
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



***Individual Income Tax Returns Were Timely
Processed in 2005; However, Implementation
of Tax Law Changes Could Be Improved***

December 2005

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

Redaction Legend:

- 2(a) – Law Enforcement Criteria
- 2(e) – Law Enforcement Procedure

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

December 29, 2005

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM:

Michael R. Phillips

Michael R. Phillips

Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Individual Income Tax Returns Were Timely Processed in 2005; However, Implementation of Tax Law Changes Could Be Improved (Audit # 200540018)

This report presents the results of our review of the 2005 Filing Season.¹ The overall objective of this review was to evaluate whether the Internal Revenue Service (IRS) timely and accurately processed Tax Year (TY) 2004 individual income tax returns² during the 2005 Filing Season. The audit focused on the implementation of new tax law changes³ that affected TY 2004 tax returns. In addition, we reviewed the corrective actions for the conditions identified in our review of the 2004 Filing Season⁴ to determine whether they were adequate.

Synopsis

Overall, the IRS had a successful 2005 Filing Season. The IRS completed processing of returns on schedule and timely issued refunds within the required 45 days of the April 15, 2005, due date.⁵

Through May 27, 2005, the IRS had processed over 117.5 million individual income tax returns. This total included 66.6 million returns processed electronically, an increase of nearly 11 percent

¹ The period from January through mid-April when most individual income tax returns are filed.

² Paper and electronic U.S. Individual Income Tax Returns (Forms 1040 and 1040A) and Income Tax Returns for Single and Joint Filers With No Dependents (Form 1040EZ).

³ See Appendix V for an overview of the new tax law provisions examined during this review.

⁴ *The 2004 Filing Season Was Completed Timely and Accurately, but Some Tax Law Changes Have Not Been Effectively Implemented* (Reference Number 2005-40-016, dated December 2004).

⁵ Internal Revenue Code Section 6611(e) (2002).



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over the same time last year. This was the first year in which more than one-half of all taxpayers filed an electronic return.

Our review of key tax law changes for the 2005 Filing Season showed most were correctly implemented. Additionally, the IRS had effectively implemented recommendations to address conditions reported during our 2004 Filing Season review. This included identifying taxpayers that appear eligible for, but did not claim, the Additional Child Tax Credit on their tax returns and correcting a programming deficiency to properly decrease the student loan interest deduction based on modified Adjusted Gross Income.⁶

However, we also determined some tax law changes were not effectively implemented during the 2005 Filing Season.

- The election to include nontaxable combat pay as earned income reduces the Earned Income Tax Credit for some military taxpayers.
- The new sales tax deduction is not benefiting all eligible taxpayers.
- Questionable large-dollar amounts on tax returns are causing erroneous credits and understatements of tax liabilities.
- Some taxpayers are receiving erroneous Education Credits.
- Single taxpayers continue to claim a questionable dual benefit by taking both the tuition and fees deduction and the Education Credit.

Recommendations

The recommendations included in this report can assist the IRS in effectively administering tax law changes. We recommended the Commissioner, Wage and Investment Division:

- Revise the instructions for U.S. Individual Income Tax Returns (Forms 1040 and 1040A), the *Armed Forces' Tax Guide* (Publication 3), and the *Earned Income Credit (EIC)* (Publication 596) to include examples that will assist military taxpayers to accurately calculate the Earned Income Tax Credit for the maximum tax benefit available to them and their families.
- Include instructions for the Optional State Sales Tax Deduction within the overall instructions for Itemized Deductions and Interest and Ordinary Dividends (Form 1040

⁶ Adjusted Gross Income is calculated after certain adjustments are made but before standard or itemized deductions and personal exemptions are subtracted. Modified Adjusted Gross Income is calculated without regard to certain deductions or exclusions.



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Schedules A and B) and provide the general State sales tax rate used to construct the Optional State Sales Tax Tables for each State.

- Implement a computer check that would identify questionable large-dollar entries for review and resolution for both paper and electronic individual income tax returns.
- Ensure tax return error correction procedures are clarified and emphasized during annual employee training sessions prior to each filing season.
- Revise Education Credits (Hope and Lifetime Learning Credits) (Form 8863) to combine and include applicable information for the tuition and fees deduction and Education Credit to ensure compliance and promote simplicity and fairness, as noted by the Joint Committee on Taxation.

Response

The IRS agreed in full with three of our five recommendations and is taking corrective actions. The IRS will revise the TY 2005 instructions for Form 1040, Schedules A and B, to include the Optional State Sales Tax Tables and instructions and to also include the general State sales tax rate used to construct the tax tables for each State. The IRS is reviewing its procedures to determine which error correction instructions need to be revised for additional clarity. The revised procedures will be incorporated into its training process. Lastly, if legislation is enacted to extend the tuition and fees deduction beyond TY 2005, the IRS will revise Form 8863 to include the tuition and fees deduction on the form.

The IRS agreed with our other two findings but is taking alternative corrective actions. As we recommended, the IRS will add examples to Publication 3 and Publication 596 to assist military taxpayers in determining whether they should include nontaxable combat pay as earned income to compute the maximum allowable EITC. However, IRS management believes revisions to the instructions for Forms 1040 and 1040A are not needed because the issue affects so few people and the recommended revisions to the publications should be sufficient for this target audience. The IRS agreed to consider the feasibility of our recommendation to implement a computer check that would identify questionable large-dollar entries for review. If IRS management determines that enhanced programming is needed, they will coordinate with the appropriate operating and support organizations. We believe the IRS' alternative corrective actions will reasonably address our findings. Management's complete response to the draft report is included as Appendix VI.



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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 Scott A. Macfarlane, Acting Assistant Inspector General for Audit (Wage and Investment Income Programs), at (925) 210-7027, extension 102.



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Background

The processing of income tax returns during the filing season¹ is always a highly critical program for the Internal Revenue Service (IRS). The IRS estimated that 131.7 million² individual income tax returns³ would be filed during Calendar Year 2004 and that most of these would be filed during the 2005 Filing Season. Through May 27, 2005, the IRS had processed over 117.5 million individual income tax returns, including 66.6 million processed electronically. One of the challenges the IRS confronts in processing these returns is the correct implementation of new tax law changes.

***"The IRS must find a way to digest and explain the Code in a way that taxpayers can understand, and enforce it."
(National Taxpayer Advocate)***

The National Taxpayer Advocate's 2004 Annual Report to Congress identified the complexity of the tax laws, the Internal Revenue Code (I.R.C.), as the most serious problem facing taxpayers, while acknowledging the challenges resulting from these complexities are "equally daunting" from an IRS perspective. The report states, "The IRS must find a way to digest and explain the Code in a way that taxpayers can understand, and enforce it." Changes to the tax law have a major impact on how the IRS conducts its activities, how many resources are required, and how quickly its strategic goals can be met.

Generally, the tax laws are changed each year. These tax law changes can be complex, and the application of complex laws will continue to create challenges for the IRS and for taxpayers. These challenges include the use of considerable IRS resources to identify the tax law changes and reprogram IRS' computer system; revise various tax forms, instructions, and publications; and educate taxpayers and IRS employees about the new tax law changes. All of these challenges must be met to ensure returns are accurately processed.

The IRS processed individual income tax returns in seven Wage and Investment (W&I) Division Submission Processing sites⁴ located throughout the country.⁵ All of the seven sites processed

¹ The period from January through mid-April when most individual income tax returns are filed.

