The 2004 Filing Season Was Completed Timely and Accurately, but Some Tax Law Changes Have Not Been Effectively Implemented

December 2004

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Redaction Legend:

7 = Predecisional staff recommendation or suggestions to agency decision makers

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

December 27, 2004

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael R. Phillips
for Gordon C. Milbourn III
Assistant Inspector General for Audit
(Small Business and Corporate Programs)

SUBJECT: Final Audit Report - The 2004 Filing Season Was Completed Timely and Accurately, but Some Tax Law Changes Have Not Been Effectively Implemented (Audit # 200440005)

This report presents the results of our review of the 2004 Filing Season.[1] The overall objective of this review was to determine whether the Internal Revenue Service (IRS) timely and accurately processed Tax Year (TY) 2003 individual income tax returns[2] during the 2004 Filing Season. The audit focused on the implementation of new tax law changes[3] that affected TY 2003 tax returns. In addition, we reviewed the corrective actions for the conditions identified in our review of the 2003 Filing Season[4] to determine if they were adequate.

Overall, the IRS had a successful 2004 Filing Season that was timely completed. Through May 28, 2004, the IRS had processed over 117 million returns and most of these returns were processed accurately.[5] We determined the IRS correctly implemented the key tax law changes that affected TY 2003 returns. However, we continue to identify previously reported tax law changes that have not been effectively implemented and could result in loss of taxpayer entitlements and erroneous tax reductions. For example, we identified taxpayers that are continuing to receive erroneous deductions for student loan interest, taxpayers with potential unclaimed Additional Child Tax Credits (ACTC), and taxpayers that were allowed questionable "dual benefits" for the tuition and fees deduction and the Education Credit.

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[1] The period from January though mid-April when most individual income tax returns are filed.
[2] Paper and electronically filed U.S. Individual Income Tax Returns (Forms 1040, 1040A, and 1040EZ).
[3] See Appendix V for an overview of the new tax law provisions examined during this review.
[4] See Appendix VI, item 4.
[5] We continued our review through May 28, 2004, to validate that tax returns received by the April 15 filing due date were timely and accurately processed.

Changes to the tax law can have a major effect on how the IRS conducts its activities, how many resources are required, and how much progress can be made on strategic goals. Certain kinds of changes can have significant effects on the IRS in terms of the quality and effectiveness of service and how taxpayers perceive the IRS. The recommendations included in this report can assist the IRS in effectively administering tax law changes. Specifically, we recommended the Commissioner, Wage and Investment (W&I) Division, ensure computer programs accurately identify and correct errors on returns; continue to identify taxpayers that appear eligible for, but do not claim, the ACTC by ensuring a scheduled computer programming change is properly modified; ensure the IRS' strategic goal of enhancing enforcement of the tax law is accomplished by strengthening controls to identify and prevent erroneous tax reductions during initial tax return processing; and monitor the W&I Division compliance project to determine if significant noncompliance, similar to the results of our review, is found.

Management's Response: IRS management appreciates our recognition of the success of the IRS' 2004 Filing Season and agrees with three of our four recommendations. Corrective actions include computer programming changes to resolve deficiencies we identified and the establishment of a cross-functional task group to conduct a study to determine if there are specific legal options that are feasible and cost effective to address compliance with the restrictions on "dual benefits."

Management also agrees with our outcome measures as presented but believes our report implies that 205,196 taxpayers received a "dual benefit" in addition to the 16,979 single taxpayers we cited as having specifically received a "dual benefit." Management's complete response to the draft report is included as Appendix VII.

Office of Audit Comment: We believe our report does not imply that 205,196 taxpayers also inappropriately received a "dual benefit" as evidenced by footnote number 29 on page 10 of the report. This footnote states that we could not readily determine how many taxpayers beyond the 16,979 cited above correctly or incorrectly claimed both the tuition and fees deduction and the Education Credit.

In addition, while the IRS disagreed with Recommendation 4, we believe the IRS' commitment to establish a cross-functional task group that will focus on the possibility of addressing errors during initial processing of the returns satisfies the spirit of this recommendation.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

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Background

The Internal Revenue Service's (IRS) mission is to provide America's taxpayers with top-quality service by helping them to understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all. The IRS has formulated strategic goals to achieve its mission, two of which include:

- Improve taxpayer service.
- Enhance enforcement of the tax law.

Making filing easier and increasing fairness of compliance are included in the objectives of these strategic goals and directly affect the filing season,[1] which in turn affects individual taxpayers. The filing season is always a critical program for the IRS. It is during the filing season that most individuals file their income tax returns and call the IRS if they have questions about specific tax laws or filing procedures.

The IRS estimated that 131.6 million[2] individual income tax returns[3] would be filed during Calendar Year (CY) 2004 and that most of these would be filed during the filing season. One of the challenges the IRS confronts in processing these returns is the correct implementation of new tax law changes.

Changes to the tax law can have a major effect on how the IRS conducts its activities, how many resources are required, and how much progress can be made on strategic goals. Generally, the Congress makes changes to the tax law each year, so some level of change is a normal part of the IRS environment. However, certain kinds of changes can have significant effects on the IRS in terms of the quality and effectiveness of service and how taxpayers perceive the IRS. The IRS must identify the tax law changes; revise the various tax forms, instructions, and publications; and reprogram its computer system to ensure returns are accurately processed.

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[1] The period from January through mid-April when most individual income tax returns are filed.
[2] This estimate includes 71.8 million paper returns and 59.8 million electronic returns.
[3] Paper and electronically filed U.S. Individual Income Tax Returns (Forms 1040, 1040A, and 1040EZ).

During the 2004 Filing Season, the IRS processed individual income tax returns in seven Submission Processing sites[4] located throughout the country. Tax returns and related schedules are processed through the IRS' computer system and recorded on each individual's tax account at these sites. The IRS' computer system is made up of a complex series of processing subsystems that are nationally linked and programmed to check the validity and accuracy of the return data provided. If an error is found, taxpayers are sent a notice that requests additional information or explains any change that is made to the amount of the tax due or the refund.

