Most Taxpayers That Could Benefit From the Farm Income Averaging Provision Are Not Using It

March 2004

Reference Number: 2004-30-085

INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 30, 2004

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Most Taxpayers That Could Benefit From the Farm Income Averaging Provision Are Not Using It (Audit #200330019)

This report presents the results of our review to identify farmers that could have benefited from the Farm Income Averaging provision of the tax law in Tax Year (TY) 2001 but did not use this provision to compute their income taxes and to determine why they did not use it.

A provision in the Taxpayer Relief Act of 1997[1] allowed farmers to elect to compute their tax liabilities by averaging, over the prior 3 years, all or a portion of their taxable income from farming. This provision was designed to smooth out the economic disparities that farmers experience from year to year. The Congress estimated this provision would provide about $50 million of tax relief to American farmers in TY 2001.

In summary, we found that during TY 2001, approximately 52,000 taxpayers used Farm Income Averaging (Schedule J) to calculate their individual income taxes.[2] However, this is less than one-half the number of taxpayers that could have benefited from this tax provision.

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[1] Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).
[2] Based on data provided by the IRS Statistics of Income function.

During a prior audit[3] in which we determined that many farmers using Schedule J did not receive the full tax benefit, we observed that many taxpayers that could have benefited from the Farm Income Averaging tax provision did not use it. In this current audit, we designed computer programs to help identify many of these taxpayers, reviewed a statistical sample of tax returns identified by our computer analyses, and developed a questionnaire to determine why taxpayers that could have benefited did not take advantage of this provision.

We estimate over 64,000 taxpayers overpaid their taxes by not taking advantage of this tax provision.[4] These taxpayers overpaid taxes on their TY 2001 individual income tax returns by more than $33 million. Eighty-nine percent of these returns were prepared by paid tax preparers.

We contacted some of these taxpayers and their paid preparers and learned that 67 percent of the taxpayers and 17 percent of the paid preparers we contacted were not aware of the Farm Income Averaging provision. Of those that were aware of the provision, 33 percent of the taxpayers and 60 percent of the paid preparers mistakenly believed using the Farm Income Averaging option would have provided no tax benefit. We probed further and found that among the reasons for these mistakes were:

- The taxpayers and/or preparers did not know the Internal Revenue Service (IRS) had changed the regulations to allow them to include negative taxable income in their averaging calculations.
- The taxpayers and/or preparers thought that, since only a fraction of their total income was from farming, the benefit of averaging would be negligible.
- The preparation software used by the taxpayers and/or preparers had erroneous instructions, which led them to believe there would be no benefit.

We recommended the Director, Taxpayer Education and Communication, Small Business/Self-Employed (SB/SE) Division, work with the Director, Tax Forms and Publications, Wage and Investment Division, to develop a strategy to further educate farmers, preparers, and income tax software developers about the availability of, benefits of, and appropriate regulations related to the Farm Income Averaging provision.

Management's Response: The Commissioner, SB/SE Division, agreed that developing a strategy to further educate farmers, preparers, and income tax software developers about the availability and benefits of the Farm Income Averaging provision will be beneficial. The Director, Taxpayer Education and Communication, SB/SE Division, will continue ongoing actions to educate taxpayers, practitioners, and tax software developers about this provision.

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[3] *The Internal Revenue Service Acted on Recommendations to Help Farmers Receive the Intended Benefit of the Farm Income Averaging Provision* (Reference Number 2003-30-142, dated July 2003).

[4] Our analyses included only those taxpayers that had income from farming during TY 2001 and had negative farm income in 1 of the prior 3 years. Taxpayers with relatively large farm income in 1 year and minimal farm income in prior years may also significantly benefit from this tax provision, and it is reasonable to assume that many of these taxpayers did not take advantage of this provision as well.

Although the IRS believes this provision is fully explained in current forms and publications, it will add instructional emphasis on the provision if practitioners and stakeholders in the farming industry indicate it is needed. IRS representatives meet annually with the National Farm Income Tax Extension Committee to gather input for the *Farmer's Tax Guide* (Publication 225) and will include this issue on the 2004 meeting agenda. Management's complete response to the draft report is included as Appendix VI.

