

**Changes to Processing Procedures and Line
Descriptions on the Form 1040 Would Reduce
Erroneous Claims for Some
Refundable Credits**

June 2005

Reference Number: 2005-30-090

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

June 3, 2005

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Changes to Processing Procedures and Line Descriptions on the Form 1040 Would Reduce Erroneous Claims for Some Refundable Credits (Audit # 200430021)

This report presents the results of our review to determine the number of taxpayers that made erroneous claims on the "Other payments from:" line of the U.S. Individual Income Tax Return (Form 1040), the reasons for these claims, and any changes needed in Internal Revenue Service (IRS) forms and instructions, processing procedures, or computer programs to help prevent future erroneous claims and any associated refunds. We initiated this audit based on information provided by the IRS Frivolous Filer Unit located at the Ogden, Utah, IRS Campus.¹ While screening tax returns for other issues, employees in this Unit identified Forms 1040 for which taxpayers were receiving (or were scheduled to receive) erroneous refunds of estimated tax payments or other payments they had made. These erroneous refunds ranged from about \$5,000 to over \$144,000.²

In summary, we found that the misreporting of estimated tax payments and other payments as refundable credits on Form 1040 is not widespread. However, it can and has resulted in some significant erroneous refundable credits. The largest refundable credit in a sample of tax returns included in our review was \$40,000. In most of the cases in our sample, the erroneous refundable credit exceeded the amount of tax owed and resulted in the taxpayer receiving an erroneous refund.

¹ 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

² Many of the cases identified by the Frivolous Filer Unit did not appear in our review because the returns involved were not for the same tax years as those included in our sample.

We identified two potential reasons why these erroneous entries were made by taxpayers and/or went uncorrected by the IRS. First, the "Payments" section of Form 1040 and the corresponding instructions, which have been in effect for over 10 years, may be confusing to some taxpayers. The "Other payments from:" line on the Form 1040 is not intended for claiming payments; it is intended for claiming refundable credits. This may confuse some taxpayers because they are looking for a line on which to report payments they have made or are making with their tax returns. Additionally, the section of the Form 1040 where the line is placed combines refundable credits and payments, which may also confuse taxpayers. Second, current IRS processing procedures designed to authenticate claims for refundable credits were not consistently followed and need improvements to identify returns with erroneous amounts on the "Other payments from:" line.

We recommended the Director, Tax Forms and Publications, Wage and Investment (W&I) Division, change the title of the "Other payments from:" line on Form 1040 to more accurately reflect that the line is for claiming certain refundable credits (and not for claiming payments to the IRS) and change instructions for this line to clarify that it is not for claiming payments made to the IRS. We also recommended the Director, Submission Processing, W&I Division, ensure employees are aware of and follow instructions for properly processing claims for refundable credits and change the instructions for researching taxpayer accounts when trying to resolve unsubstantiated claims for refundable credits. We estimated these corrective actions would result in revenue protection of approximately \$3.9 million over 5 years.

Management's Response: IRS management generally agreed with the issues presented in our report and did agree with the outcome to be realized by taking corrective actions. Management disagreed with two of our three specific recommendations but agreed to take a different corrective action. IRS management agreed with our recommendation to improve IRS employees' awareness of the reported situation and took immediate corrective action. Management did not agree to change the title of the Form 1040 "Other payments from:" line or to specifically state in the Form 1040 instructions that the line is not for claiming estimated tax payments or any other payments made to the IRS. However, management did agree to add clarification to the Form 1040 instructions for this line to reinforce that it is to be used only for payments or credits resulting from those forms specified. Management's complete response to the draft report is included as Appendix VII.

Office of Audit Comment: We believe the IRS' alternative corrective action should reasonably suffice to reduce the number of taxpayer errors.

