TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Individual Tax Returns Were Timely Processed in 2006, but Opportunities Exist to Improve Verification of Certain Tax Deductions

October 10, 2006

Reference Number: 2006-40-164

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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DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

October 10, 2006

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Individual Tax Returns Were Timely Processed in 2006, but Opportunities Exist to Improve Verification of Certain Tax Deductions (Audit # 200640016)

This report presents the results of our review to evaluate whether the Internal Revenue Service (IRS) timely and accurately processed individual paper and electronic tax returns[1] during the 2006 Filing Season. The filing season is the period from January through mid-April when most individual income tax returns are filed. This audit focused on the implementation of new tax law changes identified in Appendix V that affected Tax Year 2005 tax returns. In addition, we reviewed the corrective actions taken for the conditions identified in our review of the 2005 Filing Season[2] to determine whether they were adequate.

Impact on the Taxpayer

Each year, legislated tax law changes create complex challenges for both the IRS and individual taxpayers. Overall, our review of the 2006 Filing Season found that most of these changes were implemented correctly with no significant delays in the processing of tax returns. The IRS had processed approximately 118.9 million individual income tax returns through May 26, 2006, and had timely issued refunds to applicable taxpayers within the processing time required.

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[1] 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] *Individual Tax Returns Were Timely Processed in 2005; However, Implementation of Tax Law Changes Could Be Improved* (Reference Number 2006-40-024, dated December 2005).

Synopsis

The IRS had a successful 2006 Filing Season. It completed processing returns on schedule and timely issued refunds within the required 45 calendar days of the April 17, 2006, due date.[3] The April 15 due date was on a Saturday this year, so the deadline was extended to April 17 for timely filed returns.[4] Through May 26, 2006, the IRS had processed approximately 118.9 million individual income tax returns, including 70.9 million (59.6 percent) processed electronically.

The IRS had a successful 2006 Filing Season even though it was an unusually difficult one because of the many late tax law changes due to the Hurricanes.

The 2006 Filing Season was unusual due to the significant tax law changes to assist taxpayers adversely affected by the devastation caused by Hurricanes Katrina, Rita, and Wilma that struck the Gulf Coast States in August and October 2005. In addition, significant law changes were included in provisions from the Working Families Tax Relief Act of 2004[5] and other legislation that became effective for Tax Year 2005.

Overall, most key tax law changes for the 2006 Filing Season we reviewed were implemented correctly. Additionally, one condition reported during the 2005 Filing Season review was no longer a concern this year. Last year, we analyzed returns that were processed with an entry exceeding $100,000 for the State sales tax or State income tax deduction and/or the amount of nontaxable combat pay reported.[6] In some instances, these entries were caused by taxpayers or the IRS incorrectly entering the amounts, which created erroneous credits and understatements of tax liabilities. In this year's review, we reviewed questionable large-dollar amounts of the same deductions and nontaxable combat pay along with other tax law changes and found they were generally accurate and, when inaccuracies occurred, they were corrected during return processing.

However, we also identified opportunities to improve the processing and accuracy of tax returns containing the following tax provisions:

- Taxpayers over the age of 70½ claimed improper Individual Retirement Arrangement (IRA) deductions.
- Eligible taxpayers did not take full advantage of the sales tax deduction.

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[3] Internal Revenue Code Section 6611 (e) (2002).
[4] Some taxpayers living in the Northeast had until April 18 to file their returns because of a Massachusetts holiday.
[5] Pub. L. No. 108-311, 118 Stat. 1166 (2004).
[6] We judgmentally selected $100,000 because we believed it provided a strong indicator of an unreasonable deduction for the majority of returns.

- Single taxpayers continued to claim a non-permissible "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 IRA worksheet in all tax instructions where this worksheet is used to clearly state that taxpayers over age 70½ cannot take the IRA deduction.

If the sales tax and tuition and fees deductions are extended to Tax Year 2006 and beyond, we recommended the Commissioner, Wage and Investment Division:

- Ensure the Sales Tax Calculator is available on the IRS Internet web site (IRS.gov) to assist individuals in calculating their deductions.
- Create a new form to capture the required information for the tuition and fees deduction to ensure compliance with the tax legislation.

Response

IRS management did not agree with our first recommendation. However, the IRS is taking an alternative corrective action and will revise the IRA worksheet for Tax Year 2006 to emphasize the importance of reading the section of the instructions that addresses the issue.

IRS management agreed with both of our other recommendations. The IRS will develop a web-based version of the Sales Tax Deduction Calculator in time for the filing of Tax Year 2006 tax returns. In addition, in anticipation of legislation to extend the deduction, the IRS began developing a new form for the tuition and fees deduction. The IRS is monitoring the progress of the legislation to ensure the form will be available timely. Management's complete response to the draft report is included as Appendix VI.

Office of Audit Comment

Although we are concerned taxpayers may continue to improperly claim this deduction, we are pleased the IRS plans to revise the IRA worksheet to emphasize that taxpayers read the instructions prior to completing the worksheet. We will monitor this issue during next year's tax return filing season to determine whether the corrective action taken is effective and reduces the number of improper IRA deduction claims.

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.

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Abbreviations

AGI	Adjusted Gross Income
EGTRRA	Economic Growth and Tax Relief Reconciliation Act of 2001
EITC	Earned Income Tax Credit
GO Zone	Gulf Opportunity Zone
IRA	Individual Retirement Arrangement
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
KETRA	Katrina Emergency Tax Relief Act of 2005
MAGI	Modified Adjusted Gross Income
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year
W&I	Wage and Investment

Background

The filing season[1] is a critical program for the Internal Revenue Service (IRS) because it is during this time that most individuals file their income tax returns and contact the IRS if they have questions about specific tax laws or filing procedures. The IRS estimated that 135 million individual income tax returns[2] would be filed during 2006 and most of these would be filed during the 2006 Filing Season. It also expected continued growth in electronically filed returns, which surpassed a milestone last year when more than one-half of the returns filed were filed electronically. Through May 26, 2006, the IRS had processed approximately 118.9 million individual income tax returns, including 70.9 million (59.6 percent) processed electronically. One of the challenges the IRS encounters in processing these returns is the correct implementation of tax law changes.

The IRS expected continued growth in electronically filed returns, which surpassed a milestone last year when more than one-half of the returns were filed electronically.

Changes to the tax law are usually made each year and the changes have a major impact on how the IRS conducts its activities, how many resources are required, and how quickly it can meet its strategic goals. This filing season was an unusually difficult one for the IRS because there were many late tax law changes in response to the Hurricanes that struck the United States. Disaster relief provisions were enacted into law for taxpayers affected by Hurricanes Katrina, Rita, and Wilma. The latest legislation, the Gulf Opportunity Zone (GO Zone) Act of 2005[3] was signed into law on December 21, 2005. Late legislation gave the IRS very little time to revise the necessary tax forms and computer programs before the start of the 2006 Filing Season.

During the 2006 Filing Season, the IRS processed individual income tax returns in six Wage and Investment (W&I) Division Submission Processing sites[4] located throughout the country. All of the six sites processed paper-filed individual income tax returns, and all but the Atlanta Submission Processing Site processed electronically filed individual income tax returns.