Office of Audit Comment: In our opinion, the percentage of taxpayers that could take advantage of the Farm Income Averaging provision, but are not, warrants more definitive action from the IRS. Our results indicate ongoing actions to educate taxpayers, practitioners, and tax software developers about this provision have not been effective, so continuing those actions most likely will not resolve the problem. Likewise, adding a meeting agenda item to determine if stakeholders and practitioners believe instructional emphasis is needed on IRS forms and publications does not suggest a strong commitment on the IRS' part to proactively resolve this issue. While we believe the IRS should take more definitive action to address the issue in this report, we do not intend to elevate our concern to the Department of the Treasury for resolution.

Although IRS management agreed with the finding and recommendation in our report, they stated that they did not agree with our estimates of amounts by which taxpayers had overpaid their taxes by not taking advantage of the Farm Income Averaging provision. The basis for their disagreement was that the formula we used to determine a sample size of 100 was the formula for estimating a population proportion (attribute sample) and not for estimating the actual dollars saved (variable sample). They stated, "To correctly determine the sample size for estimating actual dollars saved 'X' by computing Schedule J, an estimate of the variance of 'X' is needed in a different formula."

The IRS' assertion is incorrect regarding the validity of our estimates. It is not requisite that the variance of the population be estimated when selecting a sample. The calculation used to determine the initial sample size is not what determines the validity of a sample for projecting dollars saved. Rather, it is the methodology used to actually select the sample and to evaluate the sample results. It is requisite that the variance be considered when determining the adequacy of a sample for projecting dollars saved and that it be a factor included when determining the precision or range for which a dollar projection is accurate at a specified confidence level. We did estimate the population variance and included it in the calculation of our estimates. It was because of the population variance that the precision of our estimate was ± $7.6 million. We had discussed this issue with IRS Statistics of Income function personnel during a prior audit and were told that this methodology was acceptable to them.

However, to further assure ourselves of the validity of our estimates, we provided our sampling workpapers to an independent sampling specialist. He stated that our sampling plan was valid, and our 95 percent confidence interval projection for the total savings for the 69,908 taxpayers in the population was correct.

Copies of this report are also being sent to the IRS managers affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Richard J. Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (631) 654-6028.

Table of Contents

Background

A provision in the Taxpayer Relief Act of 1997[1] allowed farmers to elect to compute their tax liabilities by averaging, over the prior 3 years, all or a portion of their taxable income from farming. This provision was designed to smooth out the economic disparities that farmers experience from year to year. The Congress estimated this provision would provide approximately $50 million of tax relief to American farmers in Tax Year (TY) 2001. The Internal Revenue Service (IRS) designed Farm Income Averaging (Schedule J) for calculating tax liabilities using the averaging method.

We recently completed an audit[2] to identify taxpayers using the Farm Income Averaging provision for TY 1999 returns but not receiving the full intended benefit of the averaging provision because the IRS originally did not allow farmers to include negative taxable income in their averaging calculations.[3] While trying to identify these taxpayers, we observed that many other taxpayers that could have benefited from the Farm Income Averaging provision did not use it. Because this tax provision had been in effect for only 2 years, these taxpayers may have been unaware of its existence. More tax years have now passed. During this audit, we looked at the most recently filed tax returns available to us to determine whether taxpayers are now taking advantage of this tax provision.

This review was performed at the Ogden, Utah, office of the Treasury Inspector General for Tax Administration (TIGTA) through analysis and review of IRS data from May through December 2003. The audit was conducted in

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

[2] *The Internal Revenue Service Acted on Recommendations to Help Farmers Receive the Intended Benefit of the Farm Income Averaging Provision* (Reference Number 2003-30-142, dated July 2003).

[3] The IRS originally interpreted the law to exclude negative income in the averaging calculations. Members of the Senate issued a letter to the IRS stating that this interpretation of the Farm Income Averaging provision was inconsistent with the intent of the Congress. The IRS responded by making the necessary changes to the regulations to enable farmers to use negative taxable income in their averaging calculations. In response to our report on this issue, the IRS sent letters to over 4,000 taxpayers that were affected by this misinterpretation.

accordance with *Government Auditing Standards*. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The Majority of Taxpayers That Could Benefit From the Farm Income Averaging Provision Are Not Using It

For TY 2001, approximately 52,000 taxpayers used Farm Income Averaging (Schedule J) to calculate their individual income taxes.[4] However, using computer analyses and statistical sampling, we identified at least 64,315 additional taxpayers that could have benefited from the Farm Income Averaging provision but did not use it.