² This estimate includes 63.7 million paper returns and 68 million electronic returns.

³ Paper and electronic U.S. Individual Income Tax Returns (Forms 1040 and 1040A) and Income Tax Returns for Single and Joint Filers With No Dependents (Form 1040EZ).

⁴ Submission Processing sites process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

⁵ Andover, Massachusetts; Atlanta, Georgia; Austin, Texas; Fresno, California; Kansas City, Missouri; Memphis, Tennessee; and Philadelphia, Pennsylvania, Submission Processing Sites.



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paper individual income tax returns, and five of these sites also processed electronic individual income tax returns through June 30, 2005.⁶

Both paper and electronic 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 subsystems that are nationally linked and programmed to check the validity and math accuracy of the data provided. If an error is found, the taxpayer is 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 W&I Division Headquarters in Atlanta, Georgia; the Submission Processing offices in Lanham, Maryland, and Cincinnati, Ohio; and the Austin, Texas, and Kansas City, Missouri, Submission Processing Sites during the period January through August 2005. 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.

⁶ Andover, Massachusetts; Austin, Texas; Kansas City, Missouri; Memphis, Tennessee; and Philadelphia, Pennsylvania, Submission Processing Sites.



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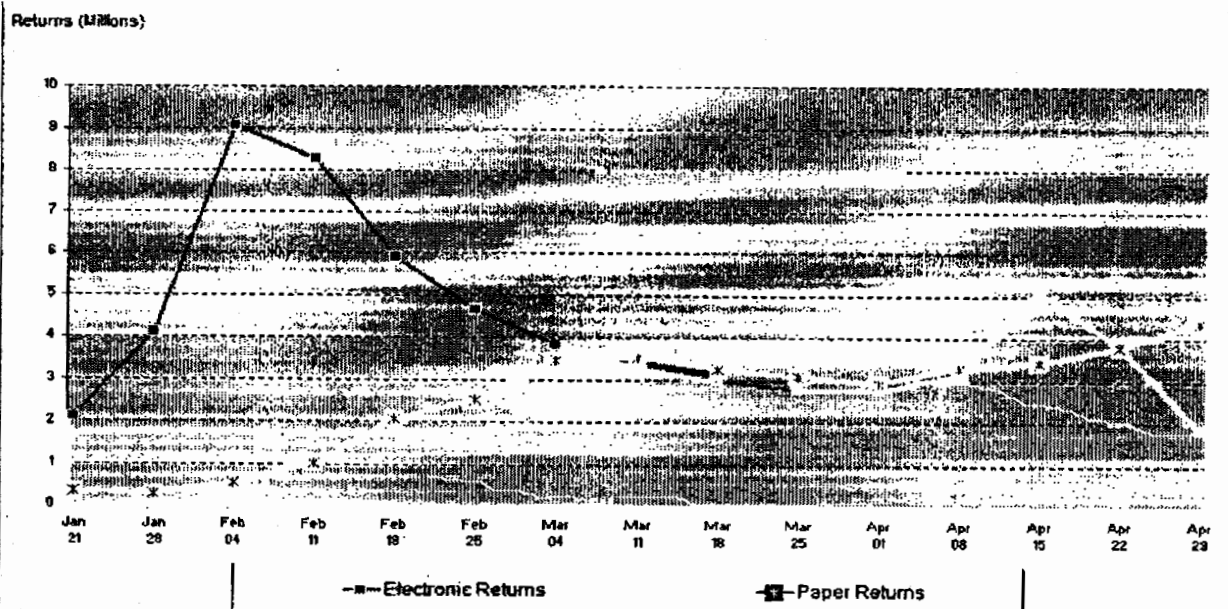
Results of Review

The 2005 Filing Season Was Timely Completed, With Most Returns Accurately Processed

Overall, the IRS had a successful 2005 Filing Season. The IRS completed processing of returns on schedule and timely issued refunds within the required 45 days of the April 15, 2005, due date.⁷ As shown in Chart 1, more than one-half of all taxpayers filed an electronic rather than a paper return. This is the first year this has occurred.

Electronic returns increased nearly 11 percent over the same time last year. The biggest increases were seen in taxpayers using the IRS' Free File Program (46 percent) and taxpayers filing online from home computers (17 percent).

Chart 1: Volumes of Paper and Electronic Returns for Tax Year (TY) 2004



Source: Treasury Inspector General for Tax Administration (TIGTA) electronic analysis of returns-processed data.

⁷ I.R.C. § 6611(c) (2002).



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Additionally, we found the IRS had effectively implemented recommendations to address the following conditions reported during our 2004 Filing Season review.⁸

- Some taxpayers that appeared eligible for the Additional Child Tax Credit (ACTC) did not claim the ACTC on their tax returns. During the 2004 Filing Season, we reviewed IRS computer programming to identify these taxpayers and found that not all would be properly identified. We recommended the IRS modify its computer programming to address this deficiency in 2005.

During the 2005 Filing Season, we identified 189,030 taxpayers that appeared eligible for, but did not claim, ACTC totaling \$139.9 million. IRS programming changes had properly identified these returns with an eligibility indicator designed to initiate a notice to the taxpayers informing them of the unclaimed ACTC.

- Student loan interest deductions were not accurately decreased based on the modified Adjusted Gross Income (AGI)⁹ reported by taxpayers. During the 2004 Filing Season, we analyzed returns processed to identify these deductions and found that they were inaccurately computed. In this year's review, we determined the IRS had corrected this programming deficiency and found student loan interest deductions were properly decreased based on the taxpayers' modified AGI, as shown on their tax returns.

Implementation of key tax law changes

The 2005 Filing Season included new and significant tax law changes created by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003;¹⁰ the Working Families Tax Relief Act of 2004;¹¹ and the American Jobs Creation Act of 2004.¹²

One of these changes included an option for taxpayers who itemize deductions to claim a State and local tax deduction for either sales or income taxes paid. This deduction will be the most beneficial to taxpayers that live in States with no State income taxes, but all taxpayers who itemize could benefit from this change. In addition, some military personnel receiving combat pay will receive larger tax credits, and new Health Savings Accounts have been established that permit individuals to save for, and pay, health care expenses on a tax-free basis. See Appendix V for an overview of the tax law provisions examined during this review.

⁸ *The 2004 Filing Season Was Completed Timely and Accurately, but Some Tax Law Changes Have Not Been Effectively Implemented* (Reference Number 2005-40-016, dated December 2004).

⁹ 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.

¹⁰ Pub. L. No. 108-173, 117 Stat. 2066 (2003).

¹¹ Pub. L. No. 108-311, 118 Stat. 1166 (2004).

¹² Pub. L. No. 108-357, 118 Stat. 1418 (2004).



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Our review of key tax law changes for the 2005 Filing Season showed that, overall, those in the following areas were correctly implemented:

- Health Savings Accounts.
- Development of the TY 2004 Optional Sales Tax Tables.
- Nontaxable Combat Pay Calculation in Relation to the ACTC.
- Calculation of the Increased Refundability of the ACTC.
- Increases in the Standard Deduction and Exemption Amounts.
- Tuition and Fees Deduction.

We also determined the new legislation allowing taxpayers to claim charitable contribution deductions for TY 2004 for cash donations to tsunami disaster relief made through January 31, 2005, was accurately and highly publicized to the public. However, we determined some tax law changes were not effectively implemented during the 2005 Filing Season.

