The 2003 Filing Season Was Completed Timely and Accurately, but Some New Tax Law Changes Were Not Effectively Implemented

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

October 17, 2003

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Assistant Inspector General for Audit (Small Business and Corporate Programs)

SUBJECT: Final Audit Report - The 2003 Filing Season Was Completed Timely and Accurately, but Some New Tax Law Changes Were Not Effectively Implemented (Audit # 200240076)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) timely and accurately processed paper and electronic individual income tax returns during the 2003 Filing Season.[1] The audit focused on the implementation of tax law changes[2] that affected Tax Year (TY) 2002 individual income tax returns.

Overall, the 2003 Filing Season went well and most of the 122 million individual income tax returns received through May 30, 2003, were timely and accurately processed. We determined that the IRS correctly implemented most of the key tax law changes that affected TY 2002 individual income tax returns. However, we identified some areas of the tax laws that were not correctly implemented and could result in loss of taxpayer entitlements and erroneous tax assessments. For example, we identified taxpayers that were allowed retirement savings contributions credits and student loan interest deductions in excess of the amounts allowed by the new tax law changes, taxpayers with potential unclaimed Additional Child Tax Credits (ACTC), and taxpayers that were allowed a "dual benefit" for the tuition and fees deduction and the education credit.

Correctly implementing tax law changes is one of the biggest challenges facing the IRS every filing season. The recommendations included in this report can assist the IRS in meeting this challenge by improving compliance with new tax legislation. Specifically, we recommended the Commissioner, Wage and Investment Division, continue to notify

[1] The period from January through mid-April when most individual income tax returns are filed.
[2] See Appendix VII for an overview of the tax law provisions examined during this review.

taxpayers that appear eligible for the ACTC and strengthen controls to prevent some taxpayers from receiving erroneous tax reductions by claiming the tuition and fees deduction when they have also claimed an education credit (dual benefit).

Management's Response: The IRS was pleased that our report recognized the success of the 2003 Filing Season. IRS management agreed with three of our four recommendations and is considering the fourth recommendation, but needs additional information prior to making a determination. Specifically, the IRS agreed to follow through with its plans to advise taxpayers who appear eligible but did not claim the ACTC on their 2002 tax returns, and will identify potentially eligible taxpayers during the processing of 2003 tax returns and notify them of their potential eligibility. The IRS plans to integrate the identification and notification of potentially eligible ACTC taxpayers into the tax return processing process for tax years after 2003. The IRS also agreed to revise Education Credits (Hope and Lifetime Learning Credits) (Form 8863) for TY 2003 to include a cautionary statement advising taxpayers that they cannot claim the tuition and fees deduction and an education credit for the same individual, and will consider the feasibility of a programming change to identify this issue during tax return processing. The IRS will request the additional information from IRS Chief Counsel before making the final decision. Finally, the IRS will have representatives from Submission Processing, Compliance, and Tax Forms and Publications review the results of examinations of tax returns claiming both the education tuition and fees deduction to determine if corrective actions are needed to address any identified compliance trends. Management's complete response to the draft report is included as Appendix VIII.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

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Background

The filing season[1] affects individual taxpayers and is always a highly critical program for the Internal Revenue Service (IRS). The IRS estimated that 132.3 million[2] individual income tax returns would be filed during Calendar Year (CY) 2003 and that most of these would be filed during the filing season. It is during the filing season that most individuals file their income tax returns and call the IRS if they have questions about specific tax laws or filing procedures.

Correctly implementing tax law changes is one of the biggest challenges facing the IRS every filing season. This is because the IRS must identify the tax law changes; revise the various tax forms, instructions, and publications; and reprogram its computer system used in processing returns.

In CY 2003, the IRS processed individual income tax returns at 10 Submission Processing sites located throughout the country. Of these 10 sites, 8 are Wage and Investment (W&I) Division sites[3] and 2 are Small Business/ Self-Employed (SB/SE) Division sites.[4] The eight W&I Division sites processed paper filed individual income tax returns, and three of these sites also processed electronically filed individual income tax returns. The two SB/SE Division sites processed the returns of small businesses and self-employed taxpayers, along with electronically filed individual income tax returns. However, if any conditions requiring further processing are identified on the electronic individual returns, they are sent to the Austin or Andover Submission Processing Sites for resolution.

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[1] The period from January through mid-April when most individual income tax returns are filed.

[2] This estimate includes 78 million paper returns and 54.3 million electronic returns.

[3] The W&I Division sites assist approximately 121 million taxpayers that file almost 93 million individual income tax returns with no accompanying business schedules (based on Tax Year 2000 data).

[4] The SB/SE Division sites assist approximately 7 million small businesses, including corporations and partnerships with assets of $10 million or less. They also assist approximately 33 million self-employed and supplemental income earners that have more complex tax issues.

Tax returns and related schedules are processed through the IRS' computer system and recorded on each individual's tax account. This computer system is made up of a complex series of sub-systems that are nationally linked and programmed to check the validity and math accuracy of the data provided.

IRS sources indicated that as of May 30, 2003, approximately 99 million individual income tax returns had been processed this year without an error. There were 15 million returns on which an error was found.[5] While not all errors require a taxpayer notice, in some instances, when a taxpayer error is found during processing, the IRS will send a notice that asks for additional information or explains any change that is made to the amount of tax due or refund.

As part of our overall 2003 Filing Season audit strategy, we conducted several reviews (see Appendix VI for a listing of these reviews) to assess the IRS' preparation for processing individual income tax returns during the 2003 Filing Season. This review is a continuation of that strategy and determined the effects on taxpayers of previously identified issues.

We conducted this review from January through May 2003 at the W&I Division office in Atlanta, Georgia, and the Submission Processing offices in Cincinnati, Ohio, and New Carrollton, Maryland. Audit fieldwork was performed at the Austin and Kansas City Submission Processing Sites.

This 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.

The 2003 Filing Season Was Timely Completed With Most Returns Accurately Processed

Overall, the 2003 Filing Season went well and most of the 122 million individual income tax returns received through May 30, 2003, were timely and accurately processed. The IRS completed processing of returns on schedule and timely issued refunds within the required 45 days of the

[5] These errors include taxpayer and IRS errors.

April 15, 2003, return due date.[6] As of May 30, 2003, the IRS had processed over 114 million individual income tax returns (including 52 million processed electronically, an increase of 12 percent over 2002). The biggest increase in alternative ways of filing was seen in the On-Line Filing From Home Computers volumes. In May 2003, the IRS reported that nearly 12 million taxpayers had used this filing method, which is a 27 percent increase over last year.