Although it is not necessary for taxpayers to have realized a loss to benefit from the Farm Income Averaging provision, we determined that among those very likely to benefit from the provision would be taxpayers that had income from farming during the current year but had negative taxable income in 1 of the prior 3 years.[5]

Using computer analyses, we identified 78,621 individual income taxpayers that had farm income of $500 or more during TY 2001 and had negative taxable income in 1 of the prior 3 years. (See Appendix I for more information regarding the selection criteria we used in our computer analyses.) Only 8,713 of these taxpayers calculated their income taxes using Schedule J. From the remaining 69,908 taxpayers, we selected a statistical sample of 100 and found that 92 of the taxpayers (92 percent) could have reduced their tax liabilities and saved money had they calculated their taxes using Schedule J. Figure 1 illustrates the percentage of these taxpayers that could have benefited from the Farm Income Averaging provision but did not use it. These taxpayers overpaid their taxes by an average of $514 each. Eighty-nine percent of these taxpayers had their tax returns prepared by paid tax preparers.

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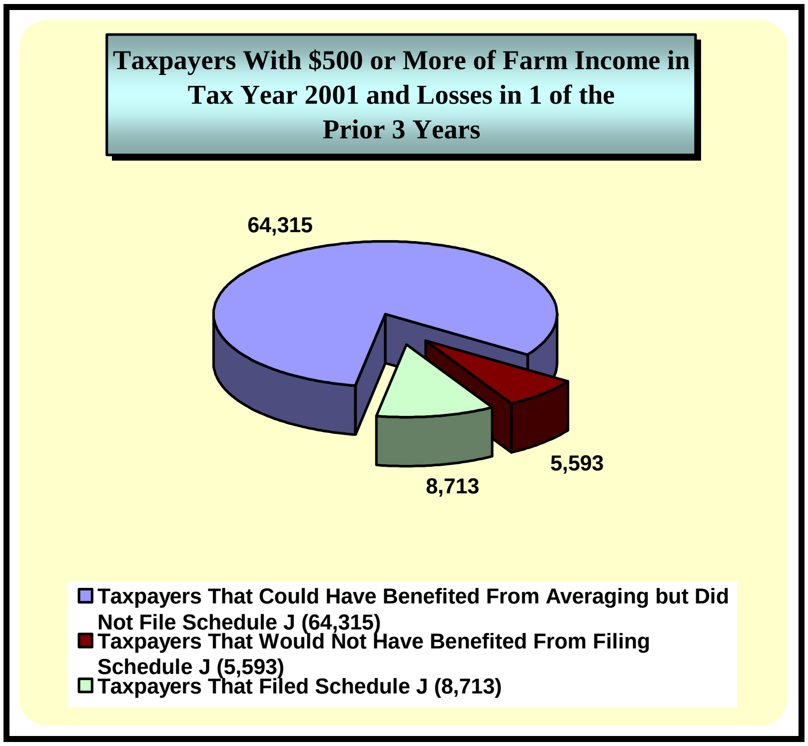
[4] Based on data provided by the IRS Statistics of Income function.
[5] Taxpayers with relatively large farm income in 1 year and minimal farm income in prior years may also significantly benefit from this tax provision. These taxpayers were not included in our analyses, but it is reasonable to assume that the occurrence rate of these taxpayers not taking advantage of the Farm Income Averaging provision would be similar to that of the taxpayers in our sample.

Figure 1:



Source: TIGTA analysis and statistical sample of taxpayer accounts with farm income of $500 or more.

To determine why these taxpayers did not take advantage of the Farm Income Averaging provision, we developed a questionnaire and attempted to contact them (and their paid tax preparers when the taxpayers gave us permission). We contacted 52 taxpayers and 30 paid tax preparers and learned that 67 percent of the taxpayers and 17 percent of the paid preparers were not aware of the Farm Income Averaging provision.