Both paper and electronic tax returns and related schedules are processed through the IRS computer systems and recorded on each individual's tax account at these sites. The IRS computer systems are made up of a complex series of processing subsystems that are linked and programmed nationally to check the validity and math accuracy of the return data provided. If

[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] Pub. L. No. 109-135, 119 Stat. 2577 (to be codified in scattered sections of 26 U.S.C. and at 19 U.S.C. § 4033).
[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. They are located in Andover, Massachusetts; Atlanta, Georgia; Austin, Texas; Fresno, California; Kansas City, Missouri; and Philadelphia, Pennsylvania.

an error is found, the taxpayer is sent a notice that asks for additional information or explains any change that is made to the amount of tax due or to the refund.

This review was performed at the W&I Division Headquarters in Atlanta, Georgia; the Submission Processing offices in Lanham, Maryland, and Cincinnati, Ohio; and the Austin, Texas, Submission Processing Site during the period January through June 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.

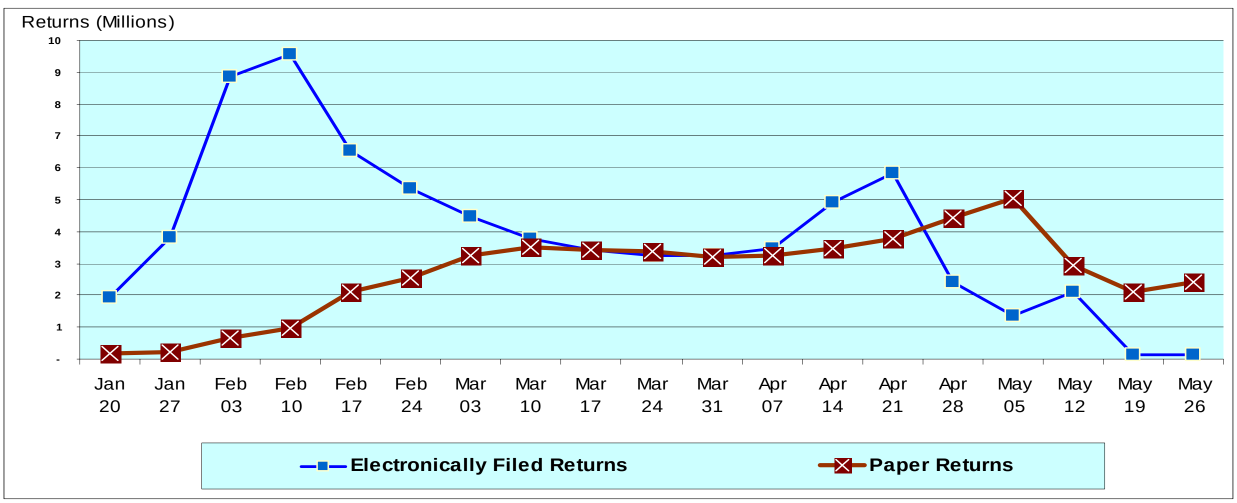
Results of Review

The 2006 Filing Season Was Completed Timely, and Most Returns Were Accurately Processed

The IRS had a successful 2006 Filing Season. It completed processing returns on schedule and timely issued refunds within the required 45 calendar days of the April 17, 2006, due date.[5] The April 15 due date was on a Saturday this year, so the deadline was extended to April 17 for timely filed returns.[6]

Electronic returns increased over 6.4 percent over the same time last year. The largest increase was seen in taxpayers filing online from home computers (19 percent),[7] but a decrease of almost 23 percent was seen in the IRS Free File Program.[8] This decrease could be attributed to limiting participation in the Program by at least 30 percent of taxpayers in October 2005. Figure 1 compares electronic returns to paper returns filed during the 2006 Filing Season.

Figure 1: Volumes of Electronic and Paper Tax Returns Filed During the 2006 Filing Season



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

[5] Internal Revenue Code Section (§) 6611 (e) (2002).
[6] Some taxpayers living in the Northeast had until April 18 to file their returns because of a Massachusetts holiday.
[7] Volumes for filing online from home computers include volumes from the IRS Free File Program.
[8] The Free File Program is an online tax preparation and electronic filing program that is offered through a partnership agreement between the IRS and the Free File Alliance, LLC.

One condition reported during the 2005 Filing Season[9] was no longer a concern this year. Last year, we analyzed returns that were processed with an entry exceeding $100,000 for the State sales tax or State income tax deduction and/or the amount of nontaxable combat pay reported.[10] In some instances, these entries were caused by taxpayers or the IRS incorrectly entering the amounts, which created erroneous credits and understatements of tax liabilities. In this year's review, we reviewed questionable large-dollar amounts of the same deductions and nontaxable combat pay along with other tax law changes. We found they were generally accurate, and when inaccuracies occurred they were corrected during return processing.

Implementation of key tax law changes

The 2006 Filing Season was unusual due to the significant tax law changes to assist taxpayers adversely affected by the devastation caused by Hurricanes Katrina, Rita, and Wilma that struck the Gulf Coast States in August and October 2005. The Katrina Emergency Tax Relief Act of 2005 (KETRA)[11] was signed into law on September 23, 2005, and contained $3.3 billion in estimated tax relief for Fiscal Year 2006. The GO Zone legislation followed in December 2005, with an additional $3.9 billion in estimated tax relief for 2006. Taxpayers who were adversely affected by the Hurricanes were able to elect to use their 2004 earned income to calculate their Earned Income Tax Credit (EITC) and refundable Child Tax Credit, double their Hope and Lifetime Learning Credits for students who attend an educational institution in the GO Zone, and deduct personal casualty or theft losses caused by the Hurricanes as a separate deduction from all other casualty losses along with many other tax benefits. Also, taxpayers who provided housing for Hurricane Katrina displaced individuals could claim an additional exemption, and cash contributions paid to qualified charitable organizations after August 27, 2005, were not subject to any limitations.

Hurricanes Katrina, Rita, and Wilma legislation provided an estimated $7.2 billion in tax relief to affected taxpayers in 2006.

In addition, significant law changes were included in provisions from the Working Families Tax Relief Act of 2004[12] and other legislation that became effective for Tax Year (TY) 2005. One of these changes provides a uniform definition of a qualifying child to be used in determining various tax benefits. See Appendix V for an overview of the tax law provisions examined during this review.

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[9] *Individual Tax Returns Were Timely Processed in 2005; However, Implementation of Tax Law Changes Could Be Improved* (Reference Number 2006-40-024, December 2005).

[10] We judgmentally selected $100,000 because we believed it provided a strong indicator of an unreasonable deduction for the majority of returns.

[11] Pub. L. No. 109-73, 119 Stat. 2016 (to be codified in scattered sections of 26 U.S.C.).

[12] Pub. L. No. 108-311, 118 Stat. 1166 (2004).

Overall, most key tax law changes for the 2006 Filing Season were implemented correctly. These tax law changes involved:

- Additional exemption for housing Hurricane Katrina displaced individuals.
- Temporary suspension of limitations on charitable contributions and personal casualty losses.
- Tax-favored withdrawals from retirement plans for qualified Hurricane distributions.
- Special rule for determining earned income for taxpayers whose main home was in a disaster area.
- Expansion of the Hope Scholarship and Lifetime Learning Credit for students in the GO Zone.
- A qualifying child for the Child Tax Credit.
- The expansion of the Individual Retirement Arrangement (IRA) deduction.
- Increases in the EITC, the standard deduction, and the exemption amounts.
- Increases in income limits for the student loan interest deduction.

However, we also identified opportunities to improve the processing and accuracy of tax returns containing the following tax provisions:

- Taxpayers over the age of 70½ claimed improper IRA deductions.
- Eligible taxpayers did not take full advantage of the sales tax deduction.
- Single taxpayers continued to claim a non-permissible "dual benefit" by taking both the tuition and fees deduction and the Education Credit.

