistant Commissioner (Forms and Submission Processing) has initiated a post review of Error Resolution cases impacted by specific legislative provisions. The results of these reviews will be used to identify needed changes to tax forms and instructions. Submission Processing has prepared and will submit requests for computer programming to identify potential errors made by taxpayers relating to two new tax provisions. Submission Processing and Customer Service will establish a formal clearance process to ensure that notices issued to taxpayers are effective, technically accurate, and clearly address taxpayers' errors.

IRS management did not implement our recommendation to correct inaccurate names and TINs on returns rather than disallowing related exemptions and credits. They expressed concern that such action would not benefit taxpayers in the long run. Since taxpayers would not be informed of the changes made on their returns, they would continue to use the wrong TINs in the future. The returns would be directed to the Error Resolution function year after year, thus steadily increasing the volume of returns requiring research, and unnecessarily delaying the processing of all returns.

Office of Audit Comment: We disagree with the IRS' response regarding correcting names and TINs on returns rather than disallowing related exemptions and credits. Correcting a taxpayer's return does not preclude the IRS from issuing a notice to the taxpayer (when applicable) explaining the taxpayer's mistake and encouraging the taxpayer to ensure that the TINs they enter on their tax returns are correct in succeeding years. Issuing such a notice would address IRS' concern of a steadily increasing volume of returns requiring research and correction.

The IRS has spent a significant amount of taxpayer dollars developing computer systems which can provide instant access to taxpayers' accounts in the name of providing "one-stop" service to taxpayers. The ability to perform the research we have recommended (which only takes a matter of seconds) resulted from these efforts. Some of the invalid names and TINs identified are the result of mistakes by IRS employees when entering the numbers into IRS computers. Performing the recommended research would allow the IRS to avoid sending erroneous notices to the taxpayers affected by these IRS errors, and would demonstrate the IRS' commitment to "one-stop" service and taxpayer education.

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### Objectives and Scope

This review was conducted as part of the Inspection Service's (now the Treasury Inspector General for Tax Administration) Fiscal Year 1999 audit plan. Prior to this report, we issued a draft report, *The Internal Revenue Service Could Enhance the Process for Implementing New Tax Legislation* (Audit Number 19990068), recommending that the Internal Revenue Service (IRS) increase emphasis on significant legislative provisions to ensure that actions necessary to implement those provisions are taken.

This audit was conducted from January through October 1999 at the Ogden and Fresno Service Centers and the National Office. The audit was conducted in accordance with *Government Auditing Standards*.

*The objectives of this audit were to evaluate the effectiveness of the IRS' implementation efforts and to ensure that tax returns affected by significant new legislative provisions were processed correctly.*

The objectives of this audit were to evaluate the effectiveness of the IRS' implementation efforts as well as to evaluate actions taken during the filing season<sup>1</sup> to ensure that tax returns affected by significant new legislative provisions were processed correctly.

To accomplish our objectives, we analyzed tax legislation to identify provisions affecting returns processing for Tax Year (TY) 1998. We identified nine individual income tax provisions which we considered to be significant to this review based on: 1) the number of taxpayers affected, 2) the anticipated revenue impact, 3) the sensitivity of the provision, 4) the complexity of the provision, and 5) the results of the IRS' implementation activities discussed in our prior report. (Appendix VII contains a list, and brief explanation, of these nine legislative provisions.) At the two service centers we tested, we identified 1998 individual income tax returns impacted by the applicable new tax

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<sup>1</sup> The IRS refers to the first half of the calendar year, when most individual taxpayers file their tax returns and the IRS processes those returns, as "the filing season."

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provisions and conducted computer analyses of data on the returns.

We sampled and reviewed these tax returns to determine whether:

1. The IRS processed the returns correctly.
2. Any errors on the returns related to the new tax provisions were corrected properly, and whether the IRS trended taxpayer errors to identify needed improvements to tax forms and instructions.
3. Notices sent to taxpayers by the IRS regarding new tax provisions were correct, clear and courteous.

We reviewed processes the IRS had in place for identifying filing season processing problems related to new tax provisions.

Where possible, when we identified tax return processing problems or recurring taxpayer errors, we determined the number of taxpayers impacted nationwide. We did this by obtaining nationwide computer data from the IRS' Individual Masterfile (IMF).<sup>2</sup>

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

### **Background**

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,<sup>3</sup> the Balanced Budget Act,<sup>4</sup> and the Taxpayer Browsing Protection Act of 1997.<sup>5</sup> The Taxpayer Relief Act of

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<sup>2</sup> IRS' IMF is the IRS database that maintains transactions or records of individual tax accounts.

<sup>3</sup> Taxpayer Relief Act of 1997, 26 U.S.C. § 24 (1999).

<sup>4</sup> Balanced Budget Act of 1997, Pub. L. No. 105-33.

<sup>5</sup> I.R.C. § 7213A (1999).

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*The Taxpayer Relief Act of 1997 contained nearly 300 new provisions. Close to half of these new provisions were effective for TY 1998.*

1997 contained nearly 300 new provisions, many of which affected returns processing activities. Close to half of the provisions were effective for TY 1998 and were considered the most complex. Many of these provisions received considerable political attention, indicating the Congress would be interested in ensuring they were implemented by the IRS as intended.

The mission of the IRS is to provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all. One step the IRS takes to accomplish this is identifying and correcting errors on taxpayers' individual income tax returns. In addition, in an effort to lessen the burden on taxpayers, the IRS has committed to take efforts sooner to promote taxpayer compliance. This includes improving returns processing, identifying issues early and adjusting refunds, telling taxpayers about recurring problems, and improving forms and publications.

### **Results**

*The IRS should take steps to timely identify and resolve processing problems.*

The IRS put forth significant effort to prepare for the filing season, and has established processes such as testing of some newly developed forms, by taxpayer focus groups, to ensure that new legislation was effectively implemented. The IRS also conducted functional reviews of Internal Revenue Manual instructions, systems acceptability testing of new computer programs, and training of IRS employees. Overall, these efforts resulted in taxpayers receiving information regarding new tax law provisions necessary to properly file tax returns. The IRS properly processed most tax returns affected by these provisions. However, taxpayers and the IRS did experience problems related to preparing and processing tax returns impacted by some new legislative provisions. This report discusses steps the IRS should take to timely identify and resolve these problems in the future. Recommendations in this report could result in the following:

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- The IRS could avoid losing over \$7 million of revenue each year to taxpayers claiming dependent exemptions to which they were not entitled.
- The IRS could also avoid losing over \$33 million of revenue each year to taxpayers receiving tax credits to which they were not entitled.
- The IRS could avoid improperly denying deductions totaling over \$32 million per year for contributions taxpayers made to Individual Retirement Accounts (IRA).
- Burden could be reduced on approximately 900,000 taxpayers if the IRS clarified tax forms and instructions or notices issued to these taxpayers regarding new tax provisions.
- Burden could be reduced on another 239,000 taxpayers if the IRS corrected inaccurate names and taxpayer identification numbers (TIN) on taxpayers' returns rather than disallowing taxpayers' credits and exemptions.
- The IRS could avoid improperly denying the Child Tax Credit to significant numbers of taxpayers, and could avoid improperly allowing the Child Tax Credit to other taxpayers.

During this review, we also identified issues requiring the IRS' immediate attention, and reported these issues to IRS management through memoranda. The IRS took corrective action on these issues. Where applicable, we have included the IRS' responses in this report, and where possible, we have provided additional data regarding the volumes of returns affected by these issues.

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### **Within Its Error Resolution Function, the Internal Revenue Service Performs No Regular Post Review of Tax Returns Impacted by Tax Provisions**

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As taxpayers' income tax returns are processed by the IRS, computers analyze and recompute information on the returns to identify potential errors. Discrepancies are resolved by employees in the Error Resolution function. If the IRS makes changes to figures the taxpayers have entered on their tax returns, employees send the taxpayers notices informing them of the changes. To evaluate the accuracy of employees' work, the IRS reviews samples of returns worked by individual employees. The samples are pulled based on the number of returns completed by the employee.

*Many of the changes the IRS made to taxpayers' returns impacted by four new legislative provisions were incorrect.*

Many of the changes the IRS made to taxpayers' returns impacted by four new legislative provisions were incorrect. These incorrect changes were not identified by the IRS. The IRS has the capability to select for review, tax returns worked by Error Resolution employees based on specific tax provisions. However, it has not implemented such a review on a regular basis. If the IRS' Error Resolution function had performed regular post reviews of tax returns by tax provision, and trended the results, they could have identified and taken action to solve processing problems related to these returns. Trend analyses could also have been used to identify recurring taxpayer errors, which might be reduced by changes or improvements to tax forms and instructions.

### **Processing Problems Could Have Been Identified and Corrected**

The IRS did not timely identify and take action to address significant error rates involving the following new legislative provisions included in our review:

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### **1. Child Tax and Additional Child Tax Credit**

*Taxpayers were often improperly denied or given Child Tax and/or Additional Child Tax Credit.*

For the returns of taxpayers receiving notices that we tested, many taxpayers were improperly denied, or improperly received, the Child Tax and/or Additional Child Tax Credit. The IRS miscalculated the Child Tax Credit on approximately 18 percent (39 of 214) of the cases in our samples. It miscalculated the Additional Child Tax Credit on approximately 36 percent (57 of 159) of the cases we reviewed. Taxpayers were denied credits totaling over \$32,000, and were given credits to which they were not entitled totaling over \$15,000 in these 96 instances. Through August 1, 1999, the IRS had issued 492,106 notices informing taxpayers they had miscalculated their Child Tax Credit and 47,175 notices informing taxpayers they had miscalculated their Additional Child Tax Credit.

Also, as of July 3, 1999, approximately 90,000 taxpayers nationwide who claimed the Child Tax Credit but did not provide a valid TIN for their child, received dependency exemptions to which they were not entitled. They received this exemption even though the IRS did not allow their related Child Tax Credit. This incorrect exemption generally resulted in these taxpayers' tax liabilities being understated by \$405 each. This condition occurred due to a combination of employee errors and a computer programming oversight. We informed the IRS of this problem in a memorandum dated March 17, 1999. The IRS took immediate action to address the employee errors and agreed to correct the computer programming for the 2000 filing season.

### **2. Farmers Income Averaging**

*Farmers who used Schedule J were improperly assessed additional tax 99 percent of the time.*

For the returns of taxpayers receiving notices that we tested, farmers who computed their income tax using the Farmers Income Averaging (Schedule J), were improperly assessed additional tax 99 percent of the time (183 of 184 notices). These taxpayers were assessed approximately \$224,000 more than they reported on their tax returns. The IRS' computers were not programmed to accept information from Schedule J. These taxpayers' returns went to the Error Resolution



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function because the tax calculated by the IRS' computer program was different than the tax calculated by the taxpayers on Schedules J. Schedules J were filed infrequently, and IRS employees were not accustomed to them. As a result, they overlooked instructions to search for a Schedule J before rejecting the taxpayer's tax calculation and accepting the calculation made by the IRS' computer. We informed the IRS of this problem in a memorandum dated May 28, 1999, and it took immediate corrective action. (See Appendices XIV and XV.)

As of August 1, 1999, the IRS issued approximately 625,600 notices informing taxpayers they had miscalculated their tax. Because Schedule J is not entered in the IRS' computers, we could not determine how many of these notices resulted from taxpayers filing a Schedule J. However, we believe the number would be low.

### **3. Changes to the Calculation of Modified Adjusted Gross Income for Purposes of Determining the Earned Income Tax Credit**

For the returns of taxpayers receiving notices that we tested, the Earned Income Tax Credit (EITC) of taxpayers also reporting distributions from Individual Retirement Accounts (IRA) or pensions was improperly reduced approximately 48 percent of the time (60 of 124). These taxpayers were denied approximately \$38,000 of the EITC. As of August 1, 1999, the IRS had issued 63,279 notices informing taxpayers they had made a mistake when determining their modified adjusted gross income for the EITC. Based on volumes in the two service centers included in our review, we estimate that close to half of these notices resulted from modifications to adjusted gross income for determining the EITC when taxpayers reported distributions from IRAs or pensions.

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### 4. Increased Adjusted Gross Income Limits for Contributions to an Individual Retirement Account

Married taxpayers who filed jointly, whose modified adjusted gross income was between \$60,000 and \$160,000, and who claimed deductions for IRAs and Keogh retirement plans, were improperly denied their IRA deductions. Computer programs for the Error Resolution program did not take into consideration the increased modified adjusted gross income limits for married taxpayers. The IRS did not properly implement manual procedures to make up for the programming error. We performed a computer analysis of data from the IRS' IMF and found that through the end of July 1999, approximately 17,000 taxpayers meeting the criteria referred to above were denied IRA deductions. The deductions disallowed in error averaged \$1,918.

### Needed Changes to Forms and Instructions Could Have Been Identified

*Trending taxpayer errors  
might identify improvements  
for tax forms and instructions.*

*Tax form instructions do not  
clearly explain eligibility for  
the Additional Child Tax  
Credit.*

Besides identifying processing errors, trend analyses of quality review results could be used to identify recurring taxpayer errors which might be reduced by changes or improvements to tax forms and instructions. For example:

- Many taxpayers claimed the Additional Child Tax Credit even though they did not have three or more children as required. In our samples, approximately 26 percent of the taxpayers (22 of 83) who made mistakes when calculating their Additional Child Tax Credit had claimed fewer than three dependents. As of August 1, 1999, the IRS had issued notices to 47,175 taxpayers informing them that they had made mistakes when calculating their Additional Child Tax Credit. The Additional Child Tax Credit (Form 8812) and its accompanying instructions, as well as instructions for the U.S. Individual Income Tax Return (Forms 1040 and 1040A), do not clearly explain that taxpayers must have at least three

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qualifying children to be eligible for the Additional Child Tax Credit.

- Taxpayers entered names for dependents they were claiming which did not match the records of the IRS or the Social Security Administration (SSA). When this occurs, IRS employees are instructed to disallow the exemption claimed for the dependent as well as any related credits such as the Child Tax Credit.

*Tax form instructions do not explain that dependents' names must match IRS or SSA records.*

We reviewed available IRS data for 125 taxpayers receiving notices informing them that their Child Tax and/or Additional Child Tax Credit was not allowed because the TIN and/or name they entered for their child did not match the records of either the IRS or the SSA. Approximately 22 percent of these taxpayers (28 of 125) had entered surnames for their children that did not match IRS or SSA records. As of August 1, 1999, the IRS had issued these notices to 773,672 taxpayers. Instructions for Forms 1040 and 1040A do not explain to taxpayers that the names of their dependents must match IRS or SSA records.

*Taxpayers were having difficulty calculating their modified adjusted gross income for the purpose of determining their EITC.*

- Taxpayers were having difficulty calculating their modified adjusted gross income for the purpose of determining their EITC. As of August 1, 1999, the IRS had issued notices to 63,279 taxpayers informing them that they had miscalculated their modified adjusted gross income for purposes of determining their EITC. In our samples, approximately half of these notices related to adjustments made necessary by the new tax law provision. The modified adjusted gross income computation is relatively complex. The IRS' instructions for computing it are in a detailed narrative with no worksheet or examples to help simplify the computation.
- Taxpayers were claiming more than the \$1,000 deduction for interest on education loans allowed by the law. In our samples, over 56 percent of the taxpayers who made mistakes when claiming a deduction for interest on education loans claimed

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*Taxpayers were claiming more than the \$1,000 deduction for interest on education loans allowed by the law.*

deductions of over \$1,000. As of August 1, 1999, the IRS had issued notices to 43,638 taxpayers informing them that they had miscalculated their student loan interest deductions. Forms 1040 and 1040A and the instructions related to the deduction for interest on education loans do not specifically inform taxpayers that they cannot claim a deduction of more than \$1,000. Taxpayers compute the deduction using a worksheet that includes the maximum \$1,000 as part of the computation.