Of those that were aware of the provision, 33 percent of the taxpayers and 60 percent of the paid preparers mistakenly believed using the Farm Income Averaging option would have provided no tax benefit. We probed further and found that among the reasons for these mistakes were:

- The taxpayers and/or preparers did not know the IRS had changed the regulations to allow them to include negative taxable income in their averaging calculations.

- The taxpayers and/or preparers thought that, since only a fraction of their total income was from farming, the benefit of averaging would be negligible.
- The preparation software used by the taxpayers and/or preparers had erroneous instructions, which led them to believe there would be no benefit.[6]

See Appendix V for more detailed information regarding our questionnaires.

The IRS has attempted to educate taxpayers and tax preparers about this tax provision through IRS publications. Normally, the onus is on taxpayers or their preparers to stay informed of tax law changes and new tax provisions. However, the inordinate number of taxpayers not using a tax provision that could save them significant tax dollars indicates a need for additional education efforts by the IRS. The IRS' mission of helping taxpayers understand their tax responsibilities includes helping them legally minimize their tax burden. This is particularly important for this issue because the IRS originally misinterpreted the Congress' intent when implementing the provision and issued instructions and proposed regulations that made the provision much less attractive to taxpayers.

Based on the results of our computer analyses and statistical samples, we estimate that approximately 64,315 taxpayers meeting our sample criteria overpaid their TY 2001 individual income taxes by more than $33 million (see Appendix IV). In addition, it is likely that many other taxpayers with large variances in farm income, but not meeting our specific criteria, overpaid their taxes as well.

Recommendation

1. The Director, Taxpayer Education and Communication, Small Business/Self-Employed (SB/SE) Division, should work with the Director, Tax Forms and Publications, Wage and Investment Division, to develop a strategy to further educate farmers, preparers, and

[6] The TIGTA is initiating an audit to determine whether the IRS has an adequate process to ensure tax software developers are provided with accurate tax law specifications (Audit Number 200440028).

income tax software developers about the availability and benefits of the Farm Income Averaging provision.

Specific and descriptive language should be used to inform these groups that the method for calculating the tax using this provision has changed from the method originally allowed and is now more favorable to the taxpayer, and that the taxpayer may benefit even if only a portion of his or her income is from farming. IRS-sponsored tax symposiums might be another effective forum through which to disseminate this information.

Management's Response: The Commissioner, SB/SE Division, agreed that developing a strategy to further educate farmers, preparers, and income tax software developers about the availability and benefits of the Farm Income Averaging provision will be beneficial. The Director, Taxpayer Education and Communication, SB/SE Division, will continue ongoing actions to educate taxpayers, practitioners, and tax software developers about this provision.

Although the IRS believes this provision is fully explained in current forms and publications, it will add instructional emphasis on the provision if practitioners and stakeholders in the farming industry indicate it is needed. IRS representatives meet annually with the National Farm Income Tax Extension Committee to gather input for the *Farmer's Tax Guide* (Publication 225) and will include this issue on the 2004 meeting agenda.

Office of Audit Comment: In our opinion, the percentage of taxpayers that could take advantage of the Farm Income Averaging provision, but are not, warrants more definitive action from the IRS. Our results indicate ongoing actions to educate taxpayers, practitioners, and tax software developers about this provision have not been effective, so continuing those actions most likely will not resolve the problem. Likewise, adding a meeting agenda item to determine if stakeholders and practitioners believe instructional emphasis is needed on IRS forms and publications does not suggest a strong commitment on the IRS' part to proactively resolve this issue.

Although IRS management agreed with the finding and recommendation in our report, they stated that they did not agree with our estimates of amounts by which taxpayers had overpaid their taxes by not taking advantage of the Farm Income Averaging provision. The basis for their disagreement was that the formula we used to determine a sample size of 100 was the formula for estimating a population proportion (attribute sample) and not for estimating the actual dollars saved (variable sample). They stated, "To correctly determine the sample size for estimating actual dollars saved 'X' by computing Schedule J, an estimate of the variance of 'X' is needed in a different formula."