The 2003 Filing Season included several new and significant tax law changes, many created by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).[7] Two of these changes will assist taxpayers with the costs of education and encourage retirement savings. These changes are significant because they could help an estimated 86.5 million taxpayers by providing tax benefits of up to $7.6 billion in Fiscal Year 2003. See Appendix VII for an overview of the tax law provisions examined during this review.

Our review of the IRS' implementation of the following key tax law changes for the 2003 Filing Season (affecting Tax Year (TY) 2002 individual tax returns) showed that most of the following changes were correctly implemented or subsequently corrected after processing began:

- Tuition and Fees Deduction.
- Retirement Savings Contributions Credit.
- Individual Retirement Arrangements (IRA) Deduction.
- Student Loan Interest Deduction.
- Adoption Credit.
- Educator Expense Deduction.
- Earned Income Tax Credit.

[6] Internal Revenue Code (I.R.C.) § 6611(e) (2002).
[7] Pub. L. No. 107-16, 115 Stat. 38 (2001).

While most of these changes were correctly implemented, we did identify some areas of the tax laws that were not correctly implemented and could result in loss of taxpayer entitlements and erroneous tax assessments.[8]

Taxpayers Benefit From Corrections of Programming Errors

Last year, we initiated several reviews to assess the IRS' preparation for the 2003 Filing Season. One review[9] focused on computer program revisions for key tax law changes that would affect TY 2002 individual income tax returns. We included follow-up tests pertaining to these revisions in this review to assess the effect on taxpayers and return processing during the 2003 Filing Season.

In the prior review, we identified an inconsistency between the IRS' computer program and the tax law. The IRS planned to not allow the retirement savings contributions credit to taxpayers that could be claimed as a dependent on another taxpayer's return. For example, assume a taxpayer files a return and claims the credit but does not claim a personal exemption. When this taxpayer does not claim his or her personal exemption, the IRS interprets the omission as an indication that someone else, such as a parent, can claim the taxpayer as a dependent. However, the law states that the dependency exemption must have been actually claimed by someone else for the taxpayer to not be eligible for the retirement savings contributions credit. The mere indication of the possibility that a taxpayer can be claimed as a dependent does not disqualify this taxpayer.

Based upon our identification and reporting of this issue during the prior review, the IRS took actions early in the 2003 Filing Season that corrected the computer program. The results of an analysis of returns processed through May 16, 2003, showed that 4,083 taxpayers received credits totaling over $833,000 that otherwise would have been disallowed if the IRS had not made the correction.

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[8] See Appendix V for the specific tax law changes that were not correctly implemented.
[9] *Computer Programming Requests for the 2003 Filing Season Were Timely Prepared and Generally Accurate* (Reference Number: 2003-40-112, dated May 2003).

Also in the prior review, we identified a computer programming error that would have affected taxpayers with the following characteristics:

- Married filing jointly filing status.
- Modified Adjusted Gross Income (AGI)[10] between $64,000 and $150,000.
- Claiming the additional $500 IRA deduction for 1 spouse age 50 or older and not covered by a retirement plan.

The IRS planned to disallow the additional $500 IRA deduction on returns that claimed a deduction for a self-employed retirement plan.[11] However, the tax law indicates that the spouse who is age 50 or older and not covered by a retirement plan is eligible for the additional $500 IRA deduction.

The IRS corrected its computer program early in the 2003 Filing Season. Using computer analysis, we verified that eligible taxpayers were correctly allowed the additional $500 deduction. However, we were unable to determine the number of returns affected because we did not obtain the necessary computer data to perform the analysis.

Actions Have Been Scheduled to Correct Several Conditions Previously Reported

Many tax credits and deductions that individual taxpayers may claim are subject to limitations based upon the taxpayer's AGI or modified AGI. The EGTRRA created the new retirement savings contributions credit and increased the income limitation for the student loan interest deduction. These provisions have a phase-out range when the deduction or credit is reduced and then eliminated, or "phased out," as the AGI or modified AGI increases and then reaches the upper limit.

For the two provisions mentioned above, we determined that the IRS disallowed the credit or deduction when the

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[10] The AGI is calculated after certain adjustments are made, but before standard or itemized deductions and personal exemptions are subtracted. Modified AGI is AGI calculated without regard to certain deductions or exclusions.

[11] This deduction is claimed on line 31 of the United States (U.S.) Individual Income Tax Return (Form 1040) for TY 2002.

upper limit was exceeded. However, the IRS did not have procedures in place to identify and adjust the credit or deduction when the AGI or modified AGI fell within the phase-out range. This allowed taxpayers to receive a larger credit or deduction than they were entitled to receive.

Retirement Savings Contributions Credit – The results of an analysis of returns processed through May 16, 2003, showed that 8,860 taxpayers received credits that exceeded the amount allowable under the tax law. The excess credits totaled over $4 million.

We first identified this issue during the review of the IRS' preparation for the 2003 Filing Season.[12] At that time, the IRS told us that the new tax form for claiming the credit, Credit for Qualified Retirement Savings Contributions (Form 8880), was not available in time to design a computer programming change to account for the different credit percentages based upon AGI and filing status. However, in the IRS' management response to our report, the IRS stated the computer programs for the 2004 Filing Season will be revised to verify that the credit has been properly reduced based upon the taxpayer's AGI and filing status. We will follow up to ensure the correction is implemented for the 2004 Filing Season.

Student Loan Interest Deduction – We identified 6,837 taxpayers that were erroneously allowed deductions that exceeded the allowable amount under the tax law based upon their modified AGI and filing status. The excess deductions totaled over $5 million.[13] Assuming all 6,837 taxpayers received a tax benefit from the student loan interest deduction, the estimated tax effect is $500,000.[14]

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[12] *Computer Programming Requests for the 2003 Filing Season Were Timely Prepared and Generally Accurate* (Reference Number: 2003-40-112, dated May 2003).
[13] This computation assumes each taxpayer's gross student loan interest amount was $2,500 and excludes returns on which the excess deduction was less than $100.
[14] We used the lowest tax rate of 10 percent to compute the tax effect (i.e., 10 percent times $5 million of student loan interest deductions equals a tax effect of $500,000).

We first identified this issue during the review mentioned above.[12] IRS management responded that they planned to correct their computer programs to limit the deduction based upon the taxpayer's modified AGI and filing status beginning with the 2004 Filing Season. We will follow up to ensure the correction is implemented for the 2004 Filing Season.