- The election to include nontaxable combat pay as earned income reduces the Earned Income Tax Credit (EITC) for some military taxpayers.
- The new sales tax deduction is not benefiting all eligible taxpayers.
- Questionable large-dollar amounts on tax returns are causing erroneous credits and understatements of tax liabilities.
- Some taxpayers are receiving erroneous Education Credits.
- Single taxpayers continue to claim a questionable dual benefit by taking both the tuition and fees deduction and the Education Credit.

***The Election to Include Nontaxable Combat Pay As Earned Income
Reduces the Earned Income Tax Credit for Some Military Taxpayers***

The Working Families Tax Relief Act of 2004 requires military taxpayers to include nontaxable combat pay as earned income for purposes of calculating the refundable portion of the ACTC. Military taxpayers may also elect to include or exclude nontaxable combat pay as earned income to calculate their EITC.

Including nontaxable combat pay in the computation of earned income affects the ACTC and EITC in different ways. For example, in TY 2004, the ACTC was limited to 15 percent of earned income over \$10,750. Therefore, by adding nontaxable combat pay to earned income, military taxpayers can potentially increase the amount of the ACTC to be refunded.

In contrast, including nontaxable combat pay as earned income to compute the EITC may increase or decrease the amount of the EITC depending on the taxpayer's total earned income, filing status, and number of qualified children.



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In TY 2004, the maximum EITC available to taxpayers was based on the following earned income ranges:

- \$10,750 and \$14,050 for taxpayers with a filing status of Single, Head of Household, or Qualifying Widow(er).
- \$10,750 and \$15,050 for taxpayers with a filing status of Married Filing Jointly.
- \$5,100 and \$6,400 for taxpayers with no children.

Once earned income exceeds the maximum range shown for each of these categories, the amount of allowable EITC begins to decrease until eligibility ceases. For example, married taxpayers with earned income between \$10,750 and \$15,050 would not benefit from electing to include nontaxable combat pay in their computation of earned income. They are already eligible for the maximum EITC. If these married taxpayers elect to include nontaxable combat pay in earned income and it increases earned income beyond \$15,050, the taxpayers' EITC will be reduced.

To accurately assess the number of taxpayers that elected to include nontaxable combat pay when it was not beneficial, we electronically identified 13,205 taxpayers that reported nontaxable combat pay and claimed the EITC. Based on this population, we reviewed a statistically valid sample of 269 taxpayer returns and found 56 returns (21 percent) on which taxpayers inadvertently reduced their EITC by \$38,205 when their nontaxable combat pay was included in the computation of earned income. Using these results, we statistically projected 2,749 taxpayers did not receive approximately \$1.9 million of EITC they were entitled to because they included nontaxable combat pay in their EITC computations.

The possible factors causing taxpayers to include nontaxable combat pay in the computation of earned income to their detriment could be unfamiliarity with the new provision and limited examples of the election in the instructions and publications. This is the first year of the election, and the legislation was not passed until October 2004. The instructions for U.S. Individual Income Tax Returns (Forms 1040 and 1040A) inform taxpayers that they can elect to include nontaxable combat pay in figuring the EITC and refer taxpayers to the *Armed Forces' Tax Guide* (Publication 3) for additional information about the election. Although the Form 1040 instructions, Publication 3, and *Earned Income Credit (EIC)* (Publication 596) alert taxpayers to compute the EITC with and without nontaxable combat pay before making the election and explain the election may increase or decrease the EITC, they do not provide any examples of how the election would work to increase or decrease the EITC.

We previously reported an issue involving the omission of nontaxable combat pay information and its impact on computing the ACTC. This omission could cause some military families to claim less than the total ACTC amount to which they may be rightfully entitled. In that report,¹³

¹³ *Forms, Publications, and Computer Programming Requests Were Adequately Addressed and Updated in Most Instances for the 2005 Filing Season* (Reference Number 2005-40-094, dated June 2005).



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we recommended Publication 3 and the *Child Tax Credit* (Publication 972) be revised to more thoroughly address the effect of nontaxable combat pay on the computation of the ACTC and inform military families of this through appropriate media outlets. As a result of that report, the IRS made the revisions to these publications and provided training and support to over 150 Military Volunteer Income Tax Assistance sites. The Executive Director of the Armed Forces Tax Council was also provided combat pay information, and the IRS updated various external communication mediums, including many IRS web sites to educate taxpayers on how to properly include combat pay in the computation of the EITC. To continue to provide military families with complete information on the treatment of nontaxable combat pay and ensure they receive the tax benefits to which they are entitled, we believe further revisions are needed.

Recommendation

Recommendation 1: The Commissioner, W&I Division, should revise the instructions for Forms 1040 and 1040A, Publication 3, and Publication 596 to include examples that will assist military taxpayers to accurately calculate the EITC for the maximum tax benefit available to them and their families.

Management's Response: IRS management agreed with our finding but is taking only part of our recommended corrective action. The IRS will add examples to Publication 3 and Publication 596 to assist military taxpayers in determining whether they should include nontaxable combat pay as earned income to compute the maximum allowable EITC. However, IRS management believes revisions to the instructions for Forms 1040 and 1040A are not needed because the issue affects so few people and the recommended revisions to the publications should be sufficient for this target audience.

Office of Audit Comment: We believe the IRS' alternative corrective action will reasonably address our finding.

The New Sales Tax Deduction Is Not Benefiting All Eligible Taxpayers

The American Jobs Creation Act of 2004¹⁴ was enacted in October 2004 and allows taxpayers who itemize deductions the option of deducting either State and local sales taxes or State and local income taxes from their Federal income tax returns. This option is available for only TYs 2004 and 2005 and is most advantageous for taxpayers living in the seven States that do not have a State income tax.¹⁵ Taxpayers can determine their deductions by using the tables provided in *Optional State Sales Tax Tables* (Publication 600) or by saving actual receipts for taxes paid throughout the year. Also, any sales tax paid on certain items such as motor vehicles may be added to the table amount.

¹⁴ Pub. L. No. 108-357, 118 Stat. 1418 (2004).

¹⁵ Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.



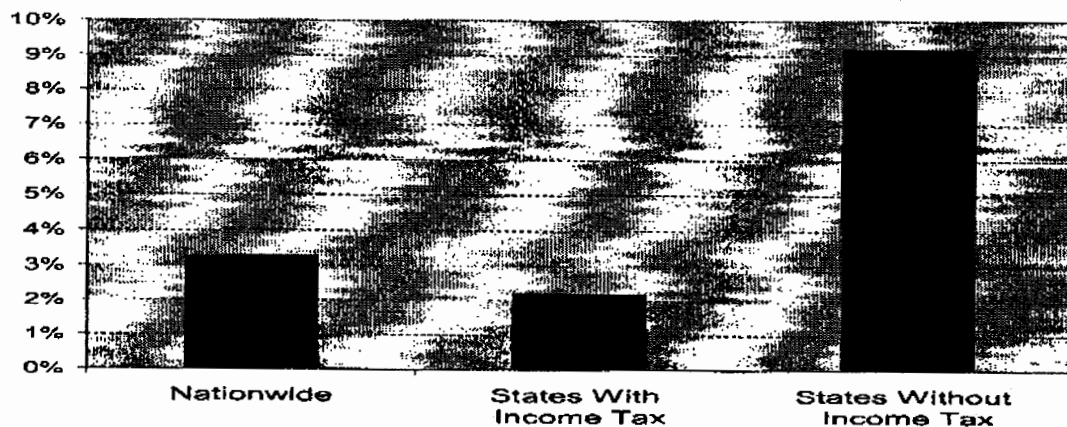
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We determined the IRS accurately developed the Optional State Sales Tax Tables using a respected statistical analysis tool and the most current data available from the Bureau of Labor Statistics and the IRS Statistics of Income Program. However, we found the design and content of Publication 600 and its tax tables may have caused additional taxpayer burden that resulted in some taxpayers misstating their deduction and others failing to claim the deduction at all.

