



*Untimely Processing of
Taxpayer Carryback Loss Claims
Resulted in Significant Interest Costs*

August 31, 2006

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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.

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FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 31, 2006

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM:

(for) Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Untimely Processing of Taxpayer Carryback Loss
Claims Resulted in Significant Interest Costs (Audit # 200540034)

This report presents the results of our review to determine whether refunds resulting from carryback claims filed by individuals on an Application for Tentative Refund (Form 1045) or an Amended U.S. Individual Income Tax Return (Form 1040X) were issued timely by the Internal Revenue Service (IRS) to minimize unnecessary taxpayer burden and avoid the payment of interest.

Synopsis

When taxpayers incur a significant loss from business activities or natural disasters to the extent their deductions exceed their income, they can opt to carry back the loss to prior tax years and obtain a refund of taxes paid in those prior years by filing a Form 1045 or Form 1040X. The IRS must process the claim and issue a refund within 45 calendar days of the received date of the Form or the due date of the loss year return (whichever is later) to avoid paying interest on the refund amount. The IRS was able to avoid or minimize the amount of interest it paid on 14 percent of the 499 carryback claims we reviewed. However, improving the processes the IRS uses to work carryback claims could reduce further the amount of interest it pays.

Delays in processing carryback claims increase the burden on taxpayers who are already experiencing financial hardship by extending the amount of time they must wait for their refunds and can result in the IRS paying additional interest. We reviewed a sample of 499 carryback claims (Form 1045 and Form 1040X transactions) that had posted to the IRS Individual Master File¹ between August 1, 2004, and July 30, 2005. While the IRS timely processed most of the

¹ The IRS database that maintains transactions or records of individual tax accounts.



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

499 claims, it paid approximately \$1.8 million in unnecessary interest on 24 percent of the refunds issued. Based on this sample, we estimate about 5,700 claims were not processed timely and interest of approximately \$20.3 million was paid unnecessarily. If this condition is not corrected, it could affect approximately 28,400 taxpayers, and the IRS could pay unnecessary interest totaling over \$101.7 million during the next 5 years.

The IRS could pay over \$101.7 million in interest during the next 5 years if processing delays are not corrected.

We identified several causes for the delays in processing carryback claims and the payment of unnecessary interest.

- Procedures in the Submission Processing sites² did not ensure expedited identification and routing of carryback claims to the appropriate IRS function for processing. Also, there were delays in scanning the claims into the Correspondence Imaging System.³
- Carryback claims were not always assigned a priority code in the Correspondence Imaging System as required. These codes help ensure carryback claims are given priority when being processed, in an effort to prevent paying interest on the claims.
- The IRS did not issue manual refunds as required on carryback claims over \$1 million and on other claims for which the 45-day interest-free period was in jeopardy. Each IRS campus⁴ was using a locally developed interest-free chart to determine when to use a system-generated refund or a manual refund. These charts were inconsistent among the campuses, and in some cases the charts contained insufficient information.
- Not all IRS campuses were working carryback claims as a priority.

The IRS could pay significantly more interest if improvements to its procedures for working carryback claims are not made soon. Rising interest rates equate to more interest paid per claim. Since September 2004, the interest rate has increased from 4 percent to 7 percent for tax overpayments to individuals. In addition, the volume of carryback claims the IRS receives is likely to increase as a result of Hurricanes Katrina, Rita, and Wilma. The National Hurricane Center⁵ estimates personal damages suffered by victims of the Hurricanes that hit the Gulf Coast Region of the United States in 2005 at almost \$100 billion. The impact of inefficiencies in IRS procedures will be compounded as the inventory of claims grows. The IRS also is going to have

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

³ The Correspondence Imaging System is a modern, digital, image-based system for processing taxpayer correspondence.

⁴ The campuses provide many of the major services to taxpayers, including processing of tax returns and other claims and responding to taxpayers that either have telephoned or written the IRS asking for assistance.

⁵ The National Hurricane Center is part of the United States Department of Commerce National Oceanic and Atmospheric Administration.



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

fewer locations available to receive and process these claims as it continues to close Submission Processing sites. The IRS Net Tax Refund Reports are one tool the IRS can use to monitor the number of carryback claims being paid with interest. However, IRS managers were not using these Reports to monitor the timeliness of carryback claims processing.

Recommendations

We recommended the Director, Submission Processing, require that all carryback claims be identified upon receipt in the Submission Processing sites and routed directly to the IRS function responsible for processing them. The Director, Accounts Management, should reemphasize the importance of following current manual refund procedures for carryback claims. The Director, Accounts Management, also should ensure the annual Program Letter emphasizes the importance of working carryback claims within the interest-free period and use the Net Tax Refund Reports as a tool to evaluate the timeliness of carryback claim processing.

Response

IRS management agreed with our recommendations. The IRS will implement a prescreening process for all Forms 1040X with carryback claims. The IRS indicated instructions are already in place to expedite Forms 1045. Management has issued employee alerts stressing the importance of working carryback claims within the 45-day interest-free period and will consider including evaluations of manual refunds on carryback claims in their business reviews. Under separate cover from the Program Letter, the IRS will issue specific guidance on processing carryback claims. Finally, the IRS will begin using the Net Tax Refund Reports as a tool to evaluate the timeliness of processing carryback claims. Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 622-5916.



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

Table of Contents

BackgroundPage 1

Results of ReviewPage 3

 Manually Issuing Refunds Resulted in Interest Savings.....Page 4

 Processing Claims More Timely Can Reduce
 Taxpayer Burden and Save InterestPage 5

Recommendation 1:.....Page 8

Recommendation 2:.....Page 10

Recommendation 3:.....Page 11

 The Amount of Unnecessary Interest Paid Could Increase
 Significantly if Procedures Are Not Changed SoonPage 11

Recommendation 4:.....Page 14

Appendices

 Appendix I – Detailed Objective, Scope, and MethodologyPage 15

 Appendix II – Major Contributors to This ReportPage 18

 Appendix III – Report Distribution ListPage 19

 Appendix IV – Outcome Measures.....Page 20

 Appendix V – Details on the Selection of Carryback Transactions
 for Review.....Page 25

 Appendix VI – Management’s Response to the Draft ReportPage 27



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

Abbreviations

CIS	Correspondence Imaging System
IMF	Individual Master File
IRS	Internal Revenue Service
TC	Transaction Code
TIGTA	Treasury Inspector General for Tax Administration
W&I	Wage and Investment



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

Background

Taxpayers incurring a significant loss from business activities or natural disasters could find their deductions exceeding their income for the year the loss occurred. When this happens, the taxpayers incur a net operating loss (loss). Taxpayers can opt to carry back a loss to earlier tax years and obtain a refund of taxes paid in those prior years. Losses generally can be carried back to the 2 prior tax years.¹

Hurricanes Katrina, Rita, and Wilma hit the Gulf Coast Region of the United States in August, September, and October 2005, respectively. In fall 2005, Congress passed the Katrina Emergency Tax Relief Act of 2005² and the Gulf Opportunity Zone Act of 2005³ to aid the victims of these Hurricanes. These Acts include provisions that eliminate the limitations on personal casualty or theft losses caused by these Hurricanes. The Gulf Opportunity Zone Act of 2005 also allows taxpayers affected by Hurricane Katrina that live in the Gulf Opportunity Zone⁴ to carry back certain qualified losses 5 years.

Individual taxpayers can get their carryback refunds by filing an Application for Tentative Refund (Form 1045) or an Amended U.S. Individual Income Tax Return (Form 1040X), depending on their situations. Figure 1 outlines the differences between a Form 1045 and a Form 1040X. Although there are different criteria for filing each Form, the Internal Revenue Service (IRS) must pay interest on a refund claimed on either Form if the refund is not issued within 45 calendar days of the received date of the Form or the due date of the loss year return,⁵ whichever is later.

