



*Efforts to Identify and Process Potential
Joint Committee on Taxation Cases Can Be
Improved*

September 19, 2006

Reference Number: 2006-30-161

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

Redaction Legend:

1 = Tax Return/Return Information

Phone Number | 202-927-7037

Email Address | Bonnie.Heald@tigta.treas.gov

Web Site | <http://www.tigta.gov>



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 19, 2006

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: *Michael R. Phillips*
Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Efforts to Identify and Process Potential Joint Committee on Taxation Cases Can Be Improved (Audit # 200630002)

This report presents the results of our review of the Internal Revenue Service's (IRS) efforts to identify and process potential Joint Committee on Taxation (JCT) cases. The overall objective of this review was to determine whether refunds that met the criteria for JCT review were correctly identified and properly reported.

Impact on the Taxpayer

Internal Revenue Code (I.R.C.) Section (§) 6405¹ provides the JCT with the responsibility and authority to review any proposed refund or credit of income or estate and gift taxes or certain other taxes in excess of \$2 million. To accomplish this responsibility, the I.R.C. also requires the submission of reports by the IRS to the JCT for cases involving refunds of tax in excess of \$2 million. We determined that current IRS procedures do not ensure all refund cases having JCT potential are identified. This impedes the JCT's ability to determine whether the many provisions of the tax law operate as intended.

Synopsis

Specifically, I.R.C. § 6405(a) provides that no refund or credit of income, estate, gift, or certain other types of taxes will be made until after 30 calendar days from the date a report is submitted to the JCT. Certain refunds, known as tentative refunds, can arise from the carryback of net

¹ 26 U.S.C. § 6405 (2002).



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operating losses,² capital losses, or certain credits. In these cases, I.R.C. § 6405(b) allows the refund to be made to the taxpayer before a report is forwarded to the JCT. According to tax statistics, 2.5 million corporations reported net losses of over \$489 billion for Fiscal Year 2002, and over 1.8 million individual income tax returns were filed with negative adjusted gross income³ during Tax Year 2003.

Not all potential JCT cases were identified and reported properly. Specifically, 20 of 58 refunds included in our judgmental samples had not been identified as having JCT potential by the IRS and were not subsequently reported to the JCT. These 20 refunds totaled \$110,311,126, an average refund of \$5,515,556.

Recommendation

We recommended the Commissioner, Wage and Investment Division, analyze the potential JCT cases identified during the review to determine the controls that need to be addressed. Among the measures that could be considered are (1) reviewing and revising the various Internal Revenue Manual sections that address the identification of potential JCT cases to ensure all cases are identified, (2) obtaining periodic computer extracts from the IRS computer system to identify all large-dollar refunds, and (3) adding an entry, where appropriate, to the history section of the taxpayer's account to notate that a refund being processed could have JCT review potential.

Response

Management agreed to analyze the potential JCT cases identified during our review to determine if any controls or procedures need to be changed or modified. Management also agreed to consider each of the three actions contained in our recommendation after completion of their analysis. Management stated that adoption of these or other corrective actions will depend on the outcome of their analysis. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers affected by the report. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-8500.

² A benefit in the tax law that permits a business to carry an operating loss back 2 years or forward 20 years to apply against a profitable year to reduce the business' tax liability.

³ Adjusted gross income is calculated after certain adjustments are made but before standard or itemized deductions and personal exemptions are subtracted.



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Abbreviations

I.R.C.	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
JCT	Joint Committee on Taxation
NOL	Net Operating Loss
TY	Tax Year



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Background

In 1926, Congress enacted legislation that provided for a Congressional Joint Committee on Internal Revenue Taxation. The name was changed in 1976 to the Joint Committee on Taxation (JCT). As prescribed by statute, the JCT has the following duties:

1. To investigate the operation and effects of internal revenue taxes and the administration of such taxes.
2. To investigate measures and methods for the simplification of such taxes.
3. To make reports to the House Committee on Ways and Means and the Senate Committee on Finance on the results of such investigations and studies and to make recommendations.
4. To review any proposed refund or credit of income or estate and gift taxes or certain other taxes set forth in Internal Revenue Code (I.R.C.) Section (§) 6405¹ in excess of \$2 million.