### **Recommendations**

1. The National Director, Submission Processing, should initiate a post review of Error Resolution cases impacted by specific legislative provisions, with special emphasis on new tax provisions. The Computer Assisted Review of the Error Resolution System (CARE) could facilitate such a review. The results of this post review should be trended to identify processing problems, recurring taxpayer errors, and needed changes or improvements to tax forms and instructions.
2. The National Director, Tax Forms and Publications Division, should receive and review the results of this trend analysis annually to help identify needed changes or improvements to tax forms and instructions.

Management's Response: The Assistant Commissioner (Forms and Submission Processing) has initiated a weekly post review of Error Resolution cases impacted by specific legislative provisions utilizing the CARE system.

The results of this review will be provided to the Tax Forms and Publications function to identify trends and target specific areas for additional research.

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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### The Internal Revenue Service did not Program Computer Checks for Two New Legislative Provisions

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*The IRS is responsible for implementing tax provisions in accordance with the specifications set by the Congress.*

As discussed earlier, the IRS assists taxpayers in understanding and meeting their tax responsibilities by using computer programs to identify errors on taxpayers' individual income tax returns. IRS employees issue notices to taxpayers explaining the taxpayers' errors and the adjustments made by the IRS to correct the errors. These computer programs are also used to ensure that certain limitations and requirements specified by the Congress are met. Often when the Congress passes tax legislation, it is intended to impact specific taxpayers. For example, many tax credits and deductions are available to taxpayers with lower income, but decrease as the taxpayers' income increases. The IRS is responsible for implementing the tax law in accordance with the specifications set by the Congress.

Because of limited programming resources and extensive priority programming requirements, the IRS postponed or cancelled computer programming to identify potential errors made by taxpayers relating to two new tax law provisions. (Because providing the specific details of the missing computer programs could have a negative effect on tax administration, they will not be discussed in the body of this report. See Appendix V for details.)

*Without computer programs to prevent them, taxpayers mistakenly received the benefit of provisions that they were not entitled to or received credits that they were not entitled to.*

As a result of these programs not being written, taxpayers mistakenly received the benefit of provisions in the tax law or received tax credits that they were not entitled to. These taxpayers were not informed of their errors, and are thus likely to repeat them. Also, these errors, if later identified by the IRS, could result in significant burden to taxpayers, as they could be subject to penalties and interest in addition to any underpaid taxes.

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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### Recommendation

3. The Chief Operations Officer should ensure that computer programming necessary to identify taxpayer errors related to these two tax law provisions is completed by the 2001 filing season.

Management's Response: Submission Processing has prepared and will submit two computer programming requests to identify potential taxpayer errors related to the two tax law provisions.

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### The Internal Revenue Service Could Improve Several Taxpayer Notices Related to New Legislative Provisions

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If the IRS makes changes to figures taxpayers have entered on their tax returns, employees send the taxpayers notices to inform them of the changes. To implement new legislation, the IRS must develop or amend notices to address taxpayer errors related to the new legislative provisions. These notices should clearly communicate to taxpayers what their errors were, and what, if any, actions are required of the taxpayers.

*The IRS could improve notices for four new tax provisions.*

Notices for the following four new tax provisions did not clearly or adequately explain the taxpayers' errors, did not inform taxpayers of actions they needed to take, or were not technically accurate.

- Child Tax and Additional Child Tax Credit
- EITC Recertification
- Changes to the Calculation of Modified Adjusted Gross Income for Purposes of Determining the EITC
- Increased Adjusted Gross Income Limits for Contributions to an IRA

For example, to claim the Additional Child Tax Credit, taxpayers must have three or more qualifying children. Taxpayers who claimed this credit, but had less than three qualifying children were often sent notices which

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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*The IRS needs to improve the process used to ensure the quality of notices.*

*If taxpayers do not receive complete, clear notices, they are likely to repeat errors in subsequent years.*

stated, “You incorrectly figured your Additional Child Tax Credit on Form 8812. We adjusted your credit accordingly.” Taxpayers receiving this notice would not know they did not have enough qualifying children to claim the Additional Child Tax Credit. (For more information regarding these notices, see Appendix VI.)

The IRS relies on employees that develop notices to review them for technical accuracy. The IRS’ Notice Clarity function reviews all new and revised notices to ensure the notices are clearly written, and inform taxpayers what they need to know, and what, if anything they need to do. These review processes were not effective for the notices referred to above. In addition, there was no review process to compare available notices to actual errors made by taxpayers during the filing season.

As of August 1, 1999, the IRS had sent 661,805 of the notices discussed above. If taxpayers do not receive complete, clear notices, they are likely to repeat errors in subsequent years, or to contact the IRS for clarification.

### **Recommendation**

4. The Chief Operations Officer should ensure that reviews of notices issued to taxpayers are effective in ensuring the notices are technically accurate, clearly address the taxpayers’ errors, and clearly inform taxpayers what steps they need to take.

Management’s Response: Submission Processing and Customer Service will establish a formal clearance process to ensure that notices issued to taxpayers are effective, technically accurate, and clearly address the errors.

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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### **The Internal Revenue Service Could Correct Inaccurate Names and Taxpayer Identification Numbers on Returns Rather than Disallowing Credits and Exemptions**

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Taxpayers must provide the name and TIN (usually a social security number) of each person they claim as an exemption on their individual income tax return. This same information is necessary to claim several credits on a tax return including the Child Tax and Additional Child Tax Credits. When either the name or TIN entered on a tax return does not match the IRS' or the SSA's records, the IRS' procedures instruct the employee to disallow the exemption and any related credits without performing computer research to correct the invalid information. Then, the IRS adjusts the taxpayer's refund or balance due accordingly.

*Correct names and social security numbers of taxpayers' dependents are often readily available to the IRS.*

Dependent children are generally claimed year after year and accurate names and social security numbers are, accordingly, often on prior year IRS records. In approximately 31 percent of 403 cases sampled (125 of 403), the IRS had the correct information elsewhere on its computer system when it sent notices informing taxpayers their Child Tax Credit was disallowed because the name or TIN for their child on their 1998 tax return did not match IRS or SSA records.

When the IRS disallows a dependency exemption and related Child Tax Credit, taxpayers may be understandably confused or angry because these exemptions were often allowed in prior years. Occasionally the names or TINs provided by the taxpayers were correct, and incorrect information was entered onto the IRS' computers by IRS employees. This occurred in 11 of the 403 cases we reviewed. In order to reclaim the disallowed credits and exemptions, taxpayers must contact the IRS to provide them with the correct information.



## **Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions**

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*By performing computer research, the IRS could prevent unnecessary notices to taxpayers.*

By performing the same basic research we did for our sample, the IRS could prevent significant numbers of notices from being issued and reduce the related burden on taxpayers. As of August 1, 1999, the IRS had issued 773,672 notices to taxpayers informing them that their Child Tax or Additional Child Tax Credit had been disallowed because of an invalid name or TIN.

The IRS would experience additional returns processing costs to provide this service to taxpayers. However, some of these costs would be recovered because fewer taxpayers would need to contact the IRS to resolve the incorrect name or TIN. Currently, approximately 75 percent of the taxpayers nationwide who receive these notices, subsequently contact the IRS with corrected information. As a result, the IRS has to adjust these taxpayers' tax accounts.

### **Recommendation**

5. We agree that the IRS needs to ensure that taxpayers' dependents are valid before allowing related exemptions and credits. However, since most of the taxpayers who provided inaccurate names and/or social security numbers for their dependents contact the IRS with correct information, the Chief Operations Officer should consider the feasibility and cost effectiveness of conducting limited computer research to find the correct information before burdening the taxpayer.

Management's Response: IRS management did not implement our recommendation to correct inaccurate names and TINs on returns rather than disallowing related exemptions and credits. They expressed concern that such action would not benefit taxpayers in the long run. Since taxpayers would not be informed of the changes made on their returns, they would probably use the same names and TINs in the future. The returns would be directed to the Error Resolution function year after year, thus unnecessarily delaying the processing of the returns.

## **Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions**

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They also expressed concern about the impact on the Error Resolution function in the Submission Processing centers. When the requirement for this type of research increases, the correction of returns is slowed, delaying processing of all returns. Returns would be received with the same errors each year, thus steadily increasing the volume of returns requiring research and a correction. The steadily increasing volume and increased requirements could limit systemic and staffing resources available for correcting other returns.

Office of Audit Comment: We disagree with the IRS' response regarding correcting names and TINs on returns rather than disallowing related exemptions and credits. Correcting a taxpayer's return does not preclude the IRS from issuing a notice to the taxpayer (when applicable) explaining the taxpayer's mistake and encouraging the taxpayer to ensure that the TINs they enter on their tax returns are correct in succeeding years. Issuing such a notice would address the IRS' concern of a steadily increasing volume of returns requiring research and correction.

The IRS has spent a significant amount of taxpayer dollars developing computer systems which can provide instant access to taxpayers' accounts in the name of providing "one-stop" service to taxpayers. The ability to perform the research we have recommended resulted from these efforts. We observed Error Resolution employees taking the steps necessary to perform this research. The entire process was completed in a matter of seconds. Some of the invalid names and TINs identified are the result of mistakes by IRS employees when entering the numbers into IRS computers. Performing the recommended research would allow the IRS to avoid sending erroneous notices to the taxpayers affected by these IRS errors, and would demonstrate the IRS' commitment to "one-stop" service and taxpayer education.

## **Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions**

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### **The Internal Revenue Service Experienced Problems with Its Computer Programs to Implement Earned Income Tax Credit Recertification**

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Taxpayers who have been denied the EITC as a result of an IRS audit are not eligible to claim the EITC in subsequent years unless they provide information to demonstrate their eligibility. They provide this on the Information to Claim Earned Income Credit After Disallowance (Form 8862).

The IRS prepared computer programs to identify the tax returns of taxpayers who were required to file this form. These taxpayers' refunds were to be stopped until IRS employees could review the information on the forms and determine if the taxpayers qualified for the EITC. The IRS' computer programs designed to implement this process had errors that would have delayed some refunds that should not have been delayed, and allowed other refunds to be issued which should not have been issued.

#### **Refunds Unnecessarily Stopped**

Based on the instructions for Forms 1040 and 1040A, we anticipated that taxpayers would be confused about when to file Form 8862, and some taxpayers would file the form unnecessarily. The computer programs prepared by the IRS did not take this situation into consideration, and would have caused these taxpayers' refunds to be delayed. We reported this issue to the IRS, and it immediately revised its programs to ensure that taxpayer refunds would only be delayed when necessary. (See Appendices VIII and IX.)

*The IRS' computer programs would have unnecessarily delayed refunds for approximately 6,500 taxpayers.*

During the filing season, approximately 6,500 taxpayers unnecessarily filed Form 8862. Left uncorrected, the incorrect computer programs would have caused refunds for these taxpayers, totaling approximately \$12.8 million (\$8.8 million of which was the EITC) to be delayed unnecessarily.

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### Refunds of Taxpayers Requiring Recertification for the Earned Income Tax Credit Were Not Being Stopped

Early in the filing season, refunds totaling approximately \$218,000 (\$143,000 of which was the EITC) were issued to 74 taxpayers who met the criteria to have their refunds stopped. Computer programs to stop these refunds were not functioning as intended.

We brought this problem to the IRS' attention in a memorandum dated February 10, 1999. The IRS took immediate action to correct the problem. (See Appendices X and XI.) Left uncorrected throughout the filing season, this programming error would have resulted in approximately 29,000 disqualified taxpayers receiving the EITC, totaling approximately \$50 million. Although IRS employees had not identified this programming error as of the date of our memorandum, we estimate they would have discovered the programming error in approximately six weeks. (Our estimate is based on the amount of time it would take for the affected returns to post to IRS' IMF, related cases to be generated for review by IRS employees, and these employees to identify that refunds had already been issued for the returns.) Therefore, we estimate the amount of the EITC that would have been incorrectly refunded would have been approximately \$30.6 million refunded to nearly 17,000 taxpayers.

*An IRS programming error, if not corrected, would have allowed credits of approximately \$50 million to be incorrectly refunded.*

Besides the potential lost revenue to the Government, the programming error could have wasted IRS resources to collect the EITC incorrectly refunded.

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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### **The Internal Revenue Service Unnecessarily Burdened Taxpayers Who Obviously Entered the Child Tax Credit on the Wrong Line**

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*The IRS was unnecessarily corresponding with taxpayers who claimed the Child Tax Credit on the wrong line.*

Taxpayers claimed amounts consistent with the Child Tax Credit on the Child Care Credit or Education Credit lines of their tax returns, but did not attach the required schedules for these credits. Although these were obviously misplaced Child Tax Credit entries, the IRS sent these returns back to, or corresponded with, taxpayers and requested that they supply the schedules necessary to claim the Child Care or Education Credits.

Taxpayers claiming the Child Tax Credit could have been confused and frustrated when they received their tax returns back with requests for additional information to support credits they did not intend to claim.

We brought this issue to the IRS' attention in a memorandum dated March 25, 1999. The IRS took corrective action which included issuing an information alert to its employees to look for misplaced entries before corresponding with taxpayers for missing schedules. (See Appendices XII and XIII.)

### **Conclusion**

The IRS properly processed most tax returns impacted by new legislative provisions. However, it needs to take steps to timely identify and resolve processing problems and recurring taxpayer errors. Taking the actions recommended in this report could significantly reduce taxpayer burden as well as protect or increase the Government's revenue.

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**Appendix I**

**Detailed Objectives, Scope, and Methodology**

The objectives of this audit were to evaluate the effectiveness of the Internal Revenue Service's (IRS) implementation efforts as well as to evaluate actions taken during the filing season<sup>1</sup> to ensure that tax returns affected by significant new legislative provisions were processed correctly.

To accomplish our objectives, we analyzed tax legislation to identify provisions affecting returns processing for Tax Year 1998. We identified nine individual income tax provisions which we considered to be significant to this review based on: 1) the number of taxpayers affected, 2) the anticipated revenue impact, 3) the sensitivity of the provision, 4) the complexity of the provision, and 5) the results of the IRS' implementation activities discussed in our prior report. (Appendix VII contains a list, and brief explanation, of these nine legislative provisions.)

Where possible, when we identified tax return processing problems or recurring taxpayer errors, we determined the number of taxpayers impacted nationwide. We did this by obtaining nationwide computer data from the IRS' Individual Masterfile (IMF).<sup>2</sup>

Specifically, we performed the following audit tests. Unless specified otherwise, these tests were completed in the Ogden and Fresno Service Centers.

- I. Child Tax Credit/Additional Child Tax Credit
  - A. Reviewed 45 judgmentally selected 1998 individual income tax returns, paper and electronic, processed from January 4, 1999, through January 29, 1999, to determine if the IRS correctly computed and validated the amount of the Child Tax Credit for returns claiming the credit for four or fewer children.
  - B. Reviewed 20 judgmentally selected 1998 paper individual income tax returns, processed from January 22, 1999, to February 5, 1999, in the Fresno Service Center to determine if the IRS correctly computed and validated the amount of the Child Tax Credit for returns claiming the credit for more than four children.