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

**Changes to Processing Procedures and Line Descriptions on the Form 1040
Would Reduce Erroneous Claims for Some Refundable Credits**

Table of Contents

Background	Page 1
Some Erroneous Refunds Could Be Avoided by Changing Certain Line Items on Form 1040 and Related Processing Practices	Page 3
<u>Recommendations 1 and 2:</u>	Page 7
<u>Recommendation 3:</u>	Page 8
Appendix I – Detailed Objectives, Scope, and Methodology	Page 9
Appendix II – Major Contributors to This Report	Page 11
Appendix III – Report Distribution List	Page 12
Appendix IV – Outcome Measures.....	Page 13
Appendix V – Page 2 of U.S Individual Income Tax Return (2004).....	Page 14
Appendix VI – Page 2 of U.S Individual Income Tax Return (2003).....	Page 15
Appendix VII – Management’s Response to the Draft Report	Page 16

Changes to Processing Procedures and Line Descriptions on the Form 1040 Would Reduce Erroneous Claims for Some Refundable Credits

Background

Taxpayers must pay Federal income taxes throughout the year as income is earned. Generally, they pay their income taxes through one of two methods. If the taxpayers are employees, their employers most likely withhold income taxes from their earnings and remit the withheld amounts to the Internal Revenue Service (IRS). If the taxpayers do not pay their taxes through withholding, they generally are required to pay estimated tax payments throughout the year. People who are self-employed generally pay their taxes this way.

Estimated tax payments post to taxpayers' accounts on the IRS Master File¹ and are applied (along with any withheld taxes and refundable credits²) to the tax liabilities reported on the taxpayers' U.S. Individual Income Tax Returns (Form 1040). If the amounts of estimated tax payments, withholding, and refundable credits are greater than the tax liabilities, the differences are refunded to the taxpayers.

The "Payments" section of the Form 1040 (see Appendix V for Tax Year [TY] 2003 and Appendix VI for TY 2004) has a line for taxpayers to enter the amount of their estimated tax payments when computing the amount of tax they owe (line 62 for TY 2003 and line 64 for TY 2004 returns). However, because the amounts paid as estimated tax payments have already posted to the taxpayers' accounts, the estimated tax payments are applied against the taxpayers' tax liabilities regardless of whether the taxpayers record the payments on the Forms 1040.

This same section of the Form 1040 also has a line entitled "Other payments from:" (line 67 for TY 2003 and line 69 for TY 2004). This line was created for taxpayers to claim certain refundable credits. The line has check boxes for taxpayers to indicate they are claiming the following refundable credits: 1) Notice to Shareholder of

¹ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

² Tax credits may be either refundable or nonrefundable. Nonrefundable credits are limited to the amount of tax owed. Refundable credits are not limited to the amount of tax. If the credit exceeds the amount of tax owed, the difference is refunded to the taxpayer.

Changes to Processing Procedures and Line Descriptions on the Form 1040 Would Reduce Erroneous Claims for Some Refundable Credits

Undistributed Long-Term Capital Gains (Form 2439), 2) Credit for Federal Tax Paid on Fuels (Form 4136), and 3) Health Coverage Tax Credit (Form 8885). In addition, a number of other “write-in” refundable credits such as Claim of Right Credits or Credits for Tax-Free Covenant Bonds may be claimed on this line by identifying the credit in the margin of the return and attaching applicable schedules (if required).

Any amount reported on this line creates a specific transaction that posts a credit to the taxpayer’s account; the credit is applied against any tax liability reported on the taxpayer’s Form 1040. The IRS computers define the transaction as a Generated Refundable Credit Allowance, Transaction Code (TC) 766. If the amount of the refundable credit is greater than the tax liability, the difference is refunded to the taxpayer.

The IRS Frivolous Filer Unit in Ogden, Utah, identified Forms 1040 for which taxpayers were receiving (or were scheduled to receive) erroneous refunds³ of estimated tax payments or other payments they had made.⁴ These erroneous refunds ranged from about \$5,000 to over \$144,000.⁵

After reviewing a sample of these returns, we determined the taxpayers were making a line entry error by entering estimated tax payments or certain other payments on the “Other payments from:” line instead of the line on which they should have been reported, resulting in the taxpayers receiving credit twice for the same payments.

³ For the purpose of our review, we considered a refund to be erroneous if the refund was issued to the taxpayer in error and not recovered by the IRS.

⁴ The returns identified by the Frivolous Filer Unit did not meet the IRS criteria to be considered “frivolous” and so would not normally be identified or worked in the Frivolous Returns Program. The erroneous refundable credits that result in an erroneous refund and are identified by the Frivolous Filer Unit are referred to the IRS Examination Division for recovery of the erroneous refund.