It should be noted that I.R.C. § 6405 provides the JCT with oversight, not approval, authority of refunds in excess of \$2 million. Specifically, § 6405(a) provides that no refund or credit of income, estate, gift, or certain other types of taxes will be made until after 30 days from the date a report is submitted to the JCT. However, some refunds, known as tentative refunds, can arise from the carryback of net operating losses² (NOL), capital losses, or certain credits. In these cases, I.R.C. § 6405(b) allows the refund to be made to the taxpayer before a report is forwarded to the JCT. In addition, refunds of estimated or withheld income tax that are made without first examining the return are not subject to JCT review. Therefore, not all refunds of \$2 million are subject to the JCT review process.

A refund or credit subject to JCT review can be claimed by either an individual or a corporate taxpayer. Each group of taxpayers has several tax forms available with which to file their refund requests, depending on such factors as the tax matter that generated the refund, the number of tax years involved, and how quickly the taxpayer wishes to receive the money. Appendix IV identifies the various tax forms, their requirements, and their characteristics.

¹ 26 U.S.C. § 6405 (2002).

² A benefit in the tax law that permits a business to carry an operating loss back 2 years or forward 20 years to apply against a profitable year to reduce the business' tax liability.



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This review was performed at the Holtsville, New York, and Ogden, Utah, Internal Revenue Service (IRS) campuses³ during the period January through May 2006. 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.

³ The data processing arms of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



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Results of Review

Current Internal Revenue Service Procedures Do Not Ensure All Refund Cases Having Joint Committee on Taxation Potential Are Identified

The JCT's web site states, "One of the important functions performed by the Joint Committee [on Taxation] staff is to determine whether the many provisions of the tax law operate as intended, or cause any unintended administrative, interpretive, or statutory problems." One of the ways in which this is accomplished is the refund review mechanism, which requires the submission of reports by the IRS in cases involving refunds of tax in excess of \$2 million.

To accomplish its mission, the JCT must rely on the IRS to identify, process, and report on all refund cases that meet the statutory requirements of I.R.C. § 6405. The JCT does not have access to taxpayer data or IRS records to identify or determine on its own the number of reports it should receive over any given time period. For instance, during the period October 1, 2003, through September 30, 2004, the JCT received 1,163 reports from the IRS covering almost \$23 billion in refunds. This represented an increase of 514 reports (126 percent) from the number received during the prior period (October 1, 2002 – September 30, 2003). However, according to tax statistics, 2.5 million corporations reported net losses of over \$489 billion for the period (July 1, 2002 – June 30, 2003), and over 1.8 million individual tax returns were filed with negative adjusted gross income⁴ during Tax Year 2003.

We requested a computer extract from the IRS Master File⁵ of large-dollar refunds for both individual and business taxpayers.⁶ We analyzed the data received to try to identify only those refunds that appeared to have JCT potential. We sent the resulting sample data to the IRS to determine if its records indicated a report had been made to the JCT for each taxpayer.

We found that 20 of the 58 refunds included in our sample had not been identified by the IRS and subsequently reported to the JCT. These 20 refunds totaled \$110,311,126, an average refund of \$5,515,556. Figure 1 illustrates the results of our sample.

⁴ Adjusted gross income is calculated after certain adjustments are made but before standard or itemized deductions and personal exemptions are subtracted.

⁵ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

⁶ See Appendix I for details concerning the audit testing.



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Figure 1: Results of Sample Review

	Businesses	Individuals	Totals
Number that appeared to meet JCT criteria	44	14	58
Number the IRS identified for JCT review	35	3	38
Number not identified that appear to meet JCT criteria	9	11	20
Refund totals for cases not identified for JCT review	\$62,673,226	\$47,637,900	\$110,311,126

Source: Treasury Inspector General for Tax Administration analysis.

The IRS faces several problems in attempting to identify correctly and properly all potential JCT refund cases.

- **The necessity of expediting certain large-dollar refunds to avoid interest payments lessens the time to identify JCT cases.** As noted previously, corporate and individual taxpayers have a choice of tax forms available to use in requesting a refund of previously paid taxes. Some of these tax forms have strict timeliness standards for processing the refund payment or the IRS will be required to pay the taxpayer additional interest on the refund. In addition, the dollar amount of the requested refund could cause the refund to fall under the same strict timeliness standards.
- **A taxpayer's choice of form(s) on which to request a refund(s) affects the IRS' ability to identify JCT cases.** Taxpayers are not required to consolidate their refund requests on one tax form. If they so desire, they can elect to file refund requests for each tax year involved on a separate and distinct tax form. However, multiple tax years involving the same type of tax are combined for JCT identification purposes. Therefore, refunds for a taxpayer who files 3 separate amended tax returns may not be identified as having JCT potential, even if the 3 refunds exceed \$2 million in total, because the returns could be filed at different times. This would be advantageous for the taxpayer who could not file for a tentative refund (which results in a quick refund disbursement) and did not want to wait for the full JCT review process before receiving the refund. Separate refund claims may be worked by different IRS employees, and there currently is no requirement for an employee working a refund claim that may have JCT review potential to make any entry in the history section of the taxpayer's account that would alert other employees that JCT potential exists. Under current Internal Revenue Manual (IRM) procedures, an IRS employee is not required to check previous tax periods for paid or allowed refund claims that would indicate JCT consideration is warranted.