This review was performed in the Wage and Investment (W&I) Division in Atlanta, Georgia; the Submission Processing offices in Lanham, Maryland, and Cincinnati, Ohio; and the Austin, Fresno, and Kansas City Submission Processing Sites during the period January through August 2004. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The 2004 Filing Season Was Timely Completed, With Most Returns Accurately Processed

Overall, the IRS had a successful 2004 Filing Season. Through May 28, 2004, the IRS processed approximately 117 million individual income tax returns (including over 60 million that were processed electronically, an increase of nearly 16 percent over the same time last year).[5] In addition, the IRS reported that Free File[6] and On-Line Filing from home computers volumes increased by 25 percent (3.5 million) and 22 percent (14.4 million), respectively, over last year.

[4] Andover, Massachusetts; Atlanta, Georgia; Austin, Texas; Fresno, California; Kansas City, Missouri; Memphis, Tennessee; and Philadelphia, Pennsylvania, Submission Processing Sites.
[5] We continued our review through May 28, 2004, to validate that tax returns received by the April 15 filing due date were timely and accurately processed.
[6] An online tax preparation and electronic filing program which is offered through a partnership agreement between the IRS and the Free File Alliance, LLC.

The IRS completed processing of returns on schedule and timely issued refunds within the required 45 days of the April 15, 2004, return due date,[7] despite an unusually large number of errors on returns caused by taxpayers in calculating the advance Child Tax Credit (CTC) payment. This problem was identified early in the filing season on electronically filed returns, and the IRS took several actions to alert the public.

Even with the proactive measures to alert the public, IRS sources indicated that, through May 28, 2004, there were approximately 16.9 million individual income tax returns (1.9 million more than last year) on which an error was found.[8] The largest percentage of errors caused by taxpayers and practitioners was attributed to the advance CTC payment. However, these errors were worked quickly, and the majority of returns did not experience any processing delays. As a result, most of the approximately 117 million individual income tax returns processed through May 28, 2004, were timely and accurately processed.

Implementation of key tax law changes

The 2004 Filing Season included new and significant tax law changes created by the Jobs and Growth Tax Relief Reconciliation Act of 2003[9] (JGTRRA) and the Military Family Tax Relief Act of 2003.[10] One of these changes reduced the taxes on dividends and capital gains and is estimated to cause an additional 6 million taxpayers to file a Capital Gains and Losses (Schedule D) to report their taxable dividends. Other changes excluded the gain from the sale of a principal residence for United States military personnel and provided a deduction for overnight travel expenses for National Guard and Reserve members. See Appendix V for an overview of the tax law provisions examined during this review.

Our review of the IRS' implementation of the following key tax law changes for the 2004 Filing Season and tax law

[7] I.R.C. § 6611(e) (2002).
[8] These errors include taxpayer and IRS errors.
[9] Pub. L. No. 108-27, 117 Stat. 752.
[10] Pub. L. No. 108-121.

changes we previously reported concerns with[11] were correctly implemented:

- Reduction in Taxes on Dividends and Capital Gains.
- Acceleration of Previously Enacted Tax Reductions.
- Child Tax Credit.
- Retirement Savings Contributions Credit.
- Military Provisions Related to the Deduction for Overnight Expenses for the National Guard and Reservists.

We also reviewed the Military Provisions related to the Sale of Residence and Death Gratuity payments. However, because the volume of tax returns we were able to review was minimal, we were unable to sufficiently determine if tax returns with these payments were receiving expedited processing. We will follow up on this issue in another audit that is currently in process.[12]

While the key tax law changes for the 2004 Filing Season were correctly implemented, we did identify additional tax law changes we previously reported concerns with[13] that have not been effectively implemented and could result in loss of taxpayer entitlements and erroneous tax reductions.

Overpaid Advance Child Tax Credit of $21 Million Was Not Recovered During the 2004 Filing Season

In accordance with the requirements of the JGTRRA, advance payments of the CTC were issued to qualifying taxpayers during CY 2003. In a prior Treasury Inspector General for Tax Administration (TIGTA) audit[14] of the advance payments, we identified a computer programming discrepancy that resulted in $39 million of excess credits being issued to taxpayers.

The IRS response to that report stated, ". . . [the] IRS anticipated that the majority of overpayments would be reconciled when these taxpayers filed Tax Year [TY] 2003

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[11] See Appendix VI for previous Treasury Inspector General for Tax Administration (TIGTA) audit reports.
[12] Audit # 200440049, *Processing Amended U.S. Individual Income Tax Returns.*
[13] See Appendix VI for previous TIGTA audit reports.
[14] See Appendix VI, item 5.

returns. As a result, any computation of dollar benefits should only include the period a taxpayer had use of funds paid in error." While we agreed this would be true in some cases, we indicated that we would perform additional work during the 2004 Filing Season review to quantify the true erroneous overpayment amount.

As of May 31, 2004, 90 percent of the taxpayers from the sample in our original review had filed their TY 2003 returns. We analyzed the return information for those taxpayers and determined that approximately 65 percent of the returns had an actual erroneous overpayment. From this, we estimated an actual erroneous overpayment amount of $21 million was not recovered when these taxpayers filed their TY 2003 returns. This estimate does not include the potential overpayment amounts from the 10 percent of taxpayers that had not filed.

Current tax law does not require taxpayers to repay excess amounts of the advance CTC payment they received on their TY 2003 returns even if they qualify for a lesser CTC amount (or no CTC amount). For example, if a taxpayer received an erroneous advance payment of $400 based on his or her 2002 tax return, the taxpayer would not be required to repay this amount if he or she did not have any qualifying children on the TY 2003 return.

Based on the IRS' response to our previous report, the IRS has limited means to recover the potential $21 million in erroneous payments; therefore, we are not making an additional recommendation for this issue.

Taxpayers Continue to Receive Erroneous Deductions for Student Loan Interest

Many tax credits and deductions that individual taxpayers may claim are subject to limitations based upon the taxpayer's filing status, Adjusted Gross Income (AGI), or Modified AGI.[15] The student loan interest deduction has a phase-out range in which the deduction is reduced and then eliminated or "phased out," as the Modified AGI increases and then reaches the upper limit.