⁵ Many of the cases identified by the Frivolous Filer Unit did not appear in our sample because the returns involved were not for the same tax years as those included in our sample.

Changes to Processing Procedures and Line Descriptions on the Form 1040 Would Reduce Erroneous Claims for Some Refundable Credits

We initiated a review to determine the extent of this problem, its cause, and changes needed to prevent the generation of these erroneous refundable credits.

This review was performed at the Frivolous Filer Unit at the Ogden, Utah, IRS Campus⁶ and the Error Resolution and Code and Edit Offices at the Fresno, California, IRS Campus during the period May through December 2004, using tax return information filed nationwide. The audit was conducted in 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.

Some Erroneous Refunds Could Be Avoided by Changing Certain Line Items on Form 1040 and Related Processing Practices

The misreporting of estimated tax payments and other payments as refundable credits on Form 1040 is not widespread. However, it can and has resulted in some significant erroneous refundable tax credits. The largest credit in our sample was about \$40,000 and the largest credit in our identified population was over \$98,000. In most of the cases in our sample, the erroneous refundable credit exceeded the amount of tax owed and resulted in the taxpayer receiving an erroneous refund. Fortunately, the IRS can take some relatively easy steps to minimize or eliminate this problem.

Using computer analyses, we identified 703 TY 2002 and TY 2003 individual income tax returns that met the following criteria:

- The tax return had an amount on the “Other payments from:” line.
- The associated tax account on the Master File had a TC 766 for \$100 or more.⁷
- The tax account showed some combination of payments made by the taxpayer equaling the amount of the TC 766.

⁶ 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.

⁷ We established this figure as part of the criteria for our audit tests; it is not an IRS threshold amount.

Changes to Processing Procedures and Line Descriptions on the Form 1040 Would Reduce Erroneous Claims for Some Refundable Credits

We reviewed a statistical sample of 134 of these tax returns and determined that 70 (52 percent) had erroneous entries of at least \$500 on the “Other payments from:” line that should have been corrected.

Further analysis of these tax returns indicated that taxpayers (or their tax preparers) were responsible for the erroneous entries on 63 of the 70 returns, and IRS employees had incorrectly entered data into IRS computers on the other 7 returns. In many cases, we determined that the amounts entered in error by taxpayers were actually one or more estimated tax payments they had made to the IRS. Other erroneous entries on the “Other payments from:” line included credit card payments made by taxpayers to pay their tax liabilities, remittances included with returns, and payments made with requests for extensions of time to file returns. Twenty-one percent of the 70 erroneous tax returns were prepared by paid preparers.

We identified two potential reasons why these erroneous entries were made or went uncorrected by the IRS.

The “Payments” section of Form 1040 and the corresponding instructions may be confusing to some taxpayers

The title of the line “Other payments from:” may be misleading. Although the purpose of the line is for reporting refundable credits, taxpayers may consider it a catchall line on which to enter any payment for which the taxpayer cannot find an appropriate line on the tax return. This is compounded by the fact the Form 1040 has no place to record a payment (credit card, check, or cash) made with the tax return.

Instructions for the “Other payments from:” line contain one sentence that guides the taxpayer to “Check the box(es) to report any credit from Form 2439, 4136, or 8885.” If the taxpayer has made a prior payment or is making a payment with the return and is looking for a line on the return to place the amount of the payment, he or she could misinterpret the instruction as meaning, ‘If you have a credit from one or more of these forms check the box(es). If you have another payment not from one of these forms, place the amount on this line and do not check any of the boxes.’ The

Changes to Processing Procedures and Line Descriptions on the Form 1040 Would Reduce Erroneous Claims for Some Refundable Credits

instructions do not tell the taxpayer that other payments cannot be placed on the “Other payments from:” line. In some instances, we found taxpayers placing amounts on the “Other payments from:” line, leaving the boxes unchecked, and indicating the source of the payment (e.g., “credit card,” “prepaid tax,” “1040-V,”⁸ etc.).

