TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

The 2008 Filing Season Was Generally Successful Despite the Challenges of Late and Unexpected Tax Legislation

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Phone Number | 202-622-6500
Email Address | inquiries@tigta.treas.gov
Web Site | http://www.tigta.gov

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 30, 2008

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The 2008 Filing Season Was Generally Successful Despite the Challenges of Late and Unexpected Tax Legislation (Audit # 200840018)

This report presents the results of our review to evaluate whether the Internal Revenue Service (IRS) accurately processed individual paper and electronic tax returns[1] in a timely manner during the 2008 Filing Season. The filing season is critical for the IRS because it is the time when most individuals file their income tax returns and contact the IRS if they have questions about specific tax laws or filing procedures. This audit focused on implementation of new tax law and administrative changes[2] that affected Tax Year 2007 returns. In addition, we reviewed the corrective actions taken for the conditions identified in our review of the 2007 Filing Season[3] to determine whether they were adequate.

Impact on the Taxpayer

Each year, legislated tax law changes create challenges for both the IRS and individual taxpayers. Moreover, the 2008 Filing Season presented additional challenges due to the late enactment of two significant tax laws. Overall, the IRS implemented these changes correctly with no significant delays in the processing of tax returns during the 2008 Filing Season. Through May 30, 2008, the IRS had received 144.2 million individual tax returns. Of those, approximately 86.7 million were electronically filed and approximately 57.5 million were filed on paper.

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[1] See Appendix VI for a glossary of terms.
[2] Appendix V provides a synopsis of tax law and administrative changes that affected the 2008 Filing Season.
[3] *The 2007 Tax Filing Season Was Generally Successful, and Most Returns Were Timely and Accurately Processed* (Reference Number 2007-40-187, dated September 21, 2007).

Synopsis

The 2008 Filing Season presented additional challenges for the IRS due to the late and unexpected enactment of two significant tax laws.

- The Tax Increase Prevention Act of 2007[4] limited the number of taxpayers who would be subject to the Alternative Minimum Tax for Tax Year 2007.
- The Economic Stimulus Act of 2008[5] provided an economic stimulus payment to more than 130 million people.

In spite of the additional challenges, the IRS generally had a successful 2008 Filing Season. Most key tax law and administrative changes were correctly implemented, and the IRS completed processing returns on schedule and issued refunds within the required 45 calendar days of the April 15, 2008, due date.[6] Individual return receipts for electronic and paper returns exceeded the IRS' estimates and the receipts from the same time last year by more than 11 percent. The largest increase was in the number of paper U.S. Individual Income Tax Returns (Form 1040A), which increased by almost 84 percent from the same time last year. This increase was largely due to returns filed by taxpayers not normally required to file tax returns who filed Tax Year 2007 returns so that they could receive the economic stimulus payment.

While the IRS was able to meet the challenges of late and unexpected enacted legislation and accurately process most returns in a timely manner, we did identify opportunities to improve the processing of some tax deductions:

- Taxpayers improperly claimed and were allowed the Qualified Mortgage Insurance Premiums deduction.
- Taxpayers age 70½ or older improperly claimed and were allowed the Individual Retirement Account deduction.
- Taxpayers did not claim the sales tax deduction.
- Taxpayers who improperly claimed a "dual benefit" for both the tuition and fees deduction and the Education Credit are not receiving the dual benefit. However, improvements still need to be made in processing these returns.

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[4] Pub. L. No. 110-166, 121 Stat. 2461.
[5] Pub. L. No. 110-185, 122 Stat. 613.
[6] Internal Revenue Code Section 6611 (e) (2002).

Recommendations

We recommended that the Commissioner, Wage and Investment Division:

- Ensure that the computer systems are programmed to identify taxpayer returns claiming the Qualified Mortgage Insurance Premiums deduction with Adjusted Gross Income that exceeds the maximum phase-out limitations. This should include programming to reject electronically filed returns with this condition and to forward paper returns to the Error Resolution System for correction.
- Ensure that the computer systems are programmed to identify taxpayer returns claiming Individual Retirement Account deductions for taxpayers age 70½ or older. This should include programming to reject electronic returns with this condition and to forward paper returns to the Error Resolution System for correction.
- Continue to inform taxpayers that they are eligible for a sales tax deduction if they itemize and do not claim a State income tax deduction, if the sales tax deduction is extended beyond Tax Year 2007. The possibility of calculating the sales tax deduction for taxpayers if it is not claimed or sending a notice to the affected taxpayers should also be considered.
- Revise or verify the computer programming to ensure all taxpayers claiming a dual benefit are identified if the tuition and fees deduction is extended beyond Tax Year 2007. This should include verifying the programming to forward paper returns with this condition to the Error Resolution System for correction.

Response

IRS management agreed with two of our four recommendations, partially agreed with one recommendation, and disagreed with one recommendation. The IRS agreed to update its programs to identify taxpayer returns improperly claiming the Qualified Mortgage Insurance Premium deduction. When the Adjusted Gross Income exceeds the threshold, paper tax returns will be forwarded to the Error Resolution System for correction and *e-filed* tax returns will be rejected. The IRS also agreed to ensure employees are correctly addressing cases identified where taxpayers improperly claimed a "dual benefit" for both the tuition and fees deduction and the Education Credit. To assist in reducing employee errors, additional procedures were implemented.

IRS management did not agree to update computer programs to identify taxpayer returns claiming Individual Retirement Account deductions for taxpayers age 70½ or older. IRS management cited that they did not have math error authority to enforce this condition. For the partially agreed to recommendation, the IRS agreed to continue to inform taxpayers of their eligibility for the sales tax deduction and plans to add a cautionary statement to the 2008 instructions for the U.S. Individual Income Tax Return (Form 1040) Itemized Deductions (Schedule A), similar to the one added in 2006. However, the IRS did not agree to calculate the sales tax deduction for the taxpayer or to send a notice, citing that it cannot calculate the deduction for sales tax with consistent accuracy because the deduction is based on the State in which the taxpayer resided on January 1st of the tax year. Taxpayers can live in more than one State in any tax year and seldom inform the IRS they have moved until they file a tax return.

IRS management agreed with the outcome measure associated with our recommendation to identify taxpayer returns improperly claiming the Qualified Mortgage Insurance Premiums. IRS management conditionally agreed with our outcome relative to the tuition and fees deduction/Education Credit. The IRS did not agree with the potential outcome measures relative to taxpayers age 70½ or older improperly claiming the Individual Retirement Account deduction and taxpayers who did not claim the sales tax deduction. Management's complete response to the draft report is included as Appendix VII.

Office of Audit Comment

IRS management disagreed with our recommendation and associated outcome measure related to identifying taxpayers who are age 70½ or older and are improperly claiming an Individual Retirement Account deduction. However, management included an alternative approach it plans to initiate to identify and address these cases. Consequently, we believe the outcome measure remains valid. The IRS also disagreed with our outcome measure related to the number of taxpayers entitled to the sales tax deduction as well as the associated amount of tax refunds. Although management agrees with the audit results which identified taxpayers adversely affected by not claiming the sales tax deduction, it objects to the use of an assumed tax rate and an average deductible amount to quantify the outcome. Notwithstanding management's position, we continue to believe the methodology we used to identify these taxpayers and quantify the outcome was appropriate.

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
AMT	Alternative Minimum Tax
e-filed; e-filing	Electronically filed; electronic filing
HSA	Health Savings Accounts
IRA	Individual Retirement Account (also known as Individual Retirement Arrangement)
IRS	Internal Revenue Service
I.R.C.	Internal Revenue Code
QMIP	Qualified Mortgage Insurance Premiums
TY	Tax Year

Background

The filing season[1] is critical for the Internal Revenue Service (IRS) because it is the time when most individuals file their income tax returns and contact the IRS if they have questions about specific tax laws or filing procedures. The IRS had received 144.2 million individual tax returns as of May 30, 2008. Of those, approximately 86.7 million were electronically filed (*e-filed*) (an increase of 12.3 percent from this time in 2007), and approximately 57.5 million were filed on paper (an increase of 10.4 percent from this time in 2007). Among the electronic filing (*e-filing*) options available for individual taxpayers, use of online *e-filed* returns continued to experience the fastest growth–from 22.2 million to 26.4 million returns.

The 2008 Filing Season presented additional challenges for the IRS due to late and unexpected enactment of two significant tax laws.