[15] AGI is calculated after certain adjustments are made but before standard or itemized deductions and personal exemptions are subtracted. Modified AGI is calculated without regard to certain deductions or exclusions.

In prior TIGTA reviews,[16] we determined that the IRS disallowed the deduction when the upper limit was exceeded; however, the IRS did not have procedures to adjust the deduction when the Modified AGI fell within the phase-out range. This allowed taxpayers to receive larger deductions than they were entitled to receive. During the 2003 Filing Season, we determined that 6,837 taxpayers were erroneously allowed excess deductions totaling over $5 million, with an estimated tax effect of $500,000. The IRS had previously responded that it planned to correct the computer programs beginning with the 2004 Filing Season.

We determined during the 2004 Filing Season that procedures are still not accurate in identifying and adjusting the deduction when the Modified AGI falls within the phase-out range. Results of an analysis of returns processed through May 28, 2004, showed that 4,950 taxpayers were erroneously allowed deductions that exceeded the allowable amount under the tax law based upon their Modified AGI and filing status. The excess deductions totaled approximately $3.1 million.[17] Assuming all 4,950 taxpayers received a tax benefit from the student loan interest deduction, the estimated tax benefit is $310,000.[18]

Recommendation

To provide the IRS with accurate procedures to identify and correct instances in which taxpayers claim student loan interest deductions that exceed the allowable amounts, the Commissioner, W&I Division, should:

1. Ensure existing computer programs are corrected to properly account for the AGI or Modified AGI phase-out ranges and future computer programming requests[19] for the student loan interest deduction

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[16] See Appendix VI, items 3 and 4.
[17] This computation assumes each taxpayer's gross student loan interest amount was $2,500 and excludes returns on which the excess deduction was less than $100.
[18] We used the tax rate of 10 percent to compute the estimated tax benefit (i.e., 10 percent times approximately $3.1 million of student loan interest deductions equals a tax benefit of $310,000).
[19] Request for Information Services.

accurately consider all applicable aspects of the tax law changes.

Management's Response: A computer programming change will be implemented in January 2005 that will address the phase-out currently in effect. If new legislation impacts the student loan deduction, programming will be changed to consider the impact of the new law.

Planned Management Action Should Ensure Taxpayers Receive the Additional Child Tax Credit

We first reported that many taxpayers appeared eligible for, but did not claim, the Additional Child Tax Credit (ACTC) during the 2002 Filing Season. Table 1 shows the number of taxpayers and the amounts potentially unclaimed from the last three filing seasons.

Table 1: Potential Unclaimed ACTC

Filing Season	**2002**[20] (1/1 – 5/31)	**2003**[21] (1/1 – 8/1)[22]	**2004** (1/1 – 9/24)[23]
Taxpayers potentially eligible for the ACTC	611,560	293,833	286,169
Potential ACTC dollars not claimed	*$238 million*	*$131 million*	*$152 million*

Source: TIGTA analysis during the three filing seasons.

Our recommendation the first year was for the IRS to reevaluate placing a higher priority on the discretionary computer programming necessary to implement future outreach initiatives based on the related tax laws the initiatives are intended to support. The IRS declined the recommendation but did agree to mail a special notice to taxpayers advising them of their potential eligibility for the ACTC.

In November 2002, the IRS began mailing the special notices to the 644,008 taxpayers identified as potentially eligible for the ACTC.[24] This effort had a positive effect; of the 644,008 taxpayers receiving notices, approximately

[20] See Appendix VI, items 1 and 2.
[21] See Appendix VI, item 4.
[22] The ACTC totals were accumulated through August 1, 2003, at the request of the IRS.
[23] The ACTC totals were accumulated through September 24, 2004, at the request of the IRS.
[24] The 644,008 taxpayers include the additional taxpayers identified from June 1, 2002, to October 4, 2002.

499,555 (78 percent) had filed a TY 2002 return through August 1, 2003, with no potentially unclaimed ACTC.

During the 2003 Filing Season, we determined the IRS was continuing its efforts to address this condition. IRS management again requested our assistance in identifying the taxpayers that appeared eligible for, but did not claim, the ACTC on their TY 2002 returns. This information was used to mail these taxpayers information needed to claim the ACTC. In our 2003 Filing Season report, we recommended the IRS continue with its plans to notify the taxpayers and submit a computer programming change. The IRS agreed to this recommendation and, for TY 2003, potentially eligible taxpayers would be identified during returns processing and notified of their potential eligibility after processing.

During this audit, we reviewed the computer programming change to identify these taxpayers and found only taxpayers that appear eligible for the CTC and did not claim it would be identified. Taxpayers that claimed the CTC and appear eligible for the ACTC but did not claim it will not be identified. We notified the IRS of this condition on February 23, 2004.

Management Actions: IRS management responded the programming issue was an oversight and the IRS is in the process of correcting the computer programming change. The new change will be implemented in January 2005. Also, in August 2004, the IRS again requested our assistance to identify these taxpayers and notify them of their potential eligibility on their TY 2003 returns.

Recommendation

To support the IRS in its efforts to continue to identify taxpayers that appear eligible for, but do not claim, the ACTC, the Commissioner, W&I Division, should:

2. Ensure the computer programming change to be implemented in January 2005 is properly modified to include the taxpayers that appear eligible for the ACTC but did not claim it.

Management's Response: Two computer programming changes will be implemented to resolve this deficiency by identifying taxpayers who appear eligible for the ACTC and to generate a notice to the identified taxpayers advising them that they may be eligible for the ACTC.

The Tuition and Fees Deduction and the Education Credit Provide Questionable "Dual Benefits" to Taxpayers

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)[25] created a new above-the-line deduction for tuition and fees, effective for the 2003 Filing Season. Taxpayers within certain income ranges[26] are allowed to deduct up to $3,000 for qualified tuition and fees paid for themselves, their spouse, or their dependents. However, the EGTRRA does not allow taxpayers to receive a "dual benefit" by taking both the tuition and fees deduction and the Education Credit for the same student in the same tax year.