IRS processing practices allow erroneous entries to go uncorrected

Current procedures require IRS employees to identify during initial processing tax returns on which taxpayers enter amounts on the “Other payments from:” line that exceed a certain amount but do not indicate the type of credit claimed and/or do not attach other forms required to claim the credit. In most cases, employees are instructed to correspond with these taxpayers to determine the reason for the entry on the “Other payments from:” line. The returns and associated tax accounts included in our sample showed no indication the required correspondence was sent.

During processing, IRS computers identify for further review by IRS employees all tax returns with an entry on the “Other payments from:” line that are not claiming fuel tax credits or are claiming fuel tax credits for amounts different from the amounts the computer calculates. If taxpayers are claiming one of the other credits listed on the “Other payments from:” line and have attached the appropriate form, IRS employees are instructed to allow the credit. Also, if taxpayers have entered any of the acceptable “write-in” credits in the margin, IRS employees are instructed to allow the credit(s). In some cases, we found IRS employees allowing the credit as long as the taxpayer entered anything in the margin. For example, as discussed earlier, we identified instances in which IRS employees accepted amounts on the “Other payments from:” line, with no boxes checked, and entries in the margins of “credit card,” “prepaid tax,” or “1040-V.”

In some instances, the amount on the “Other payments from:” line is more than the threshold amount specified in the IRS processing instructions, and the taxpayer has not

⁸ A Payment Voucher (Form 1040-V) is a statement a taxpayer sends with a remittance for any balance due on Form 1040.

Changes to Processing Procedures and Line Descriptions on the Form 1040 Would Reduce Erroneous Claims for Some Refundable Credits

checked a box indicating which credit he or she is taking or entered one of the acceptable “write-in” credits in the margin. In these cases, IRS employees are instructed to research the taxpayer’s accounts for a payment amount matching the amount on the “Other payments from:” line. If the employees find such a payment, the entry on the “Other payments from:” line is to be moved to the correct line of the tax return. Because the instructions are to look for a single payment rather than one or more payments, IRS employees were missing some of the erroneous entries. We found that 24 percent of the 70 erroneous entries on the “Other payments from:” line in our sample were actually a combination of 2 or more payments made by taxpayers. On the other hand, if the amounts entered on the “Other payments from:” line are less than the threshold amount, the IRS employees are instructed to take steps to allow the entries with no further research.

The confusion created by the Form 1040 and the problems with IRS processing resulted in erroneous refundable credits on 70 of the 134 tax returns in our sample.⁹ Based on the results of our sample, we estimate 366 of the 703 tax returns meeting our sample criteria contained inaccurate entries on the “Other payments from:” line of Form 1040 for TYs 2002 and 2003, resulting in erroneous refundable credits of over \$1.5 million (see Appendix IV). The average amount of the erroneous refundable credits in our sample was \$4,275 and the largest was about \$40,000. The largest resulting erroneous refund in our sample was over \$14,000, and the largest erroneous refund in our identified population was over \$65,000. These figures include only those taxpayers that met our specific criteria. It is reasonable to assume that many other taxpayers made these errors or were confused by the “Other payments from:” line, but their returns did not meet our criteria or their entries on the “Other payments from:” line fell below the IRS’ threshold amount.

⁹ The IRS Frivolous Filer Unit had identified and reversed the erroneous refundable credit on 8 of the 70 returns.

**Changes to Processing Procedures and Line Descriptions on the Form 1040
Would Reduce Erroneous Claims for Some Refundable Credits**

Recommendations

1. The Director, Tax Forms and Publications, Wage and Investment (W&I) Division, whose mission is to create and improve tax forms, instructions, publications and other documents to help taxpayers understand and meet their tax responsibilities, should change the title of the “Other payments from:” line on Form 1040 to more accurately reflect that this line is for claiming other refundable credits and not for claiming payments made to the IRS.

Management’s Response: IRS management agreed conditionally with this recommendation. The Commissioner, W&I Division, believes the current title for Form 1040 line 69 is descriptive of the intended use. However, the Director, Media and Publications, W&I Division, will add clarification to the instructions for this line to reinforce that it is to be used only for payments or credits resulting from the forms listed or specified in the instructions.

Office of Audit Comment: We believe the IRS’ alternative corrective action should reasonably suffice to reduce the number of taxpayer errors.

2. The Director, Tax Forms and Publications, W&I Division, should state in the instructions for the refundable credit lines on Form 1040, or in a reminder on the Form itself, that these lines are NOT for claiming estimated tax payments or any other payments made to the IRS.