¹ Losses due to a casualty or theft or those attributable to a Presidentially declared disaster for a qualified small business can be carried back 3 tax years.

² Pub. L. No. 109-73, 119 Stat. 2016 (2005).

³ Pub. L. No. 109-135, 119 Stat. 2577 (2005).

⁴ The Gulf Opportunity Zone allows affected persons in certain counties in the States of Alabama, Louisiana, and Mississippi as determined by the Federal Emergency Management Agency to be eligible for either individual only or both individual and public assistance from the Federal Government.

⁵ Without extensions.



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

Figure 1: Differences Between a Form 1045 and Form 1040X

Form	When to File	Years to Which a Loss Can Be Applied	IRS Processing Requirements	Type of Refund
Form 1045	Within 1 year of the end of the loss year.	Can be used to apply loss to multiple years.	Within 90 days of the date the claim was filed or the last day of the month that includes the due date of the loss year return, ⁶ whichever is later.	Refunds are considered “tentative.” The IRS can assess and collect tax immediately if the refund is later found to be in error.
Form 1040X	Up to 3 years after the due date of the loss year return. ⁷	Must file a separate Form 1040X for each year to which the loss is to be applied.	Taxpayer can file suit in court if Form 1040X is not processed within 6 months of the date filed.	The claim is considered correct when the refund is issued.

Source: IRS Forms 1045 and 1040X instructions and Net Operating Losses (NOLs) for Individuals, Estates, and Trusts (Publication 536).

The IRS is in the process of changing the way it processes taxpayer correspondence, including Forms 1045 and 1040X. In November 2003, the IRS Austin Campus⁸ in Austin, Texas, began piloting and implementing the Correspondence Imaging System (CIS). When fully implemented, the CIS will result in a modern, digital, image-based system for processing taxpayer correspondence instead of one that is paper intensive. Forms 1045 and 1040X, as well as other taxpayer correspondence received at the IRS campuses, are scanned into the CIS, which is part of the Accounts Management function. After scanning, the CIS assigns the imaged forms to IRS employees for processing in the Accounts Management Adjustment function. When the CIS is fully implemented at all IRS campuses,⁹ employees will have universal access to the electronically imaged claims. The Treasury Inspector General for Tax Administration (TIGTA) is in the process of evaluating implementation of the CIS.

This review was performed in the Wage and Investment (W&I) Division Headquarters in Atlanta, Georgia, and the Accounts Management and Submission Processing functions in the Austin and Kansas City, Missouri, Campuses during the period August 2005 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.

⁶ Including extensions.

⁷ Including extensions.

⁸ The campuses provide many of the major services to taxpayers, including processing of tax returns and other claims and responding to taxpayers that either have telephoned or written the IRS asking for assistance.

⁹ The IRS plans to complete implementation of the CIS in all 10 campuses in 2007.



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

Results of Review

The National Hurricane Center¹⁰ estimates the personal damages suffered by people located in the Gulf Coast Region¹¹ as a result of Hurricanes Katrina, Rita, and Wilma at almost \$100 billion.¹² It also estimates that thousands of families lost their homes and places of employment. The Insurance Information Institute reports that 2005 was by far the costliest year ever for insured catastrophic losses in the United States.

It is important that carryback claims are processed timely to reduce the financial strain on taxpayers suffering losses such as those caused by the 2005 Hurricanes.

Taxpayers who suffer significant losses such as these can obtain some financial relief by filing claims for refunds of taxes paid in prior years. Because a loss of this magnitude can place a financial strain on taxpayers, it is important that the IRS quickly process these claims and timely issue the related refunds.

Timely processing carryback claims and issuing refunds also saves considerable Federal Government resources by eliminating the need to pay interest on those refunds. Claims for refunds resulting from applying a net operating loss to a prior tax year vary significantly from other types of taxpayer claims. The IRS generally must pay interest on claims other than carrybacks, such as those to correct an error on a previously filed return, from the due date of the original return to the date the IRS received the claim. The IRS is required to pay additional interest if these claims are not processed within 45 calendar days. Regardless of how timely a noncarryback claim is processed, the IRS will pay some interest to the taxpayer.

However, it is possible for the IRS to avoid paying any interest on a carryback claim if the claim is processed within 45 calendar days. One day could mean the difference between not paying any interest and paying thousands of dollars in interest. For example, if a taxpayer files a claim that creates a potential refund of \$1 million and the IRS timely processes the claim and issues the refund, the taxpayer receives no interest. However, issuing the refund on the 46th day causes the IRS to pay \$179,000 in interest.¹³

Untimely processing of carryback claims causes the IRS to pay interest it normally would not have to pay.

¹⁰ The National Hurricane Center is part of the United States Department of Commerce National Oceanic and Atmospheric Administration.

¹¹ This includes the States of Alabama, Florida, Louisiana, Mississippi, and Texas.

¹² This estimate includes both insured and uninsured losses.

¹³ Interest computed based upon a taxpayer properly filing a Form 1040X within the required 3-year time period.



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

In Calendar Year 2004,¹⁴ individual taxpayers filed approximately 88,000 carryback claims¹⁵ that resulted in refunds and the IRS paid interest totaling \$25.1 million.¹⁶ The number of carryback claims fell to 61,700 in Calendar Year 2005, and interest paid totaled about \$23.3 million.

In September 2004, we reported the IRS could have avoided an estimated \$12.6 million in interest paid to corporations on refunds resulting from carryback claims that were not processed within the 45-day interest-free period.¹⁷ For this review, we evaluated the processing of Forms 1045 and 1040X filed by individual taxpayers between August 1, 2004, and July 30, 2005. The IRS was able to avoid or reduce the amount of interest it paid on some of the carryback claims we reviewed. However, improving the processes the IRS uses to work carryback claims can reduce further the amount of interest the IRS pays.

Manually Issuing Refunds Resulted in Interest Savings

The IRS has two methods for issuing refunds to taxpayers. Normally, a refund is generated by the IRS computer system. It generally takes 14 days to issue a generated refund because the information must post to the IRS Master File¹⁸ before the refund can be issued. The IRS also can issue a refund manually. A manual refund takes approximately 2 days to issue and is faster because the refund is issued before the refund information posts to the Master File. Therefore, issuing a manual refund allows the IRS another 2 weeks to 3 weeks to process a carryback claim.

The 45-day interest-free period is computed using the date the refund is issued. Because manual refunds take less time to issue, the IRS may be able to issue them before the 45-day interest-free period on carryback claims expires. Issuing a manual refund could eliminate the need for the IRS to pay interest. Because the 45-day interest-free period is so critical, the IRS requires that the refund be issued manually if a claim is over \$1 million. A manual refund also should be issued if the claim is over a certain dollar amount and the 45-day interest-free period is in jeopardy or has expired.

We reviewed all carryback claims over \$1 million and a statistical sample of carryback claims from \$10,000 to \$1 million that had posted to the Individual Master File¹⁹ between August 1, 2004, and July 30, 2005. The IRS avoided paying approximately \$1.6 million in interest on 69 (14 percent) of the 499 claims

***We estimate the IRS
avoided paying about
\$9.4 million in interest by
issuing manual refunds.***

¹⁴ Source: IRS Net Tax Refund Reports.

¹⁵ The number of tax years with refunds that resulted from losses carried back to those tax years.

¹⁶ Some of the interest paid may have been paid on claims filed prior to Calendar Year 2004.