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- **The large number of processing sites attempting to identify JCT cases makes it difficult to consistently identify cases that meet the criteria for JCT review.** Although the JCT review process is centralized within the IRS Large and Mid-Size Business Division, taxpayers can file their refund documents at any one of eight processing sites throughout the United States. Corporate amended tax returns and expedited refund requests are processed at the Cincinnati, Ohio; Ogden, Utah; or Philadelphia, Pennsylvania, processing sites while individual amended tax returns and refund requests are filed at one of the other five processing sites. Although the daily operations of the various processing units use the IRM as their main guidance document, almost every processing site has a set of local operating procedures, thereby ensuring not every site is operating in the same manner.
- **The IRM contains no sections specifically designed to discuss the identification and reporting of refunds to the JCT.** Instructions regarding JCT cases are fragmented throughout the IRM. For example, IRM § 4.36 provides information on the identification and process of working on a JCT case and contains a great deal of information. However, this IRM section is part of the Examination Manual and deals only with refunds that have been identified through IRS processing as potential JCT cases. References throughout the processing sections of the IRM are scattered and do not provide adequate information to identify all possible scenarios that can create a potential JCT case.

When it does not receive refund case reports for all refunds that meet the specific legal criteria, the JCT cannot adequately fulfill all of its tax law oversight functions. In addition, the JCT staff review the reports they receive with a focus on the technical aspects of the cases and the IRS' resolution of the issues presented. The review enables the JCT staff to become familiar with specific issues in individual industries and to find problems in the administration of the law. Problems in the statutory language may result in an amendment to the statute, while problems with IRS rulings or regulations may result in a request that the IRS clarify or reconsider its position. These functions cannot be accomplished if the JCT does not receive all the information it should from the IRS.

Recommendation

Recommendation 1: We recommended the Commissioner, Wage and Investment Division, analyze the potential JCT cases identified during the review to determine the controls that need to be addressed. Among the measures that could be considered are (1) reviewing and revising the various IRM sections that address the identification of potential JCT cases to ensure all cases are identified, (2) obtaining periodic computer extracts from the IRS computer system to identify all large-dollar refunds, and (3) adding an entry, where appropriate, to the history section of the taxpayer's account to notate that a refund currently being processed could have JCT review potential.



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Management's Response: Management agreed with our recommendation to analyze the potential JCT cases identified during our review to determine if any controls or procedures need to be changed or modified. Management has requested the supporting documentation associated with these cases and expects to complete their review by November 15, 2006. After completion of their review, management also agreed to consider each of the three corrective actions suggested in our recommendation. Management stated that adoption of these or other corrective actions will depend on the outcome of their analysis.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether refunds that met the criteria for JCT review were correctly identified and properly reported. To accomplish our objective, we:

- I. Determined if current processing controls in the Wage and Investment Division Accounts Management function ensure all refunds that meet the criteria for JCT review were identified and processed to the proper area for further action.
 - A. Reviewed the IRM regarding manual refunds that relate to the identification and processing of JCT cases and identified the current controls in place to ensure manual refunds in excess of \$2 million that meet JCT criteria are routed to the appropriate unit in the Compliance function. We also reviewed other sections of the IRM dealing with JCT cases and evaluated controls currently in place.
 - B. Interviewed Accounts Management function personnel at the Ogden, Utah, campus¹ and obtained local procedures involving identification and processing of JCT cases. We evaluated these local procedures and determined if they were being followed by spot checking several cases that were available during our site visit.
 - C. Reviewed available training materials (both written and online) for the processing and identification of JCT cases. Also, we discussed with Accounts Management function personnel what on-the-job training is provided to employees assigned to process manual refunds related to JCT cases.
 - D. Conducted a walkthrough of the manual refund processing area at the Ogden, Utah, campus to identify any inconsistencies in processing. We attempted to spot check manual refund cases that had been identified as meeting JCT criteria; since none were available we spot checked several cases that were not identified as requiring JCT processing and reviewed them to determine if the controls were adequate.
 - E. Determined if any management reports were generated regarding manual refunds meeting the criteria as JCT cases.
 - F. Requested Wage and Investment Division inventory reports of JCT cases received and processed and their eventual disposition. Because no inventory reports are

¹ The data processing arms of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



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compiled or available, we requested a computer listing from the IRS Business Master File² to identify manual refunds that appear to meet JCT criteria.