Taxpayers Claimed Improper Individual Retirement Arrangement Deductions

The IRA deduction was increased for TY 2005 to $4,000 and to $4,500 if a taxpayer is age 50 or older. However, the Internal Revenue Code (I.R.C.)[13] states that no deduction will be allowed as a benefit to any individual who has attained the age of 70½ before the end of the taxable year for which the contribution is made.

Our analysis showed the IRS correctly implemented the increases in the IRA deduction; however, we identified 1,826 taxpayers over age 70½ that improperly claimed over $4 million in

[13] 26 U.S.C. § 219 (2004).

IRA deductions.[14] Assuming all 1,826 taxpayers received an improper tax benefit from only the IRA deduction, the estimated loss of revenue is $601,423.[15] We realize this is a relatively small volume of taxpayers; however, with the increasing aging of the population, this could become a larger issue in the future.

The instructions for Forms 1040 and 1040A inform taxpayers to use the worksheet in the instructions to calculate the amount of their IRA deductions but to read a list that followed before preparing the worksheet. The first item on the list states, if they were age 70½ or older at the end of 2005, they cannot deduct any contributions made to a traditional IRA for 2005. However, the IRA worksheet instructs taxpayers to enter $4,000 or $4,500 if 50 or older at the end of 2005. This wording is used three different times in the worksheet and implies there is no age limit for this deduction. A taxpayer who has not read the instructions prior to preparing the worksheet would be uninformed and could claim the deduction improperly.

Recommendation

Recommendation 1: The Commissioner, W&I Division, should revise the IRA worksheet in all tax instructions where this worksheet is used to clearly state that taxpayers over age 70½ cannot take the IRA deduction.

> ***Management's Response:*** IRS management did not agree with this recommendation. The instructions for Form 1040, Line 32, IRA Deduction, already instruct the taxpayer to read the list on page 31 before filling in the worksheet. The first item on the list explains the age 70½ or older restrictions. However, the IRS will revise the worksheet for TY 2006 to emphasize the importance of reading the list on page 31 of the instructions.
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> ***Office of Audit Comment:*** Although we are concerned taxpayers may continue to improperly claim this deduction, we are pleased the IRS plans to revise the worksheet to emphasize that taxpayers read the instructions prior to completing the worksheet. We will monitor this issue during next year's tax return filing season to determine whether the corrective action taken is effective and reduces the number of improper IRA deduction claims.

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[14] These exceptions did take into account the age of the spouse if the taxpayers filed married filing jointly. If the age of the spouse was under age 70½, the allowable IRA deduction was adjusted accordingly in our results.
[15] We used the tax rate of 15 percent to compute the estimated tax benefit (i.e., 15 percent times $4,009,485 of IRA deductions equals a tax benefit of $601,423).

Eligible Taxpayers Did Not Take Full Advantage of the Sales Tax Deduction

This year, 14 percent of taxpayers living in a State with no income tax did not claim the sales tax deduction. This was up from 9 percent last year.

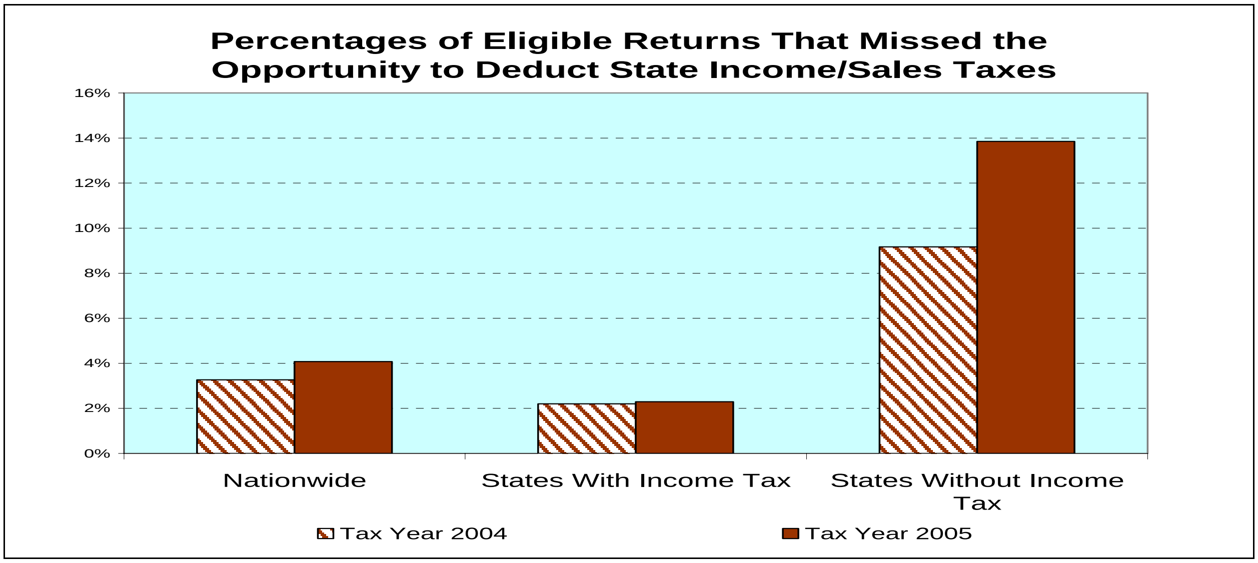
The American Jobs Creation Act of 2004[16] was enacted in October 2004 and allows taxpayers who itemize deductions the option of deducting either State and local sales taxes or State and local income taxes from their Federal income taxes. This legislation allows this deduction in TYs 2004 and 2005 and is most advantageous for taxpayers living in the seven States that do not have a State income tax.[17] During the 2005 Filing Season, taxpayers could 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 could be added to the table amount. The Optional State Sales Tax Tables and instructions were not included in the TY 2004 Form 1040 instructions because of the late passage of the legislation.

During the 2005 Filing Season, we reported 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. Of the 33.3 million tax returns processed through May 2005 with itemized deductions, 5.1 million (15 percent) were filed by taxpayers residing in the 7 States without a State income tax. Of these 5.1 million returns, 465,095 (9 percent) did not claim a sales tax deduction.

This year, the IRS included the Optional State Sales Tax Tables and instructions within the overall instructions for Itemized Deductions and Interest and Ordinary Dividends (Form 1040 Schedules A and B) and also provided the general State sales tax rate used to construct the tax tables for each State. However, taxpayers residing in the seven States without a State income tax were six times more likely to omit the sales tax deduction than taxpayers living elsewhere. Through May 2006, 34.5 million returns had been processed with itemized deductions, 5.3 million (15 percent) of which were filed by taxpayers residing in the 7 States without a State income tax. Of these 5.3 million returns, 735,415 (14 percent) did not claim a sales tax deduction. Also, taxpayers in these seven States were more likely to claim the sales tax deduction if they used a paid preparer. Conversely, taxpayers in these seven States that did not use a paid preparer were more likely to omit the sales tax deduction. Figure 2 shows the differences in the percentages between TYs 2004 and 2005.

[16] Pub. L. No. 108-357, 118 Stat. 1418 (2004).
[17] Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

Figure 2: Percentages 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 deduction for TYs 2004 and 2005.