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<sup>1</sup> The IRS refers to the first half of the calendar year, when most individual taxpayers file their tax returns and the IRS processes those returns, as "the filing season."

<sup>2</sup> The IRS' IMF is the IRS database that maintains transactions or records of individual tax accounts.

## **Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions**

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- C. Reviewed 69 judgmentally selected 1998 individual income tax returns, paper and electronic, processed during five various weeks from January 29, 1999, through April 9, 1999, to determine if the IRS correctly computed and validated the amount of the Child Tax Credit for taxpayers with adjusted gross income above the beginning phase-out level. (The phase-out level is the income level at which the law calls for the credit to begin being reduced.)
- D. Reviewed 53 judgmentally selected 1998 paper individual income tax returns processed from January 29, 1999, through February 5, 1999, in the Fresno Service Center to determine if the IRS accurately identified and corrected Child Tax Credit errors found on the returns.
- E. Based upon the problems found in step D above, we expanded the scope of this particular test to include those returns where Taxpayer Notice<sup>3</sup> number 692 (dealing with Child Tax Credit problems) or number 697 (dealing with Additional Child Tax Credit problems) were issued. We reviewed an additional 369 individual income tax returns (containing a total of 214 Taxpayer Notices number 692 and a total of 159 Taxpayer Notices number 697), processed from February 5, 1999, through February 18, 1999, to determine if adjustments made to the taxpayers' returns were accurate.
- F. Performed a computer analysis to identify 1998 individual income tax returns, paper and electronic, processed from February 5, 1999, through February 18, 1999, claiming the Child Tax Credit and receiving a Taxpayer Notice number 691 (indicating the taxpayer had provided an invalid dependent Social Security Number (SSN)). We analyzed the records to determine whether the taxpayer's exemption amount was properly reduced.
- G. Performed a computer analysis of the IRS' IMF to identify all 1998 tax returns processed through July 3, 1998, on which taxpayers claimed the Child Tax or Additional Child Tax Credit and received a Taxpayer Notice number 691 (indicating the taxpayer had provided an invalid dependent SSN), but did not receive a Taxpayer Notice number 605 (which would have indicated the taxpayer's exemption amount was reduced).

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<sup>3</sup> IRS employees send numbered notices to taxpayers informing them of changes made to figures on their tax returns.

## **Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions**

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- H. Researched 403 judgmentally selected 1998 individual income tax returns on the IRS' Integrated Data Retrieval System (IDRS)<sup>4</sup> using command code RTVUE,<sup>5</sup> to determine if there was a valid name or SSN located on the prior year (1997) individual income tax return which could have been used to correct an invalid name or SSN provided by the taxpayer on their 1998 tax return. Of those 125 cases for which prior year information was obtainable, we determined whether taxpayers had entered an incorrect name or an incorrect SSN.
- I. Performed a computer analysis of 604,382 records of 1998 individual income tax returns processed from February 12, 1999, through March 19, 1999, and for a one week period ending April 9, 1999, to determine if excessive Child Tax Credit amounts were allowed based on the number of qualifying children and the taxpayers' adjusted gross income.
- J. Evaluated the error explanations used for the Taxpayer Notice numbers 690, 691, 692, 697, and 698 (all related to Child Tax or Additional Child Tax Credit problems) since some of these taxpayer notices can be appropriately used for both Child Tax Credit and Additional Child Tax Credit to determine if the notice wording represented the actual error occurring on the return and the issues were clearly explained to the taxpayer.
- K. Reviewed 60 judgmentally selected 1998 individual income tax returns, paper and electronic, processed from January 8, 1999, through February 26, 1999, to determine if Additional Child Tax Credits were accurately computed and validated by the IRS for returns claiming the credit.
- L. See steps D and E above. The same random sample of 1998 individual income tax returns used for the Error Return Sample step for Child Tax Credit was used to test how accurately the IRS identified and corrected Additional Child Tax Credit errors found on the returns.
- M. Performed computer analyses of 72,430 records of 1998 paper and electronic individual income tax returns filed from January 18, 1999, through March 18, 1999, to determine if processes were in place to:
  - 1. Determine if Additional Child Tax Credits were allowed for returns that did not have three or more qualifying children.

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<sup>4</sup> The IDRS is an IRS computer system capable of retrieving or updating stored information. It works in conjunction with taxpayers' account records.

<sup>5</sup> The command code RTVUE provides a display of entries input into IRS' computers from individual income tax returns and their accompanying schedules and forms.



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2. Determine if excessive total Child Tax Credit and Additional Child Tax Credit was allowed for the number of qualifying children.
  3. Determine if excessive total Child Tax Credit and Additional Child Tax Credit was allowed for returns with adjusted gross income above the beginning phase-out level, considering the filing status and number of qualifying children.
- II. Credits for Higher Education (Hope Scholarship and Lifetime Learning Credits)
- A. Reviewed 90 judgmentally selected 1998 individual income tax returns, paper and electronic, filed through February 12, 1999, on which taxpayers claimed Education Credits, to determine if the IRS and taxpayers accurately computed Education Credits on returns falling below the beginning adjusted gross income phase-out levels.
  - B. Reviewed 90 judgmentally selected 1998 individual income tax returns, paper and electronic, filed through February 12, 1999, on which taxpayers claimed Education Credits, to determine if the IRS and taxpayers accurately computed Education Credits on returns within the adjusted gross income phase-out ranges.
  - C. Reviewed 89 judgmentally selected 1998 individual income tax returns, paper and electronic, filed through February 12, 1999, where the Education Credit claimed by the taxpayer was different from the amount allowed by the IRS, to determine if processes were in place to ensure the IRS accurately identified and corrected return errors for Education Credits.
  - D. Performed computer analyses of 1998 individual income tax returns filed through April 30, 1999, to determine if Education Credits were allowed when the adjusted gross income level was above the maximum phase-out level, or when taxpayers were claimed as a dependent on another return.
  - E. Performed a computer analysis of the IRS' IMF to identify all 1998 tax returns processed through October 1, 1999, receiving Education Credits that: (1) exceeded the adjusted gross income limit (based on filing status), (2) used married filing separate filing status, or (3) indicated the taxpayer was claimed as a dependent by another taxpayer.
  - F. Evaluated the error explanations used for the Taxpayer Notice numbers 693, 695, and 699 (related to Education Credit problems) to determine if the errors were clearly explained to the taxpayers on the notices they received.
  - G. Reviewed the Internal Revenue Manual for both the Error Resolution function and the Code and Edit function to determine if the instructions given were accurate.

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- III. Changes to the Calculation of Modified Adjusted Gross Income for Purposes of Determining the Earned Income Tax Credit (EITC)
- A. Reviewed 91 judgmentally selected 1998 individual income tax returns, paper and electronic, filed from January 8, 1999, through April 16, 1999, on which taxpayers claimed the EITC and reported one or more of the following: tax exempt interest, nontaxable distributions from annuities/pensions/Individual Retirement Accounts (IRA), net losses from a business or farm, or gains from the sale of business property, to determine if taxpayers calculated their modified adjusted gross income correctly.
  - B. Reviewed 89 judgmentally selected 1998 individual income tax returns, paper and electronic, filed from January 29, 1999, through February 19, 1999, on which taxpayers claimed the EITC and reported one or more of the following: tax exempt interest, nontaxable distributions from annuities/pensions/IRAs, net losses from a business or farm, or gains from the sale of business property, and where the amount claimed by the taxpayer was different than the amount allowed by the IRS. This review was to determine if the IRS corrected any taxpayer errors.
  - C. Based on the high employee error rate found in step B above for returns reporting nontaxable distributions from annuities, pensions or IRAs, reviewed an additional 124 judgmentally selected 1998 individual income tax returns, paper and electronic, filed from January 8, 1999, through April 23, 1999, on which taxpayers claimed the EITC and reported one or more of these types of income, to determine the extent these errors were occurring.
  - D. Evaluated the error explanations used for the Taxpayer Notice numbers 649 and 654 (related to problems in calculating modified adjusted gross income for determining the EITC) to determine if the errors were clearly explained to the taxpayers on the notice they received.
- IV. Interest on Education Loans
- A. Reviewed 90 judgmentally selected 1998 individual income tax returns, paper and electronic, filed through February 12, 1999, where taxpayers deducted interest for education loans and their adjusted gross income was above the beginning phase-out level to determine if taxpayers accurately computed the amount of the deduction.
  - B. Reviewed 88 judgmentally selected individual income tax returns, paper and electronic, filed through February 26, 1999, where the amount of the education interest deduction claimed by the taxpayer was different from the amount allowed by the IRS to determine if the IRS accurately calculated the deduction.

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- C. Performed computer analyses of 1998 individual income tax returns filed through April 30, 1999, to determine if deductions for interest on education loans were allowed when:
- The deduction exceeded the \$1,000 limitation.
  - Modified adjusted gross income exceeded the maximum phase-out level.
  - Taxpayers filed claiming married filing separately status.
  - Taxpayers were claimed as dependents on another return.
- D. Evaluated the error explanations used for the Taxpayer Notice numbers 140 and 699 (related to problems with interest on education loans) to determine if the errors were clearly explained to the taxpayer on the notice they received.
- V. Farmers Income Averaging
- A. Reviewed 184 judgmentally selected 1998 paper individual income tax returns, processed from March 5, 1999, through April 30, 1999, on which taxpayers used the Farm Income Averaging (Schedule J) to compute their tax liability, to determine if the IRS properly allowed the Schedule J tax liability as computed by the taxpayer.
- B. Evaluated the error explanations used for the Taxpayer Notice number 100(62) (related to Farm Income Averaging), to determine if the notice wording represented the actual error occurring on the return and the issues were clearly explained to the taxpayer. Since Taxpayer Notice number 100 can be used for generic, non-specific error explanations, IRS personnel devised a pre-printed small label (62) which was affixed to the taxpayer notice when a taxpayer made a mistake in transferring the tax liability amount from Schedule J to the appropriate line on the Form 1040. The explanation states “an error was made transferring your Schedule J amount to page 2 of your Form 1040.”
- VI. Filing Threshold for Individuals for Underpayment of Estimated Tax
- A. Reviewed 80 judgmentally selected 1998 individual income tax returns, paper and electronic, filed through March 26, 1999, where the de minimis thresholds fell between the former \$500 and revised \$1,000 limits, and there was an Estimated Tax Penalty amount computed by the taxpayer, to determine if the IRS was assessing the penalty only when applicable.
- B. Performed computer analyses of 1998 individual income tax returns filed through March 26, 1999, and again for a one week period ending April 16, 1999, to determine how many individual income tax returns had penalty threshold amounts between \$500 and the revised limit of \$1,000; and had taxpayer computed penalties.

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- C. Discussed the procedures used in determining the penalty tolerance computation with an analyst in the National Office and determined the dollar tolerance used by the IRS for assessing the Estimated Tax Penalty.
- VII. Estimated Tax Safe Harbor
- A. Performed computer analyses of 1998 individual income tax returns filed from January 8, 1999, through March 19, 1999, to identify tax returns with adjusted gross income over \$150,000, and 90 percent of the total tax less earned income tax credit minus withholding and estimated tax payment credits was greater than \$2,000. These analyses were used to select samples for steps B and C below.
  - B. Reviewed 72 judgmentally selected 1998 individual income tax returns, paper and electronic, filed through March 19, 1999, that met the estimated tax safe harbor criteria where the required annual payment was based on the prior year's tax, and there was no estimated tax penalty computed by the taxpayer. This review was performed to determine if the IRS properly computed the penalty.
  - C. Reviewed 29 judgmentally selected individual income tax returns, paper and electronic, filed through March 19, 1999, that met the estimated tax safe harbor criteria where the required annual payment was based on the prior year's tax, and there was an estimated tax penalty computed by the taxpayer. This review was performed to determine if taxpayers properly computed the penalty.
  - D. Researched and evaluated tax forms, instructions, IRS processing instructions, and taxpayer errors notated in steps B and C above for problems or areas that could be improved.
- VIII. EITC Recertification
- A. Reviewed 214 judgmentally selected 1998 individual income tax returns, paper and electronic, filed from January 22, 1999, through March 5, 1999, on which the taxpayer had claimed the EITC and the IRS had input an Audit Code "U," indicating the Information to Claim Earned Income Credit After Disallowance (Form 8862) was attached, to determine if these tax returns were processed properly.
  - B. Reviewed 90 judgmentally selected 1998 individual income tax returns, paper and electronic, filed from January 30, 1999, through February 20, 1999, to determine if returns identified by the IRS as needing recertification, but with no Form 8862 attached, were properly processed.

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- C. Reviewed the Taxpayer Notice number 653 (the only taxpayer notice used to explain errors related to the EITC Recertification to taxpayers) to determine if the notice clearly explained the error.
  - D. Performed a computer analysis of the IRS' IMF as of August 27, 1999, to identify all 1998 tax returns with an Audit Code "U" (indicating they filed Form 8862) but no corresponding recertification indicator on the taxpayer's account.
  - E. Performed a computer analysis of the IRS' IMF as of March 26, 1999, to identify all 1998 tax returns with an Audit Code "U" (indicating taxpayers filed Form 8862) and with a recertification indicator on their account.
- IX. IRAs / Roth IRAs
- A. Reviewed 35 judgmentally selected paper 1998 individual income tax returns filed from January 8, 1999, to April 9, 1999, to determine if the IRS effectively and correctly implemented the revised phase-out levels for returns claiming IRAs and Keogh deductions.
  - B. Reviewed 32 judgmentally selected paper 1998 individual income tax returns filed from February 12, 1999, to April 9, 1999, to determine if the IRS accurately identified and corrected return errors for the IRA deduction when a Keogh deduction was also present and a Taxpayer Notice indicating the IRA adjustment was made based upon adjusted gross income limitations.
  - C. Performed a computer analysis of the IRS' IMF as of July 31, 1999, to identify all taxpayers who received a Taxpayer Notice number 142 or 141 (related to problems with the IRA deduction on joint returns that also had claimed a Keogh deduction) and had modified adjusted gross income between \$60,000 and \$160,000. From this, we applied certain dollar criteria to exclude notices which we determined could have been correct in partial disallowance situations.
  - D. Evaluated the error explanations used for Taxpayer Notice number to determine if the IRS clearly explained the errors to the taxpayers on the notice they received.
  - E. Reviewed 30 judgmentally selected paper 1998 individual income tax returns, filed from January 8, 1999, to February 19, 1999, to determine if taxpayers converting amounts from traditional IRAs to Roth IRAs qualified for the conversion and accurately computed the taxable amount. We also reviewed these cases to determine if the IRS correctly implemented the new Roth IRA provisions for the conversions.

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- F. Performed a computer analysis of the IRS' IMF as of July 3, 1999, to identify all taxpayers converting their traditional IRAs to Roth IRAs who exceeded the limitations for making these conversions.
  - G. Reviewed applicable manuals, forms, and instructions for the Roth IRA to determine if the process planned for generating Roth reminder notices ensured the notices were issued to the appropriate taxpayers.
- X. Capital Gains Holding Period
- Because the IRS experienced difficulties implementing legislative changes regarding the Capital Gains and Losses (Schedule D) during the 1998 filing season, we did some limited work in this area as well. We reviewed changes made to the long-term Capital Gain provisions to determine if the IRS effectively and correctly processed returns related to the long-term tax calculations.
- A. Reviewed 87 judgmentally selected 1998 individual income tax returns, paper and electronic, filed through February 12, 1999, to determine if taxpayers accurately split long-term capital gains, using the benefit of the Schedule D tax calculation, and if the IRS effectively and correctly implemented the change to long-term capital gains with a minimum of burden to taxpayers.
  - B. Reviewed 59 judgmentally selected 1998 individual income tax returns, paper and electronic, filed through February 19, 1999, where the amount of tax claimed by the taxpayer was different than the amount calculated by the IRS to determine if the IRS accurately identified and corrected return errors when tax was computed based on long-term capital gains; and if changes to forms, instructions, or the IRS' correction processes could be made to reduce taxpayer burden.
  - C. Reviewed Taxpayer Notice numbers 181, 185, and 186 (related to problems with the revised Capital Gains provisions) to determine if they clearly explained the error to the taxpayer.

