

**Processing Improvements Have Helped
Ensure United States Estate Tax Return Filers
Receive the Maximum Allowable Credits**

July 2004

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

July 14, 2004

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Gordon C. Milbourn III

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

SUBJECT: Final Audit Report - Processing Improvements Have Helped
Ensure United States Estate Tax Return Filers Receive the
Maximum Allowable Credits (Audit # 200330029)

This report presents the results of our review of the processing of allowable credits on United States Estate Tax Returns (Form 706). The overall objective of this review was to evaluate the effectiveness of the Internal Revenue Service's (IRS) corrective actions taken in response to the recommendations in a prior Treasury Inspector General for Tax Administration report.¹ This included evaluating the actions planned or taken to update or create necessary computer programs, processing procedures, tax forms, instructions, and publications related to Form 706.

In summary, the IRS effectively implemented the corrective actions agreed to in our prior audit report. In that report, we determined that understatements of unified credit amounts,² which resulted in incorrect estate taxes, were not identified and adjusted during processing. During this review, we found the IRS' corrective actions effectively ensured filers received the maximum unified credit amounts in accordance with tax law changes.

¹ *The Internal Revenue Service Processed Most Estate and Gift Tax Returns Accurately, but Some Estates Did Not Receive the Maximum Tax Credit* (Reference Number 2000-30-115, dated August 2000).

² Taxpayer Relief Act of 1997, 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.). This Act provided for gradual increases to the maximum amount of unified credit that can be applied against a taxpayer's estate and/or gift tax. For taxpayers who died in the years 2002 and 2003, the unified credit amount is \$345,800. This amount is scheduled to increase until it reaches \$1,455,800 in 2009.

Since we are making no recommendations in this report, a response was not required. However, key IRS management officials reviewed the report prior to issuance.

Copies of this report are also being sent to the IRS managers affected by the report. Please contact me at (202) 622-6510 if you have questions or Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (215) 516-2341.

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Background

Taxpayers who give money or property during their lifetimes may be subject to Federal gift tax. Further, the money and property owned by a taxpayer at date of death (the estate) may be subject to Federal estate tax. A taxable estate is a decedent's gross estate less allowable deductions. The executor of a decedent's estate uses a United States Estate Tax Return (Form 706) to compute the estate tax imposed by the Internal Revenue Code.¹ The Form 706 must be filed within 9 months of a taxpayer's date of death.

The Form 706 allows a taxpayer or executor to subtract a "unified credit" from the gift tax or estate tax owed, thereby reducing or eliminating the tax. If a taxpayer does not use the entire maximum allowable unified credit during his or her lifetime to reduce or eliminate gift taxes, the estate can use the remainder to reduce or eliminate estate tax upon the taxpayer's death. The Taxpayer Relief Act of 1997¹ provided for gradual increases to the maximum unified credit amounts that can be used to reduce a taxpayer's estate tax. The allowable unified credit amount for Tax Years (TY) 2002 and 2003 was \$345,800. This amount is scheduled to increase until it reaches \$1,455,800 in TY 2009.

Increases in the unified credit amount affected the processing of approximately 120,000 estate tax returns filed in Fiscal Year 2002.² These returns accounted for approximately \$25 billion in gross tax revenue.

A Treasury Inspector General for Tax Administration report issued in 2000³ identified problems with the Internal Revenue Service's (IRS) procedures for handling estate tax returns. Procedures did not cover the processing of older versions of the Form 706, which had incorrect pre-printed unified credit amounts for the years being filed. As a result, understatements of the unified credit amounts, which resulted in incorrect estate taxes, were not identified and

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 IRS Data Book 2002 Tables 1 and 2 (estate tax returns).

³ *The Internal Revenue Service Processed Most Estate and Gift Tax Returns Accurately, but Some Estates Did Not Receive the Maximum Tax Credit* (Reference Number 2000-30-115, dated August 2000).

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adjusted during processing. We estimated that, without corrective actions, approximately 1,250 estates of entitled decedents would overpay \$11.6 million in TY 1999.

Our audit work for the current review was conducted at the Brookhaven Campus⁴ during the period November 2003 through March 2004, covering work performed by the Cincinnati Internal Revenue Service Campus (CIRSC). The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Internal Revenue Service Actions Helped Reduce Errors in Processing Estate Tax Returns and Associated Unified Credits

We determined that the IRS effectively implemented the corrective actions agreed to in response to our prior audit report. The IRS effectively updated necessary processing procedures, tax forms, and instructions related to Form 706 and associated unified credits. The IRS effectively updated Internal Revenue Manual (IRM) instructions for processing Form 706 to reflect the correct associated unified credit amount limitations and exclusions. Form 706 and related instructions were effectively revised to help filers determine the correct unified credit amounts. In addition, due to the IRS' ongoing reorganization and centralization of campus sites, the CIRSC was chosen to process the Forms 706. All IRM sections, instructions, publications, forms, and web sites effectively gave reference to the new processing site address for Form 706.