One problem we identified was that the 2005 Sales Tax Calculator was not available on the IRS Internet web site (IRS.gov). The TY 2005 instructions for Form 1040, Schedules A and B, informed taxpayers they could use the Calculator instead of completing the worksheet included in the instructions. However, the 2005 Sales Tax Calculator was not available during the 2006 Filing Season. As such, some taxpayers who prepared their own paper returns may have not claimed the deduction because the 2005 Sales Tax Calculator was unavailable and the worksheet in the instructions was very complex. Although the sales tax deduction was initially available for TYs 2004 and 2005 only, Congress may extend this deduction to TY 2006 and beyond. If so, we believe more taxpayers will benefit from this deduction with the use of the Sales Tax Calculator.

Recommendation

Recommendation 2: If the sales tax deduction is extended to TY 2006 and beyond, the Commissioner, W&I Division, should ensure the Sales Tax Calculator is available on IRS.gov to assist individuals in calculating their deductions.

> ***Management's Response:*** IRS management agreed with this recommendation and will develop a web-based version of the Sales Tax Deduction Calculator in time for the filing of TY 2006 tax returns.

Single Taxpayers Continued to Claim a Non-permissible "Dual Benefit" by Taking Both the Tuition and Fees Deduction and the Education Credit

The Economic Growth and Tax Relief Reconciliation Act of 2001[18] created a new "above-the line" deduction for tuition and fees.[19] For TY 2005, taxpayers were allowed to take a deduction of up to $4,000 for qualified tuition and fees paid for the taxpayer, his or her spouse, or his or her dependents. 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 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. 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.

During this filing season, we identified 15,250 single taxpayers claiming no dependents that claimed both the Education Credit and the tuition and fees deduction. We focused on single taxpayers claiming no dependents because it is clear that both the tuition and fees deduction and the Education Credit were claimed for the same individual, which is not allowable. Our audit analysis showed these taxpayers claimed Education Credits of over $11 million and tuition and fees deductions of nearly $34 million. Assuming all 15,250 taxpayers received an erroneous tax benefit from only the tuition and fees deduction, the estimated loss of revenue is nearly $5.1 million.[20]

This condition was reported in the 2003, 2004, and 2005 Filing Seasons

This is the fourth year in which we have identified and reported this issue. When this issue was identified during the 2003 Filing Season,[21] the IRS included a cautionary statement on the Form 8863 specifically to alert taxpayers not to claim both the tuition and fees deduction and the Education Credit for the same student in the same year.

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[18] Pub. L. No. 107-16, 115 Stat. 38 (2001).

[19] An "above-the-line" deduction refers to a deduction that is taken directly on Form 1040 rather than on the Schedule A. Consequently, this type of deduction can be taken by taxpayers who do not itemize their deductions.

[20] We used the tax rate of 15 percent to compute the estimated tax benefit (i.e., 15 percent times $34 million of tuition and fees deductions equals a tax benefit of $5.1 million).

[21] *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).

During the 2004 Filing Season, we 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 to disallow the dual benefits claimed by single taxpayers with no dependents.[22] 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 the 2005 Filing Season, we recommended the IRS revise Form 8863 to combine and include applicable information for the tuition and fees deduction and the Education Credit to ensure compliance and promote simplicity and fairness, as noted by the Joint Committee on Taxation. The IRS responded that, if legislation was enacted to extend the tuition and fees deduction beyond the TY 2005 expiration date, it would revise Form 8863 to include the tuition and fees deduction on the Form.

We have been reporting that single taxpayers with no dependents are claiming both the tuition and fees deduction and the Education Credit since the deduction was created.

While still significant, the number of single taxpayers with no dependents claiming both the Education Credit and the tuition and fees deduction has decreased 18.8 percent from the previous year (15,250 in the 2006 Filing Season compared to 18,776 in the 2005 Filing Season). Figure 3 provides a comparison of our results for this issue from the last four filing seasons.

Figure 3: Single Taxpayers With No Dependents Claiming Both the Education Credit and the Tuition and Fees Deduction

Filing Season	Tuition and Fees Deduction Claimed (millions)	Education Credit Claimed (millions)	Single Taxpayers With No Dependents	Average Deduction Taken
2003	77	24	42,058	$1,831
2004	30	11	16,979	$1,767
2005	39	13	18,776	$2,077
2006	34	11	15,250	$2,230

Source: TIGTA electronic analysis of returns processed data for the 2003-2006 Filing Seasons.

This issue may affect more than single taxpayers

The extent of the dual benefit problem may not be limited to single taxpayers with no dependents. A total of 232,545 taxpayers that filed as other than single claimed both the tuition and fees deduction and the Education Credit in the 2006 Filing Season, compared to

[22] *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).

241,862 taxpayers that filed as other than single in the 2005 Filing Season (a decrease of 3.8 percent). These 232,545 taxpayers claimed $656 million in tuition and fees deductions and $245 million in Education Credits. However, because taxpayers claiming the tuition and fees deduction 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, neither we nor the IRS can determine whether the taxpayers are claiming a 'dual benefit' for the same student.

A research project conducted by the W&I Division Compliance Program recognized the dual benefit issue as a potential area of noncompliance. The analysis was limited to taxpayers filing as single or head of household because there was insufficient information about returns using other filing statuses and claiming dual benefits.

The tuition and fees deduction was scheduled to expire on December 31, 2005. However, there is a chance that Congress will extend this provision to TY 2006 and beyond, in which case the issues we identified would continue to exist. Our recommendation is contingent upon the passage of legislation extending the tuition and fees deduction.

Recommendation

Recommendation 3: If Congress extends the tuition and fees deduction to TY 2006 and beyond, the Commissioner, W&I Division, should create a new form for the tuition and fees deduction to ensure compliance with the tax legislation. The form should require taxpayers to specifically identify the student, by name and Social Security Number, who qualifies for the tuition and fees deduction.

> ***Management's Response:*** IRS management agreed with this recommendation. In anticipation of legislation to extend the deduction, the IRS began developing a new form for the tuition and fees deduction. The IRS is monitoring the progress of the legislation to ensure the form will be available timely.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the review was to evaluate whether the IRS timely and accurately processed individual paper and electronic tax returns[1] during the 2006 Filing Season.[2] The audit focused on the implementation of new tax law changes[3] that affected TY 2005 tax returns. In addition, we reviewed the corrective actions for the conditions identified in our review of the 2005 Filing Season[4] 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 2006 Filing Season.

  A. Used 100 percent computer analysis of TY 2005 individual income tax returns processed nationally between January 1 and May 26, 2006,[5] to identify returns affected by recent tax legislation. We used random sampling for some tests to ensure each return had an equal chance of being selected. We also used judgmental sampling if we needed to ensure the original returns could be quickly obtained to evaluate the accuracy of processing. To determine whether systemic controls at the Submission Processing sites[6] assured processing accuracy for the KETRA and GO Zone legislation, we performed the following tests.

    1. Determined whether the new Exemption Amount for Taxpayers Housing Individuals Displaced by Hurricane Katrina (Form 8914) was processed accurately by reviewing a random sample of 30 of the 6,117 returns processed through February 3, 2006. We also analyzed 43,351 returns processed through March 17, 2006, to determine whether taxpayers were claiming a dependent as a displaced individual.

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[1] 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] *Individual Tax Returns Were Timely Processed in 2005; However, Implementation of Tax Law Changes Could Be Improved* (Reference Number 2006-40-024, dated December 2005).

[5] To assess the reliability of computer-processed data, programmers in the TIGTA Office of Information Technology validated the data that were extracted, and we verified the appropriate documentation. Judgmental samples were selected and reviewed to ensure the amounts presented were supported by external sources. As appropriate, data in the selected data records were compared to the physical tax returns to verify the amounts were supported. Based on these tests, we determined the computer-processed data were reliable.

[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.