Management Response: IRS management does not believe the instructions should be revised to state what not to include on Form 1040 line 69 because it could lead taxpayers to assume that, if the list of what not to include is limited, then there are unlisted items that can be included. However, as stated in management’s response to Recommendation 1, the Director, Media and Publications, W&I Division, will add clarification to the instructions for this line to reinforce that it is to be used only for payments or credits resulting from the forms listed or specified in the instructions.

**Changes to Processing Procedures and Line Descriptions on the Form 1040
Would Reduce Erroneous Claims for Some Refundable Credits**

Office of Audit Comment: We believe the IRS' alternative corrective action for Recommendation 1 should reasonably suffice to reduce the number of taxpayer errors and address this recommendation.

3. The Director, Submission Processing, W&I Division, whose responsibility is providing oversight for the processing of paper and electronic individual returns and related payments and refunds, should:
- Ensure employees follow instructions to correspond with taxpayers who claim refundable credits but do not indicate a form to which the credit applies.
 - Ensure employees are aware of the acceptable "write-in" credits and accept only those specified.
 - Change processing instructions to require employees researching taxpayer accounts for amounts claimed on the "Other payments from:" line to look for a payment or combination of payments equaling the amount claimed as a refundable credit.

Management's Response: The Director, Submission Processing, W&I Division, has issued clarifying instructions to Submission Processing function employees highlighting the requirements to initiate the required correspondence to taxpayers claiming the credit without indicating the source. The clarifying instructions also delineate the credits that are acceptable and advise employees researching the amounts on Form 1040 line 69 to be mindful that the amounts claimed may be a combination of payments.

Changes to Processing Procedures and Line Descriptions on the Form 1040 Would Reduce Erroneous Claims for Some Refundable Credits

Appendix I

Detailed Objectives, Scope, and Methodology

The overall objectives of this review were to determine the number of taxpayers that made erroneous claims on the “Other payments from:” line of the U.S. Individual Income Tax Return (Form 1040), the reasons for these claims, and any changes needed in Internal Revenue Service (IRS) education, processing, or computer programming to help prevent future erroneous claims and any associated refunds.

To accomplish our objectives, we:

- I. Identified and evaluated controls to determine whether they were functioning properly to identify and stop erroneous refunds issued as a result of erroneous claims for refundable credits on the “Other payments from:” line of the Form 1040.
 - A. Reviewed the Internal Revenue Manual procedures for handling returns with additional payments entered on the “Other payments from:” line without checking one of the three boxes indicating the source of the payment.
 - B. Determined whether the controls in place at the time of the review should have stopped the generation of the duplicate credits.
 - C. Interviewed employees in the Frivolous Filer Unit at the IRS Ogden Campus¹ and employees in the Code and Edit, Data Conversion, and Error Resolution functions at the IRS Fresno Campus.
 - D. Obtained available documentation for claims for erroneous refundable credits that were identified by the Frivolous Filer Unit, determined what control breakdowns allowed these refunds to be issued, and reviewed the claims for trends or similar characteristics.
 - E. Determined whether control procedures had been changed to prevent similar breakdowns from occurring.
 - F. Determined the extent to which erroneous claims for refundable credits were processed by the IRS during Tax Years (TY) 2002 and 2003.
 1. Prepared computer requests to identify erroneous refundable credits that posted to the IRS Master File² from TYs 2002 and 2003. To do this, we identified tax returns that met the following criteria:

¹ 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.

² The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

Changes to Processing Procedures and Line Descriptions on the Form 1040 Would Reduce Erroneous Claims for Some Refundable Credits