¹⁷ *Avoidable Interest Was Paid on Tentative Carryback Refunds Requested by Corporate Taxpayers* (Reference Number 2004-30-171, dated September 2004).

¹⁸ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

¹⁹ The IRS database that maintains transactions or records of individual tax accounts.



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

reviewed by issuing manual refunds as required. Based on these results, we estimate the IRS saved about \$9.4 million by issuing manual refunds on 2,882 claims for which the interest-free period would not have been met otherwise. Details on our sample selection can be found in Appendices I and V.

Processing Claims More Timely Can Reduce Taxpayer Burden and Save Interest

While the IRS was able to avoid some interest costs by issuing manual refunds, it can further reduce the burden on taxpayers filing carryback claims and the amount of interest it pays on those claims. Taxpayers who file carryback claims generally have suffered catastrophic losses, which can create a financial hardship on individuals. Any delay these taxpayers experience in receiving a valid refund as a result of that loss can increase that financial hardship. Delays in processing carryback claims also cause the IRS to pay interest it does not necessarily have to pay.

The IRS can refine its processes for working carryback claims to better ensure claims are processed timely and refunds are issued within the 45-day interest-free period. An analysis of our statistical sample of carryback claims showed

The IRS could pay approximately \$101.7 million in interest over the next 5 years if processing delays are not corrected.

120 (24 percent) of the 499 claims were not processed within the 45-day interest-free period and the IRS paid interest totaling approximately \$1.8 million as a result. Figure 2 provides the details on our samples and the related test results. We estimate about 5,700 claims were not processed timely and interest of approximately \$20.3 million was paid unnecessarily. If this condition is not corrected, it could

affect approximately 28,400 taxpayers, and the IRS could pay unnecessary interest totaling about \$101.7 million over the next 5 years.²⁰ We anticipate the actual amount of interest the IRS will pay unnecessarily over the next 5 years may be significantly higher than estimated because of continually increasing interest rates and a likely increase in the volume of claims resulting from Hurricanes Katrina, Rita, and Wilma.

²⁰ See Appendix IV for details.



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

Figure 2: Carryback Claim Samples and Test Results

Claim	Claims Reviewed	Claims Not Processed Timely	Percentage Not Processed Timely	Interest Paid
Form 1045				
\$10,000 to \$1 million	150	24	16.0%	\$25,572
Over \$1 million	72	10	13.9%	\$429,030
Form 1040X				
\$10,000 to \$1 million	250	80	32.0%	\$388,094
Over \$1 million	27	6	22.2%	\$953,000
Total Claims	499	120	24.0%	\$1,795,696

Source: TIGTA review of a sample of carryback claims processed between August 1, 2004, and July 30, 2005.

We identified the following areas that contributed to the payment of unnecessary interest:

- Procedures to identify and route carryback claims for processing may have prevented the IRS from working the claims timely.
- Claims were not given the correct priority codes when scanned into the CIS.
- Manual refunds were not always issued as required.
- Claims were not processed timely once they were assigned to an IRS employee.

Procedures to identify and route carryback claims for processing may have prevented the IRS from working the claims timely

When carryback claims are received at a Submission Processing site,²¹ a received date is recorded on each claim. The received date generally begins the 45-day period the IRS has to process those claims without having to pay interest. Forms 1045, along with other various taxpayer correspondence, are routed to the Accounts Management Adjustment function, which is responsible for processing the claims. All Forms 1040X, regardless of whether they include a carryback claim, go through a screening process in the Submission Processing site to determine if they can be processed. Once the IRS identifies the Form 1040X as a carryback claim, the claim is forwarded to the Accounts Management Adjustment function for processing. In sites where the CIS has been implemented, the Forms 1045 and 1040X have to be scanned into the CIS before being assigned to an examiner for processing.

²¹ The data processing arm of the IRS. The processing sites process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

The Submission Processing sites have up to 12 calendar days,²² starting with the received date, to forward carryback claims to either the CIS or the Accounts Management Adjustment function. Because interest is payable if a claim is not processed within 45 days, this routing time reduces the time the Accounts Management Adjustment function has to work the claim once it is received. The impact is even greater in locations at which the CIS has been implemented, where IRS employees must sort through and image thousands of taxpayer forms, letters, and other correspondence each day. Employees are supposed to scan carryback claims into the CIS before any other taxpayer correspondence. However, identifying the claims may take a few days depending on the daily workload. Once the imaged data have been validated, the claims are finally assigned to an examiner in the Accounts Management Adjustment function to be processed. The additional time it takes to scan the claims into the CIS coupled with the time to send the claims to the Accounts Management Adjustment function could mean an examiner has only a few days to work the claim and issue the refund before the 45-day interest-free period expires.

One Submission Processing site we reviewed has a local procedure to prioritize the routing of both Form 1045 and Form 1040X carryback claims to the Accounts Management function. This site screens all incoming documents to identify both Form 1045 and Form 1040X carryback claims as they come into the IRS. The claims are then routed daily to the CIS where they are imaged.²³ This eliminates any potential delay in getting the claims to the CIS and increases the likelihood the claims will be processed timely. Separately identifying and routing carryback claims to the Accounts Management function also may improve timeliness in scanning the claims in locations where the CIS has been implemented because the claims would already have been identified for priority scanning.

For the carryback claims we reviewed that had interest paid and were processed in this Submission Processing site, none of the interest paid was the result of delays in getting the claims to the Accounts Management Adjustment function. In contrast, we found that other Submission Processing sites sometimes had lengthy delays before the claims were assigned to be processed by the Accounts Management Adjustment function. We identified 44 claims that were processed in the Submission Processing sites where the CIS had been implemented and that had interest paid. It took more than 15 calendar days from the date the claim was received to scan 15 (34 percent) of the 44 claims into the CIS. Because the IRS does not record when the claims are received in the unit responsible for scanning them, we cannot be certain whether the delay was in routing the claims to this unit or in scanning the documents into the CIS. Regardless, prioritizing the identification and routing of carryback claims in the Submission Processing sites

²² Prior to November 15, 2004, the standard was 11 workdays. Workdays are defined as nonholiday Mondays through Fridays.

²³ During the brief period of time after April 15 when the volume of documents received is extremely high, it may take up to 7 days before claims are identified and routed to the Accounts Management function.



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

could increase significantly the amount of time the Accounts Management function has to process the claims once they are received.

We are in the process of conducting a separate review to determine the timeliness and accuracy of processing taxpayer correspondence through the CIS. Therefore, we are making no recommendations in this report related to the procedures for receiving and tracking work to be scanned into the CIS.

Recommendation

Recommendation 1: The Director, Submission Processing, should require that all Forms 1045 and 1040X with a carryback claim be identified upon receipt in the Submission Processing sites and routed directly to the Accounts Management function.

Management's Response: IRS management agreed with this recommendation. The IRS will implement prescreening of all Forms 1040X with carryback claims. This will allow the returns to be identified upon receipt in Submission Processing sites and routed directly to the Accounts Management functions. The IRS indicated procedures are already in place to expedite the routing of Forms 1045.

Claims were not given the correct priority codes when scanned into the CIS

The IRS has procedures in place to enter a priority code during the CIS scanning process to ensure higher dollar carryback claims are identified and processed first. These priority codes are specific to carryback claims and do not apply to other types of taxpayer correspondence processed in the Accounts Management function. The priority code assigned to a carryback claim depends on the dollar amount of the claim. For example, carryback claims of \$1 million or more receive the highest priority. Accounts Management function employees must enter a priority code manually for each claim above a certain dollar amount. If the amount of the claim falls below the set amount, the system will default to "no priority."