Efforts Continue to Ensure Taxpayers Receive the Additional Child Tax Credit

In prior TIGTA reviews,[15] we reported that during the 2002 Filing Season, the IRS processed over 600,000 TY 2001 individual income tax returns on which taxpayers appeared eligible for, but did not claim, Additional Child Tax Credits (ACTC) totaling $238 million. We recommended that the IRS reevaluate placing a higher priority on the discretionary computer programming necessary to implement future outreach initiatives based on the related tax laws that the initiatives are intended to support. The IRS declined the recommendation and did not implement any additional computer programming to identify taxpayers that appeared eligible for, but did not claim, the ACTC.

However, the IRS did agree to mail a special notice to taxpayers advising them of their potential eligibility for the ACTC. We assisted in this notification effort by providing the names and addresses of taxpayers who appeared eligible for, but did not claim, the ACTC on TY 2001 returns processed through October 4, 2002. In November 2002, the IRS began mailing the special notices to the 644,008 taxpayers identified as potentially eligible for the ACTC.[16]

This effort had a positive effect. Of these 644,008 taxpayers, approximately 499,555 (78 percent) had filed a

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[15] *Outreach Initiatives Need to Ensure Taxpayers Receive the Benefit of the Child Tax and Additional Child Tax Credits* (Reference Number: 2002-40-203, dated September 2002), and *Although the 2002 Filing Season Was Completed Timely, Customer Service Can Be Improved During Error Processing* (Reference Number: 2002-40-200, dated September 2002).
[16] *Analysis of Statistical Information for Returns With Potentially Unclaimed Additional Child Tax Credit* (Reference Number: 2003-40-046, dated January 2003).

TY 2002 return as of August 1, 2003,[17] with no potentially unclaimed ACTC.

The IRS is continuing its efforts to address this condition in 2003. In a memorandum dated March 18, 2003, the Commissioner, W&I Division, again requested our assistance in identifying the taxpayers that appear eligible for, but did not claim, the ACTC on their TY 2002 returns. The IRS intends to use this data to mail potentially eligible taxpayers information needed to claim the ACTC.

We completed this request and informed the IRS on August 21, 2003, that we had identified 293,833 taxpayers with potentially unclaimed ACTC totaling $131 million on TY 2002 returns processed through August 1, 2003. It is important that taxpayers are aware of this valuable tax benefit because the recently enacted Jobs and Growth Tax Relief Reconciliation Act of 2003[18] provision that increases the Child Tax Credit (CTC) to $1,000 will also likely increase the number of taxpayers eligible for the ACTC in TY 2003.

For TY 2003 returns, the IRS has submitted a computer programming change to identify taxpayers that appear eligible for the ACTC but did not claim the credit.

Recommendation

1. The Commissioner, W&I Division, should continue with plans, as outlined in the March 18, 2003, memorandum, to identify and notify taxpayers by a process similar to that used for TY 2001 returns, and to notify taxpayers in 2003 and beyond that appear eligible for the ACTC but did not claim the credit.

Management's Response: The IRS plans a mail-out similar to that for TY 2001 filers for both TYs 2002 and 2003. For tax years after 2003, the IRS plans to integrate the identification and notification of taxpayers into returns

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[17] The ACTC totals were accumulated through August 1, 2003, at the request of the IRS.
[18] Pub. L. No. 108-27, 117 Stat. 752 (2003).

processing rather than notifying taxpayers by a mail-out after the filing season.

Tuition and Fees Deduction and Education Credit Create Questionable "Dual Benefit"

For the 2003 Filing Season, taxpayers were allowed to take a deduction of up to $3,000 for qualified tuition and fees paid for the taxpayers, their spouses, or their dependents. However, taxpayers may not receive a "dual benefit" by taking both the tuition and fees deduction and the education credit for the same student.

The results of an analysis of returns processed through May 16, 2003, showed that 294,743 taxpayers claimed both the tuition and fees deduction and the education credit. These taxpayers were allowed nearly $608 million of tuition and fees deductions and over $231 million of education credits.

The 294,743 taxpayers included 42,058 taxpayers with a filing status of "single" and no dependents[19] who erroneously claimed approximately $77 million in tuition and fees deductions and over $24 million in education credits. Assuming all 42,058 taxpayers received a tax benefit from the tuition and fees deduction,[20] the estimated tax effect is $7.7 million.[21] The remaining 252,685[22] taxpayers claimed $531 million in tuition and fees deductions and $207 million in education credits.

Taxpayers who claim education credits are required to complete Education Credits (Hope and Lifetime Learning Credits) (Form 8863) and identify the student, by name and Social Security Number, for whom the credit is being

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[19] We focused on single taxpayers with no dependents because it is clear that both the tuition and fees deduction and the education credit would have been claimed for the same individual, which is not allowable and, therefore, an error. It is not as clear with the taxpayer populations that filed as married filing jointly with or without dependents, head of household, and single with dependents. These taxpayers could have claimed the tuition and fees deduction and education credit for the same individual or for different individuals, which is allowable.

[20] The tuition and fees deduction should be disallowed if the taxpayer also claims the education credit.

[21] We used the lowest tax rate of 10 percent to compute the tax effect (i.e., 10 percent times $77 million of tuition and fees deductions equals a tax effect of $7.7 million).

[22] Population of 294,743 minus 42,058.

claimed. Taxpayers who claim the tuition and fees deduction, however, are not required to provide additional information, other than what is already on the return, to identify the student for whom the deduction is being claimed. Thus, the IRS is unable, manually or electronically, to compare individual identifying information for the tuition and fees deduction with the individual identifying information captured on Form 8863 for the education credit and prevent taxpayers from claiming a "dual benefit" for the same student.

We discussed this issue with W&I Division and Submission Processing officials who plan to review the issue further. IRS managers in the Tax Forms and Publications function have taken the position that, since the tuition and fees deduction is limited to expenses paid during the year by the taxpayers, their spouses, or dependents, the identifying information is already provided on the top half of the tax return, which satisfies the legal requirement. They contend that requiring additional identifying information from the taxpayer regarding the tuition and fees deduction would unnecessarily increase taxpayer burden. However, they agreed to add a cautionary statement at the top of Form 8863 to specifically alert taxpayers not to claim both the tuition and fees deduction and the education credit for the same student. This change will appear on the TY 2003 Form 8863.

The W&I Division's Compliance function is currently planning a project for Fiscal Year 2004 that will examine returns claiming the tuition and fees deduction. The purpose will be to determine if the deduction is allowable and if the education credit was also allowed.