A significant challenge for the IRS in processing these tax returns is implementation of new tax law changes.[2] Each year, legislated tax law changes create challenges for both the IRS and individual taxpayers. Before each filing season begins, the IRS must identify new tax law and administrative changes and, where possible, revise the various tax forms, instructions, and publications. The IRS must also reprogram its computer systems to ensure that returns are accurately processed. The 2008 Filing Season presented additional challenges due to the late and unexpected enactment of two significant tax laws:

- The Tax Increase Prevention Act of 2007,[3] signed on December 26, 2007, limited the number of taxpayers who would be subject to the Alternative Minimum Tax (AMT) for Tax Year (TY) 2007. The Act extended the allowance of personal credits against the AMT and increased the AMT exemption amounts to $44,350 for single individuals and $66,250 for married taxpayers filing jointly. This legislation provided AMT relief to an estimated 25 million taxpayers who would have been subject to higher taxes in TY 2007.

[1] See Appendix VI for a glossary of terms.
[2] Appendix V provides a synopsis of tax law and administrative changes that affected the 2008 Filing Season.
[3] Pub. L. No. 110-166, 121 Stat. 2461.

- The Economic Stimulus Act of 2008,[4] signed on February 13, 2008, was passed to energize the national economy. This legislation provided a stimulus payment generally ranging from $300 to $1,200 to more than 130 million people. Individuals can receive up to $600 and couples can receive up to $1,200, with an additional $300 for each qualifying child. To receive a stimulus payment, an individual must file a TY 2007 return with a valid Social Security Number. As of May 31, 2008, the IRS had received about 7.7 million additional tax returns from individuals who would not normally have been required to file returns.

During the 2008 Filing Season, the IRS processed individual income tax returns in five Wage and Investment Division Submission Processing sites located throughout the country. All of the five sites processed paper individual income tax returns, and all but the Atlanta, Georgia, Submission Processing Site processed *e-filed* individual income tax returns. Both paper and *e-filed* returns and related schedules are processed through the IRS computer systems and recorded on each individual's tax account at the Submission Processing 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 mathematical accuracy of the tax return data provided. If 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 Wage and Investment Division Headquarters in Atlanta; the Submission Processing function offices in Lanham, Maryland, and Cincinnati, Ohio; and the Austin Submission Processing Site during the period December 2007 through July 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

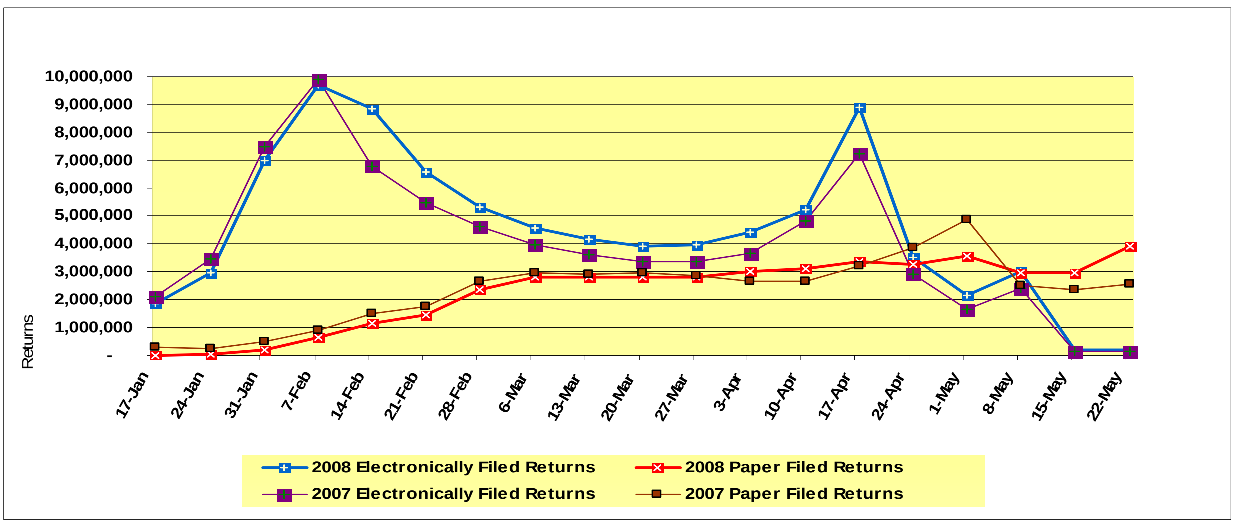
[4] Pub. L. No. 110-185, 122 Stat. 613.

Results of Review

The 2008 Filing Season Was Completed in a Timely Manner, and Most Returns Were Accurately Processed

The IRS had a successful 2008 Filing Season despite the challenges of the late and unexpected enactment of legislation to extend relief from the AMT and to provide taxpayers with economic stimulus payments. The IRS completed the processing of returns on schedule and issued refunds within the required 45 calendar days of the April 15, 2008, due date.[5] Total return receipts for *e-filed* and paper returns exceeded the IRS' estimates and the receipts from the same time last year by more than 11 percent. The largest increase was in the number of paper U.S. Individual Income Tax Returns (Form 1040A), which increased by almost 84 percent from the same time last year. This increase was largely due to returns filed by taxpayers not normally required to file tax returns who filed TY 2007 returns so they could receive the economic stimulus payment. Figure 1 compares the numbers of *e-filed* and paper returns processed during the 2007 and 2008 Filing Seasons.

Figure 1: Comparison of the Volumes of Tax Returns[6] Processed During the 2007 and 2008 Filing Seasons



Source: Our analysis of tax return processed data from the Individual Return Master File.

[5] Internal Revenue Code Section 6611 (e) (2002).
[6] This analysis includes U.S. Individual Income Tax Returns (Forms 1040 and 1040A), and Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ).

In addition, there continues to be a steady growth in *e-filing*, with the largest increase coming from taxpayers who used the Free File Program (22.58 percent). Figure 2 provides comparative statistics for the 2007 and 2008 Filing Seasons.

Figure 2: Comparative Filing Season Statistics

Cumulative Filing Season Data	2007 Actual As of June 1 (in thousands)	2008 Actual As of May 30 (in thousands)	% Change
Individual Income Tax Returns:			
Receipts	129,280	144,150	11.50%
Paper Returns Received	52,070	57,476	10.38%
Electronic Returns Received	77,210	86,674	12.26%
Filed Through Tax Practitioner	55,119	60,231	9.27%
Filed From Home Computer (includes Free File)	22,191	26,444	19.17%
Taxpayers Using Free File	3,795	4,652	22.58%

Source: IRS 2008 Filing Season Weekly Reports. Percentages are rounded.

In most instances, the IRS correctly implemented the key tax law and administrative changes for the 2008 Filing Season. Tax products required for the preparation of individual income tax returns were correctly updated with new, expiring, or pending tax law provisions, including the credit for prior year minimum tax which was made refundable. We did identify two publications, *Tax-Sheltered Annuity Plans (403(b) Plans) For Employees of Public Schools and Certain Tax-Exempt Organizations* (Publication 571) and *Your Federal Income Tax* (Publication 17), with incomplete updates. Publication 571 had not been updated with regard to increased Adjusted Gross Income (AGI) limitations for the Retirement Savings Contributions Credit, and Publication 17 did not address whistleblower fees. After we notified the IRS, it corrected Publication 571 immediately online and agreed to correct Publication 17 next year.

Despite the challenges of the late and unexpected enacted legislation, the IRS properly implemented the following tax law and administrative changes:

- Changes to the AMT as a result of the Tax Increase Prevention Act of 2007. These changes included increasing the AMT exemption amounts for TY 2007 to $66,250 for Married Filing Jointly or Qualifying Widow(er), $44,350 for Single or Head of Household, and $33,125 for Married Filing Separately taxpayers.

- Increased AGI limits for the Retirement Savings Contributions Credit and Individual Retirement Accounts (IRA) as a result of the Pension Protection Act of 2006.[7]
- Changes to Health Savings Accounts (HSA) as a result of the Tax Relief and Health Care Act of 2006.[8] These changes included the contribution limitation not being reduced for part-year coverage, the repeal of the annual deductible limitation on HSA contributions, and a one-time rollover of the balance or an amount less than the balance of a Health Reimbursement Arrangement or Health Flexible Spending Arrangement into an HSA.
- Increased Earned Income Tax Credit, standard deduction, and exemption amounts.