The IRS' assertion is incorrect regarding the validity of our estimates. It is not requisite that the variance of the population be estimated when selecting a sample. The calculation used to determine the initial sample size is not what determines the validity of a sample for projecting dollars saved. Rather, it is the methodology used to select the sample and to evaluate the sample results. It is requisite that the variance be considered when determining the adequacy of a sample for projecting dollars saved and that it be a factor included when determining the precision or range for which a dollar projection is accurate at a specified confidence level. We did estimate the population variance and included it in the calculation of our estimates. It was because of the population variance that the precision of our estimate was ± $7.6 million. We had discussed this issue with IRS Statistics of Income function personnel during a prior audit and were told that this methodology was acceptable to them.

However, to further assure ourselves of the validity of our estimates, we provided our sampling workpapers to an independent sampling specialist. He stated that our sampling plan was valid, and our 95 percent confidence interval projection for the total savings for the 69,908 taxpayers in the population was correct.

Appendix I

Detailed Objectives, Scope, and Methodology

The overall objectives of this audit were to identify farmers that could have benefited from the Farm Income Averaging provision of the tax law in Tax Year (TY) 2001 but did not use this provision to compute their income taxes and to determine why the farmers did not take advantage of this tax provision.

To accomplish our objectives, we:

I. Identified all taxpayers that had positive income from farming during TY 2001 as well as negative taxable income in any of the prior 3 years.

   A. Prepared a computer request to identify taxpayers on the Internal Revenue Service's (IRS) Individual Master File[1] that had positive farm income in TY 2001 and negative taxable income in any of the prior 3 years (TYs 2000, 1999, or 1998).

   B. To verify the information in the database of accounts created by our computer request, randomly reviewed 21 returns and researched these returns on the IRS Integrated Data Retrieval System (IDRS)[2] to confirm the information in our database was accurate.

   C. Analyzed our entire database through computerized queries to confirm the taxpayers identified in this database had farm income and taxable income losses in any of the prior 3 years (TYs 2000, 1999, or 1998).

II. Determined whether taxpayers were taking advantage of Farm Income Averaging by analyzing the database to determine the number of taxpayers that were using the Farm Income Averaging (Schedule J) and those that did not file a Schedule J but could have benefited by using it.

   A. Analyzed the database to identify the total number of taxpayers that most likely would benefit from filing a Schedule J by selecting returns with the following criteria: positive farm income in TY 2001, Taxable Income greater than $500 in TY 2001, Profit or Loss From Farming (Schedule F) income greater than $500 in TY 2001, Alternative Minimum Tax equal to zero in TY 2001, and Taxable Income less than zero in 1 of the prior 3 years (TYs 2000, 1999, or 1998). This analysis resulted in the identification of a total of 78,621 taxpayers.

   B. Identified the total number of taxpayers that filed a Schedule J from those identified in Step II.A. This analysis identified 8,713 taxpayers that filed a Schedule J.

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[1] The IRS database that maintains transactions or records of individual tax accounts.
[2] The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

C. Determined the number of taxpayers that met the criteria described in Step II.A. for TY 2001 but did not file a Schedule J by selecting returns with the following criteria: positive farm income in TY 2001, Taxable Income greater than $500 in TY 2001, Schedule F income greater than $500 in TY 2001, Alternative Minimum Tax equal to zero in TY 2001, no Schedule J filed in TY 2001, and Taxable Income less than zero in 1 of the prior 3 years (TYs 2000, 1999, or 1998). This analysis resulted in the identification of a total 69,908 taxpayers.

D. Examined a statistical sample[3] of 100 of the 69,908 taxpayers that were identified in Step II.C. as meeting the Farm Income Averaging criteria by reviewing them on the IDRS and ordering the returns to determine the impact on the taxpayers' tax liabilities for TY 2001. We calculated the tax liabilities for TY 2001 returns with the Schedule J allowing them to average their farm income. To ensure our calculations were accurate, we requested that IRS employees with experience working the Schedule J review 10 returns from our sample and all the returns that had a Net Operating Loss.

E. Developed the outcome measure from the above steps for the taxpayers that were qualified to file a Schedule J in TY 2001, but did not, by calculating the average change in tax ($514) and applying this to the number of taxpayers identified in the database (64,315) that would have benefited from filing a Schedule J.