Taxpayers claiming the Education Credit are required to complete Education Credits (Hope and Lifetime Learning Credits) (Form 8863) and identify the student, by name and Social Security Number (SSN), for whom the credit is being claimed. Taxpayers claiming the tuition and fees deduction, however, are not required to provide additional information, other than what is already on the return, to identify the student for whom the deduction is being claimed. Thus, the IRS is unable to compare, manually or electronically, individual identifying information for the tuition and fees deduction with the individual identifying information captured on Form 8863 for the Education Credit and prevent taxpayers from claiming a "dual benefit" for the same student.

In our 2003 Filing Season review,[27] we reported taxpayers were claiming both the tuition and fees deduction and the Education Credit. The IRS' official response to this report included adding a cautionary statement to the Form 8863 to specifically alert taxpayers not to claim both the tuition and fees deduction and the Education Credit for the same student in the same year. However, in our current review, we have identified these questionable "dual benefits" as a recurring condition requiring further IRS attention.

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[25] Pub. L. No. 107-16, 115 Stat. 38 (2001).
[26] The AGI cannot exceed $65,000 for single taxpayers and $130,000 for married taxpayers filing jointly.
[27] See Appendix VI, item 4.

Although we have concluded that adding the cautionary statement appears to have contributed to a reduction in the number of taxpayers claiming a "dual benefit," a large number of taxpayers remain potentially noncompliant. Our audit analysis through May 28, 2004, showed 222,175 taxpayers were allowed both the tuition and fees deduction and the Education Credit, as compared to the 294,743 taxpayers identified in 2003.[28]

In 2004, these 222,175 taxpayers were allowed approximately $469 million in tuition and fees deductions and $208 million in Education Credits. Within this population, 16,979 were single taxpayers with no dependents[29] that were erroneously allowed approximately $30 million in tuition and fees deductions and over $11 million in Education Credits.[30] Assuming all 16,979 taxpayers received a tax benefit from the tuition and fees deduction, the estimated tax benefit is $3 million.[31] The remaining 205,196 taxpayers were allowed approximately $439 million in tuition and fees deductions and over $196 million in Education Credits.

Existing tax law requires that the taxpayer include the name and taxpayer identification number[32] of the individual for whom the tuition and fees deduction is being claimed on the tax return for the taxable year. The IRS has taken the position that, since the deduction is limited to expenses paid during the year for the taxpayer, his or her spouse, or a dependent, this information is already provided on the top half of the tax return and the legal requirement has been

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[28] These taxpayers were identified through May 16, 2003.

[29] We focused on single taxpayers with no dependents because it is clear that both the tuition and fees deduction and the Education Credit would have been claimed for the same individual, which is not allowable. It is not as clear with the taxpayer populations that filed as married filing jointly with or without dependents, head of household, and single with dependents. These taxpayers could have claimed the tuition and fees deduction and Education Credit for the same individual or for different individuals, which is allowable.

[30] The tuition and fees deduction would be disallowed if the taxpayer also claims the Education Credit.

[31] We used the tax rate of 10 percent to compute the estimated tax benefit (i.e., 10 percent times $30 million of tuition and fees deductions equals a tax benefit of $3 million).

[32] A nine-digit number assigned to taxpayers for identification purposes.

satisfied. The IRS contends that requiring additional information from the taxpayer regarding the tuition and fees deduction would unnecessarily increase taxpayer burden. However, based on the recurring condition of "dual benefits" being claimed by taxpayers, we believe the IRS' concern regarding a tax burden should be reconsidered given the potential improvement in taxpayer compliance that could be realized by requiring additional information from the taxpayers.

Management Actions: The W&I Division Compliance function is currently performing a compliance project that is identifying tax returns claiming the tuition and fees deduction and the Education Credit. These returns are identified after processing and samples of them are being reviewed to determine if the deduction is allowable and if the Education Credit was also allowed. This project is scheduled to run through September 2005, and when completed, Submission Processing will be provided with the results.

Recommendations

To ensure the IRS' strategic goal of enhancing enforcement of the tax law is accomplished and taxpayers receive fair tax administration, the Commissioner, W&I Division, should:

3. Work with the IRS' Chief Information Officer and Chief Counsel to change or develop processes to identify and prevent erroneous deductions during initial tax return processing. For example, the IRS should explore opportunities to use existing processes such as math errors or unallowable items to disallow the "dual benefits" received by single taxpayers with no dependents that claim both the tuition and fees deduction and the Education Credit.

Management's Response: The IRS will establish a cross-functional task group to conduct a study to determine if there are specific legal options that are feasible and cost effective to address compliance with the restrictions on "dual benefits." The study will focus on the possibility of addressing errors during the initial processing of return.

4. Monitor the W&I Division compliance project to determine if significant noncompliance, similar to the results of our review, is found. Based on the interim and final results, the IRS should explore opportunities to develop ways to supplement the processes suggested above to identify and prevent erroneous deductions during tax return processing, especially for other than single taxpayers. For example, the IRS could consider revising the Form 8863 to require student identifying information, such as name and SSN. This would permit the IRS to validate the appropriateness of credits claimed on the tax returns. With modifications to existing computer programs, or enhancements to planned modernized systems, this information could be used to systemically identify improper claims. Identifying and preventing improper claims during tax return processing would reduce the number of compliance cases generated and would allow the IRS to use its scarce Compliance resources to focus on more egregious compliance problems.

Management's Response: IRS management disagrees with this recommendation and is instead conducting the compliance research study mentioned above and using its results to determine the scope of this problem, net tax impact on revenue, and reasons taxpayers inappropriately claimed the "dual benefit." When the results are analyzed, the IRS will review options for cost-effective corrective measures based on the information obtained from this research effort.

Office of Audit Comment: While the IRS disagreed with this recommendation, we believe the IRS' commitment to establish a cross-functional task group that will focus on the possibility of addressing errors during initial processing of the returns satisfies the sprit of this recommendation.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the review was to determine whether the Internal Revenue Service (IRS) timely and accurately processed Tax Year (TY) 2003 individual income tax returns[1] during the 2004 Filing Season.[2] The audit focused on the implementation of new tax law changes[3] that affected TY 2003 individual income tax returns. In addition, we reviewed the corrective actions for the conditions identified in our review of the 2003 Filing Season.[4] To accomplish our objective, we:

I. Determined whether the computer programming changes[5] necessary to implement new tax legislation and to correct problems identified in our review of last year's filing season were accurately prepared for the 2004 Filing Season.