Recommendations

To ensure that taxpayers do not improperly claim a dual benefit with the tuition and fees deduction and the education credit, the Commissioner, W&I Division, should:

2. Modify Form 8863 by adding a caution to taxpayers that they cannot claim the tuition and fees deduction and the education credit for the same individual.

Management's Response: The TY 2003 revision of Form 8863 will have a cautionary statement advising taxpayers that they cannot claim a tuition and fees deduction and an education credit for the same individual.

3. Revise IRS computer programs to identify individual income tax returns filed by single taxpayers with no dependents that claim both the tuition and fees deduction and the education credit.

Management's Response: The IRS is considering this recommendation but needs additional information before making a determination. The IRS will ask IRS Chief Counsel to provide an opinion on the legal issues of denying, during the processing of the return, the tuition and fees deduction when a single taxpayer with no dependents also claimed the education credit. Based on IRS Counsel's opinion and other feasibility considerations, the IRS will decide by January 15, 2004, if it will implement this recommendation.

4. Identify and coordinate corrective actions between the Submission Processing and Tax Forms and Publications functions that result from the IRS' planned examination of tax returns claiming the tuition and fees deduction.

Management's Response: Representatives from the W&I Division's Submission Processing, Compliance, and Tax Forms and Publications functions will coordinate to review the results of the examinations of tax returns claiming the tuition and fees deduction. Based on this research, the representatives will determine if corrective actions are needed to address any identified compliance trends.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the review was to determine whether the Internal Revenue Service (IRS) timely and accurately processed paper and electronic individual income tax returns during the 2003 Filing Season.[1] The audit focused on the implementation of tax law changes[2] that affected Tax Year (TY) 2002 individual income tax returns. To accomplish our objective, we:

I. Evaluated whether the IRS correctly implemented new tax legislation that could affect the processing of individual income tax returns during the 2003 Filing Season.

   A. Used 100 percent computer analysis of TY 2002 individual income tax returns processed nationally between January 1 and May 16, 2003, to determine if systemic controls at the Submission Processing sites incorrectly:

      1. Allowed deductions for educator expenses that exceeded the $250 limit ($500 if married filing jointly).

      2. Allowed deductions for tuition and fees that exceeded predetermined limits based on the taxpayers' filing statuses and modified Adjusted Gross Income (AGI),[3] or if the taxpayer claimed an education credit for the same student.

      3. Allowed deductions for student loan interest that exceeded predetermined limits based on the taxpayers' filing statuses and modified AGI.

      4. Processed deductions for the Individual Retirement Arrangements (IRA) by:
         a) Allowing deductions that exceeded $3,000 or $6,000 if married filing jointly.
         b) Allowing deductions that exceeded the predetermined limit based on the taxpayer's modified AGI.
         c) Disallowing an additional $500 deduction for taxpayers 50 or older.

      5. Processed credits for the retirement savings contributions by:
         a) Allowing credits that exceeded predetermined limits based on the taxpayers' filing statuses and AGI.
         b) Disallowing credits to taxpayers that could be claimed as a dependent on another taxpayer's return.

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[1] The period from January through mid-April when most individual income tax returns are filed.
[2] See Appendix VII for an overview of the tax law changes examined during this review.
[3] The AGI is calculated after certain adjustments are made, but before standard or itemized deductions and personal exemptions are subtracted. Modified AGI is AGI calculated without regard to certain deductions or exclusions.

6. Allowed adoption credits that exceeded the allowable amount of $10,000 per child or the predetermined limits based on the taxpayer's modified AGI.

B. For the returns identified as having deductions and/or credits incorrectly processed in Step A above, we judgmentally selected samples from one or more IRS processing cycles[4] to validate the exception criteria. Our 100 percent computer analysis identified taxpayers that incorrectly claimed the following:

1. A dual benefit for both the tuition and fees deduction and education credit. We reviewed 60 returns from the 33,499 processed through March 14, 2003, and identified a total population of 294,743 processed through May 16, 2003.

2. A student loan interest deduction that exceeded the allowable amount based upon the modified AGI. We reviewed 30 returns from the 1,913 processed through March 21, 2003, and identified a total population of 6,837 processed through May 16, 2003.

3. A retirement savings contributions credit that exceeded the allowable amount based upon the taxpayers' filing statuses and AGI. We reviewed 35 returns from the 542 processed through February 21, 2003, and identified a total population of 8,860 processed through May 16, 2003.

C. Manually screened TY 2002 individual income tax returns between January 29 and February 3, 2003, at the Austin Submission Processing Site and reviewed 30 returns claiming the Earned Income Tax Credit (EITC) to ensure the following:

- The EITC amount was increased for certain jointly filed returns.
- The new definition of earned income was properly applied.
- The Alternative Minimum Tax was not used to reduce the EITC.
- The modified AGI was eliminated from the EITC calculation.

II. Determined whether the IRS' monitoring system indicated that returns were being processed timely and accurately.

A. Monitored various Submission Processing site production and inventory reports produced between January and April 25, 2003.

B. Monitored the Error Resolution System (ERS)[5] inventories from various ERS reports produced between January and April 25, 2003, to determine whether any ERS capacity issues caused any processing delays in the resolution of errors on returns.

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[4] Submission Processing sites process returns on a weekly basis that ends each Friday of the calendar year. Each weekly period is referred to as a "cycle." For example, the cutoff date for cycle 200321 is May 16, 2003.
[5] The ERS is used to correct errors made by taxpayers or IRS employees during the initial processing of tax returns.

C. Monitored the weekly teleconferences coordinated by the Submission Processing office in Cincinnati, Ohio, and the Austin Submission Processing Site weekly meetings between January and April 2003, to identify emerging issues that could affect the processing of TY 2002 individual income tax returns.

D. Monitored the Submission Processing office web site, the IRS public web site, and other web sites deemed necessary to identify potentially significant issues that could affect the processing of TY 2002 individual income tax returns.

III. Evaluated whether the IRS corrected problems identified in a prior Treasury Inspector General for Tax Administration report.[6]

A. Used the computer to extract and analyze IRS Individual Master File (IMF)[7] Return Transaction File return data processed between January and August 1, 2003, to identify TY 2002 individual income tax returns on which the taxpayer appeared to be eligible for, but did not claim, the Additional Child Tax Credit (ACTC).[8]

B. Evaluated a judgmental sample of 30 return records to determine whether the computation of the unclaimed ACTC was correct.

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[6] *Outreach Initiatives Need to Ensure Taxpayers Receive the Benefit of the Child Tax and Additional Child Tax Credits* (Reference Number: 2002-40-203, dated September 2002).
[7] The IMF is the IRS database that maintains transactions or records of individual tax accounts.