III. Determined why farmers are not taking advantage of the Farm Income Averaging provision.

A. Contacted farmers directly and determined their reasons for not taking advantage of the provision.

1) Contacted the Office of Management and Budget to obtain permission to directly contact taxpayers concerning the Farm Income Averaging provision.

2) Developed a questionnaire to obtain information from taxpayers about the Farm Income Averaging provision.

3) Using the questionnaire developed in Step III.A.2., attempted to contact the taxpayers selected in the statistical sample of Step II.D. that we had determined could benefit from the Farm Income Averaging provision.

4) Analyzed the results to determine why taxpayers were not using the Farm Income Averaging provision.

B. Determined the IRS' efforts to educate taxpayers and tax preparers of the Farm Income Averaging provision of the tax law and the potential benefits.

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[3] We used a 95 percent confidence level, an expected error rate of 7 percent, and a precision of $\pm$ 5 percent.

1) Reviewed News Releases and Bulletins to determine what efforts were made to educate taxpayers and tax preparers.

2) Interviewed management to determine the efforts that were made to inform taxpayers and tax preparers of the Farm Income Averaging provision.

IV. Contacted the Statistical Information Services office of the IRS Statistics of Income function to obtain data regarding the number of U.S. Individual Income Tax Returns (Form 1040) containing Schedules J in TY 2001.

Appendix II

Major Contributors to This Report

Richard J. Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)
Kyle R. Andersen, Acting Director
L. Jeff Anderson, Acting Audit Manager
W. George Burleigh, Senior Auditor
Greg A. Schmidt, Senior Auditor
James E. Adkisson, Computer Specialist

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Acting Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Wage and Investment Division SE:W
Director, Customer Assistance, Relationships, and Education, Wage and Investment Division SE:W:CAR
Director, Taxpayer Education and Communication, Small Business/Self-Employed Division SE:S:T
Director, Communications and Liaison, Small Business/Self-Employed Division SE:S:M:CL
Director, Media and Publications, Wage and Investment Division SE:W:CAR:MP
Director, Tax Forms and Publications, Wage and Investment Division SE:W:CAR:MP:T
Staff Assistant, Small Business/Self-Employed Division SE:S
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaisons:
    Commissioner, Small Business/Self-Employed Division SE:S:COM
    Commissioner, Wage and Investment Division SE:W:S:PA

Appendix IV

Outcome Measures

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

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; $33,057,910 in overpaid tax from 64,315 taxpayer accounts (see page 2).

Methodology Used to Measure the Reported Benefit:

Using computer programs, we identified 206,752 taxpayer accounts on the Internal Revenue Service's (IRS) Individual Master File[1] with positive farm income in Tax Year (TY) 2001 and a loss in 1 of the prior 3 years. We downloaded information from these accounts into our own database.

We reduced the number of accounts in our database to 78,621 by identifying taxpayer accounts with farm income of $500 or more, Taxable Income of $500 or more, no Alternative Minimum Tax in TY 2001, and a loss in 1 of the prior 3 years. We found 8,713 of these accounts had used a Farm Income Averaging (Schedule J) to calculate their TY 2001 taxes, leaving 69,908 accounts in our database.

We selected a statistical sample of 100 accounts from the population of 69,908 accounts that remained. Our sample size was determined based on a 95 percent confidence level, an expected error rate of 7 percent, and a precision of ± 5 percent. The actual error rate from our sample was 8 percent. There were 92 of the 100 returns that we reviewed that would benefit from averaging the farm income. The average tax savings from completing a Schedule J for TY 2001 and averaging the farm income for the 92 returns reviewed was $514 per return. When this average adjustment is projected to 92 percent of the population of 69,908, it resulted in 64,315 taxpayers and a total of $33,057,910[2] in overpaid taxes.

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[1] The IRS database that maintains transactions or records of individual tax accounts.
[2] This point estimate is based on a 95 percent confidence level and a precision of ± $7.6 million.

Appendix V

Taxpayer and Tax Preparer Questionnaire Results

We requested and obtained approval from the Office of Management and Budget to contact taxpayers to determine why farmers or preparers were not using Farm Income Averaging (Schedule J) to calculate income taxes on their Tax Year (TY) 2001 U.S. Individual Income Tax Returns (Form 1040).