- G. Requested and received a computer extract from the IRS Master File³ identifying all individual and corporate tax returns processed for Tax Years 2002 through 2004 that received (1) a single refund in excess of \$2 million for 1 tax period, (2) single refunds in multiple concurrent years that totaled \$2 million or more in the aggregate, or (3) multiple refunds in multiple concurrent years that totaled \$2 million or more. We validated the data received by tracing data in each sample to the corresponding tax accounts on the Master File.
- H. Our initial Individual Master File⁴ extract resulted in the identification of 303 refunds for Tax Years 2002 through 2004. We selected a sample of 83⁵ refunds from this extract by identifying taxpayers with refunds above the JCT dollar criteria of \$2 million who had either (1) no other refunds for the same period or (2) if other refunds were present, the taxpayer's other refunds were also (a) greater than the JCT dollar criteria, or (b) could not reduce the selected refund to below \$2 million if this was later reversed. We analyzed these refunds to determine if the refund met basic JCT criteria. We found that 68 refunds did not meet JCT criteria and [REDACTED]. The remaining [REDACTED] refunds were sent to the IRS for comparison to the IRS' database of reports issued to the JCT and JCT cases currently in progress.
- I. Our initial Business Master File extract resulted in the identification of 732 refunds in Tax Years 2002 through 2004. A sample of 458 refunds was selected from this extract by eliminating those corporate taxpayers who were large enough to most likely be part of the Coordinated Examination Program and, therefore, under continuous examination coverage. This examination coverage would ensure that JCT identification would be made. The sample was sent to the IRS for comparison to the IRS' database of reports issued to the JCT and JCT cases currently in progress. The reply from IRS noted that 35 refunds had JCT reports submitted. We selected a judgmental sample from the remaining cases that were not identified as meeting JCT criteria by selecting every fourth taxpayer case, which resulted in a sample of 43 taxpayers with 111 refunds that we analyzed to determine if the refunds met basic

² The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

³ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

⁴ The IRS database that maintains transactions or records of individual tax accounts.

⁵ We did not select statistical samples here or in Step I because we did not plan to project the results over the population.



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JCT criteria. Of these 111 refunds, we found 9 that would meet JCT criteria (in addition to the 35 that were already identified by the IRS).



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Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs)

Kyle R. Andersen, Director

Robert K. Irish, Audit Manager

Brian F. Kelly, Lead Auditor

Philip W. Peyser, Senior Auditor

Nancy E. VanHouten, Management Auditor

James Adkisson, Information Technology Specialist



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Commissioner, Large and Mid-Size Business Division SE:LM
Deputy Commissioner, Large and Mid-Size Business Division SE:LM
Deputy Commissioner, Wage and Investment Division SE:W
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:
 Commissioner, Large and Mid-Size Business Division SE:LM
 Commissioner, Wage and Investment Division SE:W



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Appendix IV

Tax Form Comparison

Individual Taxpayers

Amended U.S. Individual Income Tax Return (Form 1040X)

- **When To File:** Must be filed within 3 years of the date the original return was filed (in general).
- **Where To File:** Mailed to the IRS Center where the taxpayer files the original return (per IRS instructions).
- **Tax Years Involved:** A separate Form 1040X is required for each year that is being amended.
- **Restrictions On Usage:** None.
- **Processing Time:** Per the 1040X instruction sheet, 2 to 3 months. However, if the IRS does not process the Form 1040X within 6 months from the date filed, the taxpayer can file suit in court.

Application for Tentative Refund (Form 1045)

- **When To File:** Must be filed within 1 year after the end of the year in which an NOL¹ or unused credit arose.
- **Where To File:** Mailed to the IRS Center where the taxpayer files the original return (per IRS instructions).
- **Tax Years Involved:** Up to 3 tax years can be adjusted on the same Form 1045.
- **Restrictions On Usage:** Refund must result from either (1) carryback of an NOL, (2) carryback of an unused general business credit, (3) carryback of a net I.R.C. § 1256² contracts loss, or (4) overpayment of tax due to a claim of right adjustment (I.R.C. § 1341 (b) (1)³).
- **Processing Time:** The IRS is required to process the application within 90 days from the later of (1) the date on which the taxpayer filed the complete application or (2) the last day of the month that includes the due date (including extensions) for filing the taxpayer's income tax return.