Appendix II

Major Contributors to This Report

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Appendix III

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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 the Congress.

For all of the outcomes listed in this appendix, we conducted computer analyses of Tax Year (TY) 2002 individual income tax return records. The records were processed by the Internal Revenue Service (IRS) Submission Processing sites between January 1, 2003, and May 16, 2003,[1] and posted to the Individual Master File (IMF).[2] We developed specific criteria to identify returns affected by the tax law changes covered in this review. We used further computer analysis and auditor evaluation of return data to determine if the IRS accurately processed individual paper and electronic tax returns during the 2003 Filing Season.[3]

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Actual; 4,083 taxpayers received retirement savings contributions credits totaling over $833,000 that otherwise would have been disallowed if the IRS had not implemented corrective action early in the 2003 Filing Season (see page 4).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify all taxpayers with a Dependency Status Indicator[4] of "1" and the total retirement savings contributions credits allowed by the IRS that would have been disallowed if the IRS had not corrected the computer program error that we identified in a prior review.[5]

Type and Value of Outcome Measure:

- Revenue Protection – Potential; 8,860 taxpayers received over $4 million of retirement savings contributions credits in excess of the amount allowable under the law (see page 5).

[1] The Additional Child Tax Credit totals were accumulated through August 1, 2003, at the request of the IRS.
[2] The IMF is the IRS database that maintains transactions or records of individual tax accounts.
[3] The period from January through mid-April when most individual income tax returns are filed.
[4] A taxpayer may indicate that he or she could be claimed on the tax return of another taxpayer by not checking the personal exemption box for self on line six of the return. When a taxpayer makes such an indication, IRS processing sets a value known as the Dependency Status Indicator to "1."
[5] *Computer Programming Requests for the 2003 Filing Season Were Timely Prepared and Generally Accurate* (Reference Number: 2003-40-112, dated May 2003).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify the number of taxpayers with retirement savings contributions credits that exceeded the amount allowable under the tax law based upon their Adjusted Gross Income (AGI)[6] and filing status. In certain instances, the potential tax effect from the excess credit allowed may be less since this credit is not refundable and may only be used to reduce the tax liability.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; 6,837 taxpayers received over $5 million of student loan interest deductions in excess of the amount allowable under the law. Assuming all 6,837 taxpayers received a tax benefit from the student loan interest deduction, the estimated tax effect is $500,000 (see page 5).[7]

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify the number of taxpayers that were erroneously allowed student loan interest deductions that exceeded the allowable amount under the tax law based upon their modified AGI and filing status. In certain instances, the potential tax effect from the excess deductions may be reduced. This would be true if the taxpayer's income level was too low and did not create a tax liability high enough to benefit fully by the amount of excess deductions.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 293,833 taxpayers appear eligible for, but did not claim, Additional Child Tax Credits (ACTC) totaling $131 million (see page 7).

Methodology Used to Measure the Reported Benefit:

To identify taxpayers and credits not claimed, we selected only the TY 2002 returns for which IRS processing determined that the taxpayer was eligible for the Child Tax Credit (CTC), but not all the CTC had been used to offset the taxpayer's tax liability, and the following three conditions: (1) the taxpayer did not claim the ACTC, (2) the taxpayer had sufficient earned income to qualify for the ACTC, and (3) the taxpayer showed a tax liability of zero.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; 42,058 taxpayers erroneously claimed approximately $77 million in tuition and fees deductions. Assuming all 42,058 taxpayers received a tax

[6] The AGI is calculated after certain adjustments are made, but before standardized and itemized deductions and personal exemptions are subtracted. Modified AGI is AGI calculated without regard to certain deductions or exclusions.
[7] We used the lowest tax rate of 10 percent to compute the tax effect (i.e., 10 percent times $5 million of student loan interest deductions equals a tax effect of $500,000).

benefit from the tuition and fees deduction, the estimated tax effect is $7.7 million[8] (see page 9).

Methodology Used to Measure the Reported Benefit:

One of the criteria we used in analyzing the TY 2002 individual income tax return records was to identify all taxpayers who claimed, and were allowed, the tuition and fees deduction and the education credit. We also identified the total amount of tuition and fees deductions and the total amount of education credits allowed by the IRS. This analysis identified 294,743 taxpayers that were allowed nearly $608 million of tuition and fees deductions and over $231 million of education credits. Since the tax law prohibits taxpayers from claiming both the deduction and the credit for the same individual, we conducted further computer analysis on the 294,743 taxpayers to identify the number of taxpayers that filed as "single" with no dependents.[9] This analysis identified 42,058 taxpayers that claimed nearly $77 million in tuition and fees deductions and over $24 million in education credits.[10]

Type and Value of Outcome Measure:

- Revenue Protection – Potential; 252,685 taxpayers may have received a "dual benefit" by claiming the tuition and fees deduction and the education credit (see page 9).

Methodology Used to Measure the Reported Benefit:

The 252,685 potential taxpayers represents the difference between the 294,743 and 42,058 taxpayers discussed in the previous outcome measures. These 252,685 taxpayers claimed $531 million ($608 million less $77 million) in tuition and fees deductions and $207 million ($231 million less $24 million) in education credits.

[8] We used the lowest tax rate of 10 percent to compute the tax effect (i.e., 10 percent times $77 million of tuition and fees deductions equals a tax effect of $7.7 million).
[9] We focused on single taxpayers with no dependents because it is clear that both the tuition and fees deduction and the education credit would have been claimed for the same individual, which is not allowable and, therefore, an error. It is not as clear with the taxpayer populations that filed as married filing jointly with or without dependents, head of household, and single with dependents. These taxpayers could have claimed the tuition and fees deduction and education credit for the same individual or for different individuals, which is allowable.
[10] The tuition and fees deduction would be disallowed if the taxpayer also claims the education credit.

Appendix V

Table: Tax Law Changes That Were Not Correctly Implemented[1]

Type of Deduction or Credit	Returns Processed[(a)]	Erroneous Returns[(b)]	Percentage[(c)]
Retirement Savings Contributions Credit	3.5 million	8,860 (potential)	0.25%
Student Loan Interest Deduction	6.1 million	6,837 (potential)	0.11%
Tuition and Fees Deduction	3.3 million	42,058 (potential)	1.28%
		252,685 (potential)	7.66%

Source: Returns processed were obtained from the Internal Revenue Service Taxpayer Usage Study Weekly Report #13. Erroneous returns were taken from the audit findings discussed in this report.