We sent questionnaires to 92 taxpayers that would have paid less income tax had they computed their TY 2001 income taxes using Schedule J. The purpose of the questionnaires to taxpayers was to determine why the taxpayers did not use Schedule J if they prepared their own tax returns and, if their returns were prepared by paid tax preparers, to obtain permission to contact their preparers. The purpose of the questionnaires to tax preparers was to determine why they did not use Schedule J when preparing their clients' tax returns.

Taxpayer Responses

We obtained responses from 52 taxpayers and found that 67 percent of the taxpayers were not aware of the Farm Income Averaging provision and 23 percent were aware of the provision. The other 10 percent either did not respond to that question on our questionnaire, or did not recall if they were aware of the provision when they prepared their tax return.

Paid Preparer Responses

Through our contact with the 52 taxpayers above, we obtained permission and were able to contact 30 paid tax preparers. The questions we asked these preparers and their answers are summarized below:

1) At the time you prepared your client's TY 2001 Form 1040, were you aware of the Farm Income Averaging provision?

    - Yes – 83 percent.
    - No – 17 percent.

2) If you answered yes, please indicate why you did not calculate the tax using Schedule J.[1]

    - Thought there would be no benefit[2] – 60 percent.
    - Oversight – 20 percent.

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[1] The percentages indicated for this question were based on the 25 preparers that were aware of the Farm Income Averaging provision.
[2] This figure includes those preparers that did not know the IRS had changed the regulations to allow negative taxable income in an averaging calculation; those that used software with inappropriate instructions that led them to believe there would be no benefit; and those that thought since only a fraction of the total income was from farming, the benefit of averaging would be negligible.

- Miscellaneous reasons – 20 percent.

3) Are you aware of the Internal Revenue Service's (IRS) Bulletins for farmer groups and preparers?

   - Yes – 60 percent.
   - No – 40 percent.

4) Do you use the IRS Internet site to review for tax law changes?

   - Yes – 77 percent.
   - No – 23 percent.

5) Were you aware changes were made to the IRS' tax regulations in TY 2000 that enabled farmers to use negative taxable income in the income averaging computation?

   - Yes – 67 percent.
   - No – 30 percent.
   - Not sure – 3 percent.

6) If you answered yes to question 5, how did you learn about the change?

   - Tax symposium – 53 percent.
   - IRS Publication 225[3] – 7 percent.
   - Other – 7 percent.
   - Not applicable – 33 percent.
     (Preparer was not aware of the provision at all or was not aware the provision had changed to allow the use of negative taxable income.)

[3] *Farmer's Tax Guide*.

Appendix VI

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

RECEIVED
MAR 16 2004

March 12, 2004

MEMORANDUM FOR GORDON C.MILBOURN, III
ASSISTANT INSPECTOR GENERAL FOR AUDIT
(SMALL BUSINESS AND CORPORATE PROGRAMS)

FROM: Dale F. Hart
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Most Taxpayers That Could Benefit from The Farm Income Averaging Provision Are Not Using It (Audit #200330019)

I have reviewed your report identifying farmers that could have benefited from the Farm Income Averaging legal provision in Tax Year (TY) 2001 and your determination as to why they did not use this provision to compute their income tax.

We agree with your recommendation. We have already taken actions to educate farmers, preparers, and tax software developers about the Farm Income Averaging provision and its potential benefits. However, we will explore whether additional outreach efforts or changes to form instructions can improve the understanding of taxpayers and tax professionals. For reasons cited in our attachment, we disagree with the Statement of Outcome Measures.

Our detailed response to your recommendation is attached. If you have any questions concerning this matter, please contact me or have a member of your staff contact Sherrill Fields, Acting Director, Taxpayer Education and Communication, Small Business/Self-Employed Division at (202) 283-0222.

Attachment

ATTACHMENT

The Service's response to your recommendation follows:

RECOMMENDATION 1

The Director, Taxpayer Education and Communication, Small Business/Self-Employed Division, should work with the Director, Tax Forms and Publications, Wage and Investment Division, to develop a strategy to further educate farmers, preparers, and income tax software developers about the availability and benefits of the Farm Income Averaging provision.