¹ A benefit in the tax law that permits a business to carry an operating loss back 2 years or forward 20 years to apply against a profitable year to reduce the business' tax liability.

² 26 U.S.C. § 1256 (2002)

³ 26 U.S.C. § 1341(b)(1) (1999)



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Corporate Taxpayers

Amended U.S. Corporation Income Tax Return (Form 1120X)

- **When To File:** Must be filed within 3 years of the date the original return was filed (in general).
- **Where To File:** Mailed to the IRS Center where the corporation filed its original return.
- **Tax Years Involved:** A separate Form 1120X is required for each year that is being amended.
- **Restrictions On Usage:** Instructions note various situations in which Form 1120X should not be used (e.g., quick refund of estimated taxes and request for approval of change in accounting method). Instructions for Form 1139 (see below) note that a Form 1120X is necessary if the NOL or capital loss carryback results in the release of prior year's foreign tax credits.
- **Processing Time:** Per the 1120X instruction sheet, it often takes 3 to 4 months to process the Form.

Corporation Application for Tentative Refund (Form 1139)

- **When To File:** Must be filed within 12 months after the end of the tax year in which an NOL, net capital loss, or unused credit arose.
- **Where To File:** Mailed to the IRS Center where the corporation filed its income tax return.
- **Tax Years Involved:** Up to 3 preceding tax years can be adjusted on the same Form.
- **Restrictions On Usage:** Refund must result from either (1) carryback of an NOL, (2) carryback of an unused general business credit, (3) carryback of a net capital loss, or (4) overpayment of tax due to a claim of right adjustment (I.R.C. § 1341 (b) (1))⁴.
- **Processing Time:** The IRS is required to process the application within 90 days from the later of (1) the date the corporation filed the complete application or (2) the last day of the month that includes the due date (including extensions) for filing the corporation's income tax return for the year in which the credit arose.

⁴ 26 U.S.C. § 1341(b)(1) (1999)



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Appendix V

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

September 12, 2006

RECEIVED
SEP 13 2006

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard J. Morgante *Richard J. Morgante*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Efforts to Identify and Process Potential
Joint Committee on Taxation Cases Can Be Improved
(Audit # 200630002)

I have reviewed the subject draft report that focused on whether refund requests received in the Wage and Investment Accounts Management (AM) function were correctly identified as potentially meeting criteria for review by the Joint Committee on Taxation (JCT) and properly referred to Examination.

I appreciate your observations regarding our identification and processing of potential JCT referrals. The AM procedures are documented in Internal Revenue Manual (IRM) 21, which includes information on refunds where the total/aggregate refund is \$2 million or more, that potentially meet JCT criteria. Also, IRM 21 provides information regarding how to recognize tax modules that contained refunds previously identified as meeting JCT criteria.

I agree with your recommendation to analyze the refunds identified during your review as potentially meeting JCT criteria to determine if any of our AM controls or procedures should be modified. We received these refund cases from the audit team on August 24, 2006. We requested supporting documentation associated with these cases and expect to complete our review by November 15, 2006.

Our detailed response to your recommendation is attached. If you have any questions, please contact me at (404) 338-7060, or members of your staff may contact Betsy Kinter, Director, Customer Account Services, at (404) 338-8910.

Attachment



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Attachment

RECOMMENDATION 1

We recommend the Commissioner, W&I Division, analyze the potential JCT cases identified during the review to determine the controls that need to be addressed. Among the measures that could be considered are (1) reviewing and revising the various IRM sections that address the identification of potential JCT cases to ensure all cases are identified, (2) obtaining periodic computer extracts from the IRS computer system to identify all large-dollar refunds, and (3) adding an entry, where appropriate, to the history section of the taxpayer's account to notate that a refund currently being processed could have JCT review potential.

CORRECTIVE ACTION

We agree with the recommendation to analyze the potential JCT cases identified during your review to determine if any controls or procedures in AM need to be changed or modified. We received the refund cases from the audit team on August 24, 2006, and have subsequently requested supporting documentation associated with them. We will consider each of the three actions suggested in your recommendation. However, whether these or other corrective actions are adopted will depend on the outcome of our analysis of the cases. We expect to complete our review by November 15, 2006.

IMPLEMENTATION DATE

November 15, 2006

RESPONSIBLE OFFICIAL

Director, Customer Account Services AM

CORRECTIVE ACTION MONITORING PLAN

We will monitor or update the corrective action as part of our internal management control system.