However, while the IRS was able to meet the challenges created by the late and unexpected enacted legislation and accurately process most returns in a timely manner, we did identify opportunities to improve the processing of some tax deductions. These include:

- Taxpayers improperly claimed and were allowed the Qualified Mortgage Insurance Premiums (QMIP) deduction.
- Taxpayers age 70½ or older improperly claimed and were allowed the IRA deduction.
- Taxpayers did not claim the sales tax deduction.
- Taxpayers improperly claimed and were allowed a "dual benefit" for both the tuition and fees deduction and the education credit.

Late enactment of the AMT legislation

The IRS began processing paper tax returns on January 7, 2008, and *e-filed* tax returns on January 11, 2008. However, to achieve these dates, the IRS did not process until February 11, 2008, tax returns that included the following five tax forms affected by the AMT legislation:

Processing of some tax returns was delayed due to late enactment of the AMT legislation.

- Child and Dependent Care Expenses for Form 1040A Filers (Schedule 2 (Form 1040A)).
- District of Columbia First-Time Homebuyer Credit (Form 8859).
- Education Credits (Hope and Lifetime Learning Credits) (Form 8863).
- Mortgage Interest Credit (Form 8396).
- Residential Energy Credits (Form 5695).

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[7] Pub. L. No. 109-280, 120 Stat. 780.
[8] Pub. L. No. 109-432, 120 Stat. 2922.

Delaying the processing of tax returns with these Forms allowed the IRS time to update and test its systems for the needed changes to the Forms without major disruptions to other return processing operations. To prevent these Forms from being *e-filed* before February 11, 2008, the IRS put in place programming that would reject a tax return with any of the Forms. A total of 90,262 returns with these 5 Forms were rejected through February 11, 2008. The processing of paper tax returns filed with any of these Forms before February 11 was suspended by the IRS until its systems were ready to process the Forms.

Processing the economic stimulus payments

Taxpayers had to file a Tax Year 2007 return to receive the economic stimulus payment. No other action, form, or call was necessary. The IRS determined the taxpayer's eligibility, calculated the stimulus payment amount, and sent the payment. The Department of the Treasury estimated up to 20 million additional tax returns would be filed by individuals who were not normally required to file tax returns so they could receive the economic stimulus payment. However, as of May 31, 2008, the IRS had received only about 7.7 million paper and *e-filed* "stimulus-only" returns.

These additional returns did create additional volumes of error returns. Much of this increase came from Forms 1040A, which traditionally have higher error rates. Paper receipts of this Form increased by 84 percent over the same time last year, and most of this increase was due to the economic stimulus payments. To ensure that the workload was balanced and that returns were processed in a timely manner, the IRS shipped returns between Submission Processing sites.

We are performing a series of reviews to assess all aspects of the IRS' planning for and issuance of stimulus payments.[9]

Use of split refunds

Beginning in 2007, an individual taxpayer could file a Direct Deposit of Refund to More Than One Account (Form 8888) to elect to have his or her Federal income tax refund split and electronically deposited into up to three accounts (e.g., checking, savings, or IRA). In addition, the accounts could be with up to three different United States financial institutions, including banks, brokerage firms, or credit unions.

As of May 30, 2008, a total of 225,867 Forms 8888 had been filed to split refunds totaling $816.9 million. This represents a 180 percent increase over the same period last year when only 80,673 Forms 8888 had been received. The increase is probably attributable to the addition of

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[9] The economic stimulus payments were not included in this review. The Treasury Inspector General for Tax Administration issued two reports on the economic stimulus payments: *Evaluation of Planning Efforts for the Issuance of Economic Stimulus Payments* (Reference Number 2008-40-149, dated July 31, 2008); and *Evaluation of the Computation of Economic Stimulus Payments* (Reference Number 2008-40-174, dated September 4, 2008).

this option in tax preparation software. Last year, two of the largest providers of tax preparation software did not offer the split refund option in their software.

Some Taxpayers Improperly Claimed and Were Allowed the Qualified Mortgage Insurance Premiums Deduction

Some taxpayers improperly claimed and were allowed the QMIP deduction even though their AGIs exceeded income phase-out limitations. Through May 30, 2008, we had identified 4,988 taxpayers who incorrectly claimed more than $7.4 million in QMIP deductions. We estimate that the revenue loss was approximately $1.4 million.[10]

The Tax Relief and Health Care Act of 2006 amended the tax code to allow premiums paid or accrued for "qualified mortgage insurance" with respect to home acquisition debt on a qualified home to be deductible as an itemized deduction. The deductible amount is reduced by 10 percent for every $1,000 ($500 for Married Filing Separately) by which AGI exceeds $100,000 ($50,000 for Married Filing Separately). The deduction cannot be taken if the AGI is more than $109,000 ($54,500 for Married Filing Separately). Originally, the QMIP deduction was going to be available only during TY 2007. However, legislation passed at the end of Calendar Year 2007 extended the deduction through December 31, 2010.

Line 13 was changed on the Itemized Deductions and Interest and Dividend Income (Schedules A&B (Form 1040)[11]) to enable taxpayers to claim this deduction. Figure 3 provides an example of where this deduction is claimed on Schedule A.

Figure 3: Example of Schedule A Line 13 Used to Claim the QMIP Deduction

Interest You Paid (See page A-5.)	10	Home mortgage interest and points reported to you on Form 1098	10	
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-6 and show that person's name, identifying no., and address ▶	11	
Note. Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-6 for special rules	12	
	13	Qualified mortgage insurance premiums (See page A-7)	13	
	14	Investment interest. Attach Form 4952 if required. (See page A-7.)	14	
	15	Add lines 10 through 14		15

Source: 2007 Schedules A&B (Form 1040).

Taxpayers were allowed the erroneously claimed QMIP deduction because IRS computer systems were not programmed to identify individuals claiming the QMIP deduction when their

[10] This was calculated using a method based on average taxable incomes per filing status, which resulted in an average tax rate of 18.3 percent. See Appendix IV for details.

[11] U.S. Individual Income Tax Return.

AGIs exceeded the income limitations. In addition, IRS employee guidance was not updated regarding how to work cases in which taxpayers claimed a QMIP deduction with an AGI exceeding the income limitations. Although IRS procedures were not updated, tax products to alert taxpayers of the AGI limitations on this deduction were correctly updated.

Recommendation

Recommendation 1: The Commissioner, Wage and Investment Division, should ensure that the computer systems are programmed to identify taxpayer returns claiming the QMIP deduction with AGI that exceeds the maximum phase-out limitations. This should include programming to reject *e-filed* returns with this condition and to forward paper returns to the Error Resolution System for correction.

> **Management's Response:** IRS management agreed with this recommendation. Submission Processing will input a Unified Work Request requesting programming that limits the deduction for the QMIP so that when the AGI exceeds the threshold, the paper return will be forwarded to the Error Resolution System for correction. In addition, programming will be requested to reject *e-filed* tax returns for this condition.

Some Taxpayers Age 70½ or Older Improperly Claimed and Were Allowed the Individual Retirement Account Deduction

During the 2006 and 2007 Filing Seasons, we reported that taxpayers age 70½ or older improperly claimed the IRA deduction. For the 2008 Filing Season, as of May 30, 2008, we had identified 1,779 taxpayers age 70½ or older who had improperly claimed and were allowed nearly $3.9 million in IRA deductions.[12] The estimated revenue loss was $584,225.[13] Figure 4 compares the numbers of taxpayer accounts identified from the last three filing seasons.

[12] These exceptions did take into account the age of the spouse if the taxpayers filed as Married Filing Jointly.
[13] We used a conservative 15 percent tax rate to compute the estimated revenue loss (i.e., 15 percent times $3,894,830 of IRA deductions equals $584,225). See Appendix IV for details.

Figure 4: Taxpayers Age 70½ or Older Claiming the IRA Deduction in Filing Seasons 2006-2008

Filing Season	Taxpayers Improperly Claiming the Deduction	Amount of IRA Deductions	Estimated Revenue Loss
2006	1,826	$4,009,485	$601,423
2007	1,693	$3,533,993	$530,099
2008	1,779	$3,894,830	$584,225
Totals	5,298	$11,438,308	$1,715,747

Source: Our analysis of returns processed with IRA deductions for the 2006, 2007, and 2008 Filing Seasons.

Some taxpayers are also improperly claiming the IRA deduction for more than 1 year. Of the 5,298 taxpayer accounts identified, we found that 563 taxpayers claimed the deduction for multiple years as follows:

An IRA deduction cannot be taken if the individual is age 70½ or older before the end of the taxable year for which the contribution is made.

- 400 taxpayers claimed improper deductions totaling more than $1.7 million for 2 different years.
- 163 taxpayers claimed improper deductions totaling more than $909,000 for all 3 years.