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**Appendix II**

**Major Contributors to This Report**

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Layne Powell, EDP Specialist

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Experienced Problems With Some New Tax Provisions**

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**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 and Quality OP:C:A  
National Director, Customer Service Telephone Operations and 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:O  
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



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**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:

Many of the changes the Internal Revenue Service (IRS) made to taxpayers' returns impacted by four new legislative provisions were incorrect. These incorrect changes were not identified by the IRS. The IRS has the capability to select for review, tax returns worked by Error Resolution employees based on specific tax provisions. However, it has not implemented such a review on a regular basis. As a result, it did not timely identify and take action to address significant error rates involving new legislative provisions included in our review. This resulted in loss of funds to both the Government and taxpayers.

Taxpayers were improperly denied, or improperly received, the Child Tax and/or Additional Child Tax Credit. The IRS miscalculated the Child Tax Credit on approximately 18 percent (39 of 214) of the cases in our samples. They miscalculated the Additional Child Tax Credit on approximately 36 percent (57 of 159) of the cases in our samples. Taxpayers were denied credits totaling over \$32,000, and were given credits to which they were not entitled totaling over \$15,000 in the 96 instances. Through August 1, 1999, the IRS had issued 492,106 notices informing taxpayers they had miscalculated their Child Tax Credit and 47,175 notices informing taxpayers they had miscalculated their Additional Child Tax Credit.

The National Director, Submission Processing, should initiate a post review of Error Resolution cases impacted by specific legislative provisions with emphasis on new tax provisions. The Computer Assisted Review of the Error Resolution System (CARE) could facilitate such a review. The results of this post review should be trended to identify processing problems, recurring taxpayer errors, and needed changes or improvements to tax forms and instructions.

Type of Outcome Measure:

Taxpayer rights and entitlements/Revenue protection

Value of the Benefit:

While not statistically valid, if the percentages of errors and average dollars of the samples from the Ogden and Fresno Service Centers were applied nationwide, taxpayers would have received over \$20 million in Child Tax and Additional Child Tax Credits that

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they were not entitled to. Similarly, they would have been denied over \$33 million that they were entitled to.

### Methodology Used to Measure the Reported Benefit:

We sampled and reviewed 214 returns that were issued an IRS' Taxpayer Notice<sup>1</sup> number 692 (dealing with Child Tax Credit problems), and we sampled and reviewed 159 returns that were issued the Taxpayer Notice number 697 (dealing with Additional Child Tax Credit problems). The Ogden and Fresno Service Center error rates and average dollars were projected to the 492,106 Taxpayer Notices number 692 and the 47,175 Taxpayer Notices number 697 issued nationwide. We used the IRS' Individual Masterfile (IMF)<sup>2</sup> Error Code Report (480-62-11), dated August 1, 1999, to determine the number of notices issued to taxpayers.

### Finding and Recommendation:

Many of the changes the IRS made to taxpayers' returns impacted by four new legislative provisions were incorrect. These incorrect changes were not identified by the IRS. The IRS has the capability to select for review, tax returns worked by Error Resolution employees based on specific tax provisions. However, it has not implemented such a review on a regular basis. As a result, it did not timely identify and take action to address significant error rates involving new legislative provisions included in our review. This resulted in loss of funds to both the Government and taxpayers.

Employees disallowing all or part of a taxpayer's claimed Child Tax Credit because the taxpayer did not provide a valid taxpayer identification number (TIN) for their child, did not properly disallow the related dependency exemption on 90,160 cases nationwide. This condition occurred due to a combination of employees' errors and a computer programming oversight. Not disallowing the exemption resulted in the tax liability being understated, generally by \$405.

The National Director, Submission Processing, should initiate a post review of Error Resolution cases impacted by specific legislative provisions with emphasis on new tax provisions. The CARE system could facilitate such a review. The results of this post review should be trended to identify processing problems, recurring taxpayer errors, and needed changes or improvements to tax forms and instructions.

### Type of Outcome Measure:

Increased revenue/Revenue protection

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<sup>1</sup> IRS employees send numbered notices to taxpayers informing them of changes made to figures on their tax returns.

<sup>2</sup> The IRS' IMF is the IRS database that maintains transactions or records of individual tax accounts.

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### Value of the Benefit:

Additional revenue of \$7.43 million

### Methodology Used to Measure the Reported Benefit:

We performed a computer analysis of all 1998 individual income tax returns posted to the IRS' IMF as of July 3, 1999. We selected all returns (727,586) with the Taxpayer Notice number 691 (where employees disallowed the Child Tax Credit because the taxpayer did not provide a valid TIN for their child). Of these, we identified 90,160 that did not have a corresponding Taxpayer Notice number 605 or 604 (disallowing the related dependency exemption).

We reviewed a statistically valid sample (90 percent confidence +/- 5 percent) of these cases to determine how often taxpayers subsequently provide the necessary information to the IRS. Based on this sample, we determined that 23.4 percent of the cases were not reversed. We used an average of \$405 per case to estimate taxes lost based on a 15 percent tax bracket multiplied by the \$2,700 dependency exemption that was not disallowed. We eliminated 11,756 cases with a tax liability of less than \$405. Therefore, 90,160 cases less 11,756 multiplied by 23.4 percent multiplied by \$405 results in \$7.43 million of additional revenue.

### Finding and Recommendation:

Many of the changes the IRS made to taxpayers' returns impacted by four new legislative provisions were incorrect. These incorrect changes were not identified by the IRS. The IRS has the capability to select for review, tax returns worked by Error Resolution employees based on specific tax provisions. However, it has not implemented such a review on a regular basis. As a result, it did not timely identify and take action to address significant error rates involving new legislative provisions included in our review. This resulted in loss of funds to both the Government and taxpayers.

For the returns of taxpayers receiving Taxpayer Notice 649 (related to problems in calculating modified adjusted gross income for determining the Earned Income Tax Credit (EITC)) that we tested, the EITC of taxpayers also reporting distributions from Individual Retirement Accounts (IRA) or pensions was improperly reduced approximately 48 percent of the time (60 of 124). These taxpayers were denied approximately \$38,000 of the EITC. As of August 1, 1999, the IRS had issued 63,279 of these notices informing taxpayers they had made mistakes when determining their modified adjusted gross income for the EITC. Based on volumes in the Ogden and Fresno Service Centers, we estimate that close to half of these notices resulted from modifications to adjusted gross income for determining the EITC when taxpayers reported distributions from IRAs or pensions.

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The National Director, Submission Processing should initiate a post review of Error Resolution cases impacted by specific legislative provisions with emphasis on new tax provisions. The CARE system could facilitate such a review. The results of this post review should be trended to identify processing problems, recurring taxpayer errors, and needed changes or improvements to tax forms and instructions.

Type of Outcome Measure:

Taxpayer rights and entitlements/Revenue protection

Value of the Benefit:

While not statistically valid, if the percentages of errors and average dollars of the samples from the Ogden and Fresno Service Centers were applied nationwide, taxpayers would have been denied approximately \$9.5 million of the EITC that they were entitled to.

Methodology Used to Measure the Reported Benefit:

We performed a computer analysis of returns filed at the Ogden and Fresno Service Centers and determined that approximately 49 percent of taxpayers receiving Taxpayer Notice number 649 had filed returns reporting distributions from IRAs or pensions. We sampled and reviewed 124 returns that were issued IRS' Taxpayer Notice number 649 and had these distributions from IRAs or pensions and found a 48 percent error rate and average dollar error of \$635. We projected these percentages and average dollars to the 63,279 Taxpayer Notices number 649 issued nationwide. We used the IRS' IMF Error Code Report (480-62-11), dated August 1, 1999, to determine the total number of notices issued to taxpayers.

Finding and Recommendation:

Many of the changes the IRS made to taxpayers' returns impacted by four new legislative provisions were incorrect. These incorrect changes were not identified by the IRS. The IRS has the capability to select for review, tax returns worked by Error Resolution employees based on specific tax provisions. However, it has not implemented such a review on a regular basis. As a result, it did not timely identify and take action to address significant error rates involving new legislative provisions included in our review. This resulted in loss of funds to both the Government and taxpayers.

Employees incorrectly disallowed deductions for IRAs on approximately 17,000 returns nationwide when taxpayers' filing joint returns and having Keogh deductions also had modified adjusted gross income between \$60,000 and \$160,000. The deductions disallowed in error averaged \$1,918 per return and totaled \$32 million.

The National Director, Submission Processing, should initiate a post review of Error Resolution cases impacted by specific legislative provisions with emphasis on new tax provisions. The CARE system could facilitate such a review. The results of this post

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review should be trended to identify processing problems, recurring taxpayer errors, and needed changes or improvements to tax forms and instructions.

### Type of Outcome Measure:

Taxpayer burden/Taxpayer rights and entitlements

### Value of the Benefit:

This recommendation could reduce taxpayer burden for those 17,000 taxpayers whose IRA deductions were incorrectly disallowed. Without this, these taxpayers would either be denied the right to deductions of approximately \$32 million or incur additional burden filing an amended return or contacting Customer Service to correct the inappropriate disallowance. At the lowest tax rate of 15 percent, this \$32 million dollars in deductions would equate to \$4.8 million in tax.

### Methodology Used to Measure the Reported Benefit

We performed a computer analysis of all 1998 individual income tax returns posted to the IRS' IMF as of July 31, 1999. We selected all returns with a Taxpayer Notice number 142 or number 141 (related to problems with the IRA deduction on joint returns that also had claimed a Keogh deduction) and had modified adjusted gross income between \$60,000 and \$160,000. From this, we applied certain dollar criteria to exclude notices which we determined could have been correct in partial disallowance situations.

### Finding and Recommendation:

Within the Error Resolution function, the IRS performs no regular post review of returns impacted by specific tax provisions. If the IRS' Error Resolution function had performed regular post reviews of tax returns by tax provision, and trended the results, they could have identified and taken action to solve processing problems related to these returns. Trend analyses could have also been used to identify recurring taxpayer errors that might be reduced by changes or improvements to tax forms and instructions.

The National Director, Submission Processing, should initiate a post review of Error Resolution cases impacted by specific legislative provisions with emphasis on new tax provisions. The CARE system could facilitate such a review. The results of this post review should be trended to identify processing problems, recurring taxpayer errors, and needed changes or improvements to tax forms and instructions. The National Director, Tax Forms and Publications, should receive and review the results of this trend analysis.

### Type of Outcome Measure:

Cost savings and reduced taxpayer burden for the following four outcome measures related to this finding.

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### Value of the Benefit (1):

If instructions were improved to clearly explain that taxpayers must have at least three qualifying children to be eligible for the Additional Child Tax Credit, a significant portion of the 47,175 notices sent to taxpayers (and related processing delays) informing them that their credit was either incorrectly claimed or incorrectly computed, could be eliminated.

### Methodology Used to Measure the Reported Benefit (1):

We sampled 83 returns filed in the Ogden Service Center for which taxpayers received Additional Child Tax Credit error notices and found that approximately 26 percent of the taxpayers (22 of 83) claimed less than the three dependents required to claim the additional credit. We used the IRS' IMF Error Code Report (480-62-11), dated August 1, 1999, to determine the number of notices related to Additional Child Tax Credit issued to taxpayers.

### Value of the Benefit (2):

If instructions for the U.S. Individual Income Tax Return (Forms 1040 and 1040A) had emphasized that a dependent's name entered on a tax return must **exactly** match the name on the dependent's card issued by the Social Security Administration (SSA), a significant portion of the 773,672 notices sent to taxpayers (and related processing delays) could have been avoided. We reviewed available IRS data for 125 taxpayers receiving notices informing them that their Child Tax and/or Additional Child Tax Credit was not allowed because the TIN and/or name they entered for their child did not match the records of either the IRS or the SSA. Over 22 percent (28 of 125) of these taxpayers had entered surnames for their children that did not match IRS or SSA records. Instructions for Forms 1040 and 1040A do not explain to taxpayers that the names of their dependents must match IRS or SSA records.

### Methodology Used to Measure the Reported Benefit (2):

We reviewed 125 cases in the Ogden and Fresno Service Centers where the Child Tax Credit was reduced or denied because the name or social security number of the taxpayer's child did not match the records of the IRS or the SSA. We used the IRS' IMF Error Code Report (480-62-11), dated August 1, 1999, to determine the number of these notices issued to taxpayers.

### Value of the Benefit (3):

Improving the instructions for computing modified adjusted gross income for the purpose of determining the EITC could reduce a significant portion of the 63,279 notices issued to taxpayers informing them that they miscalculated this figure. Otherwise, each of these returns would have to be sent to Error Resolution for corrections. The modified adjusted gross income computation is relatively complex. The IRS' instructions for computing it

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are in a detailed narrative, but could be improved with a worksheet or examples to help simplify the computation.

Methodology Used to Measure the Reported Benefit (3):

To determine the number of notices nationwide that could have the same problem, we computer analyzed the Ogden and Fresno notices and returns processed as of April 23, 1999, and determined that approximately 49 percent of returns with Taxpayer Notice number 649 (related to problems in calculating modified adjusted gross income for determining the EITC) had taxable IRA or pension distributions. These are new provisions affecting the computation of modified adjusted gross income. (The notice also applies to the EITC cases with business losses.) We used the IRS' IMF Error Code Report (480-62-11), dated August 1, 1999, to determine the number of these notices issued to taxpayers.

Value of the Benefit (4):

By specifically providing a statement on Forms 1040 and 1040A and their related instructions explaining that the maximum interest deduction for education loans is \$1,000, the IRS could reduce a significant portion of the 43,638 notices issued to taxpayers informing them that they miscalculated their student loan interest deduction. Although taxpayers compute the deduction using a worksheet that includes the maximum \$1,000 as part of the computation, there are no specific warnings on the tax forms or instructions that indicate the deduction is limited to \$1,000. In a sample of 88 returns where the interest deduction computed by the taxpayer did not match the amount computed by the IRS, we found approximately 56 percent of the returns (49 of 88) claimed a deduction greater than \$1,000.

Methodology Used to Measure the Reported Benefit (4):

We sampled 88 returns at the Ogden and Fresno Service Centers where the interest deduction computed by the taxpayer did not match the amount computed by the IRS. We used the IRS' IMF Error code Report (480-62-11), dated August 1, 1999, to identify the 43,638 notices issued between January 1, 1999, and August 1, 1999, informing taxpayers that they had miscalculated their student loan interest deduction.

Finding and Recommendation:

Because of limited programming resources and extensive priority programming requirements, the IRS postponed, or cancelled, computer programming to identify potential errors made by taxpayers relating to two new tax law provisions.

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2d, 2e-----  
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The Chief Operations Officer should ensure that computer programming necessary to identify taxpayer errors related to the tax law provision is completed by the 2001 filing season.

Type of Outcome Measure:  
Taxpayer burden

Value of the Benefit:  
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We brought this issue to IRS' attention, and they took steps to reduce the significant tax consequences to these taxpayers.