Our review of claims processed in Submission Processing sites that used the CIS showed a significant number of higher dollar claims were incorrectly coded as no priority. IRS employees did not enter a priority code, causing the CIS to incorrectly assign the default no priority code to these claims. It is likely that the way in which the CIS is programmed is contributing to the high error rate in assigning priority codes to carryback claims. For example, the system does not force employees to enter a priority code. When an employee does not enter a priority code as required, the CIS simply defaults to no priority. Of the 120 claims for which interest was paid because the 45-day interest-free period was not met, 44 were processed in locations using the CIS. A priority code was not entered when required in 22 (50 percent) of the 44 claims. While we could not determine with certainty that giving these claims an improper priority code caused them to be processed untimely, it is likely the incorrect priority codes were a contributing factor.



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

Management Action: Requiring Accounts Management function employees to input a priority code for each carryback claim would prevent claims from being scanned and processed without a priority code. Subsequent to our review, the Accounts Management function modified the programming of the CIS to require employees to enter a priority code for each carryback claim. If a priority code is not entered, the employee will receive a system error. The Internal Revenue Manual procedures were updated to reflect this change.

Manual refunds were not always issued as required

IRS procedures require that a manual refund be issued on any carryback claim over \$1 million and on any claim over a certain dollar amount for which the 45-day interest-free period is in jeopardy or has expired. However, IRS employees did not always issue manual refunds when required. Of the 120 carryback claims that were not processed timely, 44 (37 percent) should have had a manual refund issued but did not. The IRS could have avoided paying \$108,381 in interest on these 44 claims if it had issued a manual refund as required. Based on these results, we estimate the IRS should have used a manual refund for 2,196 claims and would have avoided paying unnecessary interest totaling about \$4.7 million. The IRS also could have reduced the amount of interest it paid on other claims for which the 45-day interest-free period had already expired if it had issued a manual refund. The savings varied based upon the refund amount, the period of time the refund was computed on, and the applicable interest rate(s).

One factor that may have contributed to the payment of unnecessary interest is the lack of an IRS-wide tool to determine the last day a system-generated and a manual refund can be issued to avoid paying interest. The IRS campuses use a chart showing the last day a system-generated refund and a manual refund can be issued to avoid paying interest. However, each IRS campus developed its own chart, and the charts were not reviewed or approved by the W&I Division Headquarters.

Review of the individual IRS campus charts identified inconsistencies among the charts. These inconsistencies, along with uncertainty on how to use the charts, contributed to the IRS not issuing manual refunds as required. For example, the chart in one campus indicated interest could be avoided completely if a manual refund was issued on or before the 38th day after the carryback claim was received. Employees in this campus also believed mistakenly that, once the 38-day deadline had passed, they were not required to issue a manual refund. The chart in another campus showed a manual refund could be issued on the 42nd day to avoid paying interest. Charts in two other IRS campuses did not provide a specific date by which employees should issue a manual refund instead of a system-generated refund. The IRS could not explain the reason for the differences in the charts used in each campus.

Management Action: Developing one chart that can be used by all of the IRS campuses would help ensure consistency in the use of manual refunds by ensuring all campuses are using the same critical maximum number of days to issue manual refunds and avoid paying interest. Subsequent to our review, the W&I Division took steps to develop an interest-free chart for use



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

in all campuses in determining when a manual refund should be used to avoid paying interest. The IRS also issued two alerts to its employees to discontinue use of their local charts and immediately begin using this new interest-free chart.

Recommendation

Recommendation 2: The Director, Accounts Management, should reiterate the importance of following current IRS procedures to issue manual refunds on carryback claims. The Director also should consider including an evaluation of the proper use of manual refunds for carryback claims in all business reviews of the Accounts Management Adjustments function.

Management's Response: IRS management agreed with this recommendation. The IRS has issued two employee alerts stressing the carryback claims and the 45-day interest-free period. Management will consider including evaluations of manual refunds on carryback claims in their business reviews.

Employees did not always consider carryback claims as priority work

Employees are required to monitor all carryback claims to ensure the 45-day interest-free period is met. We determined interest could have been avoided had some of these claims been monitored more closely. While failure to issue a manual refund was a contributing factor in some of these claims, in many instances the delays in processing the claims were so long that interest was due even though a manual refund was issued. For example, if a Form 1045 received by the IRS was scanned into the CIS 3 days after receipt, but the claim was not closed until over 2 months later, the 45-day interest-free period would have expired even if a manual refund was issued.

Delays in reviewing and processing claims were a contributing factor in the payment of interest in at least 62 (52 percent)²⁴ of the 120 carryback claims we reviewed on which interest was paid. It took the IRS an average of 39 days (43 days for Forms 1045 and 37 days for Forms 1040X) to review and process these 62 claims.

IRS guidelines state that carryback claims are to be given priority when working inventory. However, local procedures in at least one IRS campus indicated all inventory, including carryback claims, was to be processed on a first-in, first-out basis. This means other types of work, such as noncarryback Form 1040X claims, would be processed ahead of carryback claims if they are received first. This site's local management processed all inventory as it was received, at least in part, because the annual Program Letter from the W&I Division Headquarters Accounts Management function did not mention the importance of avoiding paying interest when possible. The annual Program Letter outlines the Accounts Management

²⁴ Eighteen of 34 Forms 1045 and 44 of 86 Forms 1040X.



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

function goals, objectives, and measures that employees will be held accountable for during the year and clarifies certain operating guidelines and procedures.

We reviewed the Fiscal Year 2005 Accounts Management function Program Letter and determined the Program Letter did not mention the need to give carryback claims priority or the importance of processing those claims timely to avoid the payment of interest. The Program Letter emphasized the overall importance of timeliness but did not indicate any one type of taxpayer correspondence should be given priority attention. Emphasizing carryback claims and their priority in the annual Program Letter would ensure all IRS campuses understand the importance of meeting the 45-day interest-free period for carryback claims. The IRS advised us it is revising the 2006 annual Program Letter to include an emphasis on the timely processing of carryback claims.

Recommendation

Recommendation 3: The Director, Accounts Management, should ensure all current and future annual Program Letters for the Accounts Management function include a statement that emphasizes the importance of processing carryback claims within the 45-day interest-free period.

Management's Response: IRS management agreed with this recommendation. The IRS will provide specific guidance with regard to the timely processing of carryback claims within the 45-day interest-free period. The guidance will be issued under separate cover from the Program Letter.

The Amount of Unnecessary Interest Paid Could Increase Significantly if Procedures Are Not Changed Soon

The IRS could pay significantly more interest on refunds from carryback claims if the recommended changes to its procedures are not made soon. Factors that could contribute to increased interest payments include a higher interest rate required for payments to individuals and the likelihood the volume of carryback claims will increase as more victims of the 2005 Hurricanes determine if their losses qualify to be carried back to prior tax years. Data also indicate the IRS is paying interest on a higher percentage of carryback claims filed by individuals than it has in the past.