- a) The tax return had an amount on the “Other payments from:” line.
 - b) The associated tax account on the Master File had a Transaction Code (TC) 766³ for \$100 or more.⁴
 - c) The tax account showed some combination of payments made by the taxpayer equaling the amount of the TC 766.
2. To verify the data we received met our criteria, researched 31 accounts on the IRS Integrated Data Retrieval System (IDRS)⁵ to confirm the data in the database were accurate.
 3. Examined a statistical sample⁶ of 134 of the 703 taxpayers that were identified in our computer analysis. The sample was selected using a 95 percent confidence level, 30 percent expected error rate, and a precision of ± 7 percent. We ordered and reviewed the tax returns and researched the accounts on the IDRS to determine the cause of the erroneous refundable credit.
- II. Reviewed the Form 1040 and the associated instructions to determine whether the Form and/or instructions may be confusing to taxpayers, causing them to place the amount for estimated tax and/or other payments on the wrong line of the return.
- A. Reviewed the Form 1040 “Other payments from:” line to determine whether the Form provides adequate information about the amounts that should appear on the line.
 - B. Reviewed Form 1040 instructions to determine whether they clearly inform taxpayers where to place estimated tax or other payments on the return.

³ Any amount reported on the “Other payments from:” line of Form 1040 creates a specific transaction that posts a credit to the taxpayer’s account; the credit is applied against any tax liability reported on the taxpayer’s Form 1040. The IRS computers call the transaction a Generated Refundable Credit Allowance (TC 766).

⁴ We established this figure as part of the criteria for our audit tests; it is not an IRS threshold amount.

⁵ IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer’s account records.

⁶ A statistical sample was used to allow us to project our sample result over our identified population.

**Changes to Processing Procedures and Line Descriptions on the Form 1040
Would Reduce Erroneous Claims for Some Refundable Credits**

Appendix II

Major Contributors to This Report

Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)

Richard J. Dagliolo, Director

Parker Pearson, Director

Kyle R. Andersen, Audit Manager

Robert M. Jenness, Acting Audit Manager

W. George Burleigh, Lead Auditor

Lisa M. Stoy, Senior Auditor

James Adkisson, Information Technology Specialist

**Changes to Processing Procedures and Line Descriptions on the Form 1040
Would Reduce Erroneous Claims for Some Refundable Credits**

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Wage and Investment Division SE:W
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Customer Assistance, Relationships and Education, Wage and Investment Division
SE:W:CAR
Director, Media and Publications, Wage and Investment Division SE:W:CAR:MP
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Director, Tax Forms and Publications, Wage and Investment Division SE:W:CAR:MP:T
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 Liaison: Commissioner, Wage and Investment Division SE:W

Changes to Processing Procedures and Line Descriptions on the Form 1040 Would Reduce Erroneous Claims for Some Refundable Credits

Appendix IV

Outcome Measures

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

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$3.9 million over 5 years in erroneous refundable credits on 366 taxpayer returns (see page 3).

Methodology Used to Measure the Reported Benefit:

Using computer programs, we identified 703 Tax Year (TY) 2002 and 2003 taxpayer returns on the Internal Revenue Service (IRS) Individual Master File¹ that met the following criteria:

- The U.S. Individual Income Tax Return (Form 1040) had an amount on the “Other payments from:” line.
- The associated tax account on the Master File had a Transaction Code (TC) 766² for \$100 or more.³
- The tax account showed some combination of payments made by the taxpayer equaling the amount of the TC 766.

We selected a statistical sample of 134 accounts from the population of 703 accounts. Our sample size was determined based on a 95 percent confidence level, an expected error rate of 30 percent, and a precision of ± 7 percent. Of the 134 returns we reviewed, 70 received erroneous refundable credits. The average erroneous credit for the 70 returns reviewed was \$4,275 per return. When this average amount was projected to 52 percent of the population of 703, it resulted in \$1,564,650 in erroneous refundable credits generated on taxpayers’ accounts for TYs 2002 and 2003. Therefore, over 5 years the erroneous refundable credits would total \$3,911,625. We estimate the number of returns affected for TYs 2002 and 2003 totaled 366.

¹ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

² Any amount reported on the “Other payments from:” line of Form 1040 creates a specific transaction that posts a credit to the taxpayer’s account; the credit is applied against any tax liability reported on the taxpayer’s Form 1040. The IRS computers call the transaction a Generated Refundable Credit Allowance (TC 766).

³ We established this figure as part of the criteria for our audit tests; it is not an IRS threshold amount.