Methodology Used to Measure the Reported Benefit:  
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Finding and Recommendation:  
Because of limited programming resources and extensive priority programming requirements, the IRS postponed, or cancelled, computer programming to identify potential errors made by taxpayers relating to two new tax law provisions.  
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The Chief Operations Officer should ensure that computer programming necessary to identify taxpayer errors related to the tax law provision is completed by the 2001 filing season.

Type of Outcome Measure:

Increased revenue/Revenue protection

Value of the Benefit:

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Methodology Used to Measure the Reported Benefit:

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Finding and Recommendation:

To implement new legislation, the IRS must develop, or amend, notices to address taxpayer errors related to the new legislative provisions. These notices should clearly communicate to taxpayers what their errors were, and what, if any, actions are required of the taxpayers.

Notices for the following four new tax provisions did not clearly or adequately explain the taxpayers' errors, did not inform taxpayers of actions they needed to take, or were not technically accurate:

- Child Tax and Additional Child Tax Credit
- Changes to the Calculation of Modified Adjusted Gross Income for Purposes of Determining the EITC
- The EITC Recertification
- Increased Adjusted Gross Income Limits for Contributions to an IRA

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The Chief Operations Officer should ensure that reviews of notices issued to taxpayers are effective in ensuring the notices are technically accurate, clearly address the taxpayers' errors, and clearly tell taxpayers what steps they need to take.

Type of Outcome Measure:

Taxpayer burden

Value of the Benefit:

If taxpayers do not receive complete, clear notices, they are likely to repeat errors in subsequent years, or to contact the IRS for clarification. We determined there were 661,805 of these notices issued as of August 1, 1999.

Methodology Used to Measure the Reported Benefit:

We used the IRS' IMF Error Code Report (480-62-11), dated August 1, 1999, to determine the number of these notices issued to taxpayers.

Finding and Recommendation:

The IRS could correct inaccurate names and TINs on many taxpayers' returns rather than disallowing taxpayers' credits and exemptions. In over 31 percent of 403 notices sampled (125 of 403), the IRS had the correct information elsewhere on its computer system when it sent notices informing taxpayers their Child Tax Credit was disallowed because the name or TIN for their child on their 1998 tax return did not match IRS or SSA records.

Approximately 75 percent of the taxpayers nationwide, who received these notices subsequently contacted the IRS with corrected information.

Since most of the taxpayers who provided inaccurate names and/or social security numbers for their dependents contact the IRS with correcting information, the Chief Operations Officer should consider the feasibility and cost effectiveness of conducting limited computer research to find the correct information before burdening the taxpayer.

Type of Outcome Measure:

Taxpayer burden

Value of the Benefit:

This would reduce burden for approximately 239,838 taxpayers by avoiding unnecessary notices and subsequent contact by the taxpayers to correct the errors.

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### Methodology Used to Measure the Reported Benefit:

We sampled 403 cases where taxpayers had received notices disallowing Child Tax Credits due to invalid TINs and reviewed their 1997 tax returns using the IRS' computer command code RTVUE<sup>3</sup> to see if a similar, but valid, TIN was on record. Over 31 percent of the time, (125 of 403) the correct name or TIN could have been determined and burden to the taxpayer avoided. We used the IRS' IMF Error Code Report (480-62-11) dated August 1, 1999, to determine that 773,672 of these notices were issued nationwide. Although our sample was limited to returns at the Ogden and Fresno service centers, if it were representative of the national population, it would translate to reduced burden for 239,838 taxpayers (31 percent of 773,672 taxpayers receiving notices).

### Finding and Recommendation:

The IRS experienced problems with its computer programs to implement the EITC recertification. Based on the instructions for Forms 1040 and 1040A, we anticipated that taxpayers would be confused about when to file the Information to Claim Earned Income Credit After Disallowance (Form 8862), and some taxpayers would file the form unnecessarily. The computer programs prepared by the IRS did not take this situation into consideration, and would have caused these taxpayers' refunds to be delayed. We reported this issue to the IRS and they immediately revised their programs to ensure that taxpayer refunds would only be delayed when necessary. (See Appendices VIII and IX.) During the filing season, approximately 6,500 taxpayers unnecessarily filed Form 8862.

### Type of Outcome Measure:

Cost savings/Taxpayer burden

### Value of the Benefit:

Refunds totaling over \$12.8 million (\$8.8 million of which was the EITC) were not unnecessarily delayed and related taxpayer burden for approximately 6,500 taxpayers (and costs to release these refunds) were avoided.

### Methodology Used to Measure the Reported Benefit:

We performed a computer analysis of the IRS' IMF as of August 27, 1999. We identified all returns with an Audit Code "U" (indicating they filed Form 8862) but no recertification indicator on their account.

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<sup>3</sup> The command code RTVUE provides a display of entries input into IRS' computers from individual income tax returns and their accompanying schedules and forms.

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### Finding and Recommendation:

Early in the filing season, we found that refunds of taxpayers requiring recertification for the EITC were not being stopped as intended. In a memorandum issued February 10, 1999, we notified the IRS of this problem. The IRS took immediate action to correct their computer programming to stop these refunds. (See Appendices X and XI.) As a result, only 74 incorrect refunds with the EITC totaling over \$143,000 were issued.

### Type of Outcome Measure:

Revenue protection/cost savings

### Value of the Benefit:

Although IRS employees had not identified this programming error as of the date of our memorandum, we estimate they would have discovered the programming error in approximately six weeks. (Our estimate is based on the amount of time it would take for the affected returns to post to IRS' IMF, related cases to be generated for review by IRS employees, and these employees to identify that refunds had already been issued for the returns.) Therefore, we estimate that approximately 17,000 taxpayers would have received incorrect refunds of the EITC totaling approximately \$30.6 million.

Besides the potential lost revenue to the Government, the programming error could have wasted IRS resources to collect the EITC incorrectly refunded.

### Methodology Used to Measure the Reported Benefit:

We performed a computer analysis of the IRS' IMF as of March 27, 1999. We identified all returns with an Audit Code "U" (indicating they filed Form 8862) and with a recertification indicator on the account.





### **Taxpayer Notices Needing Improvement**

Notices developed for the following four new tax provisions did not clearly or adequately explain the taxpayers' errors, did not inform taxpayers of actions they needed to take, or were not technically accurate.

#### **Child Tax and Additional Child Tax Credit**

- Taxpayers often claimed the Child Tax and Additional Child Tax Credits for children who were too old to qualify for the credits. The Internal Revenue Service (IRS) does not currently have a computer program to identify these errors. However, Error Resolution employees were required to research the birthdates of children for whom the Child Tax Credit was claimed if the taxpayer forgot to check the applicable box on the front of his/her tax return. Often when performing this research, the employee would find that the child was too old to qualify for the credit. The IRS has no specific notice to explain this to a taxpayer. The notices available to Error Resolution employees relate to all types of Child Tax and Additional Child Tax Credit errors. The IRS' Taxpayer Notice<sup>1</sup> 692 states, "You incorrectly figured your Child Tax Credit. We adjusted your credit accordingly." Taxpayer Notice 697 states, "You incorrectly figured your additional Child Tax Credit on Form 8812. We adjusted your credit accordingly." As of August 1, 1999, the IRS had issued 539,281 of these notices.
- Taxpayers often claimed the Additional Child Tax Credit when they did not have three qualifying children as required by the law. The IRS has no specific notice to explain this to a taxpayer. Employees would either send Taxpayer Notice 697 referred to above, or would request manually typed notices be sent to the taxpayer. In our samples, approximately 25 percent (22 of 83) of the taxpayers who made mistakes when calculating their Additional Child Tax Credit had claimed fewer than three dependents.
- Because of a very complicated computer programming problem, some taxpayers received notices explaining that they made a mistake when figuring their Additional Child Tax Credit when their error was actually elsewhere on the return.

Taxpayers who made math errors on their tax returns resulting in changes to their tax liabilities of less than \$100, and who claimed the Child Tax Credit and Additional Child Tax Credit received confusing notices because of tolerances programmed into

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<sup>1</sup> IRS employees send numbered notices to taxpayers informing them of changes made to figures on their tax returns.

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the Error Resolution System (ERS). Mistakes on tax returns that did not affect the 2a, 2c-----  
2a, 2c----- If one of these same returns also had an error in the “Total Payments” section of the return that caused the refund or balance due amount to change by \$1 or more, this issue was identified as an error on the ERS, requiring a notice be sent to the taxpayer. However, the notice sent to the taxpayer had nothing to do with the real error on the tax return.

For example, if a taxpayer had a tax liability of \$1,000 before any tax credits were applied and made an error on the Itemized Deductions (Schedule A) which resulted in a \$99 increase in his/her tax liability, the Schedule A error would not be identified by the ERS. However, if this taxpayer claimed the Child Tax Credit and the Additional Child Tax Credit, this \$99 error would have caused the Child Tax Credit to increase and the additional Child Tax Credit (which is in the “Total Payments” section of the return) to be decreased. In this case, an Error Resolution employee would have sent a notice to the taxpayer informing him/her that the change in his/her refund amount was because he/she made a mistake in calculating his/her Additional Child Tax Credit. This taxpayer would have had no idea that the error was actually elsewhere on his/her return.

### **Earned Income Tax Credit Recertification**

The IRS’ Taxpayer Notice number 653 states, “We cannot allow your Earned Income Credit. You have not recertified that you are eligible for the credit.” While this notice properly explains why the credit was disallowed, it does not inform the taxpayer what to do to recertify that they are eligible for the Earned Income Tax Credit (EITC).

### **Changes to the Calculation of Modified Adjusted Gross Income for Purposes of Determining the Earned Income Tax Credit**

Beginning with the 1998 tax year, required modifications to adjusted gross income (used to determine the amount of the EITC) were expanded to include tax exempt interest and nontaxable distributions from pensions, annuities and Individual Retirement Accounts (IRA). The IRS’ Taxpayer Notice number 649 advises taxpayers that they made an error when determining their modified adjusted gross income for determining their EITC. The notice refers to nontaxable distributions from pensions, annuities and IRAs, but does not refer to tax exempt interest.

### **Increased Adjusted Gross Income Limits for Contributions to an Individual Retirement Account**

The IRS’ Taxpayer Notice number 142 is sent to taxpayers whose IRA deduction is disallowed because they are also claiming a Keogh deduction and have modified adjusted gross income which exceeds the limitations in the tax law. However, this notice does not clearly explain that modified adjusted gross income exceeds limitations. The notice does



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not clearly state that active participants in a Keogh plan are considered to be covered by a retirement plan. The notice also refers taxpayers to General Rules for Individual Retirement Accounts Under the Tax Reform Act of 1986, (Publication 1602) which contains outdated, inaccurate information.

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**Appendix VII**

**Key Legislative Provisions Affecting Individual  
Returns Processing for the 1999 Filing Season Included in this Review**

<u><b>Legislative Provision</b></u>	<u><b>Brief Overview</b></u>
<b>Child Tax Credit / Additional Child Tax Credit</b>	<p>Beginning with the 1998 tax year, many taxpayers could receive a \$400 tax credit for each child under age 17. (The credit increases to \$500 for the 1999 tax year.) Taxpayers can use this credit to reduce, dollar for dollar, the amount of tax they owe.</p> <p>There are some restrictions to the amount of credit that can be used. The credit amount is reduced, and eventually eliminated, as taxpayers' income increases. Also, taxpayers with fewer than three children can only use the credit to reduce their tax to zero. The difference, if any, cannot be refunded to them. However, if a taxpayer has more than two children who qualify for the credit, the credit amount, if greater than the amount of tax, is generally refunded to the taxpayer. This portion is called the Additional Child Tax Credit.</p>
<b>Credits for Higher Education</b>	<p>Beginning with the 1998 tax year, taxpayers received two new tax credits for education expenses, the Hope Scholarship Credit and Lifetime Learning Credit. These credits can be claimed by taxpayers who pay tuition and related expenses for college or graduate degrees or vocational training. These credits reduce a taxpayer's tax amount dollar for dollar, but only until the tax is reduced to zero. The difference cannot be refunded.</p>
(Hope Scholarship Credit)	<p>The Hope Scholarship Credit can only be claimed for expenses incurred for the first two years of education after high school. The credit</p>

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(Lifetime Learning Credit)	<p>can amount to as much as \$1,500 per student.</p> <p>The Lifetime Learning Credit is also available for education expenses incurred after high school, but is not limited to any number of years. It can be claimed for expenses incurred for undergraduate, graduate, and professional degrees, as well as courses taken to acquire or improve job skills. The credit is limited to \$1,000 per return.</p> <p>Both credits are reduced, or completely eliminated, as taxpayers' incomes increase. Neither credit is available for married taxpayers who file separate returns, nor for students who are claimed as dependents by another taxpayer.</p>
<b>Changes to the Calculation of Modified Adjusted Gross Income for Purposes of Determining the Earned Income Tax Credit (EITC)</b>	<p>Beginning with the 1998 tax year, the Congress expanded the types of income that must be included in a taxpayer's modified adjusted gross income for the purposes of computing the EITC amount.</p> <p>The new types of income now required to be included in modified adjusted gross income are non-taxable. They specifically include non-taxable interest amounts and non-taxable distributions from pensions, annuities, and individual retirement accounts. Also, the percentage of net business losses that must be added back into modified adjusted gross income increased from 50 to 75 percent.</p>
<b>Farmers Income Averaging</b>	<p>Beginning in the 1998 tax year, farmers can compute their current year's income tax liability by using an income averaging method. Their current income from farming is evenly spread over the three prior year incomes and then taxed using the respective prior year tax rates.</p>
<b>Interest on Education Loans</b>	<p>Beginning in the 1998 tax year, taxpayers could deduct up to \$1,000 from their taxable income for interest paid on loans used to pay the cost of</p>

## **Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions**

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obtaining higher education. The maximum amount deductible will continually increase over a three-year period until it reaches \$2,500 in 2001.

The amount of interest that can be deducted from income is reduced, or completely eliminated, as taxpayers' income increases. Also, the interest deduction is not available for married taxpayers who file separate returns or for students who are claimed as dependents by other taxpayers.

### **Filing Threshold for Individuals for Underpayment of Estimated Tax**

Beginning in the 1998 tax year, the amount that taxpayers could under-pay their tax without penalty was increased from \$500 to \$1,000.

### **Estimated Tax Penalty Safe Harbor**

Beginning in the 1998 tax year, taxpayers with adjusted gross income greater than \$150,000 may avoid estimated tax penalties if their estimated tax payments are at least 100 percent of the tax shown on last year's returns. This is down from the 1997 requirement of 110 percent, but the percentage requirements generally increase for years after 1998.

### **EITC Recertification**

Beginning with the 1997 tax return, if the Internal Revenue Service (IRS) audits a taxpayer and finds that the taxpayer incorrectly took the EITC, the taxpayer will not be allowed the credit in any subsequent year until he/she can recertify. A taxpayer can recertify by providing the IRS with information showing that he/she qualifies for the credit. The taxpayer will not need to recertify if all, or part, of the EITC was not allowed due to a mathematical or clerical error.

### **Individual Retirement Accounts (IRA)**

(Roth IRAs)

Beginning in the 1998 tax year, a new type of IRA called a Roth IRA was established for low

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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to middle income taxpayers. The rules that apply to traditional IRAs generally apply to Roth IRAs except for the following:

- Contributions made to a Roth IRA cannot be deducted from taxable income.
- Distributions from a Roth IRA are generally not taxable.
- Distributions are not required to begin at age 70½.
- Contributions can be made after age 70½.