(a) This column shows the total number of returns processed by the Internal Revenue Service (IRS) through May 2, 2003, that claimed the deductions or credits listed in the table.

(b) This column shows the actual or potential number of erroneous returns processed by the IRS through May 16, 2003, that we identified.

(c) This column shows the percentage of erroneous returns to total returns processed. The IRS did not have a report available to correspond with the date of our audit work. However, we estimate the potential increase in the returns processed would be small and have a negligible effect on the calculated percentages.

[1] This table excludes the 4,083 returns on which the taxpayer received retirement savings contributions credits totaling over $833,000 that otherwise would have been disallowed if the IRS had not implemented corrective action early in the filing season.

Appendix VI

Listing of Prior Reviews to Assess the Internal Revenue Service's Preparation for the 2003 Filing Season

The following is a list of four 2003 Filing Season[1] reviews that are included in our Fiscal Year 2003 Annual Audit Plan for the Treasury Inspector General for Tax Administration's Wage and Investment (W&I) Income Programs, Customer Account Services business unit. The overall purpose of the reviews was to evaluate the Internal Revenue Service's (IRS) success in planning and executing the 2003 Filing Season. The specific objective for each review is shown below.

The Internal Revenue Service Has Procedures to Ensure There Is Sufficient Trained Staff to Process Individual Income Tax Returns in 2003 **(Reference Number: 2003-40-055, dated February 2003)**

- Overall Objective: To determine whether the IRS' W&I Division has procedures in place to ensure there is a sufficient number of trained staff to process individual income tax returns during the 2003 Filing Season.

Pre-Filing Season Activities to Address Specific Individual Electronic Filing Issues Were Adequately Conducted **(Reference Number: 2003-40-073, dated March 2003)**

- Overall Objective: To determine the state of readiness of the IRS to accept electronically filed individual income tax returns for processing during the 2003 Filing Season. The audit was limited to the activities necessary to ensure the acceptance of electronic returns that may be affected by tax law change provisions relating only to the education and retirement provisions.

Forms and Publications for the New Education and Retirement Tax Provisions Were Addressed for the 2003 Filing Season **(Reference Number: 2003-40-105, dated April 2003)**

- Overall Objective: To determine whether the IRS identified the new tax law provisions that had a significant impact on W&I Division taxpayers and ensured that tax forms, instructions, and publications related to these new provisions were clearly and accurately updated for the 2003 Filing Season. The audit focused on the education and retirement provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001

[1] The period from January through mid-April when most individual income tax returns are filed.

(EGTRRA).[2] These provisions could affect an estimated 86.5 million taxpayers[3] by providing tax benefits of up to $7.6 billion in Fiscal Year 2003.[4]

Computer Programming Requests for the 2003 Filing Season Were Timely Prepared and Generally Accurate **(Reference Number: 2003-40-112, dated May 2003)**

- Overall Objective: To determine whether the IRS timely prepared and accurately initiated computer programming requests[5] for new tax law provisions that affect individual income tax return processing during the 2003 Filing Season. The audit focused on those requests for computer programming changes needed to implement the education and retirement provisions in the EGTRRA.

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[2] Pub. L. No. 107-16, 115 Stat. 38 (2001).
[3] National Center for Education Statistics, Projections of Education Statistics to 2012, May 2002, and United States Selected Income and Tax Items 1040, 1040A, and 1040EZ, Report Number R-S-92, January – September 2002.
[4] Congressional Budget Office, *Pay-As-You-Go Estimate*, June 4, 2001.
[5] Requests for Information Services.

Appendix VII

Overview of Tax Law Provisions Examined During the Review

The following information describes various tax law provisions that affect Tax Year (TY) 2002 individual income tax returns. During our review, we determined if returns containing the various provisions were accurately processed, in accordance with the law.

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)[1]

The EGTRRA contained the following six tax law provisions:

1) Higher Contribution Limits for Individual Retirement Arrangements (IRA) Deductions – These higher limits increase the maximum deductible contribution amount for both traditional and Roth IRA deductions from $2,000 per individual to $3,000 for TYs 2002 and beyond. In addition, individuals age 50 or older at the end of the tax year can make an additional deduction of up to $500 for catch-up contributions. In TY 2005, the maximum contribution limit increases to $4,000, and for TYs 2008 and later it increases to $5,000. Separately, the catch-up contributions also increase from $500 to $1,000 for TYs 2006 and later.[2]

   The IRA deduction is limited based upon the taxpayer's modified Adjusted Gross Income (AGI)[3] if the taxpayer is covered by a retirement plan at work or has a self-employment retirement plan.[4] As the taxpayer's modified AGI exceeds a defined threshold, the deduction allowed is reduced until it is eliminated when modified AGI exceeds the maximum. This phase-out can be illustrated by the following hypothetical example: a single taxpayer, who is covered by a retirement plan, with a modified AGI of $34,000 can claim up to $3,000 in IRA deductions (up to $3,500 if age 50 or older). However, if the taxpayer's modified AGI was $40,000, the maximum deduction would be limited to $1,200 (up to $1,400, if age 50 or older). Once this taxpayer's modified AGI reaches $44,000, the IRA deduction is eliminated completely.

2) Retirement Savings Contributions Credit – This credit provides low- and middle-income taxpayers a nonrefundable tax credit for qualified contributions or deferrals to retirement savings plans. This credit can be claimed in addition to the IRA deduction. The credit amount is equal to a percentage (maximum of 50 percent) of the qualified contributions (not to exceed $2,000). Therefore, the maximum credit amount per taxpayer is

1 Pub. L. No. 107-16, 115 Stat. 38 (2001).
2 Internal Revenue Code (I.R.C.) § 219 (2002).
3 The AGI is calculated after certain adjustments are made, but before standard or itemized deductions and personal exemptions are subtracted. Modified AGI is AGI calculated without regard to certain deductions or exclusions.
4 There is no phase-out for taxpayers that are not covered by a retirement plan.