The IRA deduction was increased to $5,000 for a taxpayer age 50 or older at the end of 2006. However, the Internal Revenue Code (I.R.C.)[14] states that no deduction will be allowed as a benefit to any individual who is age 70½ or older before the end of the taxable year for which the contribution is made.

In our previous reviews of this deduction, we believed that the IRA Deduction Worksheet instructions did not clearly inform taxpayers that they could not deduct any contributions made to a traditional IRA if they were age 70½ or older at the end of the year. We previously recommended that the IRA Deduction Worksheet be revised in all the tax instructions where this Worksheet was included to clearly state that taxpayers age 70½ or older could not take the IRA deduction. The IRS revised the Worksheet for the 2007 Filing Season but not to the extent that we had recommended.

When we reported this same issue for the 2007 Filing Season, we again recommended that the IRA Deduction Worksheet clearly state that taxpayers age 70½ or older cannot take the IRA

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[14] 26 U.S.C. § 219 (2004).

deduction. The IRS agreed with our recommendation and further revised the IRA Deduction Worksheet and its instructions for the 2008 Filing Season to thoroughly emphasize that taxpayers age 70½ or older cannot take the deduction. Figure 5 provides the cautionary statement added to the Worksheet.

Figure 5: Caution Included in the Form 1040 Instructions for the IRA Deduction

> CAUTION *If you were age 70½ or older at the end of 2007, you cannot deduct any contributions made to your traditional IRA or treat them as nondeductible contributions.* ***Do not*** *complete this worksheet for anyone age 70½ or older at the end of 2007. If you are married filing jointly and only one spouse was under age 70½ at the end of 2007, complete this worksheet only for that spouse.*

Source: 2007 Form 1040 instructions.

We believe that the current IRA Deduction Worksheet instructions are clear and no other changes are required. However, taxpayers continue to improperly claim the IRA deduction.

Recommendation

Recommendation 2: The Commissioner, Wage and Investment Division, should ensure that the computer systems are programmed to identify taxpayer returns claiming IRA deductions for taxpayers age 70½ or older. This should include programming to reject *e-filed* returns with this condition and to forward paper returns to the Error Resolution System for correction.

> ***Management's Response:*** IRS management did not agree with this recommendation or the related outcome measure. They do not currently have math error authority to enforce this condition because it requires information not present on the tax return per Section 6213 of the Internal Revenue Code. However, Submission Processing will partner with the Wage and Investment Division Compliance function and Small Business/Self-Employed Division Campus Compliance function to determine the feasibility of identifying such instances during processing and assigning an unallowable code for an Examination review.
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> ***Office of Audit Comments:*** While management disagrees with the recommendation and associated outcome measure, they addressed the intent of the recommendation by providing an alternative approach they plan to initiate to identify and address these cases. Consequently, we believe the outcome measure remains valid.

Many Taxpayers Did Not Claim the Sales Tax Deduction

The American Jobs Creation Act of 2004[15] was enacted in October 2004 and allowed taxpayers who itemize deductions the option of claiming either State and local sales taxes or State and local income taxes as a deduction. This legislation allowed the deduction in TYs 2004 and 2005. The

[15] Pub. L. No. 108-357, 118 Stat. 1418.

sales tax deduction is most advantageous to taxpayers living in the seven States[16] with no State income tax (because they paid no State income tax and therefore would otherwise be unable to take any deduction). Any taxpayer who itemizes deductions and does not claim a State income tax deduction is eligible to take the sales tax deduction. The deduction was extended through TY 2007 in the late passage of the Tax Relief and Health Care Act of 2006. Presently, Congress is considering legislation to extend this deduction or to make it permanent.

Almost 1.8 million eligible taxpayers did not claim sales tax deductions that could have resulted in $438 million in tax refunds for these individuals.

Many eligible taxpayers continued to not claim the sales tax deduction. For the 2005 through 2007 Filing Seasons, we reported that significant and increasing numbers of eligible taxpayers did not claim the sales tax deduction.[17] For the 2008 Filing Season, the number of eligible taxpayers decreased by 14 percent but was still significant–almost 1.8 million eligible taxpayers failed to claim the sales tax deduction as of May 30, 2008. We determined that these taxpayers are entitled to a potential $2.9 billion in missed deductions. Based on a conservative 15 percent tax rate, these taxpayers are entitled to a potential $438 million in tax refunds.[18]

Fortunately for these taxpayers, it is not too late to claim the deductions for which they are eligible. These taxpayers have the right to file amended tax returns and claim the missed deductions. Given that almost 1.8 million taxpayers might be entitled to as much as $438 million in tax refunds for TY 2007, we believe that the IRS should notify these taxpayers that they appear to be eligible for this deduction and could file amended tax returns to claim it.

Figure 6 illustrates the steady rise from TY 2004 to TY 2006 in the number of eligible taxpayers who did not claim the deduction. In TY 2007, the number fell slightly to 1.8 million eligible taxpayers. This was a decrease of 14 percent from TY 2006. Cumulatively, 6.4 million taxpayers who were eligible to claim the sales tax deduction have not claimed it thus far (some taxpayers might be included more than once in this total if they did not claim the sales tax deduction in more than 1 year).

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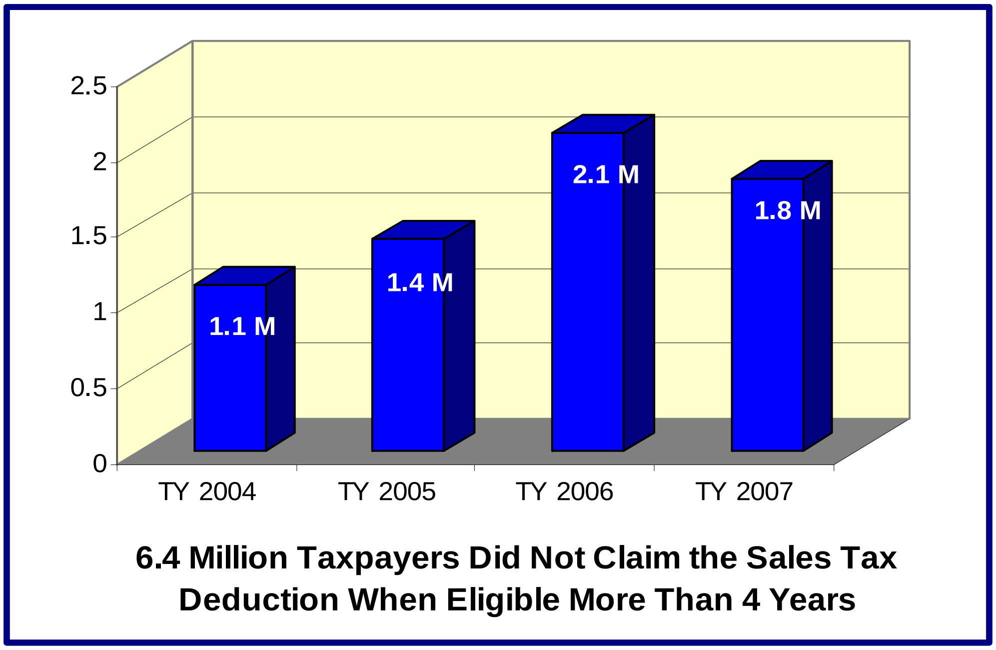
[16] Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

[17] *Individual Income Tax Returns Were Timely Processed in 2005; However, Implementation of Tax Law Changes Could Be Improved* (Reference Number 2006-40-024, dated December 2005), *Individual Tax Returns Were Timely Processed in 2006, but Opportunities Exist to Improve Verification of Certain Tax Deductions* (Reference Number 2006-40-164, dated October 10, 2006), and *The 2007 Tax Filing Season Was Generally Successful, and Most Returns Were Timely and Accurately Processed* (Reference Number 2007-40-187, dated September 21, 2007).

[18] See Appendix IV for details.

Figure 6: Number of Eligible Taxpayers Who Did Not Claim the Sales Tax Deduction for TYs 2004-2007



Source: Our electronic analysis of returns processed without the State and local sales tax deduction for TYs 2004-2007.

The original legislation that created the sales tax deduction allowed the deduction for only TYs 2004 and 2005. However, subsequent legislation passed in late December 2006 extended this deduction through TY 2007. The timing of this legislation did not allow the IRS to change tax forms or instructions, and the guidance on how to take the deduction had already been removed from the overall instructions for Schedules A&B (Form 1040). In addition, the IRS had removed the checkboxes on Line 5 separating State and local income taxes from sales taxes.