Changes to Processing Procedures and Line Descriptions on the Form 1040
Would Reduce Erroneous Claims for Some Refundable Credits

Appendix V

Page 2 of U.S Individual Income Tax Return (2004)

Form 1040 (2004) Page 2

Tax and Credits	37 Amount from line 36 (adjusted gross income) 37 38a Check <input type="checkbox"/> You were born before January 2, 1940, <input type="checkbox"/> Blind, } Total boxes if: <input type="checkbox"/> Spouse was born before January 2, 1940, <input type="checkbox"/> Blind, } checked ▶ 38a b If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here ▶ 38b <input type="checkbox"/>		
Standard Deduction for— • People who checked any box on line 38a or 38b or who can be claimed as a dependent, see page 31. • All others: Single or Married filing separately, \$4,850 Married filing jointly or Qualifying widow(er), \$9,700 Head of household, \$7,150	39 Itemized deductions (from Schedule A) or your standard deduction (see left margin) 39 40 Subtract line 39 from line 37 40 41 If line 37 is \$107,025 or less, multiply \$3,100 by the total number of exemptions claimed on line 6d. If line 37 is over \$107,025, see the worksheet on page 33 41 42 Taxable income. Subtract line 41 from line 40. If line 41 is more than line 40, enter -0- 42 43 Tax (see page 33). Check if any tax is from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 43 44 Alternative minimum tax (see page 35). Attach Form 6251 44 45 Add lines 43 and 44 45		
	46 Foreign tax credit. Attach Form 1116 if required 46 47 Credit for child and dependent care expenses. Attach Form 2441 47 48 Credit for the elderly or the disabled. Attach Schedule R 48 49 Education credits. Attach Form 8863 49 50 Retirement savings contributions credit. Attach Form 8880 50 51 Child tax credit (see page 37) 51 52 Adoption credit. Attach Form 8839 52 53 Credits from: a <input type="checkbox"/> Form 8396 b <input type="checkbox"/> Form 8859 53 54 Other credits. Check applicable box(es): a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8801 c <input type="checkbox"/> Specify _____ 54		
	55 Add lines 46 through 54. These are your total credits 55		
	56 Subtract line 55 from line 45. If line 55 is more than line 45, enter -0- 56		
	Other Taxes	57 Self-employment tax. Attach Schedule SE 57 58 Social security and Medicare tax on tip income not reported to employer. Attach Form 4137 58 59 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required 59 60 Advance earned income credit payments from Form(s) W-2 60 61 Household employment taxes. Attach Schedule H 61 62 Add lines 56 through 61. This is your total tax 62	
	Payments	63 Federal income tax withheld from Forms W-2 and 1099 63 64 2004 estimated tax payments and amount applied from 2003 return 64 65a Earned income credit (EIC) 65a b Nontaxable combat pay election ▶ 65b _____ 66 Excess social security and tier 1 RRTA tax withheld (see page 54) 66 67 Additional child tax credit. Attach Form 8812 67 68 Amount paid with request for extension to file (see page 54) 68 69 Other payments from: a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136 c <input type="checkbox"/> Form 8885 69 70 Add lines 63, 64, 65a, and 66 through 69. These are your total payments 70	
	Refund	71 If line 70 is more than line 62, subtract line 62 from line 70. This is the amount you overpaid 71 72a Amount of line 71 you want refunded to you 72a Direct deposit? See page 54 and fill in 72b, 72c, and 72d. ▶ b Routing number _____ ▶ c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings ▶ d Account number _____ 73 Amount of line 71 you want applied to your 2005 estimated tax ▶ 73	
	Amount You Owe	74 Amount you owe. Subtract line 70 from line 62. For details on how to pay, see page 55 ▶ 74 75 Estimated tax penalty (see page 55) 75	
	Third Party Designee	Do you want to allow another person to discuss this return with the IRS (see page 56)? <input type="checkbox"/> Yes. Complete the following. <input type="checkbox"/> No Designee's name ▶ _____ Phone no. ▶ () _____ Personal identification number (PIN) ▶ _____	
	Sign Here	Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge. Your signature _____ Date _____ Your occupation _____ Daytime phone number () _____ Spouse's signature. If a joint return, both must sign. _____ Date _____ Spouse's occupation _____	
Paid Preparer's Use Only	Preparer's signature _____ Date _____ Check if self-employed <input type="checkbox"/> Preparer's SSN or PTIN _____ Firm's name (or yours if self-employed), address, and ZIP code _____ EIN _____ Phone no. () _____		