$1,000 ($2,000 for married taxpayers filing jointly). The percentage is decreased based upon the taxpayer's filing status and AGI. Once the AGI reaches a certain level, the credit is eliminated. A table provides the applicable percentage based upon the filing status and AGI. For example, for TY 2002, a single taxpayer with an AGI of $15,000 or less can claim the maximum retirement savings contributions credit of $1,000, if otherwise eligible. However, if the taxpayer's AGI is $20,000, the maximum credit is reduced to $200. If the AGI exceeds $25,000, the taxpayer is ineligible for the credit. Higher AGI limits exist for a taxpayer filing as head of household ($37,500 maximum) or married filing jointly ($50,000 maximum). The credit is effective for tax years beginning on or after January 1, 2002, and is scheduled to expire as of TY 2007.[5]

3) Student Loan Interest Deduction Expansion – The student loan interest deduction allows individual taxpayers to take a deduction for interest on loans taken out to pay for qualified higher education expenses, such as college tuition. This above-the-line deduction is limited to a maximum of $2,500 and is further reduced as the modified AGI exceeds a certain level. For single taxpayers, the phase-out range was increased to $50,000 – $65,000 (previously $40,000 – $55,000). As the modified AGI exceeds $50,000, the deduction is reduced by a certain ratio or percentage until it is completely phased out when the modified AGI equals or exceeds $65,000. For example, a single taxpayer with a modified AGI of $50,000 could take the maximum $2,500 deduction. However, if the modified AGI was $59,000, the maximum deduction would be limited to $1,000. For married taxpayers filing jointly, the phase-out range was increased to $100,000 – $130,000 (previously $60,000 – $75,000). Married taxpayers filing separately are not allowed to take this deduction. In addition to the increase to the phase-out ranges, the 60-month limitation for interest payments to be deductible was repealed. These changes to the student loan interest deduction are effective for tax years beginning on or after January 1, 2002.[6]

4) Child Tax Credit (CTC) and Additional Child Tax Credit (ACTC) – The EGTRRA included several new provisions for TY 2001 intended to provide tax relief to low-income families.[7] Among these was a provision to modify the existing CTC. The CTC was established by the Tax Relief Act of 1997 (TRA 97)[8] and was the first tax credit based solely on a family's number of children. The TRA 97 initially provided a $500 credit for each child in the family under the age of 17. The Congress believed this credit would help reduce the tax burden for taxpayers, recognize the financial responsibilities of raising dependent children, and promote family values.

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[5] I.R.C. § 25B (2002).
[6] I.R.C. § 221 (2002).
[7] For the purpose of this report, low-income taxpayers are considered to have earned income of less than $25,000, regardless of family size.
[8] Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 United States Code (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).

In Congressional testimony[9] prior to the passage of the EGTRRA, concern was raised that the original proposal to increase the amount of the CTC over the next 10 years to a maximum of $1,000 per child would not benefit an estimated 12.2 million low- and moderate-income families with children. To address this concern, the Congress modified the CTC provisions and made the credit refundable for taxpayers with any number of children. All taxpayers can now receive a refund of their CTC when they have no tax liability; however, the refund is limited to 10 percent of a taxpayer's earned income over $10,350. This percentage will be increased to 15 percent for TYs 2005 and beyond. Refundable CTC is commonly known as the ACTC. The recently enacted Jobs and Growth Tax Relief Reconciliation Act of 2003[10] accelerated the credit increase so that taxpayers can take a $1,000 credit per child in TYs 2003 and 2004.

5) Tuition and Fees Deduction – A new above-the-line deduction or adjustment to income is provided to individual taxpayers for qualified tuition and related expenses. Because it is above-the-line, this deduction can be taken even if the taxpayer does not itemize deductions. It is effective for tax years beginning on or after January 1, 2002, and is scheduled to expire as of TY 2006. The deduction is limited to a maximum of $3,000 (it increases to $4,000 in TYs 2004 and 2005). A taxpayer cannot take the deduction if his or her modified AGI exceeds $65,000 ($130,000 for married taxpayers filing jointly). Married taxpayers filing separately are not allowed to take this deduction. In TYs 2004 and 2005, a smaller deduction of $2,000 will be available to higher-income taxpayers, e.g., those with an AGI of $65,001 – $80,000 ($130,001 – $160,000 for married taxpayers filing jointly). This deduction cannot be taken for a student's educational expenses if the taxpayer is claiming either the Hope or Lifetime Learning Credit education credits for that same student.[11]

6) Adoption Credit Increase – For tax years beginning on or after January 1, 2002, the adoption tax credit is increased from a maximum of $5,000 to $10,000. In addition, the phase-out range, whereby a taxpayer's potential credit is reduced or eliminated, was raised from $75,000 – $115,000 to $150,000 – $190,000. Therefore, in TY 2002, taxpayers with a modified AGI of up to $150,000 can claim an adoption credit of $10,000 before any reductions have to be made in the credit computation.[12]

Job Creation and Worker Assistance Act of 2002[13]

This Act contained the following tax law provision:

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[9] *President's Tax Relief Proposals: Tax Proposals Affecting Individuals, Hearing Before The Committee On Ways And Means House Of Representatives, Serial No. 107–6 (March 21, 2001).*
[10] Pub. L. No. 108-27, 117 Stat. 752 (2003).
[11] I.R.C. § 222 (2002).
[12] I.R.C. § 23 (2002).
[13] Pub. L. No. 107-147, 116 Stat. 21 (codified as amended in scattered sections of 26 U.S.C., 29 U.S.C., and 42 U.S.C.).

New Deduction for Educator Expenses – This provision allows qualified educators, including teachers, counselors, and principals, to take an above-the-line deduction of up to $250 for qualified expenses such as books, supplies, and equipment that are used in the classroom. For married taxpayers filing jointly, the deduction can be up to $500 if both spouses are qualified educators. In contrast to other credits and deductions, this deduction is not reduced or phased out based upon the taxpayer's AGI.[14]

[14] I.R.C. § 62 (2002).

Appendix VIII

Management's Response to the Draft Report

COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

OCT 03 2003

RECEIVED
OCT 03 2003

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: Henry O. Lamar, Jr. Henry O. Lamar, Jr.
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – The 2003 Filing Season Was Completed Timely and Accurately, but Some New Tax Law Changes Were Not Effectively Implemented (Audit No. 200240076)

We are pleased that your report recognizes the success of the 2003 filing season. This success is the result of the combined efforts of the staffs of nearly all Business Operating Divisions (BOD) and our staffs' expertise and dedication in conducting a highly detailed planning process. It is important to recognize the scope of the operation to have a proper perspective on this accomplishment. Through July, we processed over 125 million income tax returns, issued over $189 billion dollars in refunds, and exceeded our refund timeliness goal.

Preparing for the filing season is always a challenge, the complexity of that challenge increases when we must address tax law changes. Your report acknowledges the complexity of the task and recognizes that we addressed the provisions of the new tax law and accurately processed returns. In preparation for the 2003 Filing Season, Wage and Investment's Submission Processing Division submitted requests for 130 enhancements and changes to computer programming. Approximately 20 percent of these changes resulted directly from legislation that impacted Tax Year (TY) 2002 returns.