Taxpayers with modified adjusted gross income of \$100,000 or less (except married taxpayers filing separately) can roll over or “convert” amounts from their traditional IRAs to Roth IRAs, but any amount not previously taxed must be included in the taxpayers’ gross income. If the amount was rolled over in 1998, the income could be evenly spread and taxed over the subsequent four years.

(Increase Adjusted Gross Income  
Limits for Contributions to an  
IRA)

The amount that taxpayers who participate in their employers’ retirement plans (“active participants”) can earn and still make deductible taxable contributions to their own IRAs is increased. (This includes taxpayers who participate in Keogh Retirement Plans.)

In addition, an individual who is not an active participant but is married to someone who is, can generally make a deductible IRA contribution. The amount that is deductible is reduced as the taxpayer’s income increases.

**Taxpayers and the Internal Revenue Service  
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**Appendix VIII**

**Memorandum #1: Taxpayers Who Have Had the Earned Income Tax Credit  
Denied Through Math Error Procedures May Unnecessarily File for  
Recertification**

**Internal Revenue Service  
memorandum**

date: December 16, 1998

**Response Date: January 8, 1999**

to: Assistant Commissioner  
(Forms and Submission Processing) OP:FSP

  
from: Regional Inspector  
Western Region

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subject: **Taxpayers Who Have Had The Earned Income Tax Credit (EITC) Denied Through  
Math Error Procedures May Unnecessarily File For Recertification**

As part of our audit to evaluate the effectiveness of the Service's actions to implement legislative changes affecting the 1999 filing season, we are performing an in-depth evaluation of Requests for Information Services (RISs) and tax forms and instructions that have been prepared and submitted for key provisions in the legislation. This memorandum discusses problems regarding the Service's implementation of EITC recertification provisions. If not corrected, these problems could result in increased burden to taxpayers because taxpayers may unnecessarily file Form 8862, Information To Claim Earned Income Credit After Disallowance, and may have their refunds delayed.

We have discussed these issues with employees from Submission Processing, Customer Service, and Information Systems. Please provide your written response to this memorandum by the date shown above. Please include an assessment of the cause, the proposed corrective action, the completion date or the proposed completion date for the corrective action, and the responsible management official. If you disagree with any of the facts as presented in this memorandum, or if you would like to meet to discuss these issues, please contact Audit Manager, Kyle Andersen at (801) 620-6550.

**Background**

Service officials consider legislation enacted in 1997 (Taxpayer Relief Act, Balanced Budget Act, and Taxpayer Browsing Act) as the most extensive and complicated legislation the Service has faced since the Tax Reform Act of 1986. In addition, the Service is faced with implementing the IRS Restructuring and Reform Act of 1998. These legislative provisions will have significant organizational impact throughout the Service through the 1999 filing season.

Many of the provisions will require revisions to computer programs to implement. These programming revisions are initiated by preparation of a RIS. Because of the complexity of the tax law changes combined with other significant factors which will affect the 1999 filing season (Year 2000 Initiatives, and Mainframe Consolidation), some Service

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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Assistant Commissioner (Forms and Submission Processing) OP:FSP

executives have expressed concern that the Service may have trouble managing all of the changes required for the 1999 filing season.

To address this issue, we initially reviewed the legislation affecting processing of tax returns during the 1999 filing season and ensured that RISs were prepared and that forms and instructions changes were scheduled as necessary. We are now performing in-depth reviews of actions taken by the Service to implement several key legislative provisions. Specifically, we are reviewing RISs to ensure that they fully and accurately address all aspects of a legislative provision, and we are reviewing tax forms and instructions to ensure they are accurately prepared and use plain, clear and courteous language.

This memorandum discusses specific issues we found regarding implementation of the new EITC Recertification process. As we continue to identify issues, we will bring them to your attention.

### Results

From our reviews, we concluded that:

- ◆ Taxpayers who have had EITC denied through math error procedures may misunderstand the tax package instructions pertaining to when a Form 8862, Information To Claim Earned Income Credit After Disallowance, must be filed and unnecessarily attach the form when recertification is not required; and
- ◆ Proposed recertification processing procedures could result in delay of taxpayers' refunds and/or an unnecessary use of resources to screen returns with erroneous Forms 8862 attached.

1998 Tax Package instructions state:

"If your 1997 earned income credit was disallowed as the result of deficiency procedures, you must complete and attach Form 8862 to claim the credit this year."

On 1997 returns, many claims for earned income credits were eliminated using Error Resolution math error processing rather than Examination deficiency procedures. Publication 596, Earned Income Credit, provides an explanation distinguishing between math error and deficiency procedures. However, many taxpayers may not get all related publications when preparing their returns, and the specific instructions which discuss the need to file Form 8862 when claiming EIC, do not refer to Publication 596.

As a result, we believe that many taxpayers will not know the difference between math error and deficiency procedure disallowance of the credit and may unnecessarily submit a Form 8862 with their 1998 tax return. The unnecessary preparation will increase the burden to taxpayers. The Service estimates the time necessary to research, prepare, and file the form to be 94 minutes.

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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Assistant Commissioner (Forms and Submission Processing) OP:FSP

This taxpayer burden could be increased by proposed processing procedures and computer programming related to Forms 8862. These procedures and programs call for tax returns with Form 8862 attached to receive an Audit Code U, which would result in a freeze on any refund associated with the return, and would cause the return to be routed to Service Center Examination for screening. The taxpayer's refund would remain frozen until released by a tax examiner. This could result in significant delays for refund issuance, and would also result in unnecessary use of compliance resources to screen returns for taxpayers who mistakenly filed Form 8862. (See attachment for details of processing procedures and computer programs).

Subsequent to our bringing this issue to management's attention, the Information Systems' analyst responsible for computer programs related to this issue informed us that he would modify the computer program. The modified program would freeze the refund and route the return to Service Center Examination only if the EITC Recertification Indicator present on the Masterfile indicated that recertification was required.

### **Recommendations:**

1. The National Director, Submission Processing should follow up to ensure that the computer programming changes referred to above are made. If for some reason the programming changes could not be made, the Director should notify the National Director, Customer Service Compliance, Accounts and Quality to assure resources are provided to screen returns with Form 8862 prior to their receiving Audit Code U to determine if the Form 8862 was filed in error.
2. The National Director, Tax Forms and Publications should ensure that instructions related to attaching Form 8862 when claiming EIC are clarified.

cc: National Director, Submission Processing  
National Director, Tax Forms and Publications Division  
National Director, Customer Service Compliance, Accounts and Quality




**Taxpayers and the Internal Revenue Service  
Experienced Problems With Some New Tax Provisions**

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**Appendix IX**

**Management's Response to Memorandum #1**

 <small>ASSISTANT COMMISSIONER (FORMS AND SUBMISSION PROCESSING)</small>	<small>DEPARTMENT OF THE TREASURY INTERNAL REVENUE SERVICE WASHINGTON, D.C. 20224</small>	January 21, 1999
 <b>MEMORANDUM FOR REGIONAL INSPECTOR WESTERN REGION</b>		
<b>FROM:</b>	Brien T. Downing <i>Brien T. Downing</i> Assistant Commissioner (Forms and Submission Processing)	
<b>SUBJECT:</b>	Taxpayers Who Have Had the Earned Income Tax Credit (EITC) Denied Through Math Error Procedures May Unnecessarily File for Recertification – URMEM dated December 16, 1998	
 Thank you for bringing to our attention issues related to the new EITC recertification process, and providing the opportunity to respond to your recommendations. We concur with both recommendations and have provided a summary of the actions we have taken or will take to comply.		
<u>Recommendation:</u>		
The National Director, Submission Processing should follow up to ensure that the computer programming changes, referred to in the memorandum, are made. If for some reason the requested programming changes cannot be made, the Director should notify the National Director, Customer Service Compliance, Accounts and Quality to ensure that resources are provided to screen returns with Form 8862 prior to their receiving Audit Code "U", to determine if the Form 8862 was filed in error.		
<u>Assessment of Cause:</u>		
Proposed recertification processing procedures could result in the delay of taxpayer's refunds and/or an unnecessary use of resources to screen returns with erroneous Forms 8862 attached. These procedures and programs call for tax returns, with Form 8862 attached, to receive an Audit Code "U", resulting in a freeze on any refund associated with the return, and routing to Service Center Examination for screening.		
<i>c/4.2</i>		

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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Corrective Action:

Procedures and programs have been established for tax returns with a Form 8862 attached to be "U" coded by Code and Edit tax examiners in the service centers. If the EITC recertification indicator is on at the master file, the "U" code will cause the taxpayer's refund to be delayed until the Examination function completes their review and takes subsequent action. If the taxpayer erroneously submits a Form 8862, the same manual process will occur. However, when the return posts to the master file, the EITC recertification indicator will not be on, therefore, the refund will not be delayed by this process.

Implementation Date:

Completed: January 4, 1999

Responsible Official(s):

Assistant Commissioner (Forms and Submission Processing)  
National Director, Submission Processing  
Chief, Paper Submissions Branch

Recommendation:

The National Director, Tax Forms and Publications should ensure that instructions related to attaching Form 8862 when claiming EIC are clarified.

Assessment of Cause:

Because many taxpayers have had their earned income credits adjusted as a result of the math error procedures, they may confuse this process with the deficiency procedures and erroneously attach Form 8862. The 1998 tax package instructions could be revised to clarify this distinction. Erroneously attaching Form 8862 could unnecessarily delay a refund and cause IRS to expend resources to review the return.

Corrective Action:

We will clarify the 1999 tax package instructions regarding when Form 8862 needs to be attached to a tax return.

Implementation Date:

Proposed: October 31, 1999

**Taxpayers and the Internal Revenue Service  
Experienced Problems With Some New Tax Provisions**

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Responsible Official(s):

Assistant Commissioner (Forms and Submission Processing)  
National Director, Tax Forms and Publications Division  
Chief, Tax Forms Development Branch

If you have any questions or require additional information, please have your staff call  
Cris Balzereit on (202) 622-7055.


cc: Chief Operations Officer  
National Director, Submission Processing Division  
National Director, Tax Forms and Publications Division

**Taxpayers and the Internal Revenue Service  
Experienced Problems With Some New Tax Provisions**

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**Appendix X**

**Memorandum #2: Refunds Are Not Being Frozen on Returns Requiring  
Recertification for the Earned Income Credit**

 DIRECTOR GENERAL FOR TAX ADMINISTRATION	DEPARTMENT OF THE TREASURY WASHINGTON, D.C. 20220	
	February 10, 1999	Response Date February 25, 1999
MEMORANDUM FOR: ASSISTANT COMMISSIONER (FORMS AND SUBMISSION PROCESSING) OP:FS ASSISTANT COMMISSIONER (CUSTOMER SERVICE) OP:C ASSISTANT COMMISSIONER (SYSTEMS DEVELOPMENT) IS:S		
FROM: REGIONAL INSPECTOR GENERAL FOR AUDIT <i>Stephen D. Sullivan</i> WESTERN REGION		
SUBJECT: Refunds Are Not Being Frozen on Returns Requiring Recertification for the Earned Income Credit		
<p>As part of our audit to evaluate the effectiveness of the IRS's actions to implement legislative changes affecting the 1999 filing season, we are performing an on-line review of the processing of 1998 individual income tax returns affected by key provisions in the legislation. We are issuing this memorandum to notify you of an issue that we think needs your immediate attention. We believe this problem was caused by a programming error. We will provide you more information later as we develop the cause and effect. This memorandum has not been through our normal quality review process, because we feel it is important to get this issue elevated to you immediately. If not corrected, this problem could cause lost revenue, undue taxpayer burden, and waste IRS resources.</p> <p>Please provide your written response to this memorandum by the date shown above. Please include an assessment of the cause, the proposed corrective action, the completion date or the proposed completion date for the corrective action, the responsible management official, and the plan and methodology for tracking and ensuring effectiveness of the corrective action. If you disagree with any of the facts as presented in this memorandum, or if you would like to meet to discuss these issues, please contact Audit Manager, Kyle Andersen at (801) 620-6550.</p>		

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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### Background

Taxpayers who have been denied the Earned Income Credit (EIC) as a result of an examination of their return are not eligible to claim the EIC in subsequent years unless they provide information to demonstrate eligibility for the credit. This process, referred to as recertification, was planned to function as follows.

- Taxpayers with EIC disallowed as the result of an examination of their 1997 tax return have an indicator, the recertification indicator, posted to their account. Over 197,000 accounts currently have this indicator identifying that the taxpayer will require recertification before EIC can be allowed.
- In order to claim EIC in subsequent years these taxpayers must provide documentation to show they qualify for the credit. Taxpayers do this by attaching a form with the required information to their subsequent tax return.
- Tax returns with this form attached are identified and coded during processing using an Audit Code U.
- When a return with an Audit Code U posts to a Master File account for a taxpayer requiring recertification, the refund should be frozen and the return sent to Examination for an evaluation of the documentation provided. The posting of these returns should generate a transaction code, TC810, which freezes the refund.

### Results

Refunds are not being frozen as intended for taxpayers requiring recertification to claim EIC. This could result in lost revenue to the government for taxpayers who do not demonstrate their eligibility for EIC and do not repay the EIC; could result in undue taxpayer burden for taxpayers who repay; and could waste IRS resources to collect the EIC refunded.

Our analysis of returns from early processing identified taxpayers with accounts indicating they were required to recertify, and whose returns were coded to indicate they had requested recertification. Although the posting of these returns generated the transaction code intended to freeze the refund, TC810, the refunds were issued. We analyzed eight returns and found the following:

- 7 with a TC810 posted the same cycle as the return, with refunds issued;

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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- 1 with a TC810 posted in a cycle prior to the return posting, with the refund frozen.<sup>1</sup>

It appears that the TC810 does not function as intended when it posts in the same cycle as the return. We will be happy to provide the identity of the taxpayers if desired.

### **Recommendations:**

1. The Director, Corporate Processing should ensure programming is corrected to prevent improper refunds on returns requesting EIC recertification.

cc: National Director, Submission Processing OP:FS:S  
National Director, Customer Service Compliance, Accounts & Quality OP:C:A  
Director, Corporate Processing IS:S:CP

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<sup>1</sup> The TC810 may be input manually by Examination if the 1997 return is under examination for EIC. In this case, the TC810 was input prior to the examination closure, which created the recertification indicator on the account.