Our analysis identified over 33 million tax returns (processed through May 2005) that had itemized deductions. Of these returns, there were approximately 1.1 million (3 percent) on which the taxpayer could have claimed, but did not claim, either a State income tax or a sales tax deduction despite approximately one-half of the returns showing a paid preparer was retained by the taxpayer. We also found that taxpayers residing in the seven States without a State income tax were four times more likely to omit the sales tax deduction than taxpayers living elsewhere. The taxpayers residing in these seven States filed nearly 5.1 million returns with itemized deductions; however, 465,095 taxpayers (9 percent) in these seven States did not claim the sales tax deduction.

We believe this disparity, shown in the Chart 2, is primarily attributable to the late passage of the legislation in October 2004, which prevented the Optional State Sales Tax Tables and instructions from being included in the Form 1040 instructions. Instead, taxpayers were referred to IRS Publication 600, which contained the State sales tax tables and deduction worksheet. However, Publication 600 omitted the general sales tax rate used to construct the tax table for each State, which required taxpayers and paid preparers to research outside the IRS to accurately compute their full deduction if the State tax rate was not readily known.

Chart 2: Percentage of Eligible Returns That Missed the Opportunity to Deduct State Income/Sales Taxes



Source: TIGTA electronic analysis of returns processed with the State and local sales tax deduction and the State and local income tax deductions for TY 2004.



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These statistics point to a need to better educate taxpayers and tax preparers about the availability of the sales tax deduction and to ensure all eligible taxpayers have sufficient information to correctly compute and take advantage of the sales tax deduction.

Recommendation

Recommendation 2: The Commissioner, W&I Division, should include instructions for the Optional State Sales Tax Deduction within the overall instructions for Itemized Deductions and Interest and Ordinary Dividends (Form 1040 Schedules A and B) and provide the general State sales tax rate used to construct the Optional State Sales Tax Tables for each State.

Management's Response: IRS management agreed with this recommendation and will revise the TY 2005 instructions for Form 1040, Schedules A and B, to include the Optional State Sales Tax Tables and instructions and to also include the general State sales tax rate used to construct the tax tables for each State.

Questionable Large-Dollar Amounts on Tax Returns Are Causing Erroneous Credits and Understatements of Tax Liabilities

Our analysis of all individual tax returns submitted through May 27, 2005, identified 46,143 returns that were processed with an entry exceeding \$100,000 for the amount of State sales tax or State income tax deducted and/or the amount of nontaxable combat pay reported. Of the 46,143 returns, 37,141 were attributed to questionable amounts claimed for a State sales tax or State income tax deduction and 9,002 to nontaxable combat pay elections.¹⁶

Returns with questionable State sales tax or State income tax deductions

On the 37,141 returns filed, the State sales tax and State income tax deductions totaled approximately \$33.9 billion, or approximately \$913,072 per return. We reviewed a judgmental sample of 34 paper returns processed with a questionable State sales tax or State income tax deduction and found that 18 (53 percent) of the deductions were incorrect based upon the amount claimed as compared with the sales tax tables or the wages shown on the Wage and Tax Statement (Form W-2). Only 2 of these 18 returns were attributable to IRS input errors. We determined that 15 of the returns reflected a total difference over \$10.2 million between the State sales tax deduction and the amount allowable per the appropriate State sales tax table, or approximately \$681,000 per return. The remaining 3 returns showed a total difference of \$802,600 between the State income tax deductions and the Form W-2 amounts, or about \$268,000 per return.

¹⁶ The 46,143 returns include 10 returns that were identified with questionable amounts claimed for both a State sales tax or State income tax deduction and a nontaxable combat pay election.




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The net tax effect for these 18 error returns resulted in understated tax liabilities totaling an estimated \$30,760. We also reviewed a random sample of 100 electronic returns processed with questionable State sales tax deductions and determined that 80 returns had additional understated tax liabilities totaling an estimated \$167,119.

Returns with questionable nontaxable combat pay reported

On the 9,002 returns filed, the nontaxable combat pay totaled \$504.3 billion, or approximately \$56 million per return. A judgmental sample of 18 paper returns showed that, in all 18 cases, the amount shown for nontaxable combat pay was due to an IRS error. For 16 of these 18 returns, the IRS mistakenly input the tax preparer's 10-digit telephone number as the amount of nontaxable combat pay reported. We believe this IRS error is primarily responsible for causing the unrealistic average of \$56 million per return. We also judgmentally sampled 24 returns and determined that the taxpayer's ACTC was increased as a result of the overstated nontaxable combat pay reported on 20 of the 24 returns. These 20 errors resulted in erroneous ACTC totaling \$21,328.

2(a),2(e)



While the overall volume of these types of errors is small in comparison to total returns processed, the significant impact resulting from such large-dollar discrepancies prevents the IRS from being able to provide accurate quantifiable information to Congress and other outside stakeholders as to the amount of State sales tax or State income taxes claimed or nontaxable combat pay reported.

Recommendation

Recommendation 3: The Commissioner, W&I Division, should implement a computer check that would identify questionable large-dollar entries for review and resolution for both paper and electronic individual income tax returns.

Management's Response: IRS management agreed to consider the feasibility of this recommendation. If IRS management determines that enhanced programming is needed for detection and resolution of questionable large-dollar entries, corrective actions will be coordinated with the appropriate operating and support organizations.

Office of Audit Comment: We believe the IRS' corrective action will adequately address our finding.



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Some Taxpayers Are Receiving Erroneous Education Credits

The Taxpayer Relief Act of 1997¹⁷ allows taxpayers to receive tax credits for education expenses, subject to limitations based upon the taxpayer's filing status, AGI, or modified AGI. For TY 2004, no Education Credits were allowed if a taxpayer's modified AGI exceeded certain income ranges.¹⁸

We identified 964 tax returns on which taxpayers claimed Education Credits they were not entitled to receive because their modified AGI exceeded the allowable amount under the tax law. We found that, although the erroneous Education Credits claimed by taxpayers on 755 (78 percent) of the 964 returns were correctly disallowed, 209 (22 percent) were improperly allowed. The erroneous Education Credits claimed by taxpayers on these 209 returns totaled \$261,314.

Our analysis showed that the IRS computer system effectively identified the 964 returns as having an error condition; however, IRS error correction employees did not disallow the erroneous Education Credits in their subsequent reviews of the 209 returns. We reviewed various IRS procedures intended to assist employees in correcting these types of errors and found them to be unclear, which we feel contributed to why these returns were not properly adjusted to disallow the erroneous Education Credits claimed. While we acknowledge that this condition represents only a small percentage of the total returns claiming an Education Credit, we believe it is important to identify areas where reasonable efforts could be taken to help prevent or decrease erroneous credits from being allowed.

Recommendation

Recommendation 4: The Commissioner, W&I Division, should ensure tax return error correction procedures are clarified and emphasized during annual employee training sessions prior to each filing season.