  A. Reviewed recent tax law legislation and determined which tax provisions would have a significant effect on individual taxpayers during the 2004 Filing Season.

  B. Obtained the computer programming requests for the tax provisions identified above and to correct the conditions identified in the 2003 Filing Season and reviewed them for accuracy. We then compared these computer programming requests to the related computer program documentation to determine if the programming was correctly updated. If problems were identified, we determined if the computer programming request was included in systems testing and the results of the testing.

II. Evaluated whether the IRS correctly implemented new tax legislation that could affect the processing of returns during the 2004 Filing Season.

  A. Used 100 percent computer analysis of TY 2003 individual income tax returns processed nationally between January 1 and May 28, 2004,[6] to determine if systemic controls at the Submission Processing sites incorrectly:

    1. Computed the reductions in taxes on dividends and capital gains.

    2. Processed credits for the Child Tax Credit (CTC) by:

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[1] Paper and electronically filed U.S. Individual Income Tax Returns (Forms 1040, 1040A, and 1040EZ).
[2] The period from January through mid-April when most individual income tax returns are filed.
[3] See Appendix V for an overview of the tax law changes examined during this review.
[4] See Appendix VI, item 4.
[5] Requests for Information Services.
[6] We continued our review through May 28, 2004, to validate that tax returns received by the April 15 filing due date were timely and accurately processed.

a) Allowing credits that exceeded predetermined limits based on the taxpayers' filing statuses and Adjusted Gross Income (AGI).[7]

b) Allowing the incorrect amount of CTC when the taxpayer received an advanced child tax credit.

B. Electronically identified 443 returns from a statistical sample of 492 taxpayer accounts that received overpayments during the 2003 advance payment of the CTC.[8] We reviewed account information for the 443 returns to determine whether the overpayments were recovered and, if not, calculated the actual amount of improper payments.

C. Manually screened TY 2003 individual income tax returns on February 3, 2004, at the Austin Submission Processing Site and reviewed 30 returns to verify the correct tax rate and standard deduction were used.

D. Reviewed procedures for identifying returns affected by the Military Family Tax Relief Act of 2003.[9] In addition, we reviewed a judgmental sample of 38 amended returns indicating a sale of residence or death gratuity payments and a judgmental sample of 10 current year and 4 amended returns indicating a deduction for Reserve and National Guard duty overnight travel expenses.[10]

III. Determined whether the IRS' monitoring system indicated that returns were being processed timely and accurately.

A. Monitored various Submission Processing site production and inventory reports between January 23 and April 30, 2004, for key indicators for returns processing and compared the statistics to those from the previous filing season. In addition, we monitored the Error Resolution System (ERS)[11] inventories from various ERS reports between January 23 and April 30, 2004, to determine whether any Submission Processing site exceeded capacity or incurred delays in working returns.

B. Computer analyzed filing patterns to determine whether processing inventories were adversely affected by taxpayers filing returns at the wrong Submission Processing site.

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[7] The AGI is calculated after certain adjustments are made, but before standard or itemized deductions and personal exemptions are subtracted. Modified AGI is AGI calculated without regard to certain deductions or exclusions.
[8] The statistical sample was selected during the prior review; the methodology for selecting the sample is explained in its entirety in the prior report (see Appendix VI, item 5).
[9] Pub. L. No. 108-121.
[10] A judgmental sample was used for this analysis because these returns could not be identified with computer analysis. IRS personnel in the Austin, Texas; Fresno, California; and Kansas City, Missouri Submission Processing Sites provided us with a copy of these returns when they were identified during processing.
[11] The ERS is used to correct errors made by taxpayers or IRS employees during the initial processing of tax returns.

C. Monitored the weekly 2004 Filing Season Wage and Investment Production meetings between January 22 and April 28, 2004, and reviewed the IRS' Weekly Tracking Reports between January 30 and April 30, 2004. We also monitored the IRS Submission Processing web site, the IRS public web site, and other applicable web sites between February 4 and May 7, 2004, to identify potentially significant issues that could affect processing of TY 2003 individual returns.

IV. Determined whether the IRS corrected problems identified in the 2003 Filing Season.[12] We electronically identified TY 2003 returns processed by the Submission Processing sites between January 1 and May 28, 2004, which met specific criteria. We determined whether:

A. Returns with retirement savings contributions credits and student loan interest deductions were properly reduced based upon the amount of AGI or Modified AGI by:

1. Reviewing a judgmental sample of 105 returns[13] from the 766 returns with retirement savings contributions credits that contained errors that were processed through March 26, 2004, and identified a total population of 5,088,553 processed through May 28, 2004.

2. Reviewing a judgmental sample of 30 returns from the 2,987 returns processed through April 2, 2004, and identified a total population of 4,950 returns processed through May 28, 2004.

B. Electronically identified 286,169 TY 2003 returns on which the taxpayers appeared to be eligible for, but did not claim, the Additional Child Tax Credit (ACTC) through September 24, 2004.[14]

C. Electronically identified 222,175 taxpayers that were allowed the "dual benefit" (16,979 of these taxpayers were single taxpayers with no dependents) through May 28, 2004.

[12] See Appendix VI, item 4.
[13] We judgmentally selected samples to verify the integrity of the data transcription to the data processed.
[14] The ACTC totals were accumulated through September 24, 2004, at the request of the IRS.

Appendix II

Major Contributors to This Report

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Appendix III

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Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaison: Senior Operations Advisor, Wage and Investment Division SE:W:S

Appendix IV

Outcome Measures

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

For all of the outcomes listed in this appendix, we conducted computer analyses of Tax Year (TY) 2003 individual income tax returns.[1] The returns were processed by the Internal Revenue Service (IRS) Submission Processing sites between January 1, 2004, and May 28, 2004,[2] and posted to the Individual Master File (IMF).[3] We developed specific criteria to identify returns affected by the tax law changes covered in this review. We used further computer analysis and auditor evaluation of return data to determine if the IRS accurately processed individual tax returns during the 2004 Filing Season.[4]

Type and Value of Outcome Measure:

- Revenue Protection – Potential; 4,950 taxpayers erroneously received approximately $3.1 million of student loan interest deductions in excess of the amount allowable under the law.[5] Assuming all 4,950 taxpayers received a tax benefit from the student loan interest deduction, the estimated tax benefit is $310,000 (see page 5).[6]

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify the number of taxpayers that were erroneously allowed student loan interest deductions that exceeded the allowable amount under the tax law based upon their Modified Adjusted Gross Income (AGI)[7] and filing status. In certain instances, the potential tax benefit from the excess deductions may be reduced. This would be true if the taxpayer's income level was too low and did not create a tax liability high enough to benefit fully by the amount of excess deductions.