**Taxpayers and the Internal Revenue Service  
Experienced Problems With Some New Tax Provisions**

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**Appendix XI**

**Management's Response to Memorandum #2**

 <small>TAXPAYER SERVICE</small>	<small>DEPARTMENT OF THE TREASURY INTERNAL REVENUE SERVICE WASHINGTON, D.C. 20224</small>
 <b>MAR 8 1999</b>  	
<b>MEMORANDUM FOR REGIONAL INSPECTOR GENERAL FOR AUDIT WESTERN REGION</b>	
<b>FROM:</b>	Marilyn Soulsburg <i>Marilyn Soulsburg</i> Acting Assistant Commissioner (Customer Service) <b>OP:C</b>
<b>SUBJECT:</b>	Refunds Not Being Frozen on Returns Requiring Recertification for the Earned Income Credit
 <p>Thank you for alerting us to the programming problem causing refunds to be released erroneously. When the recertification programming was written it allowed for the automatic generation of a TC811 when a TC30X was input to the account. For this automatic TC 811 to generate, the TC810 required a unique indicator which was transparent to the user. Unfortunately, the refund program did not recognize this unique indicator on the TC810 and treated the account as if the TC810 was not present.</p> <p>Based on an analysis of the returns filed from the beginning of the year through cycle 9906, seventy-four (74) refunds were issued erroneously. These accounts have been identified and Service Center Examination will be working them as post-refund audits.</p> <p>Effective cycle 9907 the recertification program was corrected. To ensure the correction will effect the desired results, Service Center Examination has identified and is tracking returns that meet recertification requirements.</p> <p>If you have any questions please contact me, or a member of your staff may contact Louise Brown at (516) 447-4442.</p>	

**Taxpayers and the Internal Revenue Service  
Experienced Problems With Some New Tax Provisions**



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

MAR 10 1999

OFFICE OF TREASURY  
INSPECTOR GENERAL  
RECEIVED

199903-45284984  
1999 MAR 15 P 3:43

FOR TAX ADMINISTRATION

MEMORANDUM FOR TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

FROM:  David W. Junkins  
Director, Office of Information Resources Management IS:IR

SUBJECT: Refunds are Not Being Frozen on Returns Requiring Recertification  
for the Earned Income Credit

The Assistant Commissioner for Systems Development (IS:S) has reviewed the subject Treasury Inspector General for Tax Administration (TIGTA) audit memorandum and provides the attached management response.

If you have any questions, please call me on (202) 283-4060 or have a member of your staff call Donna Downing on (202) 283-4159.

Attachment

cc: Regional Inspector General for Audit (Western Region)



## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

### **Management Response to Treasury Inspector General for Tax Administration (TIGTA) Audit Memorandum - Refunds are Not Being Frozen on Returns Requiring Recertification for the Earned Income Credit (EIC)**

#### **Recommendation #1**

The Director, Corporate Processing should ensure programming is corrected to prevent improper refunds on returns requesting EIC recertification.

#### **Assessment of the Cause**

For January 1999, processing was modified to incorporate a refund freeze for taxpayers claiming Earned Income Credit (EIC), when the EIC was reversed via an examination in a prior year. These modifications were based on Request for Information Services (RIS) TCP-8-0073.

Master file generates a Transaction Code (TC) 810 and a TC 424 when posting a return containing Audit Code U input to an account containing the EIC Recertification Indicator. The TC 810 should freeze the refund and the TC 424 sends the case to Audit Information Management System (AIMS). To aid with the release of the 810 freeze (-E freeze), it was decided that master file would release the generated 810 freeze when posting an audit adjustment. In addition to generated TC 810s, field personnel can input a TC 810 manually. In an effort to distinguish between the generated and manually input TC 810s, a decision was made to use a unique bit setting (8 bit) of the 810 freeze for generated TC 810s. Unfortunately, the refund freeze program was not modified to recognize the new bit setting.

#### **Corrective Action #1**

The refund program was modified to recognize the new bit setting of the 810 freeze. This modification was transmitted in cycle 199907 (run on 2-14-99). In addition, pertinent information (Social Security Number, service center) for all 74 records that refunded incorrectly was given to the responsible customer analyst. As mentioned earlier, all of these cases were correctly forwarded to AIMS due to the generation of TC 424s.

**Taxpayers and the Internal Revenue Service  
Experienced Problems With Some New Tax Provisions**

**Management Response to Treasury Inspector General for Tax Administration  
(TIGTA) Audit Memorandum - Refunds are Not Being Frozen on Returns  
Requiring Recertification for the Earned Income Credit (EIC)**

**Implementation Date**

Completed: 02/14/1999

Proposed: \_\_\_\_\_

**Responsible Official**

Chief Information Officer IS  
Deputy Chief Information Officer (Systems) IS  
Assistant Commissioner for Systems Development IS:S

**Corrective Action Monitoring Plan**


A file search of the master file was performed to ensure that refunds were frozen for any new cases containing a generated TC 810. For all generated TC 810 cases, the refund was frozen. All action is completed and the effectiveness of the action has been verified.

**Taxpayers and the Internal Revenue Service  
Experienced Problems With Some New Tax Provisions**

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**Appendix XII**

**Memorandum #3: The Internal Revenue Service is Unnecessarily  
Burdening Some Taxpayers Who Claim the Child Tax Credit on the Wrong  
Line of Their Tax Return**

 INSPECTOR GENERAL for TAX ADMINISTRATION	DEPARTMENT OF THE TREASURY WASHINGTON, D.C. 20220
March 25, 1999	
Response Date April 9, 1998	
MEMORANDUM FOR ASSISTANT COMMISSIONER (FORMS AND SUBMISSION PROCESSING) OP:FS	
FROM:	Stephen R. Mullins <i>Stephen R. Mullins</i> Regional Inspector General for Audit Western Region
SUBJECT:	The Internal Revenue Service is Unnecessarily Burdening Some Taxpayers Who Claim the Child Tax Credit on the Wrong Line of Their Tax Return
<p>As part of our audit to evaluate the effectiveness of the Internal Revenue Service's (IRS) actions to implement legislative changes affecting the 1999 filing season, we are performing an on-line review of the processing of 1998 individual income tax returns affected by key provisions in the legislation. We have found that the IRS is unnecessarily sending tax returns back to taxpayers and/or corresponding with taxpayers who obviously placed their Child Tax Credit on the wrong line of the return.</p> <p>We have discussed this issue with employees from Submission Processing. Please provide your written response to this memorandum by the date shown above. Please include an assessment of the cause, the proposed corrective action, the completion date or the proposed completion date for the corrective action, the responsible management official, and the plan and methodology for tracking and ensuring effectiveness of the corrective action. If you disagree with any of the facts as presented in this memorandum, or if you would like to meet to discuss these issues, please contact Audit Manager, Kyle Andersen at (801) 620-6550.</p>	
<p><b>Background</b></p> <p>For tax year 1998, taxpayers with children under age 17 who qualify as their dependents are generally entitled to a Child Tax Credit. The amount of the credit for 1998 is \$400 per qualifying child. The credit is used to reduce the taxpayer's tax liability, but is not refundable.</p>	

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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The Child Tax Credit is claimed on page two of the tax return along with other tax credits such as the Child Care Credit, and the Education Credit, both of which require a supporting schedule. No supporting schedule is required to claim the Child Tax Credit. IRS's Code and Edit tax examiners are instructed to correspond with or send tax returns back to taxpayers who claim the Child Care or Education Credits but do not attach the necessary supporting schedules.

Because this is the first year taxpayers could claim the Child Tax Credit, and because of the complexity of the credit, concerns were raised that taxpayers may misunderstand where and how to claim it. As part of our review to address these concerns, we scanned 1,596 tax returns (over 5 days) for which the IRS was corresponding with taxpayers for missing forms and schedules. We selected for review 102 cases where the return was scheduled to be sent back to the taxpayer because the taxpayer had claimed a Child Care or Education Credit and had not attached the required supporting schedule.

### **Results**

**The IRS is unnecessarily corresponding with and/or sending tax returns back to taxpayers who obviously placed their Child Tax Credit on the wrong line of the return.**

We identified returns on which taxpayers had obviously claimed the Child Tax Credit on the wrong line of the return. We based our conclusion on the taxpayers claiming an amount consistent with the Child Tax Credit (number of qualifying children multiplied by \$400) on the Child Care Credit or Education Credit line, and not attaching the corresponding schedule. Although these were obviously misplaced Child Tax Credit entries, the IRS was sending these returns back to taxpayers and requesting the taxpayers to supply the schedules necessary to claim the Child Care or Education Credits. In certain instances, such as when remittances are included with the returns, IRS will retain the tax return and send correspondence to the taxpayers requesting the schedules, rather than sending the returns back.

While Code and Edit tax examiners are instructed to correspond with taxpayers who claim the Child Care or Education Credits but do not attach the necessary supporting schedules, they are also instructed to, "delete an entry on a transcribed line when it is obviously misplaced, and edit the deleted amount to the correct transcribed line when appropriate." On 12 of the 102 returns in our review, taxpayers had obviously misplaced their Child Tax Credit. No specific national guidelines have been provided to tax examiners to address obviously misplaced Child Tax Credit claims. Code and Edit personnel in 7 of 10 Service Centers stated that they were corresponding with taxpayers rather than moving the misplaced entries.

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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Sending returns back to taxpayers and/or sending correspondence to taxpayers requesting them to complete schedules to support claims for Child Care and Education Credits which they obviously did not intend to claim may confuse taxpayers and cause them unnecessary anxiety and burden, as well as waste IRS resources.

### **Recommendation**

The National Director, Submission Processing, should provide specific instructions to move obviously misplaced claims for Child Tax Credit rather than sending tax returns back and/or corresponding with taxpayers.


cc: National Director, Submission Processing OP:FS:S

**Taxpayers and the Internal Revenue Service  
Experienced Problems With Some New Tax Provisions**

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**Appendix XIII**

**Management's Response to Memorandum #3**



INTERNAL REVENUE SERVICE  
WESTERN REGION

April 15, 1999

**MEMORANDUM FOR REGIONAL INSPECTOR GENERAL FOR AUDIT  
WESTERN REGION**

**FROM:** Brien T. Downing *Brien T. Downing*  
Assistant Commissioner  
(Forms and Submission Processing) OP:FS

**SUBJECT:** The Internal Revenue Service is Unnecessarily Burdening  
Taxpayers Who Claim the Child Tax Credit on the Wrong Line of  
Their Tax Return -- URMEM 3/25/99

Thank you for the opportunity to respond to the concern documented in the memorandum referenced above.

**IDENTITY OF RECOMMENDATION/FINDINGS**  
The National Director, Submission Processing, should provide specific instructions to move obviously misplaced claims for Child Tax Credit rather than sending tax returns back and/or corresponding with taxpayers.

**ASSESSMENT OF CAUSE(S)**  
Due to the fact that this is the first year that taxpayers could claim the Child Tax Credit, and the complexity of the instructions for claiming the credit, a large number of taxpayers are misunderstanding where and how to claim it. In particular, taxpayers are claiming the Child Tax Credit on the wrong line of the return; they are entering it on the line for the refundable portion of the credit which requires that Form 8812, Additional Child Tax Credit, be attached.

Code & Edit tax examiners had been corresponding with taxpayers rather than moving the misplaced entries, even though the Code & Edit Internal Revenue Manual instructs them to "delete an entry on a transcribed line when it is obviously misplaced, and edit the deleted amount to the correct transcribed line when appropriate."

**CORRECTIVE ACTIONS**  
On March 5, 1999, revised instructions were issued to Code & Edit to specifically address the issue of misplaced Child Tax Credit amounts. These instructions provide for either editing the entry if misplaced, or preparing a "dummy" Form 8812 from the information on the return, if available. Code & Edit will correspond for a missing Form 8812 only if other correspondence is required.

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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The Error Resolution (ERS) function will correspond when Form 8812 is required and could not be, or was not, prepared by Code & Edit. On March 31, 1999, an information alert (ticket number 2469) was issued to ERS tax examiners instructing them to look for misplaced Child Tax Credit entries before corresponding with the taxpayer for the missing Form 8812.

IMPLEMENTATION DATE:  
COMPLETED March 5, 1999

RESPONSIBLE OFFICIAL(S)  
Chief, Paper Submissions Branch  
National Director, Submission Processing Division  
Assistant Commissioner (Forms and Submission Processing)

#### CORRECTIVE ACTION(S) MONITORING PLAN

Submission Processing will employ the following methods for tracking the corrective actions to ensure that they had the desired effect and have cured the underlying cause of this problem:

- Verify with processing center management that the revised instructions issued on March 5, 1999, and the quality alert issued on March 31, 1999, regarding correspondence for Form 8812, have been received and implemented. We anticipate completing this verification process by April 14, 1999.

If there are questions regarding this memorandum, please contact Miss Shari Jacobs at (202) 283-0728.

cc: Chief Operations Officer

**Taxpayers and the Internal Revenue Service  
Experienced Problems With Some New Tax Provisions**

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*Collection Action*  
*MISPLACED*  
*ENTRIES*

\*\* INOMS Production (V9903) 1.4sp7 IR \*\*  
 Date: 04/22/1999 15:52 record print of infoalert - 2469  
 Operator: ELCOFF00 Selection: Page: 1  
 Sequence:

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Status: closed INFORMATION ALERT Sites: NOCC  
 Info Ticket No: 2469 Open Time: 03/31/1999 15:04  
 Problem Ticket: Update Time: 03/31/1999 15:10  
 Close Time: 04/04/1999 19:58

Key Fld: I 3.12.3  
 Opened By: SJPATT00 Helpdesk: NOCC  
 Contact Name: COFFIN, ELEANOR  
 Phone: (202) 283-0376 Ext  
 Assignment Group: OP:FS:S:P:M

Information Description: Attachments: 0

Before corresponding with the taxpayer for missing entries  
 when figuring Child Tax Credit, Tax Examiners in ERS units  
 should look for misplaced entries.

Comments:

Login ID	***** Site	Acknowledgements Date/Time	***** Status

*c/s-4*



**Taxpayers and the Internal Revenue Service  
Experienced Problems With Some New Tax Provisions**

Appendix XIV

**Memorandum #4: The Internal Revenue Service is Incorrectly Recomputing  
the Tax Liability of Taxpayers Who Use Schedule J, Farm Income  
Averaging, to Figure Their Tax**



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

May 28, 1999

Response Date  
June 14, 1999

MEMORANDUM FOR ASSISTANT COMMISSIONER (FORMS AND SUBMISSION  
PROCESSING) OP:FS

FROM: Mary V. Baker *Mary V Baker*  
Deputy Regional Inspector General for Audit  
Western Region

SUBJECT: The Internal Revenue Service (IRS) is *Incorrectly Recomputing*  
the Tax Liability of Taxpayers Who Use Schedule J, Farm  
Income Averaging, to Figure Their Tax

As part of our audit to evaluate the effectiveness of the IRS' actions to implement legislative changes affecting the 1999 filing season, we are performing an *on-line review* of the processing of 1998 individual income tax returns affected by key provisions in the legislation. This memorandum discusses the IRS *improperly recomputing* the tax liability for taxpayers that figure their tax using Farm Income Averaging. This condition results in taxpayers being assessed too much tax.

We have discussed this issue with employees from the Submission Processing Division. Please provide your written response to this memorandum by the date shown above. Please include an assessment of the cause, the proposed corrective action, the completion date or the proposed completion date for the corrective action, the responsible management official, and the plan and methodology for tracking and ensuring effectiveness of the corrective action. If you disagree with any of the facts as presented in this memorandum, or if you would like to meet to discuss these issues, please contact Audit Manager, Kyle Andersen at (801) 620-6550.

**Background**

Starting in tax year 1998, Congressional legislation provided taxpayers with the option of figuring their current year's income tax liability by averaging, over the prior three-

	Initiator	Proofreader	Reviewer	Reviewer	Reviewer	Reviewer	Reviewer	Reviewer
Office Symbols	IG A OSC		IG A OSC	IG A WR				
Surname	B Russell		K Andersen	M Baker				
Date	5/26/99		5/26/99	5/26/99				

Form 1937-A (Inspection Service) (Rev. 1-96) Correspondence Approval and Clearance

Department of the Treasury / Internal Revenue Service

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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years, all or a portion of their taxable income from farming. The IRS designed Schedule J, Farm Income Averaging, for the purpose of figuring this tax liability.

As taxpayers' returns come into the IRS, IRS employees enter pertinent information from each return into IRS computers. The computers analyze and recompute the information entered to identify any potential errors on the return. All discrepancies are resolved by employees (tax examiners) in the Error Resolution units.