Interest rates have climbed significantly in the last year

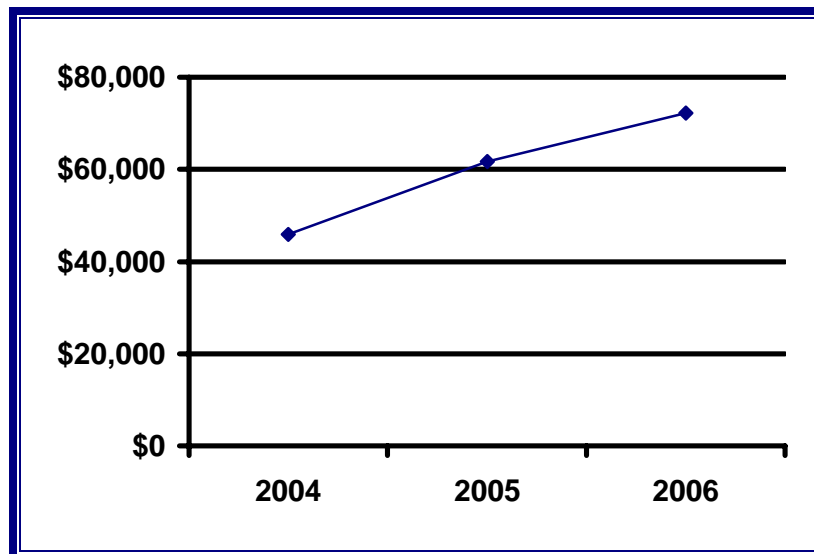
Each calendar quarter, interest rates on tax overpayments and underpayments are adjusted using the Federal Government short-term rate as a baseline, with an additional percentage added depending upon various factors such as whether the payments apply to an individual or



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

corporation.²⁵ Since September 2004, the interest rate has increased steadily from 4 percent to the current rate of 7 percent for tax overpayments to individuals. This means interest issued on refunds now, which is compounded daily,²⁶ would be much higher than interest on refunds issued a year ago. As a result, it becomes more critical that the IRS timely process carryback claims within the 45-day interest-free period. Figure 3 illustrates how increases in the interest rate have affected the amount of interest paid on refunds. It represents interest due on a \$1 million refund paid to an individual taxpayer for 1 year computed to the nearest \$100 and assumes the 7 percent interest rate will remain constant for the remainder of 2006.

Figure 3: Interest on a \$1 Million Refund



Source: TIGTA computation of potential interest paid on a refund of \$1 million for 1 year.

The Hurricane disasters of 2005 and legislation enacted to assist the victims could soon lead to a higher volume of carryback claims

Millions of people suffered immense losses from the three Hurricanes that hit the United States Gulf Coast Region in 2005. To assist the victims, Congress enacted the Katrina Emergency Tax Relief Act of 2005 and the Gulf Opportunity Zone Act of 2005, which included provisions that allow people potentially to take larger casualty loss deductions. The Gulf Opportunity Zone Act also allows taxpayers affected by Hurricane Katrina to carry back certain net operating losses 5 years. Taxpayers affected by the Hurricanes were given additional time to file and pay their taxes. In addition, taxpayers hit by the Hurricanes will have until October 16, 2006, to decide whether to claim their losses on their Tax Year 2004 or Tax Year 2005 tax returns.

²⁵ Internal Revenue Code Section 6621 (2005).

²⁶ Internal Revenue Code Section 6622 (2005).



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

It is probable the IRS will see an increase in carryback claims for refunds due to casualty losses from these Hurricanes. During our review, we monitored the volume of carryback claims using one of the IRS Net Tax Refund Reports. This Report provides fiscal year monthly and cumulative nationwide totals for various types of IRS refunds, including carryback claims filed by individuals. The Report does not provide the number of refunds issued by the type of carryback claim filed but does provide total refunds issued for all carryback claims. The Net Tax Refund Report for the period October 2005 through March 2006 showed a 25 percent decline in the volume of refunds on individual carryback claims when compared to the same period for the previous year. However, the decline in volume slowed considerably in the last 2 months, with a decline of only 1 percent in March 2006 compared to March 2005. This significant change could be an indicator that the trend is now changing, and future months could see increased volumes of carryback claims.

The IRS is paying interest on a higher percentage of claims

The Net Tax Refund Report also provides both the number of refunds on which interest was paid and the total interest paid on refunds for carryback claims filed by individuals. Although the total number of refunds issued on individual carryback claims dropped approximately 25 percent, the total interest paid on those refunds increased about 10 percent, from \$12.3 million to \$13.6 million. The Report for October 2005 through March 2006 showed the IRS is paying interest on a significantly higher number of refunds from carryback claims. The IRS paid interest on about 48 percent of the carryback refunds during these 6 months. In comparison, the IRS paid interest on about 38 percent of the carryback refunds for the period October 2004 through March 2005.

Part of the reason for the increasing amount of interest being paid could be implementation of the CIS. Although our tests did not show significant differences between carryback claims processed in IRS campuses that used the CIS and those that did not, we did find areas where improvements in the CIS could improve the timeliness of claims processing. Another indicator that the CIS could be affecting the amount of interest being paid can be found in the Net Tax Refund Reports. Our analysis of these Reports for October 2005 through March 2006 for the individual IRS Submission Processing sites showed a significant increase in the percentage of claims on which interest was paid in one IRS site. This site paid interest on 24 percent of the refunds issued on individual carryback claims between October 2004 and July 2005. This same site paid more than twice as much interest, 62 percent, between October 2005 and March 2006. The only significant change in this site was implementation of the CIS in July 2005.

With higher interest rates, the potential for an increased volume of carryback claims, and the rising amounts of interest paid per refund issued on those claims, it is important that the IRS continually evaluate the timeliness of processing carryback claims both from a nationwide perspective and by individual IRS campus. Other changes within the IRS also could affect the processing of carryback claims. For example, the IRS plans to continue reducing the number of Submission Processing sites based upon the growth in electronic filing. Taxpayers are instructed



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

to file their carryback claims at the Submission Processing site where they file their tax returns. As Submission Processing sites close, fewer sites will be available to receive and process these claims.

The Net Tax Refund Reports could be a valuable tool for the IRS to evaluate the timeliness of carryback claim processing. We asked the IRS about these Reports and determined that no one appeared to be using them to evaluate the processing of carryback claims. These Reports cannot pinpoint the causes of the increasing number of carryback claims or the rising interest costs associated with refunds paid on those claims. However, they can provide an indication of where problems may exist. These indicators will help the IRS identify and correct any problems that could be affecting its ability to process carryback claims timely.

Recommendation

Recommendation 4: The Director, Accounts Management, should use the Net Tax Refund Reports as a tool to evaluate the timeliness of processing carryback claims for refunds.

Management's Response: IRS management agreed with this recommendation. The Accounts Management function has instituted a process for reviewing the Net Tax Refund Reports and will use these data as an indicator of progress in conjunction with the guidelines provided to the sites related to the processing of carrybacks claims.



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

Appendix I

*Detailed Objective, Scope, and Methodology*¹

The overall objective of this review was to determine whether refunds resulting from carryback claims filed by individuals on an Application for Tentative Refund (Form 1045) or an Amended U.S. Individual Income Tax Return (Form 1040X) were issued timely by the IRS to minimize unnecessary taxpayer burden and avoid the payment of interest. The audit focused on individual carryback claims that were processed and closed between August 1, 2004, and July 30, 2005.

We verified the reliability of the electronic data used in this review by comparing actual tax documents to the information contained on the IRS Integrated Data Retrieval System.¹

To accomplish our objective, we:

- I. Determined whether controls over the receipt and processing of carryback claims ensured the claims were processed timely to minimize taxpayer burden and avoid unnecessary interest costs.
 - A. Reviewed the Internal Revenue Manual² to identify how carryback claims are routed to and subsequently processed by the Accounts Management function and whether these claims received higher priority than other taxpayer correspondence. This included obtaining copies of interest-free charts used by the IRS sites to determine when manual refunds should be issued, to avoid paying interest.
 - B. Reviewed the IRS Wage and Investment Division Accounts Management function Fiscal Year 2005 Program Letter to determine whether the need to give carryback claims priority over other types of refund claims was mentioned specifically.
 - C. Conducted a walk-through of the Submission Processing and Accounts Management functions in the Kansas City, Missouri, and Austin, Texas, Campuses³ to observe how carryback claims are processed, including the imaging of claims as part of the CIS⁴ operation. This included interviews with managers and lead personnel of the various functions concerning the carryback claims procedures and controls.