[1] Paper and electronically filed U.S. Individual Income Tax Returns (Forms 1040, 1040A, and 1040EZ).
[2] We continued our review through May 28, 2004, to validate that tax returns received by the April 15 filing due date were timely and accurately processed.
[3] The IMF is the IRS database that maintains transactions or records of individual tax accounts.
[4] The period from January through mid-April when most individual income tax returns are filed.
[5] This computation assumes each taxpayer's gross student loan interest amount was $2,500 and excludes returns on which the excess deduction was less than $100.
[6] We used the tax rate of 10 percent to compute the estimated tax benefit (i.e., 10 percent times $3.1 million of student loan interest deductions equals a tax benefit of $310,000).
[7] The AGI is calculated after certain adjustments are made but before standard or itemized deductions and personal exemptions are subtracted. Modified AGI is calculated without regard to certain deductions or exclusions.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 286,169 taxpayers appear eligible for, but did not claim, Additional Child Tax Credits (ACTC) totaling approximately $152 million (see page 7).

Methodology Used to Measure the Reported Benefit:

To identify taxpayers and credits not claimed, we selected only the TY 2003 returns for which IRS processing determined the taxpayer was eligible for the Child Tax Credit (CTC), but not all the CTC had been used to offset the taxpayer's tax liability, and the following three conditions applied: (1) the taxpayer did not claim the ACTC, (2) the taxpayer had sufficient earned income to qualify for the ACTC, and (3) the taxpayer showed a tax liability of zero.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; 16,979 taxpayers were erroneously allowed approximately $30 million in tuition and fees deductions. Assuming all 16,979 taxpayers received a tax benefit from the tuition and fees deduction, the estimated tax benefit is $3 million[8] (see page 9).

Methodology Used to Measure the Reported Benefit:

One of the criteria we used in analyzing the TY 2003 individual income tax return records was to identify all taxpayers who claimed, and were allowed, the tuition and fees deduction and the Education Credit. This analysis identified 222,175 taxpayers that were allowed approximately $469 million in tuition and fees deductions and $208 million in Education Credits. Since the tax law prohibits taxpayers from claiming both the deduction and the credit for the same individual in the same year, we conducted further computer analysis on the 222,175 taxpayers to identify the number of taxpayers that filed as "single" with no dependents.[9] This analysis identified 16,979 taxpayers that were erroneously allowed approximately $30 million in tuition and fees deductions and over $11 million in Education Credits.[10]

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[8] We used the tax rate of 10 percent to compute the estimated tax benefit (i.e., 10 percent times $30 million of tuition and fees deductions equals a tax benefit of $3 million).

[9] We focused on single taxpayers with no dependents because it is clear that both the tuition and fees deduction and the Education Credit would have been claimed for the same individual, which is not allowable. It is not as clear with the taxpayer populations that filed as married filing jointly with or without dependents, head of household, and single with dependents. These taxpayers could have claimed the tuition and fees deduction and Education Credit for the same individual or for different individuals, which is allowable.

[10] The tuition and fees deduction would be disallowed if the taxpayer also claims the Education Credit.

Appendix V

Overview of Tax Law Provisions Examined During the Review

The following information describes various tax law provisions that affect individual taxpayers. During our review, we determined if returns containing the various provisions were accurately processed in accordance with the law.

Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)[1]

The JGTRRA contained three tax law provisions that were reviewed:

1) Reductions in Taxes on Dividends and Capital Gains

   Dividends received by an individual shareholder from domestic corporations and qualified foreign corporations are taxed at the rates for net capital gains (5 or 15 percent), effective for taxable years beginning after 2002 and before 2009.[2] The 5 percent rate falls to 0 percent for 2008. The maximum tax rate on net capital gains (i.e., net long-term capital gain reduced by any net short-term capital loss) has been reduced from 20 percent to 15 percent (and from 10 percent to 5 percent for taxpayers in the 10 percent and 15 percent tax rate brackets) for property sold or otherwise disposed of after May 5, 2003 (and installment sale payments received after that date). The 5 percent rate falls to 0 percent for 2008. The reduced rate applies for both the regular tax and the alternative minimum tax.[3]

2) Acceleration of Previously Enacted Tax Reductions

   Acceleration of the Expansion of the 10 percent and 15 percent Rate Brackets and Reduction in Individual Income Tax Rates and Acceleration of the Standard Deduction:

   - The amount of the 15 percent regular income tax rate bracket for joint returns is increased to twice the amount of the 15 percent regular income tax rate bracket for single individual returns for Tax Years (TY) 2003 and 2004.
   - The taxable income level for the 10 percent regular income tax rate brackets is increased for single individual returns from $6,000 to $7,000 and from $12,000 to $14,000 for joint returns, for TYs 2003 and 2004.
   - The regular income tax rates in excess of 15 percent were reduced to 25 percent, 28 percent, 33 percent, and 35 percent for TY 2003. The higher rates will go back

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[1] Pub. L. No. 108-27, 117 Stat. 752.
[2] There are exceptions that apply to this provision that would make the dividends ineligible for the capital gains rates.
[3] The higher rates that apply to unrecaptured Internal Revenue Code (I.R.C.) § 1250 gain, collectibles gain, and I.R.C. § 1202 gain have not changed.

into effect for tax years beginning after 2010 due to a sunset provision in the Economic Growth and Tax Relief Reconciliation Act of 2001.[4]

- The basic standard deduction amount for joint returns is increased to twice the basic standard deduction amount for unmarried individuals filing single returns, effective for TYs 2003 and 2004.