However, information from Schedule J is not entered into IRS computers. Therefore, when the IRS computers analyze the tax return information, the tax liability calculated by the computer equals the amount that the taxpayer would have owed without income averaging. Therefore, the IRS amount computed does not match the amount figured by the taxpayer on Schedule J. As a result, these returns are sent to Error Resolution to resolve the discrepancy between the IRS' and the taxpayers' calculations.

The IRS anticipated this issue and wrote instructions to resolve it. These instructions directed Error Resolution tax examiners to determine if the taxpayer attached a Schedule J. If Schedule J was attached, the tax examiner is instructed to accept the tax amount figured by the taxpayer.

To determine if tax examiners were properly applying these instructions, we computer identified individual income tax returns with income from farming that had been routed to error resolution because the IRS' calculation of tax on the return differed from the taxpayers'. Through April 30, 1999, we identified 895 of these returns in the Fresno and Ogden Service Centers. In every case, taxpayers had been sent a notice informing them that they had miscalculated their tax. We have scanned 281 of these returns and found 183 (65%) where the taxpayer had used Schedule J to calculate their tax. We reviewed these returns to determine if the tax examiner had taken the Schedule J into consideration when determining the tax.

### Results

Error Resolution tax examiners generally did not ensure that taxpayers filing Schedules J were assessed the correct amount of tax. Tax examiners accepted the amount calculated by IRS computers without considering the tax figured on Schedule J for 182 of 183 (99.5 %) returns we reviewed. As a result, most<sup>1</sup> of these taxpayers were assessed more tax than owed and were sent an erroneous taxpayer notice.

This condition exists for several reasons related to the implementation of new legislation:

<sup>1</sup> On three returns, the tax examiner's error did not negatively impact the taxpayer. In each of these cases, the taxpayer used erroneous information or made other errors on their Schedule J.

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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- Schedules J are filed infrequently so tax examiners may not be accustomed to working them.
- Instructions written to address the Schedule J issue include only three lines within a ten page section of the Internal Revenue Manual and could easily be overlooked.
- IRS performs no specific quality review of new legislative provisions. Rather they select for review, samples of returns processed by individual employees. Sample sizes are based on the number of returns processed by the employee. In addition, IRS had not performed any trend analyses of quality review results for new tax provisions.

We are bringing this information to your attention so that immediate action can be taken to address this issue at all of the processing centers. Currently the volumes of returns with Schedules J are low, but we expect this volume to increase as the IRS completes the processing of refund returns and begins processing balance due returns.

**Recommendation:**

1. The National Director, Submission Processing, should ensure that all processing centers are aware of this condition by alerting Error Resolution tax examiners of the necessity to always check returns for attached Schedule J when resolving returns with identified Tentative Tax discrepancies and make the appropriate adjustment.
2. The National Director, Submission Processing, should also consider performing some quality review for this specific tax provision during the remainder of the filing season.

cc: National Director, Submission Processing OP:FS:S

**Taxpayers and the Internal Revenue Service  
Experienced Problems With Some New Tax Provisions**

**Appendix XV**

**Management's Response to Memorandum #4**



ASSISTANT COMMISSIONER  
FORMS AND SUBMISSION  
PROCESSING

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

June 21, 1999

MEMORANDUM FOR DEPUTY REGIONAL INSPECTOR GENERAL FOR AUDIT  
WESTERN REGION

FROM:

Brien T. Downing   
Assistant Commissioner  
(Forms and Submission Processing) OP:FS

SUBJECT:

The Internal Revenue Service (IRS) is Incorrectly Recomputing  
the Tax Liability of Taxpayers Who Use Schedule J, Farm  
Income Averaging, to Figure Their Tax – URMEM May 28, 1999

Thank you for the opportunity to respond to the concerns documented in the subject memorandum.

**IDENTITY OF RECOMMENDATION/FINDING #1**

The National Director, Submission Processing, should ensure that all processing centers are aware of this condition by alerting Error Resolution tax examiners of the necessity to always check returns for attached Schedule J when resolving returns with identified Tentative Tax discrepancies and make the appropriate adjustment.

**ASSESSMENT OF CAUSE(S)**

This is the first year that taxpayers could use Schedule J for Farm Income Averaging. Computer programming was requested to support Schedule J processing; however, the programming was not performed due to staffing limitations within the Information Systems (IS) due to Century Date Change activities. Instructions were placed in the Error Resolution (ERS) Internal Revenue Manual (IRM) 3.12.3 to enter the Schedule J amount when a Schedule J is attached to the return. In some cases, the Schedule J tax calculation was not input. This caused the taxpayer to be assessed more tax than owed, which resulted in an erroneous math error notice being generated.

**CORRECTIVE ACTIONS**

On May 14, 1999, an ERS Quality Alert, TEBB-99176 was issued to all service centers reiterating the correct procedure to ensure that all Schedules J are properly processed. The office of the Assistant Commissioner (Customer Service) issued TEBB-99176 to alert the service center Adjustments functions, which provided instructions for their employees to follow when an inquiry is received.

## **Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions**

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We are working with our course development staff to ensure that appropriate emphasis is placed on Schedule J processing during next year's training. Although we again requested computer programming to support tax year 1999 Schedule J processing, it will not be performed due to continuing staffing limitations within IS due to the Century Date Change activities.

We have coordinated with Media Relations to post alerts on the following Web Pages on the IRS Web Site: Tax Information for Businesses, News for Tax Professionals, and News Stand. Media Relations has also forwarded this information to the Farm Bureau for dissemination to their members, who are most affected by this problem.

**IMPLEMENTATION DATE:**  
COMPLETED May 14, 1999

**RESPONSIBLE OFFICIAL(S)**  
Chief, Paper Submissions Branch  
National Director, Submission Processing  
Assistant Commissioner (Forms and Submission Processing)

#### **CORRECTIVE ACTION(S) MONITORING PLAN**

Submission Processing will employ the following methods for tracking the corrective actions to ensure they have addressed the underlying cause of this problem:

- Error codes (180, 181, 184, 185, and 186) associated with the Schedule J processing problem are now mandatory codes in our Computer Assisted Review of ERS (CARE) program, and becomes mandatory beginning the fourth quarter of this fiscal year. We will track both the accuracy rates for this error code, as well as compliance with the 100 percent review requirements, using the reports generated from the CARE program.

#### **IDENTITY OF RECOMMENDATION/FINDING #2**

The National Director, Submission Processing, should also consider performing some quality review for this specific tax provision during the remainder of the filing season.

#### **ASSESSMENT OF CAUSE(S)**

This is the first year that taxpayers could use Schedule J for Farm Income Averaging. Computer programming was requested to support Schedule J processing; however, the programming was not performed due to staffing limitations within the IS due to Century Date Change activities. Instructions were placed in the ERS IRM 3.12.3 to enter the Schedule J amount when a Schedule J is attached to the return. In some cases, the Schedule J tax calculation was not input. This caused the taxpayer to be assessed more tax than owed, which resulted in an erroneous math error notice being generated.

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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### CORRECTIVE ACTIONS

To limit the impact of the manual workaround (entering the line 22 amount from the Schedule J into ERS field 0440V) on the taxpayer, we will perform a 100 percent review of math errors 265 and 268 beginning in the fourth quarter of this fiscal year.

### IMPLEMENTATION DATE:

COMPLETED May 14, 1999

### RESPONSIBLE OFFICIAL(S)

Chief, Paper Submissions Branch  
National Director, Submission Processing  
Assistant Commissioner (Forms and Submission Processing)

### CORRECTIVE ACTION(S) MONITORING PLAN

Submission Processing will employ the following methods for tracking the corrective actions to ensure they have addressed the underlying cause of this problem:

- Error codes (180, 181, 184, 185, and 186) associated with the Schedule J processing problem are now mandatory codes in our Computer Assisted Review of ERS (CARE) program and becomes mandatory beginning the fourth quarter of this fiscal year. We will track both the accuracy rates for this error code, as well as compliance with the 100 percent review requirements, using the reports generated from the CARE program.

If you have any questions regarding this memorandum, please have your staff contact Ellen Brooks at (202) 622-7055.


cc: Chief Operations Officer

**Taxpayers and the Internal Revenue Service  
Experienced Problems With Some New Tax Provisions**

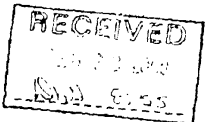
Appendix XVI

**Management's Response to the Draft Report**

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COMMISSIONER

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



February 28, 2000

**MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR  
TAX ADMINISTRATION**

**FROM:** *Robert Rossotti* Charles O. Rossotti *Bob Rossotti*  
Commissioner of Internal Revenue

**SUBJECT:** Treasury Inspector General for Tax Administration (TIGTA) Draft  
Report – Taxpayers and the Internal Revenue Service (IRS)  
Experienced Problems with Some New Tax Provisions  
(Audit No. 19990022)

Thank you for the opportunity to review and comment on the subject draft report. As noted in your report, the IRS properly processed most tax returns impacted by the extensive new legislation. We appreciate your staff's efforts to identify areas where we can improve our service to taxpayers and our ability to successfully process tax returns. The recommendations in the report will help us correct identified deficiencies and operate more effectively.

I would like to mention some additional initiatives we are taking to ensure that legislation is implemented effectively and accurately. Submission Processing has created a legislative database we will use to monitor the actions needed to implement legislative changes. We also plan to visit processing sites to evaluate whether our programming and procedural changes are working as we intended. In addition, my staff in Forms and Submission Processing reached an agreement with the Quality Assurance staff in Information Systems to use their test data to recreate situations which the field identified as potential problems. This will help us find the source of some problems in computer operations or the related procedures, and devise an appropriate solution.

In the comments below, I will describe our plans for addressing your recommendations.

**IDENTITY OF RECOMMENDATION/FINDING #1**  
The National Director, Submission Processing, should initiate a post review of Error Resolution cases impacted by specific legislative provisions, with special emphasis on new tax provisions. The Computer Assisted Review of the Error Resolution System

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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(CARE) could facilitate such a review. The results of this post review should be trended to identify processing problems, recurring taxpayer errors, and needed changes or improvements to tax forms and instructions.

**ASSESSMENT OF CAUSE(S)**

No post review of cases that had specific legislative provisions was being done. Also, no post review to identify processing problems, recurring taxpayer errors, and needed changes or improvements to tax forms and instructions being done.

**CORRECTIVE ACTIONS:**

The Computer Assisted Review of the Error Resolution System (CARE) has initiated a weekly post review of error resolution cases impacted by specific legislative provisions. The results of the post reviews will help to identify processing problems, recurring taxpayer errors, and needed changes or improvements to tax forms and instructions.

**IMPLEMENTATION DATE:**

January 3, 2000

**RESPONSIBLE OFFICIAL:**

Brien T. Downing  
Assistant Commissioner (Forms and Submission Processing)

**IDENTITY OF RECOMMENDATION/FINDING #2**

The National Director, Tax Forms and Publications, should receive and review the results of this trend analysis annually to help identify needed changes or improvements to tax forms and instructions.

**ASSESSMENT OF CAUSE(S)**

The data collected through CARE provides an opportunity to identify areas where tax forms and instructions could benefit from improvements by identifying recurring taxpayer errors.

**CORRECTIVE ACTIONS:**

Tax Forms and Publications will review CARE reports, which will be provided by Submission Processing on an ongoing basis, to identify trends and target specific areas for additional research. Since the reports can be provided periodically, Tax Forms and Publications will take advantage of the regular distribution to perform timely analyses of the data.

**IMPLEMENTATION DATE:**

April 1, 2000



## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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**RESPONSIBLE OFFICIAL:**

Brien T. Downing  
Assistant Commissioner (Forms and Submission Processing)

**IDENTITY OF RECOMMENDATION/FINDING #3**

The Chief Operations Officer should ensure that computer programming necessary to identify taxpayer errors related to these two tax law provisions is completed by the 2001 filing season.

**ASSESSMENT OF CAUSE(S)**

Because of limited programming resources and extensive priority programming requirements, the IRS postponed or cancelled computer programming to identify potential errors taxpayers may make relating to the two new tax laws.

**CORRECTIVE ACTIONS:**

Submission Processing has prepared and will submit two Requests for Information Systems (RIS) to implement these provisions under RIS numbers TSF-0-0014 and TSF-0-0015. The requested implementation date for both RIS' is January 1, 2001. We will give these requests a high priority when deciding how to use our programming resources.

**IMPLEMENTATION DATE:**

January 1, 2001

**RESPONSIBLE OFFICIAL:**

Brien T. Downing  
Assistant Commissioner (Forms and Submission Processing)

**IDENTITY OF RECOMMENDATION/FINDING #4**

The Chief Operations Officer should ensure that reviews of notices issued to taxpayers are effective in ensuring the notices are technically accurate, clearly address the taxpayers' errors, and clearly inform taxpayers what steps they need to take

**ASSESSMENT OF CAUSE(S)**

IRS' reviews of notices were not effective. Additionally, there was no review process to compare available notices to actual errors made by taxpayers during the filing season.

**CORRECTIVE ACTIONS:**

Submission Processing and Customer Service will establish a formal clearance process to ensure that the notices issued to taxpayers are effective, technically accurate, and clearly address the errors.

## Taxpayers and the Internal Revenue Service Experienced Problems With Some New Tax Provisions

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Our use of CARE will give the Service the ability to correct TPNC errors before the notices are issued to taxpayers. It will also allow the IRS to identify any training concerns, improve processing instructions, identify possible programming or wording improvements and take the necessary steps to make those corrections before each upcoming processing year.

**IMPLEMENTATION DATE:**

January 1, 2001

**RESPONSIBLE OFFICIAL:**

Brien T. Downing  
Assistant Commissioner, Forms and Submission Processing

**IDENTITY OF RECOMMENDATION/FINDING #5**

We agree that the IRS needs to ensure that taxpayers' dependents are valid before allowing related exemptions and credits. However, since most of the taxpayers who provided inaccurate names and/or social security numbers for their dependents contact the IRS with correct information, the Chief Operations Officer should consider the feasibility and cost effectiveness of conducting limited computer research to find the correct information before burdening the taxpayer.

**ASSESSMENT OF CAUSE(S)**

When either the dependent name or taxpayer identification number entered on a tax return does not match IRS or SSA records, the IRS' procedures instruct the employee to disallow the exemption and any related credits without performing computer research to correct the invalid information. By performing basic research, the IRS could prevent some notices from being issued.

**CORRECTIVE ACTIONS:**

Although by conducting research we could correct some returns and prevent a notice from being issued, in the long run, the taxpayers would not benefit from this action. Since the taxpayer would not be informed of the change we made, they probably would use the same name and taxpayer identification number in the future. The return would be directed to error resolution year after year, thus unnecessarily delaying the processing of their return.

I am also concerned about the impact on the error resolution function in the submission processing centers. When the requirement for this type of research increases, the correction of returns is slowed, delaying processing of all returns. Returns would be received with the same error each year, thus steadily increasing the volume of returns requiring research and a correction. The steadily increasing volume and increased requirements could limit the systemic and staffing resources available for correcting other returns. No further action is currently planned for this item.

**Taxpayers and the Internal Revenue Service  
Experienced Problems With Some New Tax Provisions**

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**IMPLEMENTATION DATE:**

None

**RESPONSIBLE OFFICIAL:**

Brien T. Downing

Assistant Commissioner, Forms and Submission Processing

If you have any questions, please call Brien T. Downing, Assistant Commissioner  
(Forms and Submission Processing), at (202) 622-2875.