Management's Response: IRS management agreed with this recommendation and is reviewing its procedures to determine which instructions need to be revised for additional clarity. The revised procedures will be incorporated into its training process.

¹⁷ Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).

¹⁸ Modified AGI cannot exceed \$52,000 for a taxpayer using the Single, Head of Household, or Qualifying Widow(er) filing status and \$105,000 for taxpayers using the Married Filing Jointly filing status.



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Single Taxpayers Continue to Claim a Questionable Dual Benefit by Taking Both the Tuition and Fees Deduction and the Education Credit

The Economic Growth and Tax Relief Reconciliation Act of 2001¹⁹ created a new, above-the-line deduction for tuition and fees. For TYs 2002 and 2003 returns, taxpayers were allowed to take a deduction of up to \$3,000 for qualified tuition and fees paid for the taxpayer, his or her spouse, or his or her dependents. In TY 2004, this deduction increased to \$4,000. However, taxpayers may not receive a dual benefit by taking both the tuition and fees deduction and the Education Credit for the same student in the same year. If the Education Credit is elected, the tuition and fees deduction is not allowed.

Taxpayers who claim an 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, for whom the Education Credit is being claimed. Taxpayers who claim 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. 2(e)

When this issue was first reported during the 2003 Filing Season,²⁰ the IRS agreed to include a cautionary statement on 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.

During the 2004 Filing Season, we again found this condition and recommended the IRS work on changing or developing processes to identify and prevent erroneous deductions during initial tax return processing, such as math error notices or unallowable items. 2(a), 2(e)

The IRS agreed to establish a cross-functional task group to conduct a study that would focus on the possibility of addressing errors during the initial processing of returns.

In this year's review, we identified 18,776 single taxpayers. 2(e)

Our audit analysis showed that these taxpayers claimed Education Credits of over \$13 million and tuition and fees deductions of nearly \$39 million. Assuming all 18,776 taxpayers. 2(e)

Our review

¹⁹ Pub. L. No. 107-16, 115 Stat. 38 (2001).

²⁰ *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).

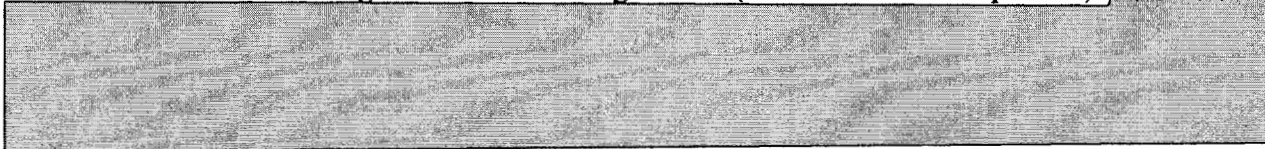
2(a), 2(e)



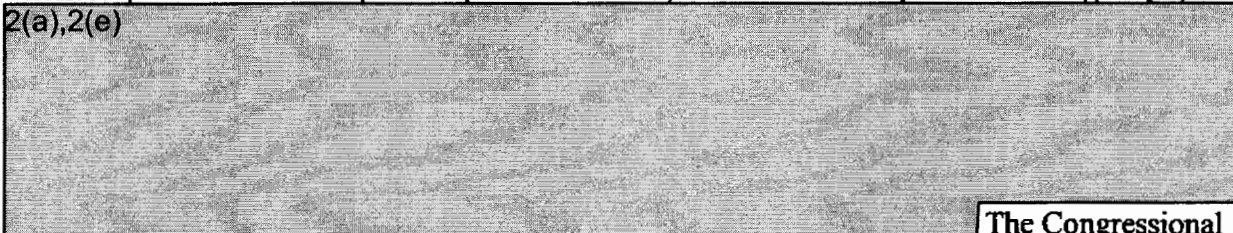
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focused on single taxpayers claiming no dependents because it is clear that both the tuition and fees deduction and the Education Credit was claimed for the same individual, which is not allowable. This segment of taxpayers showed an increase of almost 11 percent (18,776 in the 2005 Filing Season compared to 16,979 in the 2004 Filing Season).

Additionally, the extent of this problem is not limited to single taxpayers with no dependents. A total of 241,862 taxpayers that filed as other than Single claimed both the tuition and fees deduction and the Education Credit in the 2005 Filing Season, compared to 205,196 taxpayers that filed as other than Single in the 2004 Filing Season (an increase of 17.9 percent). 2(a),2(e)



The W&I Compliance Program has recognized the dual benefit issue as an area of noncompliance and has explored options to identify the extent of the problem among taxpayers.



The Congressional Joint Committee on Taxation has recognized the complexity and inequity in having similar, but different, Education Credits and a higher education deduction, and it has proposed combining the Education Credit with the tuition and fees deduction into a single credit for higher education expenses, to promote greater simplicity and fairness.

Recommendation

Recommendation 5: The Commissioner, W&I Division, should revise Form 8863 to combine and include applicable information for the tuition and fees deduction and Education Credit to ensure compliance and promote simplicity and fairness, as noted by the Joint Committee on Taxation. Although the tuition and fees deduction is scheduled to expire on December 31, 2005, we believe this deduction may be extended by legislative action and, if so, we believe there is a high probability that these conditions will continue to exist.

Management's Response: IRS management agreed with this recommendation. If legislation is enacted to extend the tuition and fees deduction beyond TY 2005, the IRS will revise Form 8863 to include the tuition and fees deduction on the form.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the review was to evaluate whether the Internal Revenue Service (IRS) timely and accurately processed Tax Year (TY) 2004 individual income tax returns¹ during the 2005 Filing Season.² The audit focused on the implementation of new tax law changes³ that affected TY 2004 tax returns. In addition, we reviewed the corrective actions for the conditions identified in our review of the 2004 Filing Season⁴ to determine whether they were adequate. To accomplish our objective, we:

- I. Determined whether the IRS correctly implemented new tax legislation that could affect the processing of individual income tax returns during the 2005 Filing Season.
 - A. Used 100 percent computer analysis of TY 2004 individual income tax returns processed nationally between January 1 and May 27, 2005,⁵ to identify returns affected by recent tax legislation. To determine whether systemic controls at the Submission Processing sites⁶ assure processing accuracy, we:
 1. Verified whether adjustments to income were correctly limited for all 463 returns electronically identified as claiming excess contributions to a Health Savings Account from a total of 62,896 returns filed through May 13, 2005.
 2. Determined the impact on the Additional Child Tax Credit (ACTC) and the Earned Income Tax Credit (EITC) by reviewing a random sample of 30 of 102,387 returns processed through March 4, 2005, and reporting nontaxable combat pay on Additional Child Tax Credit (Form 8812) and a random sample of 30 of 20,467 returns reporting nontaxable combat pay on U.S. Individual Income Tax Returns (Forms 1040 or 1040A). A random sample was used to ensure each return had an equal chance of being selected.
 3. Identified a population of 13,205 returns processed through April 22, 2005, that reported nontaxable combat pay and claimed the EITC. We reviewed a

¹ Paper and electronic U.S. Individual Income Tax Returns (Forms 1040 and 1040A) and Income Tax Returns for Single and Joint Filers With No Dependents (Form 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 new tax law provisions examined during this review.

⁴ *The 2004 Filing Season Was Completed Timely and Accurately, but Some Tax Law Changes Have Not Been Effectively Implemented* (Reference Number 2005-40-016, dated December 2004).

⁵ We selected small judgmental samples of the electronic data to validate the accuracy of the data.