Corrective actions in response to recommendations we made during subsequent reviews are not ensuring that eligible taxpayers are claiming the sales tax deduction. These actions included:

- Revising the instructions for Schedules A&B (Form 1040) to include the Optional State Sales Tax Tables and instructions and providing the general State sales tax rate used to construct the tax tables for each State.
- Developing a web-based version of the Sales Tax Calculator that would be available on IRS.gov.
- Developing a communication strategy to inform taxpayers that they are eligible for a sales tax deduction if they itemize and do not claim a State tax deduction.

For the 2008 Filing Season, taxpayers had all the tools needed to calculate the sales tax deduction, but some still did not claim this tax benefit. We did identify a decrease from last year in the number of taxpayers not claiming the sales tax deduction, but the number is still higher than in the first 2 years the deduction was in effect. We believe that these taxpayers should be notified that they are eligible for this tax benefit as intended by Congress when the legislation was passed and extended.

Recommendation

Recommendation 3: The Commissioner, Wage and Investment Division, should continue to inform taxpayers that they are eligible for a sales tax deduction if they itemize and do not claim a State income tax deduction, if the sales tax deduction is extended beyond TY 2007. The possibility of calculating the sales tax deduction for the taxpayer if it is not claimed or sending a notice to the affected taxpayers should also be considered.

Management's Response: IRS management partially agreed with this recommendation but disagreed with the related outcome measurement. They agreed to continue to inform taxpayers of their eligibility for the sales tax deduction and plan to add a caution to the 2008 Instructions for Schedule A (Form 1040), similar to the one added in 2006, informing taxpayers that:

- The sales tax deduction expired in 2007.
- Congress was considering legislation to extend that deduction.
- The IRS web site will explain how to claim the deduction, if it is extended.

They do not agree to calculate the sales tax deduction for the taxpayer or to send a notice. Submission Processing cannot calculate the deduction for sales tax with consistent accuracy because the deduction is based on the State in which the taxpayer resided on January 1st of the tax year. Tax rates vary from State to State and taxpayers may live in more than one State in any tax year and seldom inform the IRS they have moved until they file a tax return. Thus, the IRS disagrees with the outcome measure because it objects to the use of an assumed tax rate and an average deductible amount to quantify the outcome.

Office of Audit Comment: We believe that the methodology used to identify these taxpayers and quantify the outcome was appropriate and provided a reasonable estimate of the $438 million tax effect. We assumed a conservative tax rate of 15 percent and an average deduction specifically derived for the 1.8 million taxpayers identified in the 7 States that did not claim either a State income tax deduction or sales tax deduction.

Improvements Have Been Made in Reducing the Number of Improperly Claimed "Dual Benefits" for Both the Tuition and Fees Deduction and the Education Credit

We have reported this issue for the last 5 years, and the corrective actions implemented in response to our 2007 Filing Season report[19] have considerably decreased the number of taxpayers claiming a dual benefit. However, through May 30, 2008, we had identified 3,911 paper returns that claimed both the Education Credit and the tuition and fees deduction. These taxpayers claimed Education Credits of approximately $3.9 million and tuition and fees deductions of more than $10.7 million. Assuming that all 3,911 taxpayers received an erroneous tax benefit from only the tuition and fees deduction, the estimated loss of tax revenue is more than $1.6 million using a conservative estimate of a 15 percent tax rate.[20]

Creation of a new form to report tuition and fees resulted in a decrease in the number of taxpayers improperly claiming both the tuition and fees deduction and the Education Credit.

In response to one of our previous recommendations, the IRS created a new form to capture information relative to tuition and fees. The Tuition and Fees Deduction (Form 8917) now has the information needed to enable the IRS to detect taxpayers who *e-filed* and improperly claimed both the tuition and fees deduction and the Education Credit for the same student. This verification process resulted in nearly 60,000 *e-filed* returns being rejected through May 29, 2008. These returns were sent back to the originating provider for correction.

However, the rejection process used for *e-filed* returns is not available for paper returns. We were unable to verify that the IRS has a program to identify taxpayers who file paper returns and erroneously claim the dual benefit.

The Economic Growth and Tax Relief Reconciliation Act of 2001[21] created a new "above-the-line" deduction for tuition and fees that was available to taxpayers beginning in TY 2003. The deduction expired at the end of TY 2005. However, this provision of the Act was extended to the end of TY 2007 in the Tax Relief and Health Care Act of 2006. Presently, Congress is considering legislation to extend this deduction or to make it permanent.

For TY 2007, taxpayers are 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 dependent(s). Taxpayers who claim an Education Credit are required to complete Form 8863 and to identify by name and Social Security Number the student for whom the Education Credit is being claimed. For TY 2007,

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[19] *The 2007 Tax Filing Season Was Generally Successful, and Most Returns Were Timely and Accurately Processed* (Reference Number 2007-40-187, dated September 21, 2007).
[20] See Appendix IV for details.
[21] Pub. L. No. 107-16, 115 Stat. 38.

taxpayers who claim the tuition and fees deduction are required to complete Form 8917 and to provide the same information as that required on Form 8863. 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.

Recommendation

Recommendation 4: The Commissioner, Wage and Investment Division, should revise or verify the computer programming to ensure all taxpayers claiming a dual benefit are identified if the tuition and fees deduction is extended beyond Tax Year 2007. This should include testing the programming to forward paper returns with this condition to the Error Resolution System for correction.

> **Management's Response:** IRS management agreed with this recommendation and conditionally agreed with the related outcome measure. Current programming and the Submission Processing Internal Revenue Manual procedures associated with the new Form 8917 have considerably reduced the processing of these erroneous claims. A review of 14 percent of the accounts we provided to the IRS demonstrated that 100 percent of the accounts were in Error Resolution for correction and were a result of employee error. To assist in reducing the employee errors, the IRS implemented procedures on August 18, 2008, instructing the Code and Edit processing area to check tax returns claiming both the credit and the deduction for the dual benefit conditions. Additionally, alerts will be made during the filing season emphasizing the current instructions.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the review was to evaluate whether the IRS accurately processed individual paper and electronic tax returns[1] in a timely manner during the 2008 Filing Season. The audit focused on implementation of new tax law changes and administrative changes[2] that affected TY 2007 tax returns. In addition, we reviewed the corrective actions taken for the conditions identified in our review of the 2007 Filing Season[3] to determine whether they were adequate. To accomplish our objective, we:

I. Determined whether the IRS prepared for the 2008 Filing Season by taking the necessary steps to implement new, expiring, or pending tax law provisions into the tax products required for the preparation of individual income tax returns.

   A. Identified new tax law provisions pertaining to individual taxpayers for TY 2007 and reviewed the IRS Legislative Implementation Tracking System to identify the tax products affected by the new tax law provisions. We reviewed the entire available population of 45 TY 2007 draft tax products and 71 final tax products.

   B. Identified pending legislation, such as the AMT legislation, to determine what preparations had been made by the IRS and what effect the legislation could have on the 2008 Filing Season.

II. Determined whether the IRS correctly implemented new tax legislation that affected the processing of individual tax returns during the 2008 Filing Season.

   A. Used 100 percent computer analysis of TY 2007 individual income tax returns processed nationally on the Individual Return Transaction File between January 1 and May 30, 2008,[4] to identify returns affected by recent tax legislation and administrative changes. We used random sampling for some tests to ensure that each return had an equal chance of being selected. We also used judgmental sampling if we needed to

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[1] See Appendix VI for a glossary of terms.
[2] See Appendix V for an overview of the new tax law provisions and administrative changes examined during this review.
[3] *The 2007 Tax Filing Season Was Generally Successful, and Most Returns Were Timely and Accurately Processed* (Reference Number 2007-40-187, dated September 21, 2007).
[4] To assess the reliability of computer-processed data, programmers in the Treasury Inspector General for Tax Administration Office of Information Technology validated the data that were extracted, and we verified the appropriate documentation. Judgmental samples were selected and reviewed to ensure that 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 that the amounts were supported.

ensure that the original returns could be quickly obtained to evaluate the accuracy of processing. We determined whether changes to tax products were correctly implemented in return processing systems at the Submission Processing sites by assessing the accuracy of returns processed with the following changes.

1. Electronically identified 64,133 returns processed with an amount on Line 2 of the Health Savings Accounts (HSAs) (Form 8889) through February 15, 2008, and reviewed a random sample of 30 of these returns for processing accuracy. We also reviewed a random sample of 10 of the 2,495 returns processed through February 15, 2008, with amounts on Part III, Lines 18 through 22 of Form 8889.