¹ The IRS computer system capable of retrieving or updating stored information; it works in conjunction with taxpayer account records.

² The Internal Revenue Manual contains the policies, procedures, and guidelines for IRS operations.

³ The campuses provide many of the major services to taxpayers, including processing of tax returns and other claims and responding to taxpayers that either have telephoned or written the IRS asking for assistance.

⁴ The CIS is a modern, digital, image-based system for processing taxpayer correspondence.



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

- D. Obtained copies of the relevant Net Tax Refund Reports from the IRS Chief Financial Officer.
- II. Determined whether the IRS is paying unnecessary interest on refunds from carryback claims filed by individuals.
- A. Reviewed a sample of 499 carryback claim transactions that were processed and posted to the IMF⁵ between August 1, 2004, and July 30, 2005, to determine whether refunds were issued within the 45-calendar-day interest-free period.

We extracted all Transaction Codes (TC) 295, Abatement of Prior Tax Assessment With Interest Computation Date,⁶ that had posted to the IMF between August 1, 2004, and July 30, 2005. We also extracted all TCs 299, Abatement of Prior Tax Assessment Interest Computation Date,⁷ that had posted to the IMF during the same period.

Total TCs 295 identified – 43,279.

Total TCs 299 identified – 36,147.

We stratified the results into 2 categories for each type of transaction: those exceeding \$1 million and those of at least \$10,000 up to and including \$1 million. The populations were stratified to ensure our test results were not distorted by any transaction over \$1 million and because the IRS processing procedures differ for transactions above \$1 million. We did not select transactions below \$10,000 because our data analysis indicated that a high percentage of the dollars paid were on carryback claims above \$10,000.

We reviewed all 99 transactions (72 TCs 295 and 27 TCs 299) over \$1 million. We selected a statistically valid sample of 400 transactions (150 TCs 295 and 250 TCs 299) for amounts that were at least \$10,000 but not more than \$1 million. We used a 95 percent confidence level and a ± 5 percent precision level to determine our sample sizes. A 10 percent expected error rate was used for TCs 295, and a 20 percent expected error rate was used for TCs 299.⁸ These samples were selected using a random number generator.

For each of the transactions meeting our dollar criteria, we used the Integrated Data Retrieval System to validate that the transaction was a TC 295 or TC 299 and that it

⁵ The IRS database that maintains transactions or records of individual tax accounts.

⁶ A TC 295 in the account of an individual taxpayer signifies the tax adjustment was based on a Form 1045.

⁷ A TC 299 in the account of an individual taxpayer signifies the tax adjustment was based on a Form 1040X.

⁸ Expected error rates were based on information on the overall error rate for both TCs 295 and 299 from the IRS Net Tax Refund Reports and our data analysis to estimate what portion of this rate was attributable to TCs 295 and TCs 299 individually.



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

- had posted to the individual taxpayer's account for the amount listed in our data files. Additional information about the selection of our samples can be found in Appendix V.
- B. Researched the Integrated Data Retrieval System for each transaction selected to determine whether the carryback claim resulted in a refund to the taxpayer and whether interest was paid on that refund because the claim was not processed within the 45-day interest-free period. For claims on which interest was paid, we obtained either the Form 1045 or 1040X, if available, or a copy of the electronically imaged document if it was processed through the CIS and related source documentation. Where possible, we determined the reason the IRS paid interest on the refund.
 - C. Identified 337 transactions⁹ in which refunds were issued and interest was not paid. For each of these transactions, we determined whether a manual refund was required per IRS procedure.¹⁰ If a manual refund was used as required and resulted in the IRS not having to pay interest,¹¹ we computed the amount of interest the IRS avoided.

⁹ Of the 499 claims sampled, 162 either had no refund because of other outstanding tax liabilities or had interest paid.

¹⁰ IRS procedures require that manual refunds be issued for all claims over \$1 million or when claims are above a certain dollar level and the interest-free period is in jeopardy or has expired.

¹¹ For some claims, a system-generated refund could have been issued and still have been timely.



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs)

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Linda L. Bryant, Senior Auditor

Glory Jampetero, Auditor



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

Appendix III

Report Distribution List

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Director, Strategy and Finance, Wage and Investment Division SE:W:S
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Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM
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Audit Liaison: Senior Operations Advisor, Wage and Investment Division SE:W:S



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

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.

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 28,370 individual taxpayer accounts affected over the next 5 years because refunds from carryback claims were not processed timely (see page 5).

Methodology Used to Measure the Reported Benefit:

We extracted all 43,279 TCs 295,¹ Abatement of Prior Tax Assessment With Interest Computation Date, that had posted to the IMF² between August 1, 2004, and July 30, 2005. We also extracted all 36,147 TCs 299,³ Abatement of Prior Tax Assessment Interest Computation Date, that had posting during the same period. We stratified the populations based on the transaction amount. Transactions were stratified into 2 categories: those over \$1 million and those of at least \$10,000 up to and including \$1 million. Transactions were stratified to prevent our test results from being distorted by transactions over \$1 million and because the IRS has different procedures for working carryback claims over \$1 million. We did not select transactions below \$10,000 because our data analysis indicated a high percentage of the dollars paid on carryback claims was represented in these two dollar criteria.

Our estimates are based on review of all transactions over \$1 million and review of random statistical samples of transactions from \$10,000 to \$1 million. The statistical samples were selected using an attribute sampling method with a 95 percent confidence level and a precision of ± 5 percent. The expected error rate for the TC 295 sample was 10 percent, and the expected error rate for the TC 299 sample was 20 percent. Appendix V provides additional details on the results of our review.

Using the attribute sampling formula below, we estimate 5,674 taxpayers had their refunds from carryback claims delayed because the claims were not processed within the 45-calendar-day interest-free period. We projected the results of our statistical samples of transactions between

¹ A TC 295 in the account of an individual taxpayer signifies the tax adjustment was based on an Application for Tentative Refund (Form 1045).

² The IRS database that maintains transactions or records of individual tax accounts.

³ A TC 299 in the account an individual taxpayer signifies the tax adjustment was based on an Amended U.S. Individual Income Tax Return (Form 1040X).



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

\$10,000 and \$1 million. We then added the results from our review of 100 percent of the claims over \$1 million to arrive at the total estimate of 5,674 taxpayers who had their refunds delayed.

$$\sigma_p = \sqrt{\frac{p(1-p)(1-f)}{n-1}}$$

Where:

σ_p = standard error of p expressed in percentage points (decimals).

p = the percentage (in decimals) of items possessing the attribute.

n = the number of items sampled.

N = the number of items in the universe.

f = the sampling fraction (n/N).

Computation of Estimate for TCs 295 of \$10,000 to \$1 million

We estimate 2,240 taxpayer accounts with a TC 295 were affected because refunds were not issued within the 45-day interest-free period.

Using:

p = the percentage (in decimals) of items possessing the attribute is .16.

n = the number of items sampled is 150.

N = the number of items in the universe is 14,002.

f = the sampling fraction (n/N) is .010713.

The computation above equals .029866,⁴ which represents 1 standard error of the estimated percentage of affected taxpayer accounts at a confidence level of 68 percent. Because our preferred confidence level is 95 percent, we multiplied the result by the standard deviation factor for a 95 percent confidence level (1.96). This results in a precision of ± 5.85 percent. When the precision is multiplied by our population, we have a total precision of ± 820 taxpayer accounts. Therefore, we are 95 percent confident that the number of taxpayer accounts with refunds not issued within the 45-day interest-free period is $2,240 \pm 820$ and that the actual number of taxpayer accounts ranges from 1,420 to 3,060.