2. Identified a population of 3,195,081 returns processed through April 28, 2006, that reported qualified contributions on Line 15b of the Itemized Deductions and Interest and Ordinary Dividends (Form 1040 Schedules A and B) that exceeded 50 percent of the adjusted gross income (AGI).[7] We selected a random sample of 30 returns to ensure they were not subject to the limitation on itemized deductions or the 50 percent AGI limitation.
3. Identified a population of 411,141 returns processed through April 28, 2006, with an amount on Line 17 of Casualties and Thefts (Form 4684). We selected a random sample of 30 returns to ensure amounts attributable to the Hurricane disaster areas on Form 4684 were not subject to any limitations.
4. Identified a population of 2,703 returns processed through May 23, 2006, with Nondeductible IRAs (Form 8606). We selected a random sample of 29 returns to determine whether a Qualified Hurricane Retirement Plan Distributions and Repayments (Form 8915) was attached and the return was properly processed.
5. Verified whether the accurate earned income was used by taxpayers electing to use their 2004 earned income to calculate the EITC and the refundable child credit by reviewing a judgmental sample of 40 of the 13,004 returns processed at the Austin, Texas, Submission Processing Site through February 3, 2006.
6. Identified a population of 42,602 returns processed through March 31, 2006, claiming expanded Education Credits for students in the Gulf Opportunity Zone. We reviewed a judgmental sample of 30 paper returns processed in the Austin, Texas, Submission Processing Site to determine whether the Credits were accurately processed.

B. Determined whether systemic controls at the Submission Processing sites assured processing accuracy for other new legislation.

1. Determined whether the Child Tax Credit was accurately calculated when nondependent qualifying children were claimed by reviewing a random sample of 30 of the 6,092 returns processed through February 3, 2006, with qualifying children claimed on Information on Qualifying Children Who Are Not Dependents (Form 8901).
2. Identified 1,826 returns through May 26, 2006, on which taxpayers were over the age limits for receiving the IRA deduction.
3. Determined whether the EITC was accurately processed by reviewing a random sample of 30 of the 2,326 returns processed through February 3, 2006, on which

[7] AGI is calculated after certain adjustments are made but before standard or itemized deductions and personal exemptions are subtracted.

the taxpayer claimed an EITC amount that exceeded the maximum credit based on filing status, number of qualifying children, and AGI limits.

4. Verified whether the correct standard deduction and exemption amounts were used by reviewing a judgmental sample of 40 returns filed early and processed at the Austin Submission Processing Site.

C. Determined whether the student loan interest deduction was properly phased out based on AGI limits by reviewing a judgmental sample of 30 returns processed through January 27, 2006, that claimed the student loan interest deduction.

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 reports, inventory reports, and return error inventories between January 27 and April 28, 2006, for key indicators for return processing and compared the statistics to those for the 2005 Filing Season.

B. Monitored the IRS Program Completion Date reports from May 2 through May 11, 2005, to determine whether the Submission Processing sites processed all returns timely.

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 2006 Filing Season W&I Division Production meetings between January 25 and May 24, 2006, and monitored the IRS Submission Processing office web site, the IRS web site (IRS.gov), and other applicable web sites from February 13 through May 5, 2006, to identify potentially significant issues.

III. Determined whether the IRS corrected problems identified in the 2005 Filing Season. From returns processed by the Submission Processing sites between January 1 and May 26, 2006, we electronically identified TY 2005 returns that met specific criteria.

A. Identified 735,415 returns processed through May 26, 2006, that did not claim the State sales tax deduction and resided in States without a State income tax. We then compared the returns to the analysis performed last year to determine whether more taxpayers benefited from this deduction because of corrective actions taken last year.

B. Identified 31,200 returns processed through April 28, 2006, with an amount over $100,000 for the tax law changes selected for this review.[8] We selected a random sample of 30 returns to determine whether the amounts appeared accurate.

C. Identified 15,250 returns processed through May 26, 2006, filed by single taxpayers with no dependents who claimed both the Education Credit and the tuition and fees deduction.

[8] We judgmentally selected $100,000 because we believed it provided a strong indicator of an unreasonable deduction for the majority of returns.

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs)
Scott A. Macfarlane, Director
Gary L. Young, Audit Manager
Tina M. Parmer, Lead Auditor
Sharon A. Buford, Senior Auditor
Steven D. Stephens, Senior Auditor
Steven E. Vandigriff, Senior Auditor
Lawrence N. White, Senior Auditor
Bonnie G. Shanks, Auditor
Joseph C. Butler, Information Technology Specialist
Judith P. Harrald, Information Technology Specialist

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 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
Director, Media and Publications, Wage and Investment Division SE:W:CAR:MP
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 Internal Control OS:CFO:CPIC:IC
Audit Liaison: Senior Operations Advisor, Wage and Investment Division SE:W:S

Appendix IV

Outcome Measures

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

For all outcomes listed in this appendix, we conducted computer analyses of TY 2005 individual income tax returns.[1] The returns were processed by the IRS Submission Processing sites[2] between January 1 and May 26, 2006, and posted to the Individual Master File.[3] 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 whether the IRS accurately processed individual tax returns during the 2006 Filing Season.[4]

Type and Value of Outcome Measure:

- Revenue Protection – Potential; 1,826 taxpayers improperly claimed the IRA deduction, resulting in an estimated loss of revenue of $601,423 (see page 5).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 1,826 taxpayers over age 70½ that improperly claimed over $4 million in IRA deductions.[5] Assuming all 1,826 taxpayers received an erroneous tax benefit from only the IRA deduction, the estimated loss of revenue is $601,423.[6] We realize this is a very small volume of taxpayers; however, with the increasing aging of the population, this could become a bigger issue in the future.

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[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] The IRS database that maintains transactions or records of individual tax accounts.
[4] The period from January though mid-April when most individual income tax returns are filed.
[5] These exceptions did take into account the age of the spouse if the taxpayers filed married filing jointly. If the age of the spouse was under age 70½, the allowable IRA deduction was adjusted accordingly in our results.
[6] We used the tax rate of 15 percent to compute the estimated tax benefit (i.e., 15 percent times $4,009,485 of IRA deductions equals a tax benefit of $601,423).

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 735,415 taxpayers affected (see page 7).

Methodology Used to Measure the Reported Benefit:

Our analysis identified that, through May 2006, 34.5 million returns had been processed with itemized deductions, 5.3 million (15 percent) of which were filed by taxpayers residing in the 7 States without a State income tax.[7] Of these 5.3 million returns, 735,415 (14 percent) did not claim a sales tax deduction. Taxpayers in these States were six times more likely to overlook the sales tax deduction than taxpayers living in the rest of the country.

We also found that taxpayers in these seven States were more likely to claim the sales tax deduction if they used a paid preparer. Conversely, taxpayers in these seven States that did not use a paid preparer were more likely to omit the sales tax deduction.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; 15,250 single taxpayers with no dependents claimed nearly $34 million in erroneous tuition and fees deductions, resulting in an estimated loss of revenue of nearly $5.1 million (see page 9).

Methodology Used to Measure the Reported Benefit:

We focused on single taxpayers claiming no dependents because it is clear that both the tuition and fees and the Education Credit were claimed for the same individual. Our analysis identified 15,250 single taxpayers with no dependents who claimed Education Credits of over $11 million and tuition and fees deductions of nearly $34 million. Assuming all 15,250 taxpayers received an erroneous tax benefit from only the tuition and fees deduction, the estimated loss of revenue is nearly $5.1 million.[8] Because 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.