3) Child Tax Credit

The credit has been increased to $1,000 for each qualifying child in TYs 2003 and 2004. However, advance payments were paid to taxpayers during Calendar Year 2003 based on the information on their TY 2002 returns, and the credit must be reduced by this amount.

Military Family Tax Relief Act of 2003 (MFTRA)[5]

The MFTRA contained the following three tax law provisions:

1) Exclusion of Gain From Sale of a Principal Residence by a Member of the Uniformed Services or Foreign Service

Allows suspension of the 5-year test for ownership and use while an individual is absent due to military service.

2) Treatment of Death Gratuities Payable With Respect to Deceased Members of the Armed Forces

Increases and extends the exclusion for certain death gratuities to any adjustment (Cost of Living and other increases) to the amount of the death gratuity payable pursuant to provisions enacted after September 9, 1986. The death gratuity was increased from $6,000 to $12,000.

3) Above-the-Line Deduction for Overnight Travel Expenses of National Guard and Reserve Members

Provides an amount up to Federal Government per diem for members who must travel more than 100 miles away from home in connection with the performance of services as a member of a Reserve component of the Armed Forces of the United States.

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[4] Pub. L. No. 107-16, 115 Stat. 38 (2001).
[5] Pub. L. No. 108-121.

Appendix VI

Related Previous Treasury Inspector General for Tax Administration Audit Reports

1. *Although the 2002 Filing Season Was Completed Timely, Customer Service Can Be Improved During Error Processing* (Reference Number 2002-40-200, dated September 2002).
2. *Outreach Initiatives Need to Ensure Taxpayers Receive the Benefit of the Child Tax and Additional Child Tax Credits* (Reference Number 2002-40-203, dated September 2002).
3. *Computer Programming Requests for the 2003 Filing Season Were Timely Prepared and Generally Accurate* (Reference Number 2003-40-112, dated May 2003).
4. *The 2003 Filing Season Was Completed Timely and Accurately, but Some New Tax Law Changes Were Not Effectively Implemented* (Reference Number 2004-40-003, dated October 2003).
5. *The Child Tax Credit Advance Payment Was Effectively Planned and Implemented, but a Programming Discrepancy Caused Some Overpayments* (Reference Number 2004-40-042, dated January 2004).

Appendix VII

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

COMMISSIONER
WAGE AND INVESTMENT DIVISION

RECEIVED
NOV 23 2004

NOV 23 2004

MEMORANDUM FOR GORDON C. MILBOURN III
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Henry O. Lamar, Jr. Henry O. Lamar, Jr.
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – The 2004 Filing Season Was Completed Timely and Accurately, but Some Tax Law Changes Have Not Been Effectively Implemented (Audit No. 200440005)

I appreciate your recognition of our success during the 2004 filing season. Detailed planning is always critical and I am pleased that last year's efforts resulted in one of our best filing seasons ever. We provided improved telephone service, efficient tax return processing, and timely refunds. We achieved substantial increases in electronic filing and managed one of the country's most popular web sites.

I am also pleased your review recognized we correctly implemented the key tax law changes of the Jobs and Growth Tax Relief Reconciliation Act of 2003 and the Military Family Tax Relief Act of 2003 (MFTRA). One provision of MFTRA alone potentially impacted almost a million military reservists. This year we also anticipated processing challenges relating to the advanced payments for the Child Tax Credit. After successfully issuing $14 billion in advanced payments to over 25 million taxpayers in late fiscal year 2003, we recognized that despite our publicity efforts, many taxpayers would have difficulty calculating their 2003 tax return. As a result, we developed an Internet application and an automated telephone feature to provide customers with the information they needed. The interactive "Remember Your Advanced Child Tax Credit" applications provided customers with the correct amount of Additional Child Tax Credit (ACTC) credit that they were required to report on their 2003 return. These interactive applications were convenient, easy to use, and readily available through our automated telephone service and on www.IRS.GOV. These two applications received over 13 million inquires from January through the end of the fiscal year.

Our proactive approach also ensured that timely and accurate programming and processing instructions were in place for the filing season. Through the end of the fiscal year, we processed 129 million individual income tax returns and issued over 100 million refunds totaling more than $208 billion. These accomplishments are magnified

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when you consider that despite our best efforts, approximately 2.4 million taxpayers incorrectly calculated the Advanced Child Tax Credit payment, requiring us to manually correct the error during processing. I appreciate your acknowledgement of the complexity of our 2004 filing season tasks, and your recognition that we successfully addressed the provisions of the new tax law.

The information you provided in prior years to identify taxpayers that may be eligible for the ACTC has been instrumental to our outreach efforts. Your auditors provided additional assistance to us in this effort when they detected a deficiency in a Request for Information Services (RIS). We have made corrections to the RIS and are again on schedule to identify and then notify taxpayers who appear potentially eligible for the ACTC during the 2005 filing season. I appreciate your willingness to again provide us with the taxpayer data needed for our outreach efforts.

I do have concerns with your assumptions regarding "dual benefits" from both the tuition and fees deduction and the Education Credit. While I agree with your statement that, "...the IRS is unable to compare, manually or electronically, individual identifying information for the tuition and fees deduction with the individual identifying information captured on Form 8863 for the Education Credit and prevent taxpayers from claiming a "dual benefit" for the same student." I do not agree that the 205,196 taxpayers cited in your report were necessarily allowed to claim both the deduction and the credit. It is not accurate to assume that all of these taxpayers are claiming both education-related benefits for the same individual. Tax returns in this population have multiple combinations of spouses and dependents. As a result, there is an equal or greater probability that these education benefits are being claimed for separate individuals identified on the return and are entirely appropriate. We also maintain our position that the law does not require a taxpayer to provide separate identity information when claiming the tuition and fees deduction. Since this deduction is limited to expenses paid during the year for the taxpayer, his or her spouse, or a dependent, the required identifying information is already provided elsewhere on the tax return.

