



Treasury Inspector General for Tax Administration

PROCESSING OF CARRYBACK LOSS CLAIMS NEEDS TO BE IMPROVED TO ENSURE TAXPAYERS RECEIVE ACCURATE REFUNDS

Issued on February 21, 2008

Highlights

Highlights of Report Number: 2008-40-062 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

When taxpayers have significant losses from business activities or natural disasters, their deductions may exceed their income for the tax year, resulting in a net operating loss (loss). Taxpayers can file claims to apply (carry back) these losses to income in prior years, which results in refunds of taxes previously paid. The Internal Revenue Service (IRS) processed 60,865 individual carryback loss refunds totaling approximately \$1.2 billion in Fiscal Year 2007. Errors on these claims cause delays in processing and additional work for both taxpayers and the IRS.

WHY TIGTA DID THE AUDIT

This audit was initiated because the computation of claims for carryback losses can be very complex and may require taxpayers to make several adjustments. This complexity has led to errors on a significant number of taxpayers' claims for carryback loss refunds.

By carrying a loss back to a prior tax year, taxpayers may be entitled to refunds of prior year taxes paid. Taxpayers can claim this carryback refund using the Application for Tentative Refund (Form 1045) or the Amended U.S. Individual Income Tax Return (Form 1040X). The overall objective of this review was to determine whether taxpayers properly filed and the IRS accurately processed carryback loss claims for refunds submitted by individuals on Form 1045 or Form 1040X.

WHAT TIGTA FOUND

The IRS has processes to review these claims. However, it does not always identify and correct the errors before the claims are processed and the refunds are paid. TIGTA reviewed a statistical sample of 84 claims for carryback loss refunds that posted to the IRS Master File between August 1, 2004, and July 30, 2005, and determined 42 (50 percent) contained at least 1 error. The IRS

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did not correct the errors on 24 (57 percent) of the 42 claims that had errors, resulting in \$732,941 in additional refunds due taxpayers and \$1,126,501 in additional tax due the IRS. The majority of the errors on the refund claims fall into three common categories: Alternative Minimum Tax (AMT), charitable contributions deductions, and IRS changes to the originally filed loss year tax return.

Unclear tax form instructions and tax publications appear to be contributing to taxpayer errors. IRS procedures for working carryback claims are also vague and open to interpretation.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Director, Media and Publications, revise the applicable instructions for claiming the carryback loss as they relate to the charitable contributions deduction and the AMT, and change the instructions for Forms 1045 and 1040X as they pertain to carryback losses to require the taxpayer to attach the AMT form for each carryback year. The Director, Accounts Management, should work with the Office of National Public Liaison to alert the preparer community of the need to be aware of issues affecting the AMT and the charitable contributions deduction; revise the procedures for working carryback refunds to improve the identification and resolution of errors before the refunds are paid; change the procedures for verifying the carryback claim to require employees to ensure the AMT form is attached for each carryback year; and work with the Associate Chief Information Officer, Applications Development, to modify the Desktop Integration tool for the alternative tax net operating loss deduction.

In their response to the report, IRS officials stated they agreed with three of the recommendations and have taken or plan to take appropriate corrective actions. Management partially agreed with the recommendation to revise the instructions for Forms 1045 and 1040X, and TIGTA agrees that the planned corrective action is adequate. IRS officials disagreed with two recommendations requiring the taxpayer to attach the AMT form for each carryback year and requiring that employees ensure the form is attached. The IRS indicated that requiring the taxpayer to attach this form would impose an unreasonable burden and likely be viewed as a violation the Paperwork Reduction Act of 1995. TIGTA believes the only additional burden to the taxpayer would be to attach a copy of the Form 6251 for each loss year to his or her carryback claim. Taxpayers are already required to complete the Form 6251, and taxpayers voluntarily include it on most of the claims filed.

READ THE FULL REPORT

To view the report, including the scope, methodology, and full IRS response, go to:

<http://www.treas.gov/tigta/auditreports/2008reports/200840062fr.pdf>.

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