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[7] Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.
[8] We used the tax rate of 15 percent to compute the estimated tax benefit (i.e., 15 percent times $34 million of tuition and fees deductions equals a tax benefit of $5.1 million).

Appendix V

Overview of Tax Law Provisions and Other Tax Law Changes Examined During the Review

The following information describes various tax law provisions and other changes that affected TY 2005 individual income tax returns processed during the 2006 Filing Season.[1] During our review, we determined whether returns affected by the various provisions were processed accurately, in accordance with the law.

Taxpayer Relief Act of 1997[2]

This Act contained the following provision:

1) Section 301 – Restoration of IRA Deduction for Certain Taxpayers. Provides for taxpayers covered by a retirement plan at work. For TY 2005, the deduction for contributions to a traditional IRA will be phased out over a $10,000 range in the taxpayer's modified adjusted gross income (MAGI).[3] For a married couple filing a joint return or a qualified widow(er), the deduction will begin to be phased out at a MAGI of $70,000. For single individuals or taxpayers filing as head of household, the deduction will begin to be phased out at a MAGI of $50,000.

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)[4]

The EGTRRA contained the following two provisions:

1) Section 431 – Deduction for Higher Education Expenses. Provides an above-the-line deduction for qualified tuition and related expenses. For TY 2005, the tuition and fees deduction is $4,000 if the taxpayer's MAGI is not more than $65,000 ($130,000 for joint returns). If the taxpayer's MAGI is greater than $65,000 ($130,000 for joint returns), but is not more than $80,000 ($160,000 for joint returns), the maximum tuition and fees deduction is $2,000. Married taxpayers filing separately are not allowed to take this deduction. This deduction cannot be taken for a student's educational expenses if the taxpayer is claiming either the Hope or Lifetime Learning Credit for that same student.

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[1] The period from January through mid-April when most individual income tax returns are filed.
[2] 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.).
[3] AGI is calculated after certain adjustments are made but before standard or itemized deductions and personal exemptions are subtracted. MAGI is calculated without regard to certain deductions or exclusions.
[4] Pub. L. No. 107-16, 115 Stat. 38 (2001).

2) Section 601 – Modification of IRA Contribution Limits. Provides that, for TY 2005, the maximum contribution limit to a traditional IRA is increased to $4,000. The maximum catch-up contribution for individuals age 50 and over remains at $500 for TY 2005.

Working Families Tax Relief Act of 2004[5]

This Act contained the following four provisions:[6]

1) Section 101 – Repeal of Scheduled Reductions in Child Tax Credit, Marriage Penalty Relief, and 10-Percent Rate Bracket. Provides for a repeal of the scheduled reductions in the Child Tax Credit, the standard deduction and 15 percent tax rate bracket for joint returns (marriage penalty relief), and 10 percent tax rate bracket. The items will generally remain at their TY 2004 levels through TY 2010, after which the EGTRRA sunset will apply the law in effect for TY 2000. Through TY 2010, the Child Tax Credit will remain at $1,000, both the standard deduction and width of the 15 percent bracket for joint filers will continue to be twice that for single filers, and the 10 percent bracket will continue to be indexed for inflation after TY 2003.

2) Section 201 – Uniform Definition of Child, Etc.. Provides a uniform definition of "qualifying child" in I.R.C. Section (§) 152(c)[7] to be used in determining the tax benefits of the dependency exemption, Child Tax Credit, EITC, Credit for Child and Dependent Care Expenses, and Head of Household filing status. Each tax benefit has separate criteria for determining whether a taxpayer qualifies with respect to a particular child. Generally, a child is a qualifying child of a taxpayer if the child satisfies each of three tests: 1) the child has the same principal place of abode as the taxpayer for more than one-half of the taxable year (temporary absences due to illness, education, vacation, etc. are disregarded), 2) the child has a specified relationship to the taxpayer, and 3) the child has not yet attained a specified age. Except for the EITC, a child who provides over one-half of his or her own support may not be a qualifying child. The prior-law support and gross income tests for determining whether an individual is a dependent no longer apply if the child meets the requirements of the uniform definition of qualifying child.

3) Section 204 – Modifications of Child Tax Credit. Modifies I.R.C. § 24(c)(1)[8] to incorporate the new uniform definition of qualifying child provided in amended I.R.C. § 152(c). In addition, the provision eliminates the prior-law requirement that a foster child and certain other children be cared for as the taxpayer's own child.

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[5] Pub. L. No. 108-311, 118 Stat. 1166 (2004).
[6] Source: IRS *Legislative Affairs Update 2004-6, Summary of Provisions in the Working Families Tax Relief Act of 2004, P.L. 108-311* (October 2004).
[7] 26 U.S.C. § 152 (2004).
[8] 26 U.S.C. § 24 (2004).

4) Section 205 – Modifications of [the] EITC. Modifies I.R.C. § 32(c)(3)[9] to define a qualifying child for purposes of the EITC by reference to the new uniform definition of qualifying child provided in I.R.C. § 152(c). The prior-law requirement that a foster child and certain other children be cared for as the taxpayer's own child is eliminated. The tie-breaker rules applicable to the EITC remain unchanged and have been incorporated in the new uniform definition of a qualifying child in I.R.C. § 152. The provision retains the requirement that the taxpayer's principal place of abode be in the United States.

American Jobs Creation Act of 2004[10]

This Act contained the following provision:

1) Section 501 – Deduction of State and local General Sales Taxes in Lieu of State and Local Income Taxes. Provides that taxpayers may elect to claim an itemized deduction for either State and local income taxes or State and local general sales taxes. Taxpayers can deduct either their actual sales taxes paid or the amount shown for their income bracket in tables provided by the IRS. Sales taxes paid on motor vehicles 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.

Katrina Emergency Tax Relief Act of 2005[11]

This Act contained the following six provisions:[12]

1) Section 101 – Tax-Favored Withdrawals From Retirement Plans for Relief Relating to Hurricane Katrina. Provides an exception to the 10 percent early withdrawal tax in the case of a qualified Hurricane Katrina distribution up to $100,000 from a qualified retirement plan, a Section 403(b) plan, a Section 457(b) Governmental deferred compensation plan, or an IRA. In addition, income attributable to a qualified Hurricane Katrina distribution may be included in income ratably over 3 years, and, to the extent the distribution is eligible for tax-free rollover and is recontributed within a 3-year period, the amount recontributed will not be included in gross income.

2) Section 102 – Recontributions of Withdrawals for Home Purchases Cancelled Due to Hurricane Katrina. Provides that qualified distributions from a Section 401(k) plan, a Section 403(b) plan, or an IRA to purchase a home in the Hurricane Katrina disaster area may be recontributed to an eligible retirement plan. Any amounts recontributed are treated

[9] 26 U.S.C. § 32 (2004).
[10] Pub. L. No. 108-357, 118 Stat. 1418 (2004).
[11] Pub. L. No. 109-73, 119 Stat. 2016 (to be codified in scattered sections of 26 U.S.C.).
[12] Source: *TECHNICAL EXPLANATION OF H.R. 3768, THE "KATRINA EMERGENCY TAX RELIEF ACT OF 2005" AS PASSED BY THE HOUSE AND THE SENATE ON SEPTEMBER 21, 2005*, Joint Committee on Taxation, JCX-69-05 (September 2005).

as direct rollovers. The qualified distribution must have been received after February 28, 2005, and before August 29, 2005, in order to purchase or construct a principal residence in the Hurricane Katrina disaster area, but the residence was not purchased or constructed due to Hurricane Katrina. To be treated as rollovers, the recontributions must be made between August 25, 2005, and February 28, 2006.