2. Electronically identified 2,374,990 returns processed with a Credit for Qualified Retirement Savings Contributions (Form 8880) through February 15, 2008, and selected a random sample of 40 returns. We reviewed 30 of these returns for processing accuracy.

3. Electronically identified 436,401 returns processed with a QMIP deduction on Line 13 of the Itemized Deductions and Interest and Dividend Income (Schedules A&B) of the U.S. Individual Income Tax Return (Form 1040) through February 15, 2008, and reviewed a random sample of 40 returns for processing accuracy. After problems were identified, we electronically identified the entire population of 1,605,421 returns claiming the deduction through May 30, 2008, and identified 4,988 that had incorrectly claimed the deduction.

4. Electronically identified 312,582 returns processed through March 28, 2008, on which the taxpayer claimed an IRA deduction when his or her AGI was within the phase-out range for the filing status claimed. We selected a random sample of 40 of these returns to review for processing accuracy.

5. Electronically identified 6,868 returns processed with a refundable credit for prior year AMT through February 15, 2008, and researched a judgmental sample of 40 returns for accuracy. Because of inadequate information to track the carry-forward amounts, we reviewed return information for only eight of these returns for accuracy.

6. Reviewed return information for a judgmental sample of 30 of the 329 returns processed through February 15, 2008, on which the taxpayer claimed an amount that exceeded the maximum Earned Income Tax Credit based on filing status, number of qualifying children, and AGI limit to verify whether the returns were accurately processed.

7. Electronically analyzed 33,249,847 returns processed through February 15, 2008, and identified 503 returns with unusual deduction amounts and 242 returns with unusual exemption amounts. We confirmed whether the correct amounts were

used when the returns were processed at the Austin, Texas, Submission Processing site.

8. Electronically identified 2,630,312 returns processed with the AMT through May 30, 2008. We reviewed the findings in a prior report[5] on the calculation of the AMT and reviewed the computer programming changes to determine whether they were updated with the new exemption amounts for TY 2007.

B. Determined the numbers of taxpayers affected by the new tax legislation identified in Step I.A. by counting the numbers of returns and dollar amounts of the applicable deductions or credits claimed by taxpayers.

III. Determined whether the IRS monitoring systems indicated that individual returns were being processed accurately and in a timely manner.

A. Monitored various Submission Processing site production reports, inventory reports, and return error inventories between January 25 and May 30, 2008, for key indicators of return processing and compared the statistics to those for the 2007 Filing Season.

B. Monitored the IRS Program Completion Date reports from May 1 through May 14, 2008, to determine whether the Submission Processing sites processed all refund returns in a timely manner.

C. Computer analyzed filing patterns to evaluate whether processing inventories were adversely affected by taxpayers who filed returns at the wrong Submission Processing sites.

D. Monitored weekly 2008 Filing Season Wage and Investment Division Production meetings between January 24 and June 18, 2008, and monitored the IRS Submission Processing function web site, the IRS web site (IRS.gov), and other applicable web sites through April 30, 2008, to identify potentially significant issues.

IV. Determined whether the IRS had corrected problems identified in the 2007 Filing Season. From returns processed by the Submission Processing sites between January 1 and May 30, 2008, we electronically identified TY 2007 returns that met specific criteria.

A. Identified 1,779 returns through May 30, 2008, on which taxpayers age 70 ½ or older received the IRA deduction.

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[5] *Procedures Were Not Always Followed When Resolving Alternative Minimum Tax Discrepancies* (Reference Number 2008-40-146, dated July 30, 2008).

B. Identified 1,780,985 returns processed through May 30, 2008, on which taxpayers did not claim the State sales tax deduction.

C. Identified 3,911 paper returns processed through May 30, 2008, on which taxpayers claimed both the Education Credit and the tuition and fees deduction.

D. Identified 225,867 Direct Deposits of Refund to More Than One Account (Form 8888) processed through May 30, 2008, used to split refunds totaling $816.9 million.

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs)
Russell P. Martin, Director
Gary L. Young, Audit Manager
Tina M. Parmer, Lead Auditor
Steven E. Vandigriff, Senior Auditor
Lawrence N. White, Senior Auditor
Bonnie G. Shanks, Auditor
Joseph C. Butler, Information Technology Specialist

Appendix III

Report Distribution List

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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 of the outcomes listed in this appendix, we conducted computer analyses of TY 2007 individual income tax returns.[1] The returns were processed by the IRS Submission Processing sites between January 1 and May 30, 2008, and were posted to the Individual Master File. We developed specific criteria to identify returns affected by the new tax law changes covered in this review. We used further computer analyses and auditor evaluation of return data to determine if the IRS accurately processed individual tax returns during the 2008 Filing Season.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; $1.36 million from 4,988 taxpayers who improperly claimed and were allowed the QMIP deduction (see page 7).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 4,988 taxpayers who improperly claimed and were allowed more than $7.4 million in QMIP deductions. Assuming that all of these taxpayers received an improper tax benefit from only the QMIP deduction, the estimated revenue loss is $1,362,035.

To determine the tax effect, we used the calculation tool at the following address: http://www.moneychimp.com/features/tax_brackets.htm. For each filing status, we determined that the QMIP allowed and the average taxable income. Using the calculation tool, we took the average taxable income for the filing statuses and calculated a tax amount. The average taxable income was then divided by the calculated tax amount for each filing status to identify the average tax rate for each filing status. This tax rate was applied to the amount of QMIP claimed and allowed for each filing status and totaled an overall tax effect of $1,362,035. The average tax rate was figured by dividing the overall tax effect ($1,362,035) by the QMIP improperly allowed ($7,432,443) for a tax rate of 18.3 percent.

[1] See Appendix VI for a glossary of terms.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; $584,225 from 1,779 taxpayers who improperly claimed and were allowed the IRA deduction (see page 8).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 1,779 taxpayers age 70½ or older who improperly claimed and were allowed nearly $3.9 million in IRA deductions.[2] Assuming that all of these taxpayers received an improper tax benefit from only the IRA deduction, the estimated revenue loss is $584,225.[3]

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 1.8 million taxpayers, entitled to an estimated $438 million in tax refunds, who did not claim the State sales tax deduction in TY 2007 (see page 10).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify approximately 1.8 million taxpayers who had itemized their deductions, were eligible to claim the State sales tax deduction, and had not claimed the deduction. They are entitled to file amended returns and claim the sales tax deduction.

We determined that the average dollar amount of the sales tax deduction claimed was $1,640 for taxpayers living in the States with no State income tax in TY 2007. By applying the average to the approximately 1.8 million eligible taxpayers who did not take the deduction, we determined that the taxpayers are entitled to potentially $2.9 billion in missed deductions. If these taxpayers file amended tax returns, they might be entitled to as much as $438 million in tax refunds based on a conservative 15 percent tax rate.[4]

Type and Value of Outcome Measure:

- Revenue Protection – Potential; $1.6 million from 3,911 taxpayers who erroneously claimed and were allowed more than $10.7 million in tuition and fees deductions (see page 14).

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[2] These exceptions did take into account the age of the spouse if the taxpayers filed as Married Filing Jointly.
[3] We used a conservative tax rate of 15 percent to compute the estimated revenue loss (i.e., 15 percent times $3,894,830 of IRA deductions equals $584,225).
[4] We identified 1,780,985 taxpayers that did not claim the sales tax deduction. The average deduction claimed was $1,639.52 which entitles the taxpayers to potentially $2,919,960,527 in missed deductions. We then used the 15 percent tax rate to compute the estimated tax refund (i.e., 15 percent times $2,919,960,527 of missed deductions equals $437,994,079).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 3,911 taxpayers who claimed Education Credits of approximately $3.9 million and tuition and fees deductions of more than $10.7 million. Assuming that all 3,911 taxpayers received an erroneous tax benefit from only the tuition and fees deduction, the estimated revenue loss is more than $1.6 million.[5] Because the tax law prohibits taxpayers from claiming both the tuition and fees deduction and the Education Credit for the same individual in the same year, the tuition and fees deduction is not allowable.

[5] We used a conservative tax rate of 15 percent to compute the estimated revenue loss (i.e., 15 percent times $10,757,182 of tuition and fees deductions equals $1,613,577).

Appendix V

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

The following information describes various tax law provisions and other changes that affected TY 2007 individual income tax returns[1] processed during the 2008 Filing Season. We determined whether returns affected by the various provisions were accurately processed in accordance with the law.