Computation of Estimate for TCs 299 of \$10,000 to \$1 million

We estimate 3,418 taxpayer accounts with a TC 299 were affected because refunds were not issued within the 45-day interest-free period.

⁴ The numbers presented here may not provide the same results due to the rounding of numbers.



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

Using:

p = the percentage (in decimals) of items possessing the attribute is .32.

n = the number of items sampled is 250.

N = the number of items in the universe is 10,680.

f = the sampling fraction (n/N) is .023408.

The computation above equals .029214, which represents 1 standard error of the estimated percentage of affected taxpayer accounts at a confidence level of 68 percent. Because our preferred confidence level is 95 percent, we multiplied the result by the standard deviation factor for a 95 percent confidence level (1.96). This results in a precision of ± 5.73 percent. When the precision is multiplied by our population, we have a total precision of ± 612 taxpayer accounts. Therefore, we are 95 percent confident that the number of taxpayer accounts with refunds not issued within the 45-day interest-free period is $3,418 \pm 612$, and that the actual number of taxpayer accounts ranges from 2,806 to 4,030.

Combining the estimates for our samples of claims of \$10,000 to \$1 million with the results from our review of all transactions over \$1 million produced the overall estimated result shown in Figure 1.

Figure 1: Consolidation of Estimate of Taxpayer Accounts Affected

Type of Carryback Claim	Actual Accounts Affected (Over \$1,000,000)	Estimated Accounts Affected (\$10,000–\$1,000,000)	Estimated Accounts Affected (\$10,000 and Higher)
TC 295 – Form 1045	10	2,240	2,250
TC 299 – Form 1040X	6	3,418	3,424
Totals – All Claims	16	5,658	5,674

Source: TIGTA review of a sample of carryback claims processed between August 1, 2004, and July 30, 2005.

Because the condition will continue to occur if not corrected, we projected our estimate of potential taxpayer accounts affected over 5 years, which totals 28,370.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; at least \$101,742,150 in interest will be paid unnecessarily on carryback claims over the next 5 years (see page 5).

Methodology Used to Measure the Reported Benefit:

Using the samples described above, we estimate the IRS paid \$20,348,430 in unnecessary interest on carryback claims processed between August 1, 2004, and July 30, 2005. We used the variable sampling formula below to estimate the impact for each of the statistical samples and



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

combined those estimates with the results of the review of transactions over \$1 million to arrive at this estimate.

$$A = Z \frac{s}{\sqrt{n}} \left(\sqrt{1 - \frac{n}{N}} \right)$$

Where:

n = sample size.

Z = standard deviation factor.

s = standard deviation of the sample.

N = population size.

A = precision.

Computation of Estimate for TCs 295 of \$10,000 to \$1 million

Using the following information and the variable sampling formula above, we determined the IRS paid \$2,387,035 in unnecessary interest on TCs 295.

n = sample size of 150.

Z = standard deviation factor for a 95 percent confidence level is 1.96.

s = standard deviation of the sample is \$647.03.

N = population size of 14,002.

A = precision per claim of \$102.99.

We determined interest totaling \$25,572 was paid in 24 taxpayer accounts. The mean, or average, interest paid per claim was \$170.48 for the total sample of 150 taxpayer accounts. We multiplied the mean per claim by the population to compute total unnecessary interest paid of \$2,387,035. We then multiplied the total population of 14,002 by the precision per claim of \$102.99 to compute the total precision of \$1,442,063. When we apply this precision, we are 95 percent confident the amount of unnecessary interest paid on TCs 295 during our review period falls between \$944,972 and \$3,829,098.⁵

Computation of Estimate for TCs 299 of \$10,000 to \$1 million

Using the following information and the variable sampling formula above, we determined the IRS paid \$16,579,365 in unnecessary interest on TCs 299.

n = sample size of 250.

Z = standard deviation factor for a 95 percent confidence level is 1.96.

s = standard deviation of the sample is \$7,519.05.

N = population size of 10,680.

A = precision per claim of \$921.10.

⁵ The numbers presented here may not provide the same results due to the rounding of numbers.



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

We determined interest totaling \$388,094 was paid in 80 taxpayer accounts. The mean, or average, interest paid per claim was \$1,552.37 for the total sample of 250 taxpayer accounts. We multiplied the mean per claim by the population to compute total unnecessary interest paid of \$16,579,365. We then multiplied the total population of 10,680 by the precision per claim of \$921.10 to compute the total precision of \$9,837,325. When we apply this precision, we are 95 percent confident the amount of interest paid unnecessarily on TCs 299 during our review period falls between \$6,742,040 and \$26,416,690.⁶

Combining these estimates with the results from our review of all transactions over \$1 million produced the overall estimated result shown in Figure 2.

Figure 2: Consolidation of Estimate of Unnecessary Interest Paid

Type of Carryback Claim	Actual Interest Paid (Claims Over \$1,000,000)	Estimated Interest Paid (Claims of \$10,000 – \$1,000,000)	Estimated Interest Paid (Claims of \$10,000 and Higher)
TC 295 – Form 1045	\$429,030	\$ 2,387,035	\$ 2,816,065
TC 299 – Form 1040X	\$953,000	\$16,579,365	\$17,532,365
Totals – All Claims	\$1,382,030	\$18,966,400	\$20,348,430

Source: TIGTA review of a sample of carryback claims processed between August 1, 2004, and July 30, 2005.

Because the condition will continue to occur if not corrected, we projected our estimate of potential interest paid over 5 years, which totals \$101,742,150. We anticipate the actual amount of interest the IRS will pay incorrectly may be significantly higher than estimated because of continuously increasing interest rates and a likely increase in claims as a result of Hurricanes Katrina, Rita, and Wilma.

⁶ The numbers presented here may not provide the same results due to the rounding.



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

Appendix V

Details on the Selection of Carryback Transactions for Review

We reviewed a sample of 499 carryback claim transactions that were processed and posted to the IRS IMF¹ between August 1, 2004, and July 30, 2005, to determine whether refunds were issued within the 45-calendar-day interest-free period. We extracted all carryback transactions generated by the filing and posting of an Application for Tentative Refund (Form 1045)² or an Amended U.S. Individual Income Tax Return (Form 1040X).³

Form 1045 transactions identified – 43,279.

Form 1040X transactions identified – 36,147.

We stratified the results into 2 categories for each type of transaction: those exceeding \$1 million and those of at least \$10,000 up to and including \$1 million. The populations were stratified to ensure our test results were not distorted by any claim over \$1 million. Also, the IRS' processing procedures differ for claims above \$1 million. We did not select claims below \$10,000 because our data analysis indicated a high percentage of the dollars paid on carryback claims was represented in these two dollar criteria.

Carryback claims of \$10,000 up to and including \$1 million

We randomly selected statistically valid samples from both the Form 1045 and Form 1040X claims that met these dollar criteria. The samples were selected using a 95 percent confidence level and a ± 5 percent precision level. However, we applied different expected error rates to each type of claim. Our expected error rates were determined by obtaining and analyzing the IRS Net Tax Refund Reports to determine the overall error rate for all carryback claims and additional analysis of TCs 295 to estimate how much of this error rate was attributable to Form 1045 claims. Figure 1 provides additional details on the selection of our samples for claims of \$10,000 up to \$1 million.

¹ The IRS database that maintains transactions or records of individual tax accounts.

² These transactions are noted by TCs 295, Abatement of Prior Tax Assessment with Interest Computation Date, in individual tax accounts on the IMF. A Form 1045 may contain a request to carry back a loss to more than 1 prior tax year, resulting in multiple carryback transactions or "claims."