3) Section 301 – Temporary Suspension of Limitations on Charitable Contributions. Provides that, in the case of an individual, the deduction for qualified contributions is allowed up to the amount by which the taxpayer's contribution base exceeds the deduction for other charitable contributions. A taxpayer must elect this treatment for qualified contributions. Deductions elected to be treated under this Section are not subject to the overall limit on itemized deductions under Section 68. Contributions in excess of this amount are carried over to succeeding taxable years as contributions described in I.R.C. § 170(b)(1)(A), subject to the limitations of I.R.C. § 170(d)(1)(A)(i) and (ii).[13] Qualified contributions are cash contributions made between August 28, 2005, and December 31, 2005, to a charitable organization described in I.R.C. § 170(b)(1)(A) (other than a supporting organization described in I.R.C. § 509(a)(3) or donor-advised funds).[14]

4) Section 302 – Additional Exemption for Housing Hurricane Katrina Displaced Individuals. Provides an additional exemption of $500 for each Hurricane Katrina displaced individual. The maximum additional exemption amount is $2,000 for married taxpayers filing jointly, $1,000 for married taxpayers filing separately, and $2,000 for all other taxpayers. The taxpayer may claim the exemption only one time for each displaced individual for all taxable years. A Hurricane Katrina displaced individual is a person (1) whose principal place of abode on August 28, 2005, was in the Hurricane Katrina disaster area; (2) who is displaced from such abode; (3) whose abode, if located within the disaster area but outside the core disaster area, must be damaged by Hurricane Katrina, or who was evacuated from the abode because of Hurricane Katrina; and (4) who is provided housing free of charge in the taxpayer's principal residence for a period of 60 consecutive days that ends in the taxable year in which the exemption is claimed. The displaced individual cannot be the taxpayer's spouse or dependent. The taxpayer cannot receive any compensation from any source for providing housing to the displaced individual. The taxpayer must provide the Taxpayer Identification Number of the displaced individual.

5) Section 402 – Suspension of Certain Limitations on Personal Casualty Losses. Provides that casualty or theft losses of personal-use property that are attributable to Hurricane Katrina need not exceed the $100-per-casualty or -theft limitation. In addition, casualty or theft losses of personal-use property that are attributable to Hurricane Katrina are

[13] 26 U.S.C. § 170 (2004).
[14] 26 U.S.C. § 509 (2004).

disregarded for purposes of applying the 10 percent threshold to other personal casualty or theft losses.

6) Section 406 – Special Look-Back Rule for Determining the EITC and the Refundable Child Credit. Permits a qualified individual to elect to calculate both the EITC and the refundable Additional Child Tax Credit for the taxable year that includes August 25, 2005, using the earned income from the prior taxable year. This election can be made only if the qualified individual's earned income for the taxable year that includes August 25, 2005, is less than earned income for the preceding taxable year.

Gulf Opportunity Zone Act of 2005[15]

This Act contained the following two provisions:[16]

1) Section 102 – Expansion of Hope Scholarship and Lifetime Learning Credit for Students in the Gulf Opportunity Zone. Created new I.R.C. § 1400O[17] that expands the Hope and Lifetime Learning Credits for students attending an eligible education institution located in the Gulf Opportunity Zone. The Hope Credit is increased to 100 percent of the first $2,000 in qualified tuition and related expenses and 50 percent of the next $2,000 of qualified tuition and related expenses, for a maximum credit of $3,000 per student. The Lifetime Learning Credit rate is increased from 20 percent to 40 percent of up to $10,000 of qualified tuition and related expenses per taxpayer return. The definition of qualified expenses is expanded to mean qualified higher education expenses as defined under the rules relating to qualified tuition programs, including certain room and board expenses for at least half-time students. This provision applies to taxable years beginning in 2005 or 2006.

2) Section 201 – Extension of Certain Emergency Tax Relief for Hurricane Katrina to Hurricanes Rita and Wilma. This provision created the following new I.R.C. Sections:

- I.R.C. § 1400Q(a)[18] – Tax-Favored Withdrawals From Retirement Plans. Codifies Section 101 of the KETRA and expands the provision to include qualified distributions relating to Hurricanes Rita and Wilma. For purposes of Hurricane Rita, a qualified distribution includes a distribution from an eligible retirement plan made on or after September 23, 2005, and before January 1, 2007, to an individual whose principal place of abode on September 23, 2005, is located in the Hurricane Rita disaster area and who has sustained an economic loss by reason of Hurricane Rita. For purposes of Hurricane

[15] Pub. L. No. 109-135, 119 Stat. 2577 (to be codified in scattered sections of 26 U.S.C.).
[16] Source: *TECHNICAL EXPLANATION OF H.R. 3768, THE "KATRINA EMERGENCY TAX RELIEF ACT OF 2005" AS PASSED BY THE HOUSE AND THE SENATE ON SEPTEMBER 21, 2005*, Joint Committee on Taxation, JCX-69-05 (September 2005).
[17] 26 U.S.C. § 1400O (2005).
[18] 26 U.S.C. § 1400Q (2005).

Wilma, a qualified distribution includes a distribution from an eligible retirement plan made on or after October 23, 2005, and before January 1, 2007, to an individual whose principal place of abode on October 23, 2005, is located in the Hurricane Wilma disaster area and who has sustained an economic loss by reason of Hurricane Wilma.

- I.R.C. § 1400Q(b) – Recontributions of Withdrawals for Home Purchases. Codifies Section 102 of the KETRA and expands the provision to allow recontribution of certain distributions from a Section 401(k) plan, a Section 403(b) annuity, or an IRA to qualified Hurricane Rita distributions and to qualified Hurricane Wilma distributions.
- I.R.C. § 1400S(b)[19] – Suspension of Certain Limitations on Personal Casualty Losses. Codifies Section 402 of the KETRA and expands the provision to include losses that arise on or after September 23, 2005, in the Hurricane Rita disaster area and are attributable to Hurricane Rita and losses that arise on or after October 23, 2005, in the Hurricane Wilma disaster area and are attributable to Hurricane Wilma.
- Section 1400S(d) – Special Rule for Determining Earned Income Credit. Codifies Section 406 of the KETRA and expands the rule governing the Hurricane Katrina elections to permit certain qualified individuals affected by Hurricanes Rita and Wilma to make similar elections. In the case of Hurricane Rita, certain qualified individuals may elect to calculate both the EITC and the refundable Additional Child Tax Credit for the taxable year that includes September 23, 2005, using the earned income from the prior taxable year. In the case of Hurricane Wilma, certain qualified individuals may elect to calculate both the EITC and the refundable Additional Child Tax Credit for the taxable year that includes October 23, 2005, using the earned income from the prior taxable year.

Cost-of-Living (Inflation) Adjustments for TY 2005

Revenue Procedure 2004-71[20] contained the following seven inflation-adjusted items:

1) Child Tax Credit. For TY 2005, the value used in I.R.C. § 24(d)(1)(B)(i) in determining the amount of the Additional Child Tax Credit that may be refundable is $11,000.

2) Hope and Lifetime Learning Credits. For TY 2005, the $1,500 maximum Hope Credit for each eligible student and the $2,000 maximum Lifetime Learning Credit for each return begin to phase out when the taxpayer's MAGI reaches $43,000 ($87,000 for joint returns) and are completely phased out when the MAGI reaches $53,000 ($107,000 for joint returns). If a student is eligible for both Credits in TY 2005, the taxpayer can claim either Credit but not both.