Overall, our process of implementing tax law changes is highly effective in identifying needed programming changes. Although we use multiple controls to ensure the accuracy and completeness of programming, the volume and the complexity of recent tax law changes increases the difficulty of identifying all of the details needed in our requests for programming. Our system is not perfect. I appreciate the oversight that Treasury Inspector General for Tax Administration (TIGTA) provides and the in-depth analysis conducted by your audit team. Your auditors promptly identified some errors and omissions in our programming requirements, permitting us to quickly correct the programming or to develop alternative processes to mitigate taxpayer impact.

2

I am pleased that our Additional Child Tax Credit (ACTC) mail-out effort had a positive impact on the TY 2001 taxpayers that you identified for us. I appreciate your willingness to support our efforts this year by providing information for TY 2002 filers who may have failed to claim the credit. We are finalizing our plans for this year's mail-out and are confident that it will also have a positive impact. The mail-out is only a part of an ongoing effort to inform and educate taxpayers concerning their Child Tax Credit entitlements. We believe that everyone benefits when taxpayers are aware of their entitlements and file complete and accurate returns. As part of our strategy to ensure that eligible taxpayers claim the Child Tax and Additional Child Tax Credit when they initially file, the Stakeholder Partnership, Education and Communication (SPEC) organization of the Customer Assistance, Relationships and Education Division conducts outreach activities targeted to low and moderate income taxpayers. The SPEC organization conducts this outreach through its national partnerships and local community-based coalitions that work with these taxpayers to provide information that helps them understand their tax obligations and to deliver free tax preparation services.

For October 2002 through August 31, 2003, SPEC made over 143 million contacts with taxpayers using educational products and messages on such key issues as Earned Income Tax Credit (EITC), Advanced Earned Income Tax Credit, Child Tax Credit and ACTC. Approximately 108 million of the contacts were through media outlets. Mailing of information through utility bills, school report cards, Forms W-2, Form 1099 statements, company newsletters, direct mailings by housing authorities and social service agencies accounted for nearly 26 million contacts. The remaining contacts, nearly 9 million, were made through workshops, outreach seminars, brochures at conventions and other methods of distributing information.

I have considered the recommendations addressing the dual benefits that some taxpayers incorrectly claimed on their TY 2002 return. Because this was the first tax year in which eligible taxpayers could claim the deduction for tuition and fees, we believe that adding a cautionary statement to the Form 8863, *Educational Credits (Hope and Lifetime Learning Credits)*, will substantially reduce the number of taxpayers who incorrectly claimed both the tuition and fees deduction and the educational credit We will also consider your recommendation that we revise our computer program to identify returns filed by single taxpayers with no dependents that claim both the tuition and fees deduction and the educational credit. However, we must first review feasibility and legal issues that could impact your suggested action.

I reviewed the measurable benefits and agree that they appear to be an accurate projection based on the observations contained in the report.

If you have any questions, please contact me or Ronald S. Rhodes, Director, Customer Account Services, at (404) 338-8910.

Attachment

Attachment

RECOMMENDATION 1

The Commissioner, Wage and Investment (W&I) Division, should continue with plans, as outlined in the March 18, 2003, memorandum, to identify and notify taxpayers by a process similar to that used for TY 2001 returns, and to notify taxpayers in TY 2003 and beyond that appear eligible for the ACTC, but did not claim the credit.

CORRECTIVE ACTION

We agree with this recommendation:

(A) We are following through with our plans to advise taxpayers who appear eligible but did not claim the credit on their TY 2002 returns. We will use the list provided by TIGTA to advise TY 2002 filers of their potential eligibility.

(B) For TY 2003, we will identify potentially eligible taxpayers during return processing and notify them of their potential eligibility after processing.

(C) For tax years after 2003, we expect to integrate the identification and notification of taxpayers into the General Main-frame and Master-file processing rather than notifying taxpayers by a mail-out after the filing season.

IMPLEMENTATION DATE

(A) Notification to TY 2002 filers will be completed by January 15, 2004.
(B) Notification to TY 2003 filers will be completed by January 13, 2005.
(C) Modifications to computer programming and system changes to allow the computer processing systems to identify and generate a notice to the taxpayer, during TY 2004 returns processing, will be completed by January 13, 2005.

RESPONSIBLE OFFICIAL

Director, Submission Processing

CORRECTIVE ACTION MONITORING PLAN

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

To ensure that taxpayers do not improperly claim a dual benefit with the tuition and fees deduction and educational credit, the Commissioner, W&I Division, should:

RECOMMENDATION 2

Modify Form 8863 by adding a caution to taxpayers that they cannot claim the tuition and fees deduction and the educational credit for the same individual.

CORRECTIVE ACTION

We agree with this recommendation. The TY 2003 revision of Form 8863 will have a cautionary statement advising taxpayers that they cannot claim tuition and fees deduction and an education credit for the same individual.

IMPLEMENTATION DATE

November 10, 2003

RESPONSIBLE OFFICIAL

Director, Tax Forms and Publications

CORRECTIVE ACTION MONITORING PLAN

Implementation of this corrective action will be monitored as part of the Filing Season Readiness process.

RECOMMENDATION 3

Revise IRS computer programs to identify individual income tax returns filed by single taxpayers with no dependents that claim both the tuition and fees deduction and the educational credit.

CORRECTIVE ACTION

We are considering this recommendation. Before we can decide on the feasibility of implementing a programming change, we need additional information. We will ask IRS Chief Counsel to provide an opinion on the legal issues of denying, during the processing of the return, the tuition and fees deduction when a single taxpayer with no dependents also claimed the education credit. Based on Counsel's opinion and other feasibility considerations, we will decide by January 15, 2004, if we will implement this recommendation.

3

IMPLEMENTATION DATE

January 15, 2004

RESPONSIBLE OFFICIAL

Director, Submission Processing

CORRECTIVE ACTION MONITORING PLAN

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

RECOMMENDATION 4

Identify and coordinate corrective actions between Submission Processing and Tax Forms and Publications functions that result from the IRS' Planned Examination of tax returns claiming the tuition and fees deduction.

CORRECTIVE ACTION

Representatives from Submission Processing will coordinate with representatives of W&I Compliance and W&I Tax Forms and Publications to review the results of the examinations of tax returns claiming the tuition and fees deduction. Based on this research, the representatives will determine if corrective actions are needed to address any identified compliance trends.

IMPLEMENTATION DATE

September 15, 2005

RESPONSIBLE OFFICIAL

Director, Submission Processing

CORRECTIVE ACTION MONITORING PLAN

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