The IRS also successfully updated or created the necessary computer programs to accurately process the unified credits. The Requests for Information Services, the documents submitted to request computer program changes, were timely submitted. We verified that the correct tax law provisions regarding the unified credit amounts were programmed through TY 2009.

In addition, the IRS effectively educated taxpayers about changes in the estate tax credits through publications and

⁴ The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

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web sites. The IRS publication *Introduction to Estate and Gift Taxes* (Publication 950; revised March 2002)⁵ was revised effectively with tables and instructions for determining the correct unified credit amounts through TY 2009. The IRS Small Business/Self-Employed Division web site gives comprehensive explanations of estate tax, the associated unified credit, and applicable exclusion amounts through TY 2009.

We also verified, through reviews of processed returns and outgoing notices, that taxpayers received the correct unified credit amounts.

- We reviewed a judgmental sample of 100 Forms 706 for TYs 2002 and 2003 and found that filers received the correct unified credit amounts in accordance with tax law provisions.
- We researched all 138 estate tax accounts for Forms 706 processed in July 2003, 85 of which had claimed unified credits. Of the 85 accounts, 83 were available for research and showed correct unified credit amounts for the date of death in accordance with tax law provisions. Although tax returns were not available for review for the remaining two accounts, there was no indication that the credits were incorrect.
- We monitored outgoing notices from the CIRSC Notice and Review function to identify any Forms 706 with unified credits that were printed during the periods October 2002, January and October through December 2003, and February 2004. We determined the IRS accurately corrected unified credit amounts on Forms 706 that were filed incorrectly and sent explanatory notices to the administrators of the estates.

⁵ Cat. No. 14447X.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall audit objective of this review was to evaluate the effectiveness of the corrective actions taken in response to the recommendations in a prior Treasury Inspector General for Tax Administration report.¹

To accomplish the objective, we:

- I. Determined whether corrective measures had been taken by the Internal Revenue Service (IRS) to ensure filers of United States Estate Tax Returns (Form 706) receive the correct unified credit amounts.²
 - A. Reviewed corrective actions taken to resolve processing problems as a result of previous audit findings and recommendations.
 1. Reviewed the response to the original report to identify which findings required corrective actions by the IRS and identified how and when the corrective actions were implemented.
 2. Evaluated the adequacy and effectiveness of corrective measures taken.
 - B. Interviewed appropriate personnel in the Customer Account Services, Subject Matter Experts for Code and Edit and Error Resolution, and Notice and Review functions at the Cincinnati Internal Revenue Service Campus (CIRSC)³ to determine whether the necessary changes had been made. We determined whether the tax forms, instructions, and publications had been revised to help taxpayers comply with the tax laws.
 - C. Determined whether the applicable Requests for Information Services requesting computer program changes had been submitted and whether computer programs had been changed and were in place to ensure timely and accurate processing of Form 706.
- II. Determined whether Form 706 filers received the correct unified credit amounts in accordance with tax law provisions.

¹ *The Internal Revenue Service Processed Most Estate and Gift Tax Returns Accurately, but Some Estates Did Not Receive the Maximum Tax Credit* (Reference Number 2000-30-115, dated August 2000).

² Taxpayer Relief Act of 1997, 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.). This Act provided for gradual increases to the maximum amount of unified credit that can be applied against a taxpayer's estate and/or gift tax. For taxpayers who died in the years 2002 and 2003, the unified credit amount is \$345,800. This amount is scheduled to increase until it reaches \$1,455,800 in 2009.

³ The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

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- A. Selected samples of Forms 706 from the CIRSC using a Business Master File (BMF)⁴ extract. Using a randomly selected judgmental sample of Forms 706 for each of Tax Years 2002 and 2003, we determined through research of IRS records whether associated unified credit amounts were in accordance with tax law change provisions. Judgmental sampling was chosen due to time constraints.
- B. Reviewed all 34 outgoing notices identified by the CIRSC Notice and Review function that involved Forms 706 with unified credits which were printed during the periods October 2002, January and October through December 2003, and February 2004. We determined whether the notices reflected accurate unified credit amounts through research of IRS records. We also determined whether the IRS accurately adjusted any unified credit amounts on the Forms 706 that were incorrect and sent explanatory notices to the administrators of the estates.
- C. Performed a preliminary survey using an extract of all Forms 706 processed to the BMF for July 2003. Of the 138 records, 85 were found with unified credits. We determined through research of IRS records whether the unified credits were correct according to the date of death.

⁴ The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes. Form 706 is considered a business form.

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Appendix II

Major Contributors to This Report

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Appendix III

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