[19] 26 U.S.C. § 1400S (2005).
[20] Rev. Proc. 2004-71, 2004-50 I.R.B. 970.

3) Earned Income Tax Credit. For TY 2005, the earned income amounts,[21] maximum amounts of the EITC, and threshold amounts for phaseout of the Credit under I.R.C. § 32(b) were increased. For example, taxpayers filing as Single, Surviving Spouse, or Head of Household with earned income of less than $35,263 ($37,263 for joint returns) and 2 or more qualifying children can claim up to a maximum credit of $4,400. However, the amount of credit that can be claimed begins to phase out when the taxpayer's AGI (or earned income, if greater) reaches $14,370 ($16,370 for joint returns) and is completely phased out when the taxpayer's AGI (or earned income, if greater) reaches $35, 263 ($37,263 for joint returns). Also, the investment income amount under I.R.C. § 32(i)(1) was increased to $2,700.

4) Standard Deduction. For TY 2005, the standard deduction amounts under I.R.C. § 63(c)(2)[22] were increased to $5,000 for Single or Married Filing Separately filing statuses, $7,300 for Head of Household filing status, and $10,000 for Married Filing Jointly or Surviving Spouse filing statuses. The standard deduction amount under I.R.C. § 63(c)(5) for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of $800 or the sum of $250 and the individual's earned income. The additional standard deduction amounts under I.R.C. § 63(f) for the aged and for the blind are $1,000 each or $1,250 each if the individual is also unmarried and not a surviving spouse.

5) Income from United States Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses. For TY 2005, the exclusion under I.R.C. § 135[23] (regarding income from United States savings bonds for taxpayers who pay qualified higher education expenses) begins to phase out when the taxpayer's MAGI reaches $61,200 ($91,850 for joint returns) and is completely phased out when the MAGI exceeds $76,200 ($121,850 for joint returns).

6) Personal Exemption. For TY 2005, the personal exemption under I.R.C. § 151(d)[24] is $3,200.

7) Interest on Education Loans. For TY 2005, the $2,500 maximum deduction for interest paid on qualified education loans under I.R.C. § 221[25] begins to phase out when the taxpayer's MAGI reaches $50,000 ($105,000 for joint returns) and is completely phased out when the MAGI exceeds $65,000 ($135,000 for joint returns).

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[21] The earned income amount is the amount of earned income at or above which the maximum amount of the EITC is allowed. Earned income generally includes wages, salaries, tips, and other employee compensation, plus net earnings from self-employment.
[22] 26 U.S.C. § 63 (2004).
[23] 26 U.S.C. § 135 (2004).
[24] 26 U.S.C. § 151 (2004).
[25] 26 U.S.C. § 221 (2004).

Appendix VI

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

COMMISSIONER
WAGE AND INVESTMENT DIVISION

RECEIVED
SEP 11 2006

September 8, 2006

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: for Richard J. Morgante Pamela G. Watson
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Individual Tax Returns Were Timely Processed in 2006, but Opportunities Exist to Improve Verification of Certain Tax Deductions (Audit # 200640016)

I have reviewed your draft report and appreciate your acknowledgement of the enormity and complexity of preparing for and delivering a successful filing season. I am pleased by your finding that we correctly implemented the tax law changes impacting Tax Year (TY) 2005 processing, and timely and accurately processed returns. This was one of our most successful filing seasons, evidenced by the fact, that through July 28, 2006, we processed nearly 128.5 million returns and issued 97.5 million refunds totaling over $214 billion. Out of that total, our Customer Accounts Data Engine (CADE) processed 6.6 million refunds totaling over $3.4 billion, compared to the 1.4 million refunds totaling $426 million that CADE processed in 2005. The number of electronically filed returns increased by 6.5 percent, and the number of returns filed online by taxpayers from home increased 17 percent compared to 2005.

The 2006 Filing Season was unusual due to the passage of significant new tax legislation aimed at assisting taxpayers affected by Hurricanes Katrina, Rita, and Wilma which struck the Gulf Coast in 2005. Additionally, we implemented tax law changes resulting from the Working Families Tax Relief Act of 2004 and other legislation that became effective in TY 2005.

We do not agree that it is necessary to revise the Individual Retirement Arrangement (IRA) worksheet and tax instructions to the extent of your recommendation. However, we have revised the TY 2006 worksheet to reinforce the instructions.

Otherwise, we have already taken steps to address the recommendations in your report. We agree with your recommendation to ensure a Sales Tax Deduction Calculator is available on IRS.gov to make it easier for taxpayers to determine their state sales tax deduction, and already have plans to develop a web-based version of the Sales Tax Deduction Calculator in time for the TY 2006 Filing Season.

We acknowledge that some taxpayers are improperly claiming both the Tuition and Fees Deduction and Education Credits. In anticipation of legislation to extend the deduction, we have begun development of a new form for the tuition and fees deduction that will prevent taxpayers from improperly claiming both deductions. However, this change is dependent on Congress enacting legislation to extend the Tuition and Fees Deduction beyond TY 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 Betsy Kinter, Director, Customer Account Services, at (404) 338-8910.

Attachment

Attachment

RECOMMENDATION 1

The Commissioner, W&I Division, should revise the IRA worksheet in all tax instructions where this worksheet is used to clearly state that taxpayers over age 70½ cannot take the IRA deduction.

CORRECTIVE ACTION

We do not agree with this recommendation. The instructions for Form 1040, Line 32, IRA Deduction, already state that the taxpayer should "read the following list before you fill in the worksheet." The first item on the list explains that if you were 70½ or older at the end of the TY, you cannot deduct any contributions made to your traditional IRA or treat them as nondeductible contributions. We do not believe that repeating the instruction on the worksheet is the proper solution for taxpayers who erroneously complete the worksheet.

However, we will revise the worksheet for TY 2006 to emphasize the importance of reading the list on page 31 of the instructions, the first item of which is the explanation that if the taxpayer was age 70½ or older at the end of the TY, contributions to a traditional IRA can not be deducted or treated as non-deductible contributions.

IMPLEMENTATION DATE

December 15, 2006

RESPONSIBLE OFFICIAL

Director, W&I CARE

CORRECTIVE ACTION MONITORING PLAN

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

RECOMMENDATION 2

If the sales tax deduction is extended to TY 2006 and beyond, the Commissioner, W&I Division, should ensure the Sales Tax Calculator is available on IRS.gov to assist individuals in calculating their deductions.

CORRECTIVE ACTION

We agree with this recommendation, and we will develop a web-based version of the Sales Tax Deduction Calculator in time for the TY 2006 Filing Season.

IMPLEMENTATION DATE

December 15, 2006

RESPONSIBLE OFFICIAL

Director, Research Analysis & Statistics, Office of the Commissioner

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

RECOMMENDATION 3
If Congress extends the tuition and fees deduction to TY 2006 and beyond, the Commissioner, W&I Division, should create a new form for the tuition and fees deduction to ensure compliance with the tax legislation. The form should require taxpayers to specifically identify the student, by name and Social Security Number, who qualifies for the tuition and fees deduction.

CORRECTIVE ACTION
We agree with this recommendation. In anticipation of legislation to extend the deduction, we have begun developing a new form for the tuition and fees deduction. We are monitoring the progress of the legislation to ensure the form will be available in a timely manner. The projected implementation date for the new form is dependent on the enactment of the legislation.

IMPLEMENTATION DATE
The projected implementation date for the new form is dependent on the enactment of the legislation.

RESPONSIBLE OFFICIAL
Director, W&I CARE

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