Pension Protection Act of 2006[2]

This Act contained the following provisions:

Section 833(a) – AGI Limit for Retirement Savings Contributions Credit Increased. The AGI limits for the Retirement Savings Contributions Credit, now subject to inflation, were increased. In addition, the Credit was made permanent. For TY 2007, a taxpayer might be able to claim the Retirement Savings Contributions Credit if his or her AGI is not more than:

- $52,000 for Married Filing Jointly.
- $39,000 for Head of Household.
- $26,000 for Single, Married Filing Separately, or Qualifying Widow(er).

Section 833(b) – Modified AGI Limit for Traditional IRA Contributions Increased. The modified AGI limits for contributions to a traditional IRA, now subject to inflation, were increased. For TY 2007, if a taxpayer is covered by a retirement plan at work, the deduction for 2007 contributions to a traditional IRA is reduced (phased out) if modified AGI is:

- More than $83,000 but less than $103,000 for Married Filing Jointly or Qualifying Widow(er).
- More than $52,000 but less than $62,000 for Single or Head of Household.
- Less than $10,000 for Married Filing Separately.

[1] See Appendix VI for a glossary of terms.
[2] Pub. L. No. 109-280, 120 Stat. 780.

Section 833(c) – Modified AGI Limit for Roth IRA Contributions Increased. The modified AGI limits for contributions to a Roth IRA, now subject to inflation, were increased.

- For Married Filing Jointly or Qualifying Widow(er) taxpayers, the contribution limit was reduced (phased out) when modified AGI exceeds $156,000. A taxpayer whose modified AGI exceeds $166,000 cannot make a Roth IRA contribution.
- A Married Filing Separately taxpayer cannot make a Roth IRA contribution if the taxpayer 1) lived with his or her spouse at any time during the year and had a modified AGI of more than $0 or 2) did not live with his or her spouse at any time during the year and had a modified AGI of more than $10,000.
- For all other taxpayers, the Roth IRA contribution limit was reduced (phased out) when the modified AGI exceeds $99,000. Once the modified AGI exceeds $114,000, these taxpayers cannot make Roth IRA contributions.

Tax Relief and Health Care Act of 2006[3]

This Act contained the following provisions:

Section 302 – Rollovers From a Health Reimbursement Arrangement or Health Flexible Spending Arrangement Into an HSA. A taxpayer's employer can make a one-time rollover of the balance (or less) of Health Reimbursement Arrangement or Health Flexible Spending Arrangement funds into an HSA.

Section 303 – Repeal of Annual Deductible Limitation on HSA Contributions. The maximum HSA deduction increased to $2,850 ($5,650 for family coverage) regardless of the amount of health insurance deductible.

Section 305 – HSA Contribution Limitation Not Reduced for Part-Year Coverage. Taxpayers who become covered under a High-Deductible Health Plan in a month other than January are deemed to be eligible during the last month of the taxable year to make the full deductible HSA contribution for the year, as if they had been covered under the High-Deductible Health Plan for the entire year.

Section 402 – Credit for Prior Year Minimum Tax. An individual's minimum tax credit allowable for any taxable year beginning before January 1, 2013, is not less than the "AMT refundable credit amount," which is the greater of:

- 20 percent of the long-term unused minimum tax credit.
- The lesser of $5,000 or the long-term unused minimum tax credit.

[3] Pub. L. No. 109-432, 120 Stat. 2922.

Section 419 – Mortgage Insurance Premium Deduction. Premiums paid or accrued for "qualified mortgage insurance" during 2007 (only) with respect to home acquisition debt on a qualified home are deductible as an itemized deduction. The deductible amount is reduced by 10 percent for every $1,000 ($500 for Married Filing Separately) by which AGI exceeds $100,000 ($50,000 for Married Filing Separately). No deduction is allowed once AGI exceeds $109,000 ($54,500 for Married Filing Separately).

Tax Increase Prevention Act of 2007[4]

This Act contained the following provision:

Sections 2 and 3 – Extension of Increased AMT Exemption Amount and Non-Refundable Personal Credits. The laws extending increased AMT exemption amounts [I.R.C. Section (§) 55(d)(1)[5]] and retaining the application of nonrefundable personal credits against the AMT [I.R.C. Section (§) 26(a)(2)[6]] expired on December 31, 2006. For TYs 2007 and later, this meant that AMT exemption amounts would drop back to pre-2003 figures and cause an estimated 25 million more taxpayers to be subject to the AMT. To relieve this additional tax burden, Congress devised an "AMT patch" and passed the Tax Increase Prevention Act in late 2007. Section 2 of this Act extended and increased the AMT exemption amounts for TY 2007 and Section 3 of this Act retained the application of nonrefundable personal credits against the AMT. Prior to December 31, 2006, the AMT exemption amounts were $62,550 for Married Filing Jointly or Qualifying Widow(er), $42,500 for Single or Head of Household, and $31,275 for Married Filing Separately. Without the "patch," the AMT exemption amounts would have dropped to $45,000 for Married Filing Jointly or Qualifying Widow(er), $33,750 for Single or Head of Household, and $22,500 for Married Filing Separately. This Act increased the exemption amounts to $66,250 for Married Filing Jointly or Qualifying Widow(er), $44,350 for Single or Head of Household, and $33,125 for Married Filing Separately.

Economic Stimulus Act of 2008[7]

This Act contained the following provision:

Section 101 – Recovery Rebates for Individuals. The Economic Stimulus Act of 2008, signed on February 13, 2008, was passed to energize the national economy. This legislation provides a stimulus payment generally ranging from $300 to $1,200 to more than 130 million people. Individuals can receive up to $600, and couples can receive up to $1,200, with an additional

[4] Pub. L. No. 110-166, 121 Stat. 2461.
[5] 26 U.S.C. § 55 (2006).
[6] 26 U.S.C. §26 (2006).
[7] Pub. L. No. 110-185, 122 Stat. 613. We are performing a series of reviews to assess all aspects of IRS' planning for and issuance of stimulus payments.

$300 for each qualifying child. To receive a stimulus payment individuals must file a 2007 tax return with a valid Social Security Number.

Cost-of-Living (Inflation) Adjustments for TY 2007

Revenue Procedure 2006-53[8] contained the following inflation-adjusted items:

Earned Income Tax Credit Amounts Increased.

a. The maximum amount of earned income and AGI a taxpayer can have and still get the Earned Income Tax Credit are higher for TY 2007 than they were for TY 2006. Taxpayers might be able to take the Credit if they:

  - Have more than 1 qualifying child and earn less than $37,783 ($39,783 if Married Filing Jointly).
  - Have 1 qualifying child and earn less than $33,241 ($35,241 if Married Filing Jointly).
  - Do not have a qualifying child and earn less than $12,590 ($14,590 if Married Filing Jointly).

b. The maximum amount of investment income a taxpayer can have in 2007 and still get the Credit increased to $2,900.

Increases in the Standard Deduction and Exemption Amounts. For TY 2007, the standard deduction amounts under I.R.C. § 63(c)(2)[9] were increased to $5,350 for Single or Married Filing Separately, $7,850 for Head of Household, and $10,700 for Married Filing Jointly or Qualified Widow(er).

Personal Exemption. For TY 2007, the personal exemption under I.R.C. § 151(d)[10] is $3,400.

[8] Rev. Proc. 2006-53, 2006-48 I.R.B. 996 (11-27-2006).
[9] 26 U.S.C. § 63 (2004).
[10] 26 U.S.C. § 151 (2004).

Appendix VI

Glossary of Terms

Above-the-line Deduction	Refers to a deduction that is taken directly on a U.S. Individual Income Tax Return (Form 1040) rather than on the Itemized Deductions (Schedule A). Consequently, this type of deduction can be taken by taxpayers who do not itemize their deductions.
Adjusted Gross Income	Calculated after certain adjustments are made but before standard or itemized deductions and personal exemptions are subtracted.
Earned Income Tax Credit	A refundable Federal tax credit for low-income working individuals and families.
Error Resolution System	Provides for the correction of errors associated with input submissions. The error inventory is managed on an Error Resolution System database, and corrected documents are validated by Generalized Mainline Framework modules.
Filing Season	The period from January 1 through April 15 when most individual income tax returns are filed.
Free File Program	An online tax preparation and electronic filing program offered through a partnership agreement between the IRS and the Free File Alliance, LLC.
Generalized Mainline Framework	Validates and perfects data from a variety of input sources (e.g., tax returns, remittances, information returns, and adjustments). Updated transactions are controlled, validated, and corrected.
Individual Master File	The IRS database that maintains transactions or records of individual tax accounts.
Individual Paper and Electronic Returns	U.S. Individual Income Tax Returns (Forms 1040 and 1040A) and Income Tax Returns for Single and Joint Filers With No Dependents (Form 1040EZ).