⁶ Submission Processing sites process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



Individual Income Tax Returns Were Timely Processed in 2005; However, Implementation of Tax Law Changes Could Be Improved

statistically valid sample of 269 returns to determine the number of taxpayers that had elected to include nontaxable combat pay in the calculation of earned income when it was not beneficial. The statistically valid sample was selected from the population based on a 95 percent confidence level, an expected error rate of 23.33 percent, and precision of ± 5 percent. A statistical sampling method was used to make a projection about the population from which the sample was selected.

4. Determined whether the refundable portion of the ACTC was limited by 15 percent of earned income greater than \$10,750 by reviewing a random sample of 30 of the 99,048 electronic returns and paper returns processed at the Austin, Texas, Submission Processing Site through March 4, 2005, claiming the ACTC. The population for this test was limited to Austin because of the large volumes of returns claiming the ACTC, and a random sample was used to ensure each return had an equal chance of being selected.
 5. Verified whether the correct standard deduction and exemption amounts were used by reviewing a judgmental sample of 55 returns from 973 returns processed at the Austin, Texas, Submission Processing Site through February 4, 2005. The population for this test was limited to Austin, and a judgmental sample was used to ensure that 55 original returns could be quickly obtained to evaluate the accuracy of the standard deduction and exemption amounts.
 6. Identified 19,731 taxpayers through April 29, 2005, that claimed a tuition and fees deduction in excess of the maximum allowed and determined whether the deduction was correctly disallowed. We also identified and analyzed 964 returns processed through May 27, 2005, on which taxpayers had claimed the Education Credit when the taxpayer's modified Adjusted Gross Income (AGI)⁷ exceeded the allowable limits.
- B. Analyzed the process used to prepare the Optional State Sales Tax Tables for claiming the new State sales tax deduction to determine whether the process was reasonable and equitable to all taxpayers.
- C. Determined what actions were taken by the IRS to inform taxpayers of the opportunity to itemize as deductions any January 2005 tsunami disaster relief contributions and to ensure the contributions are not deducted for both TYs 2004 and 2005.

⁷ 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.



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- II. Determined whether the IRS monitoring systems indicated individual income tax returns were being processed timely and accurately.
- A. Monitored various Submission Processing site production and inventory reports produced between January 21 and April 29, 2005, for key indicators for returns processing and compared the statistics to those from the previous filing season. In addition, we monitored return error inventories from various error reports created between January 21 and April 29, 2005.
 - B. To determine whether Submission Processing sites processed all returns timely, monitored the IRS Program Completion Date reports from May 4 through May 11, 2005.
 - C. Computer analyzed filing patterns to evaluate whether processing inventories were adversely affected by taxpayers filing returns at the wrong Submission Processing site.
 - D. Monitored weekly 2005 Filing Season Wage and Investment Production meetings between January 21 and May 4, 2005, and reviewed the IRS Weekly Tracking Reports between January 21, 2005, and April 29, 2005. We also monitored the IRS Submission Processing office web site, the IRS public web site, and other applicable web sites during February 4 through May 6, 2005, to identify potentially significant issues that could affect processing of TY 2004 individual returns.
 - E. Electronically identified 46,143 individual tax returns processed through May 27, 2005, that were recorded with sales tax or State and local income tax deductions and/or nontaxable combat pay elections that exceeded \$100,000.⁸ We judgmentally selected \$100,000 because we believed it provided a strong indicator of an unreasonable deduction for the majority of returns. We selected various judgmental samples of these data⁹ and then selected a random sample of 100 of 1,721 electronic returns judgmentally identified through May 27, 2005, to determine whether the deduction was accurate. A random sample was used to ensure each return had an equal chance of being selected.
- III. Determined whether the IRS corrected problems identified in the 2004 Filing Season. From returns processed by the Submission Processing sites between January 1 and May 27, 2005, we electronically identified TY 2004 returns that met specific criteria.
- A. Determined whether the student loan interest adjustments to income were properly phased out based on AGI limits. We reviewed documented changes to IRS computer

⁸ The 46,143 returns include 10 returns that were identified with questionable amounts claimed for both a State sales tax or State income tax deduction and a nontaxable combat pay election.

⁹ Judgmental samples were initially selected at this point to determine the validity of the data.



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programs and electronically scanned all returns to identify any adjustments improperly allowed.

- B. Identified returns of taxpayers who appeared eligible for, but did not claim, the ACTC to determine whether the IRS is identifying these returns. We reviewed a random sample of 30 of 73,773 returns processed through March 4, 2005, and verified whether the cases had been identified by the IRS. We also reviewed the IRS National Roll-Up Report for Notice Volume Comparisons through May 27, 2005, and determined the number of notices issued to alert taxpayers that the ACTC may have been overlooked. A random sample was used to ensure each return had an equal chance of being selected.
- C. Determined whether single taxpayers continue to claim both an Education Credit and the tuition and fees deduction by electronically identifying and reviewing 18,776 returns of single taxpayers with no dependents processed through May 27, 2005.



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Appendix II

Major Contributors to This Report

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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
Deputy Commissioner, Wage and Investment Division SE:W
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Customer Assistance, Relationships, and Education, Wage and Investment Division
SE:W:CAR
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Chief, Performance Improvement, Wage and Investment Division SE:W:S:PI
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Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
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 Management Controls OS:CFO:AR:M
Audit Liaison: Senior Operations Advisor, Wage and Investment Division SE:W:S



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Appendix IV

Outcome Measures

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

For all of the outcomes listed in this appendix, we conducted computer analyses of Tax Year (TY) 2004 individual income tax returns.¹ The returns were processed by the Internal Revenue Service (IRS) Submission Processing sites² between January 1, 2005, and May 27, 2005,³ and were posted to the Individual Master File.⁴ We developed specific criteria to identify returns affected by the new 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 2005 Filing Season.⁵

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 2,749 taxpayers did not receive approximately \$1.9 million of Earned Income Tax Credit (EITC) (see page 5).

Methodology Used to Measure the Reported Benefit:

To accurately assess the number of taxpayers that elected to include nontaxable combat pay when it was not beneficial, we electronically identified 13,205 taxpayers that reported nontaxable combat pay and claimed the EITC. Based on this population, we reviewed a statistically valid sample of 269 taxpayer returns and found 56 returns (21 percent) on which taxpayers inadvertently reduced their EITC by \$38,205 when their nontaxable combat pay was included in the computation of earned income. Using these results, we statistically projected there are 2,749 returns (± 635) on which taxpayers did not receive approximately \$1,875,506 ($\pm \$717,702$) of EITC because they included nontaxable combat pay in the EITC computation. The EITC

¹ Paper and electronic U.S. Individual Income Tax Returns (Forms 1040 and 1040A) and Income Tax Returns for Single and Joint Filers With No Dependents (Form 1040EZ).

² Submission Processing sites process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

³ We continued our review through May 27, 2005, to validate whether tax returns received by the April 15 filing due date were timely and accurately processed.

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

⁵ The period from January through mid-April when most individual income tax returns are filed.



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computation projections were calculated using valid statistical formulas to determine the variable range of total error returns and aggregate dollars within the sampled population.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 465,095 taxpayers affected (see page 7).