³ These transactions are noted by TCs 299, Abatement of Prior Tax Assessment Interest Computation Date, in individual tax accounts on the IMF.



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

Figure 1: Samples of Transactions - \$10,000 to \$1 Million

Type of Carryback Claim	Total Number of Claims	Expected Error Rate	Number of Claims Sampled
Form 1045 (TC 295)	43,279	10%	150
Form 1040X (TC 299)	36,147	20%	250

Source: The IMF and Microsoft Access[®] database queries performed by the TIGTA.

Transactions over \$1 million

We reviewed all 99 of the transactions over \$1 million because the volume was small (72 TCs 295 and 27 TCs 299). Figures 2 and 3 provide additional information on the population of transactions, as well as the samples selected.

Figure 2: Carryback Claims Identified and Reviewed

Type of Claim	Claims Over \$1,000,000	Total Amount (Claims Over \$1,000,000)	Claims of \$10,000 – \$1,000,000	Total Amount (Claims of \$10,000 – \$1,000,000)	Statistical Sample Size (Claims of \$10,000 – \$1,000,000)	Total Amount for Samples (Claims of \$10,000 – \$1,000,000)
Form 1045	72	\$138,249,674	14,002	\$854,705,548	150	\$ 8,978,900
Form 1040X	27	\$56,200,540	10,680	\$559,835,104	250	\$12,569,381
Totals	99	\$194,450,214	24,682	\$1,414,540,652	400	\$21,548,281

Source: The IMF and Microsoft Access[®] database queries performed by the TIGTA.

Figure 3: Claims Processed in Sites With the CIS⁴

Type of Claim	Claims Over \$1,000,000	Claims Processed Using the CIS (Claims of Over \$1,000,000)	Statistical Sample (Claims of \$10,000 – \$1,000,000)	Number in Sample Processed Using the CIS	Total CIS Claims Reviewed
Form 1045	72	33	150	70	103
Form 1040X	27	11	250	92	103
Totals	99	44	400	162	206

Source: The IMF and Microsoft Access[®] database queries performed by the TIGTA.

⁴ The CIS is a modern, digital, image-based system for processing taxpayer correspondence.




*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

Appendix V

Management's Response to the Draft Report

RECEIVED
AUG 24 2006


DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

August 23, 2006

COMMISSIONER
WAGE AND INVESTMENT DIVISION

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 – Untimely Processing of Taxpayer Carryback
Loss Claims Resulted in Significant Interest Costs
(Audit # 200540034)

I reviewed the subject draft report and appreciate your recommendations to improve carryback loss claims. In response to your audit findings we have already made many of your recommended changes to improve our processes and streamline our identification procedures for carryback claims. I believe all your recommendations have merit and would like to address each of your findings in order, and list the actions we are taking or will be taking to deliver them.

Your first recommendation proposes Wage and Investment (W&I) Submission Processing (SP) require that all Forms 1045 and Forms 1040X with a carryback claim are identified upon receipt in the SP sites and routed directly to the Accounts Management (AM) function. To accomplish this recommendation SP will implement pre-screening of all Forms 1040X with a carryback claim. Once a carryback is identified it will be routed directly to AM. Instructions are currently in place for expedited routing of Forms 1045.

You also identified in your report that carryback claims were not given the correct priority codes when scanned into the Correspondence Imaging System (CIS). Your finding prompted us to modify the CIS programming to require employees to enter a priority code for each carryback claim. We made the priority code a mandatory field so it is not accidentally skipped.

Another problem noted in your report is that manual refunds were not always issued as required. In response, we have developed an interest-free chart for use in all campus locations to determine when a manual refund should be used to avoid paying interest. Two separate alerts were issued to require our employees to immediately begin using the new interest-free chart and to discontinue use of any local procedures. We will



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

2

issue specific carryback guidance further emphasizing the importance of processing these claims within the 45-day interest-free period. In addition, we will use Net Tax Refund Reports as a tool for looking at the timeliness of processing carryback claims for refunds.

Thank you again for bringing these items to our attention. Our responses to your recommendations are detailed in the attachment. If you have any questions, please call me at (404) 338-7060, or members of your staff may contact Betsy M. Kinter, Director, Customer Account Services, at (404) 338-8910.

Attachment



Untimely Processing of Taxpayer Carryback Claims Resulted in Significant Interest Costs

Attachment

RECOMMENDATION 1

The Director, SP, should require that all Forms 1045 and Forms 1040X with a carryback claim are identified upon receipt in the SP sites and routed directly to the AM function.

CORRECTIVE ACTION

Submission Processing (SP) agrees with this recommendation and will implement pre-screening of all Forms 1040X with carryback claims. This will allow the returns to be identified upon receipt in SP sites and routed directly to the AM functions.

IRM 3.10.72.4 Extracting, Sorting & Numbering currently contains expedite routing instructions for Form 1045.

IMPLEMENTATION DATE

January 15, 2007

RESPONSIBLE OFFICIAL

Director, W&I CAS SP

CORRECTIVE ACTION MONITORING PLAN

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

RECOMMENDATION 2

The Director, AM, should reiterate the importance of following current IRS procedures to issue manual refunds on carryback claims. The Director should also consider including an evaluation of the proper use of manual refunds for carryback claims in all business reviews of the AM Adjustments function.

This recommendation consists of two specific actions, which will be referenced as follows:

Recommendation 2a – The Director, AM, should reiterate the importance of following current IRS procedures to issue manual refunds on carryback claims.

Recommendation 2b – The Director should also consider including an evaluation of the proper use of manual refunds for carryback claims in all business reviews of the AM Adjustments function.

CORRECTIVE ACTION

Recommendation 2a – We agree with this recommendation and have already issued two employee alerts stressing the carryback claims and the 45-day interest free period.



*Untimely Processing of Taxpayer Carryback Claims
Resulted in Significant Interest Costs*

2

Recommendation 2b – As part of our annual Program Letter development process, we will also consider including in our business reviews evaluations for manual refunds on carryback claims.

IMPLEMENTATION DATE

Recommendation 2a – Completed – Servicewide Electronic Research Project alerts issued 3/30/06 and 3/31/06

Recommendation 2b – October 15, 2006

RESPONSIBLE OFFICIAL

Director, W&I CAS, AM

CORRECTIVE ACTION MONITORING PLAN

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

RECOMMENDATION 3

The Director, AM, should ensure the current and all future annual Program Letters for the AM function include a statement that emphasizes the importance of processing carryback claims within the 45-day interest-free period.

CORRECTIVE ACTION

We agree that we should emphasize the importance of processing carryback claims within the 45-day interest-free period. Specific guidance with regard to the timely processing of carryback claims within the 45-day interest-free period will be provided under separate cover from the program letter.

IMPLEMENTATION DATE

October 15, 2006

RESPONSIBLE OFFICIAL

Director, W&I CAS, AM

CORRECTIVE ACTION MONITORING PLAN

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

RECOMMENDATION 4

The Director, AM should use the Net Tax Refund Reports as a tool to evaluate the timeliness of processing carryback claims for refunds.



*Untimely Processing of Taxpayer Carryback Claims
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3

CORRECTIVE ACTION

We agree with the recommendation. Accounts Management has instituted a process for reviewing the Net Tax Refund Reports and will use this data as an indicator of progress in conjunction with the guidelines provided to the sites related to the processing of carrybacks.

IMPLEMENTATION DATE

October 15, 2006

RESPONSIBLE OFFICIAL

Director, W&I CAS, AM

CORRECTIVE ACTION MONITORING PLAN

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