CORRECTIVE ACTION

We agree that developing a strategy to further educate farmers, preparers and income tax software developers about the availability and benefits of the Farm Income Averaging provision will be beneficial. We will continue our ongoing actions to educate taxpayers, practitioners and tax software developers about this provision.

IRS originally interpreted the farm income averaging provision of the tax law to exclude negative income from the calculations. Members of the Senate issued a letter to IRS stating that this interpretation was inconsistent with the intent of the Congress and recommending that proposed IRS regulations be amended to clarify that "taxable income" may be negative for the purpose of farm income averaging. The IRS responded by making changes to the regulations to enable farmers to use negative taxable income in their averaging computations.

We notified approximately 4,400 farmers via letter that they were required to file amended tax returns to claim any refund of tax for TY's 1998 and 1999. The IRS published information regarding the retroactive changes in the TY's 2000, 2001, and 2002 instructions for Schedule J, "Farmer's Income Averaging". In addition, the retroactive change was reflected in Publication 225, "The Farmer's Tax Guide" and Publication 553, "Highlights of 2000 Tax Changes".

We directed farmers to send amended returns, Form 1040X, "Amended U.S. Individual Income Tax Return," or Form 872, "Consent to Extend the Time to Assess Tax," to the IRS Philadelphia Campus. As of February 23, 2004, Philadelphia has received 406 Forms 1040X from farmers. Some farmers may have sent Forms 1040X for more than one year. Approximately 180 farmers who have filed Form 872 have not yet submitted Form 1040X. Since farmers who have filed Form 872 are allowed to file Form 1040X by April 15, 2004, we may receive more Forms 1040X.

During 2003, an E-news article on farm income averaging was sent to 90,000 tax professionals. Publication 225 also addresses negative taxable income. It states that if taxable income is zero for any base year because deductions exceed income, you may have negative taxable income for that year to combine with your Elected Farm Income

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(EFI) on Schedule J. Schedule J for TY's 2000-2002 advised taxpayers that rules for using negative taxable income in computing averaged income. Schedule F, "Profit or Loss from Farming," instructs that Schedule J can be used to compute tax by averaging farm income over the previous three years, and that using this computation may reduce tax.

We have reviewed all forms and publications targeting farmers and farm income. Although this provision is fully explained in current forms and publications, we will add instructional emphasis on the provision if practitioners and stakeholders in the farming industry indicate it is needed. IRS representatives meet annually with the National Farm Income Tax Extension Committee to gather input for Publication 225. We will include this issue on the 2004 meeting agenda.

We will also analyze the extract that TIGTA prepared for this audit when targeting future outreach efforts. Where we determine that more outreach is necessary, we will advertise the potential taxpayer benefit of using the changed method for calculating taxes to targeted stakeholder groups.

IMPLEMENTATION DATE

June 15, 2004

RESPONSIBLE OFFICIAL

Director, Taxpayer Education and Communication (TEC), Small Business and Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

The Director, Tax Forms and Publications, Wage and Investment Division will work with the Director, Taxpayer Education and Communication, Small Business and Self-Employed Division to develop an educational strategy addressing this provision.

The Director, TEC will analyze the extract that TIGTA prepared for this audit when targeting future outreach efforts. Where we determine that more outreach is necessary, we will advertise the potential taxpayer benefit of using the changed method for calculating taxes to targeted stakeholder groups.

The Director, Tax Forms and Publications will include the farmer's income averaging issue on the 2004 meeting agenda for the National Farm Income Tax Extension Committee. If we determine that additional information is needed, we will add instructional emphasis on the provision.

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OUTCOME MEASURES

We do not agree with the Statement of Outcome Measures in Appendix IV that states that over 64,000 taxpayers overpaid their taxes by more than $33 million by not taking advantage of the tax provision.

We discovered a methodological error in the sample size computations in Appendix IV, Page 11. The formula used to determine a sample size of 100 is the formula for estimating a population proportion. To correctly determine the sample size for estimating actual dollars saved "X" by computing Schedule J, an estimate of the variance of "X" is needed in a different formula. Since this methodological error may significantly affect the validity of findings and projected results, we cannot accept the outcome measures.