Individual Return Transaction File	The Individual Return Transaction File contains data transcribed from initial input of the original individual tax returns during return processing.
Legislative Implementation Tracking System	An Intranet-based planning and monitoring system for implementation of tax legislation.
Modified Adjusted Gross Income	Calculated without regard to certain deductions or exclusions, unlike Adjusted Gross Income.
Program Completion Date	The date determined by the IRS for the completion of any program. Completion dates are set for processable returns received by specific dates, including timely, prior period, and delinquent returns.
Submission Processing sites	Process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts. These sites are located in Andover, Massachusetts; Atlanta, Georgia; Austin, Texas; Fresno, California; and Kansas City, Missouri.

Appendix VII

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

COMMISSIONER
WAGE AND INVESTMENT DIVISION

RECEIVED
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SEP 18 2008

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: for Richard Byrd, Jr. Pamela G. Watson
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report –The 2008 Filing Season Was Generally Successful Despite the Challenges of Late and Unexpected Tax Legislation (Audit # 200840018)

I reviewed the draft report and appreciate your acknowledgement of the enormity and complexity of preparing for and delivering a successful filing season. Through August 22, 2008, the IRS had received 149.3 million individual tax returns. Of those, approximately 88 million were electronically filed, a 12.3 percent increase over the same period in 2007. Paper filing increased 10.3 percent from the same period in 2007 to 61.3 million returns.

We quickly reacted to programming challenges created by late and critical tax legislation, specifically the Tax Increase Prevention Act of 2007, signed into law on December 26, 2007, which limited the number of taxpayers who would be subject to the Alternative Minimum Tax for Tax Year 2007 and the unexpected Economic Stimulus Act of 2008 that provided an Economic Stimulus Payment (ESP) to more than 130 million people. Even though we made these programming changes timely, we realize that additional programming changes are still needed and will take steps necessary for implementation.

Although we had an outstanding filing season, as mentioned above, there were challenges with the implementation of the ESP. As of August 22, 2008, the IRS had received about 7.9 million additional tax returns from individuals who would not normally be required to file a return. The largest increase was in the number of paper filed U.S. Individual Income Tax Returns (Form 1040A), which increased by over 90.9 percent from the same period in 2007. In spite of the additional returns we received due to the ESP legislation, we completed processing of the timely filed returns on June 13, 2008, one month ahead of the Program Completion Date.

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We have provided additional detailed information on the ESP in our recent responses to the audit report entitled, *Evaluation of Planning Efforts for the Issuance of Economic Stimulus Payments (Reference Number 2008-40-149, dated July 31, 2008)* and to the audit report entitled, *Evaluation of the Computation of Economic Stimulus Payments*, which has not yet been issued as final.

We are in partial agreement with the outcome measures stated in the report. We agree with the outcome measure for the Qualified Mortgage Insurance Premium (QMIP) deduction. We do not agree with the outcome measure for the Individual Retirement Account (IRA) deduction. The IRS does not currently have math error authority to enforce the condition because it requires information not present on the tax return. We also do not agree with the outcome measure that addresses the State Sales Tax deduction. The sales tax can not be calculated based on average amounts nationwide. It can only be calculated for the states the taxpayers lived in on a specific date in the year. The use of an average tax rate and taxable income does not support an accurate calculation. We conditionally agree with the outcome measure addressing the Tuition and Fee Deductions/Education Credit. It assumes the nationwide average tax rate of 15 percent which may or may not be indicative of this taxpayer segment. Although we agree with the outcome measure for the QMIP and conditionally agree with the Tuition and Fee Deductions/Education Credit measure, there is no way to track or verify the revenue protection potential stated in the report.

Our responses to your recommendations are attached. If you have any questions regarding this response, please call me at (404) 338-7060, or members of your staff may contact Peter J. Stipek, Director, Customer Account Services, at (404) 338-8910.

Attachment

Attachment

RECOMMENDATION 1

The Commissioner, Wage and Investment Division, should ensure that the computer systems are programmed to identify taxpayer returns claiming the QMIP deduction with AGI that exceeds the maximum phase-out limitations. This should include programming to reject *e-filed* returns with this condition and to forward paper returns to the Error Resolution System for correction.

CORRECTIVE ACTION

We agree with this recommendation. Submission Processing will input a Unified Work Request requesting programming that limits the deduction for the Qualified Mortgage Insurance so that when the Adjusted Gross Income (AGI) exceeds the threshold, the paper return will be forwarded to the Error Resolution System for correction. In addition, programming will be requested to reject e-filed tax returns for this condition.

IMPLEMENTATION DATE

In the Near Future

RESPONSIBLE OFFICIAL

Director, Submission Processing, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored as part of our internal managerial control system. The Director, Submission Processing will report progress to the Director, Customer Accounts Services.

RECOMMENDATION 2

The Commissioner, Wage and Investment Division, should ensure that the computer systems are programmed to identify taxpayer returns claiming IRA deductions for taxpayers age 70½ and older. This should include programming to reject *e-filed* returns with this condition and to forward paper returns to the Error Resolution System for correction.

CORRECTIVE ACTION

We do not agree with this recommendation. The IRS does not currently have math error authority to enforce this condition because it requires information not present on the tax return per [Section 6213 of the Internal Revenue Code]. However, Submission Processing will partner with Wage and Investment (W&I) Compliance and Small Business/Self-Employed (SB/SE) Campus Compliance to determine the feasibility of identifying such instances during processing and assigning an unallowable code for an Examination review.

IMPLEMENTATION DATE

N/A

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RESPONSIBLE OFFICIAL
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A

RECOMMENDATION 3
The Commissioner, Wage and Investment Division, should continue to inform taxpayers that they are eligible for a sales tax deduction if they itemize and do not claim a State income tax deduction, if the sales tax deduction is extended beyond TY 2007. The possibility of calculating the sales tax deduction for the taxpayer if it is not claimed or sending a notice to the affected taxpayers should also be considered.

CORRECTIVE ACTION
(a) We agree to continue to inform taxpayers of eligibility for the sales tax deduction and plan to add a caution to the 2008 Instructions for Schedule A (Form 1040), similar to the one added in 2006, informing taxpayers that:

- The sales tax deduction expired in 2007
- Congress was considering legislation to extend that deduction
- The IRS website will explain how to claim the deduction, if it is extended

(b) We do not agree with the second part of the recommendation to calculate the sales tax deduction for the taxpayer or to send a notice. Submission Processing cannot calculate the deduction for sales tax with consistent accuracy because the deduction is based on the state in which the taxpayer resided on January 1, of the tax year. Tax rates vary from state to state and taxpayers may live in more than one state in any tax year and seldom inform the IRS they have moved until they file a tax return.

IMPLEMENTATION DATE
(a) January 15, 2009
(b) N/A

RESPONSIBLE OFFICIAL
(a) Director, Media and Publications, Wage and Investment Division
(b) N/A

CORRECTIVE ACTION MONITORING PLAN
This corrective action will be monitored as part of our internal managerial control system. The Director, Submission Processing will report progress to the Director, Customer Accounts Services.

RECOMMENDATION 4
The Commissioner, Wage and Investment Division, should revise or verify the computer programming to ensure all taxpayers claiming a dual benefit are identified if the tuition and fees deduction is extended beyond Tax Year 2007. This should include testing the programming to forward paper returns with this condition to the Error Resolution System for correction.

CORRECTIVE ACTION
We agree with this recommendation. As noted in your report, current programming and the Submission Processing Internal Revenue Manual procedures associated with the new Form 8917, Tuition and Fees Deduction, have considerably reduced the processing of these erroneous claims. A review of 14 percent of the accounts Treasury Inspector General for Tax Administration (TIGTA) auditors provided to us demonstrated 100 percent of the accounts were in Error Resolution for correction and were a result of employee error. To assist in reducing the employee errors, procedures were implemented, on August 18, 2008, instructing the Code & Edit processing area to check tax returns claiming both the credit and the deduction for the dual benefit conditions. Additionally, alerts will be made during the filing season emphasizing the current instructions.

IMPLEMENTATION DATE
Completed

RESPONSIBLE OFFICIAL
N/A

CORRECTIVE ACTION MONITORING PLAN
N/A