Methodology Used to Measure the Reported Benefit:

Our analysis identified that, through May 2005, over 33 million returns had been processed with itemized deductions. Of these returns, there were approximately 1.1 million (3 percent) on which the taxpayer did not claim either a State income tax or a sales tax deduction, despite approximately one-half of the returns showing a paid preparer was retained by the taxpayer. We also found that taxpayers residing in States without a State income tax⁶ were four times more likely to overlook the sales tax deduction than taxpayers living in the rest of the country. The taxpayers residing in these 7 States filed nearly 5.1 million returns with itemized deductions; however, 465,095 taxpayers (9 percent) in these 7 States did not claim the sales tax deduction.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; 118 taxpayers that received an estimated erroneous tax benefit of \$219,207 because the data on the returns were erroneous (see page 9).

Methodology Used to Measure the Reported Benefit:

Our analysis of all individual tax returns submitted through May 27, 2005, identified 46,143 returns that were processed with an entry exceeding \$100,000 for the amount of State sales tax or State income tax deducted and/or the amount of nontaxable combat pay reported. Of the 46,143 returns, 37,141 were attributed to questionable amounts claimed for a State sales tax or State income tax deduction and 9,002 to nontaxable combat pay elections.⁷

On the 37,141 returns filed, the State sales tax and State income tax deductions totaled approximately \$33.9 billion, or approximately \$913,072 per return. We reviewed a judgmental sample of 34 paper returns processed with a questionable State sales tax or State income deduction and found that 18 (53 percent) of the deductions were incorrect based upon the amount claimed as compared with the sales tax tables or the wages shown on the Wage and Tax Statement (Form W-2). The net tax effect for these 18 returns resulted in understated tax liabilities totaling an estimated \$30,760. We also reviewed a random sample of 100 electronic

⁶ Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

⁷ The 46,143 returns include 10 returns that were identified with questionable amounts claimed for both a State sales tax or State income tax deduction and a nontaxable combat pay election.



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returns processed with questionable State sales tax deductions and determined 80 returns had additional understated tax liabilities totaling an estimated \$167,119.

The 9,002 returns filed showed nontaxable combat pay totaled \$504.3 billion, or approximately \$56 million per return. We judgmentally sampled 24 returns and determined the taxpayer's Additional Child Tax Credit (ACTC) was erroneously increased by overstated nontaxable combat pay on 20 of these returns, resulting in erroneous ACTC totaling \$21,328.

Type and Value of Outcome Measure:

- Revenue Protection – Actual; 209 taxpayers erroneously received \$261,314 in Education Credits in excess of the amount allowable under the law (see page 11).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify the number of taxpayers that were erroneously allowed Education Credits that exceeded the allowable amount under the tax law based upon their modified Adjusted Gross Income (AGI)⁸ and filing status.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; 18,776 single taxpayers with no dependents (b)(2)(a), (b)(2)(e)

Methodology Used to Measure the Reported Benefit:

One of the criteria we used in analyzing the TY 2004 individual income tax return records was to identify all single taxpayers with no dependents who claimed, (b)(2)(a), (b)(2)(e) the tuition and fees deduction and the Education Credit. This analysis identified 18,776 taxpayers (b)(2)(a), (b)(2)(e)

Since the tax law prohibits taxpayers from claiming both the deduction and the Education Credit for the same individual in the same year, the tuition and fees deduction is not allowable.

⁸ 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.

(b)(2)(a), (b)(2)(e)



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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 affected by the various provisions were accurately processed, in accordance with the law.

Taxpayer Relief Act of 1997¹

This Act contained the following tax law provision we reviewed:

Education Credits

The income limits for the Hope and Lifetime Learning Credit were increased. Beginning in Tax Year (TY) 2004, the Hope and Lifetime Learning Credit is gradually phased out if the modified Adjusted Gross Income (AGI)² is between \$42,000 and \$52,000 (\$85,000 and \$105,000 for taxpayers filing as Married Filing Jointly).

Economic Growth and Tax Relief Reconciliation Act of 2001³

This Act contained the following tax law provision we reviewed:

Tuition and Fees Deduction

The tuition and fees deduction increased from \$3,000 to \$4,000 if a taxpayer's modified AGI is not more than \$65,000 (\$130,000 for taxpayers filing as Married Filing Jointly). If the AGI is larger than \$65,000 (\$130,000), but is not more than \$80,000 (\$160,000), the maximum tuition and fees deduction is \$2,000.

¹ Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).

² 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.

³ Pub. L. No. 107-16, 115 Stat. 38 (2001).



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Medicare Prescription Drug, Improvement, and Modernization Act of 2003⁴

This Act contained the following tax law provision we reviewed:

Health Savings Account

The new Health Savings Account is essentially a permanent version of the current Archer medical savings account but with fewer restrictions and limitations (i.e., contributions to both are deductible, and distributions from both used for medical expenses are excludible). An eligible individual must be covered by a high-deductible health plan, with a plan deductible of at least \$1,000 for self-only coverage or \$2,000 for family coverage. In addition, the sum of the annual deductible and other annual out-of-pocket expenses for covered benefits cannot exceed \$5,000 in the case of self-only coverage and \$10,000 in the case of family coverage. The maximum aggregate annual contribution to a Health Savings Account in TY 2004 is the lesser of (1) 100 percent of the annual deductible under the high-deductible health plan or (2) \$2,600 in the case of self-only coverage and \$5,150 in the case of family coverage (both amounts are indexed annually for inflation). Individuals age 55-65 may make additional "catch-up" contributions of up to \$500 in TY 2004. This deduction is claimed on the new Health Savings Accounts (HSAs) (Form 8889).

Working Families Tax Relief Act of 2004⁵

This Act contained the following two tax law provisions we reviewed:

Nontaxable Combat Pay

The new law counts excludable combat pay as income when calculating the refundable portion of the Child Tax Credit and gives the taxpayer the option of counting or ignoring combat pay as income when figuring the Earned Income Tax Credit. This does not change the exclusion of combat pay from taxable income.

Increase in Child Tax Credit Accelerated

The Child Tax Credit was refundable (the refundable portion is the Additional Child Tax Credit) to the extent of 10 percent of the taxpayer's taxable earned income in excess of \$10,750. Under the prior law, the 10 percent would increase to 15 percent in TY 2005. This provision accelerated the increase in the refundability percentage to 15 percent for TY 2004.

⁴ Pub. L. No. 108-173, 117 Stat. 2066 (2003).

⁵ Pub. L. No. 108-311, 118 Stat. 1166 (2004).



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American Jobs Creation Act of 2004⁶

This Act contained the following tax law provision we reviewed:

Sales Tax Deduction

Taxpayers who itemize deductions will have a choice of claiming a State and local tax deduction for either sales or income taxes paid on their TYs 2004 and 2005 returns. Taxpayers can deduct either their actual sales taxes paid or the amount shown for their income bracket in tables provided by the Internal Revenue Service. Sales taxes paid on motor vehicles and boats may be added to the table amount but only up to the amount paid at the general sales tax rate. Taxpayers will check a box on Itemized Deductions (Schedule A), to indicate whether their deduction is for sales or income taxes.

Tsunami Relief Act of 2005⁷

This Act contained the following tax law provision we reviewed:

Acceleration of Benefits for Cash Contributions

Taxpayers who itemize their deductions may claim a charitable contribution deduction for donations made during January 2005 to organizations helping the victims of the Indian Ocean tsunami on their TY 2004 income tax returns. While contributions to foreign organizations are generally not deductible, donations to help tsunami victims made before February 1, 2005, may be deducted on a taxpayer's TY 2004 or TY 2005 return. The new law applies only to cash contributions made specifically for the relief of victims in areas affected by the December 26, 2004, tsunami in the Indian Ocean.