However, I agree that dual education benefits claimed by taxpayers filing as single with no dependents appear inappropriate. In your report titled, "The 2003 Filing Season Was Completed Timely and Accurately, but Some New Tax Law Changes Were Not Effectively Implemented" (Reference Number 2004-40-003, dated October 2003), you cited the same finding and made three recommendations. We agreed with those recommendations and initiated corrective actions. Your current report acknowledges that we added a statement to the Education Credits (Hope and Lifetime Learning Credits), Form 8863, designed to alert taxpayers that they may not be entitled to both the tuition and fees deduction and the education credit for the same individual. As reflected in your report, the cautionary statement appears to have decreased the number of taxpayers claiming both the deduction and the credit by approximately 25 percent.

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We also actively pursued your previous recommendation to revise our computer program to disallow the dual benefit for taxpayers filing as single with no dependents. As agreed in our response to your earlier report, we asked the Office of Chief Counsel to determine if we could use math error authority to prevent taxpayers filing as single with no dependents from claiming both the deduction and the credit. Chief Counsel determined that Code section 6312(b)(1) does not provide authority to disallow either the deduction or the credit while processing a tax return as you suggest. Although we advised you of this Chief Counsel decision, your current report fails to recognize the legal impediment.

I agree that the "dual benefit" issue is an area that merits attention. As a result, we are currently conducting a compliance research project designed to determine the scope, revenue impact, and reasons for taxpayers claiming both the deduction and the credit. The project is on target for completion in September 2005. We anticipate that the scope of this problem is limited and that the estimate of lost revenue will be small when compared to other compliance opportunities. Nevertheless, based on the final results of the project, we will determine if there are specific legal or administrative options that are feasible and cost effective to address this issue.

Your report lists three outcome measures. I agree with the potential revenue protection in the amount of $310,000, associated with the student loan interest deduction phase-out. I agree with your estimate of taxpayer entitlements in the amount of $152 million based on taxpayers potentially eligible for ACTC. Based on current information available, I also agree with your potential revenue protection associated with the 16,979 taxpayers who filed as single with no dependents and claimed the "dual benefit".

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If you have any questions, please call me at (404) 338-7060 or members of your staff may contact David Medeck, Director, Customer Account Services, at (404) 338-8910.

Attachment

Attachment

RECOMMENDATION 1
Ensure existing computer programs are corrected to properly account for the AGI or Modified AGI phase-out ranges and that future computer programming requests for the student loan interest deduction accurately consider all applicable aspects of the tax law changes.

CORRECTIVE ACTION
On August 8, 2004, Submission Processing submitted Request for Information Services (RIS) WSP-4-0052-A02 to correct this deficiency. This RIS will be implemented in January 2005. The new programming will address the phase-out currently in effect. If new legislation impacts the student loan deduction, programming will be changed to consider the impact of the new law.

IMPLEMENTATION DATE
February 15, 2005

RESPONSIBLE OFFICIAL
Director, Submission Processing

CORRECTIVE ACTION MONITORING PLAN
This corrective action will be monitored as part of our internal managerial control system. The Chief, Individual Master File Branch will report progress to the Director, Submission Processing.

RECOMMENDATION 2
Ensure the computer programming change to be implemented in January 2005 is properly modified to include the taxpayers that appear eligible for the ACTC, but did not claim it.

CORRECTIVE ACTION
We submitted RIS WSP-4-0052-A02 on August 8, 2004, to resolve this deficiency by identifying taxpayers who appear eligible for ACTC. In addition, Submission Processing also submitted RIS WSP-4-0001-A00 for processing year 2005 to generate a notice to the identified taxpayers advising them that they may be eligible for ACTC. Both RIS will be implemented in January 2005.

IMPLEMENTATION DATE
February 15, 2005

RESPONSIBLE OFFICIAL
Director, Submission Processing

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CORRECTIVE ACTION MONITORING PLAN
This corrective action will be monitored as part of our internal managerial control system. The Chief, Individual Master File Branch will report progress to the Director, Submission Processing.

RECOMMENDATION 3
Work with the IRS' Chief Information Officer and Chief Counsel to change or develop processes to identify and prevent erroneous deductions during initial tax return processing. For example, explore opportunities to use existing processes such as math errors or unallowable items to disallow the "dual benefits" received by single taxpayers with no dependents that claim both the tuition and fees deduction and the Education Credit.

CORRECTIVE ACTION
We will establish a cross-functional task group to determine if there are specific legal options that are feasible and cost effective to address compliance with the restrictions on "dual benefits". Although this study will conclude about the same timeframe as our compliance study, we will focus this study on the possibility of addressing errors during initial processing of the return.

IMPLEMENTATION DATE
The task group will be formed by December 15, 2004. We anticipate concluding the review of options by July 15, 2005.

RESPONSIBLE OFFICIAL
Director, Submission Processing

CORRECTIVE ACTION MONITORING PLAN
This corrective action will be monitored as part of our internal managerial control system. The Chief, Individual Master File Branch will report progress to the Director, Submission Processing.

RECOMMENDATION 4
Monitor the W&I compliance project to determine if significant non-compliance, similar to the results of our review, is found. Based on the interim and final results, explore opportunities to develop ways to supplement the processes suggested above to identify and prevent erroneous deductions during tax return processing, especially for other than single taxpayers. For example, consider revising the Form 8863 to require student identification information, such as name and SSN. This would permit the IRS to validate the appropriateness of credits claimed on the tax returns. With modifications to existing computer programs, or enhancements to planned modernized systems, this information could be used to systemically identify improper claims. Identifying and preventing improper claims during return processing would reduce the number of compliance cases generated and would allow the IRS to use scarce Compliance resources to focus on more egregious compliance problems.

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CORRECTIVE ACTION
We disagree with this recommendation as stated. We previously committed to conduct a compliance research study and based on the results determine if corrective measures are needed to address any identified compliance trends. We will continue our compliance research study to better determine the scope of this problem, net tax impact on revenue, and reasons taxpayers inappropriately claimed the "dual benefit." We scheduled the start and completion dates of this research effort with reasonable timeframes to allow us to complete other critical compliance projects and ensure the results were statistically valid and our conclusions accurate. When the results are analyzed, we will review options for cost-effective corrective measures based on the information obtained from this research effort.

IMPLEMENTATION DATE
N/A

RESPONSIBLE OFFICIAL
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A