⁶ Pub. L. No. 108-357, 118 Stat. 1418 (2004).

⁷ Pub. L. No. 109-1, 119 Stat. 3 (2005).



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Appendix VI

Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

RECEIVED
NOV 21 2005

NOV 18 2005

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *for* Richard J. Morgante *Dorene B. Watson*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Individual Income Tax Returns Were Timely
Processed in 2005; However, Implementation of Tax Law
Changes Could Be Improved (Audit # 200540018)

I appreciate your acknowledgement of the enormity of delivering a successful filing season in your report entitled *Individual Income Tax Returns Were Timely Processed in 2005; However, Implementation of Tax Law Changes Could Be Improved*. I agree with your conclusion that we correctly implemented the tax law changes impacting Tax Year 2004 processing, and timely and accurately processed returns. This was one of our most successful filing seasons, evidenced by the fact that, through September 30, we processed nearly 130.3 million returns, issued 98.8 million refunds totaling over \$210 billion in refunds, and the number of electronically filed returns increased by over 11 percent. This year marks the first time more than half of all taxpayers filed electronically. The Free File Program showed a 48 percent increase and on-line home filing increased 17 percent compared to the prior year.

The late passage of key legislation is always a challenge. This year two pieces of legislation, Working Families Tax Relief Act of 2004 (WFTRA) and American Jobs Creation Act of 2004 (AJCA), were passed late in our planning process. Despite the timing of the new tax law provisions, we successfully provided the needed computer programming, procedural changes and revisions to tax forms necessitated by these new tax law provisions. However, we agree with your statement that some taxpayer confusion occurred because of the late passage of this legislation.

We have already taken corrective actions to address the recommendations in your report regarding tax form instructions and publications. For Tax Year 2005, we will provide examples for military taxpayers in two publications to help them determine whether including nontaxable combat pay as earned income for purposes of the Earned Income Tax Credit is beneficial. To make it easier for taxpayers to determine their state sales tax deduction, we included the instructions for the Optional State Sales Tax



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Deduction and the general state sales tax rate in the 2005 instructions for Itemized Deductions and Interest and Ordinary Dividends.

I appreciate your recognition of our effectiveness in identifying and disallowing erroneous education credits due to the modified Adjusted Gross Income limitation. I agree we can improve the Internal Revenue Manual (IRM) guidance to ensure that our error correction employees properly interpret the information and appropriately adjust returns identified as exceeding this limitation. We have also taken steps to reduce the potential for incorrect input of large dollar amounts, by moving the line for reporting nontaxable combat pay to a different section of the form. We are reviewing the situation that you reported concerning large dollar amounts for state sales tax or state income tax deductions, to determine if additional controls should be added to our detection process.

We acknowledge that some taxpayers are claiming both the Tuition and Fees Deduction and the Educational Credit, and that some of these returns are improper. To address this we added a statement to the Tax Year 2003 Form 8863 to alert taxpayers that they may not be entitled to both the tuition and fees deduction and the education credit for the same individual. Your 2004 Filing Season report noted that after the revision to this form the number of taxpayers claiming a "dual benefit" dropped from 294,743 taxpayers in 2003 to 222,175 in 2004. In addition, a targeted examination effort was initiated to audit returns claiming the "dual benefit." I believe that your recommendation to revise Form 8863 to combine and include applicable information for the Tuition and Fees Deduction and Education Credit on the form will further educate taxpayers and reduce the number of returns inappropriately claiming these credits. However, this change is dependent on Congress enacting legislation to extend the Tuition and Fees Deduction beyond Tax Year 2005.

I agree with the outcome measures reported in Appendix IV of the report. Attached are our comments to your recommendations. If you have any questions, please call me at (404) 338-7060, or members of your staff may contact David L. Medeck, Director, Customer Account Services, at (404) 338-8910.

Attachment



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Attachment

RECOMMENDATION 1

The Commissioner, W&I Division, should revise the instructions for Forms 1040 and 1040A, Publication 3, and Publication 596 to include examples that will assist military taxpayers to accurately calculate the EITC for the maximum tax benefit available to them and their families.

CORRECTIVE ACTION

We will add examples to Publication 3, Armed Forces Tax Guide, and Publication 596, Earned Income Credit, to assist military taxpayers in determining whether they should include nontaxable combat pay as earned income to compute the maximum allowable earned income credit. However, we do not believe revisions to the instructions for Forms 1040 or 1040A are needed because the issue affects so few people. We believe the recommended revisions to the publications should be sufficient for this target audience.

IMPLEMENTATION DATE

January 15, 2006

RESPONSIBLE OFFICIAL

Director, CARE Media & Publications

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 2

The Commissioner, W&I Division, should include instructions for the Optional State Sales Tax Deduction within the overall instructions for *Itemized Deductions and Interest and Dividend Income* (Form 1040 Schedules A and B) and provide the general State sales tax rate used to construct the Optional State Sales Tax Tables for each State.

CORRECTIVE ACTION

We will revise the 2005 instructions for Form 1040, Schedules A and B, to include the Optional State Sales Tax Deduction tables and instructions, and to also include the general state sales tax rate used to construct the tax tables for each state.

IMPLEMENTATION DATE

January 15, 2006

RESPONSIBLE OFFICIAL

Director, CARE, Media & Publications



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CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 3

The Commissioner, W&I Division, should implement a computer check that would identify questionable large-dollar entries for review and resolution for both paper and electronic individual income tax returns.

CORRECTIVE ACTION

We agree to consider the feasibility of this recommendation. If we determine that enhanced programming is needed for detection and resolution of questionable large-dollar entries, we will coordinate with the appropriate Internal Revenue Service operating and support organizations.

IMPLEMENTATION DATE

September 15, 2006

RESPONSIBLE OFFICIAL

Director, W&I, CAS, Submission Processing
Director, W&I, Compliance

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 4

The Commissioner, W&I Division, should ensure tax return error correction procedures are clarified and emphasized during annual employee training sessions prior to each filing season.

CORRECTIVE ACTION

We agree with this recommendation. We are currently reviewing the IRM procedures to determine which instructions need to be revised for additional clarity. The revised procedures will be incorporated in our training process. We also plan to include additional test cases for Education Credits in the Error Resolution System (ERS) training material for 2006. Due to our recruiting cycle, ERS training is conducted throughout the filing season.

IMPLEMENTATION DATE

April 15, 2006



**Individual Income Tax Returns Were Timely
Processed in 2005; However, Implementation
of Tax Law Changes Could Be Improved**

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RESPONSIBLE OFFICIAL
Director, W&I CAS, Submission Processing

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 5
The Commissioner, W&I Division, should revise Form 8863 to combine and include applicable information for the tuition and fees deduction and Education Credits to ensure compliance and promote simplicity and fairness as noted by the Joint Committee on Taxation. Although the tuition and fees deduction is scheduled to expire on December 31, 2005, we believe this deduction may be extended by legislative action and, if so, we believe there is a high probability that these conditions will continue to exist.

CORRECTIVE ACTION
If legislation is enacted to extend the tuition and fees deduction beyond Tax Year 2005, we will coordinate with the appropriate Internal Revenue Service operating and support organizations to revise Form 8863 to include the deduction on the form.

IMPLEMENTATION DATE
December 15, 2006

RESPONSIBLE OFFICIAL
Director, CARE, Media & Publications

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.