Form 1040 (2004)

Changes to Processing Procedures and Line Descriptions on the Form 1040 Would Reduce Erroneous Claims for Some Refundable Credits

Appendix VI

Page 2 of U.S Individual Income Tax Return (2003)

Form 1040 (2003)		Page 2
Tax and Credits	<p>35 Amount from line 34 (adjusted gross income) 35</p> <p>36a Check <input type="checkbox"/> You were born before January 2, 1939. <input type="checkbox"/> Blind. <input type="checkbox"/> Total boxes if: <input type="checkbox"/> Spouse was born before January 2, 1939. <input type="checkbox"/> Blind. <input checked="" type="checkbox"/> checked ▶ 36a</p> <p>b If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 34 and check here ▶ 36b <input type="checkbox"/></p> <p>37 Itemized deductions (from Schedule A) or your standard deduction (see left margin) 37</p> <p>38 Subtract line 37 from line 35 38</p> <p>39 If line 35 is \$104,625 or less, multiply \$3,050 by the total number of exemptions claimed on line 6d. If line 35 is over \$104,625, see the worksheet on page 35 39</p> <p>40 Taxable income. Subtract line 39 from line 38. If line 39 is more than line 38, enter -0- 40</p> <p>41 Tax (see page 36). Check if any tax is from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 41</p> <p>42 Alternative minimum tax (see page 38). Attach Form 6251 42</p> <p>43 Add lines 41 and 42 43</p> <p>44 Foreign tax credit. Attach Form 1116 if required 44</p> <p>45 Credit for child and dependent care expenses. Attach Form 2441 45</p> <p>46 Credit for the elderly or the disabled. Attach Schedule R 46</p> <p>47 Education credits. Attach Form 8863 47</p> <p>48 Retirement savings contributions credit. Attach Form 8880 48</p> <p>49 Child tax credit (see page 40) 49</p> <p>50 Adoption credit. Attach Form 8839 50</p> <p>51 Credits from: a <input type="checkbox"/> Form 8396 b <input type="checkbox"/> Form 8859 51</p> <p>52 Other credits. Check applicable box(es): a <input type="checkbox"/> Form 3800 b <input type="checkbox"/> Form 8801 c <input type="checkbox"/> Specify 52</p> <p>53 Add lines 44 through 52. These are your total credits 53</p> <p>54 Subtract line 53 from line 43. If line 53 is more than line 43, enter -0- ▶ 54</p>	
Other Taxes	<p>55 Self-employment tax. Attach Schedule SE 55</p> <p>56 Social security and Medicare tax on tip income not reported to employer. Attach Form 4137 56</p> <p>57 Tax on qualified plans, including IRAs, and other tax-favored accounts. Attach Form 5329 if required 57</p> <p>58 Advance earned income credit payments from Form(s) W-2 58</p> <p>59 Household employment taxes. Attach Schedule H 59</p> <p>60 Add lines 54 through 59. This is your total tax ▶ 60</p>	
Payments	<p>61 Federal income tax withheld from Forms W-2 and 1099 61</p> <p>62 2003 estimated tax payments and amount applied from 2002 return 62</p> <p>63 Earned income credit (EIC) 63</p> <p>64 Excess social security and tier 1 RRTA tax withheld (see page 56) 64</p> <p>65 Additional child tax credit. Attach Form 8812 65</p> <p>66 Amount paid with request for extension to file (see page 56) 66</p> <p>67 Other payments from: a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136 c <input type="checkbox"/> Form 8865 67</p> <p>68 Add lines 61 through 67. These are your total payments ▶ 68</p>	
Refund	<p>69 If line 68 is more than line 60, subtract line 60 from line 68. This is the amount you overpaid 69</p> <p>70a Amount of line 69 you want refunded to you ▶ 70a</p> <p>Direct deposit? See page 56 and fill in 70b, 70c, and 70d.</p> <p>▶ b Routing number <input type="text"/> ▶ c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings</p> <p>▶ d Account number <input type="text"/></p> <p>71 Amount of line 69 you want applied to your 2004 estimated tax ▶ 71</p>	
Amount You Owe	<p>72 Amount you owe. Subtract line 68 from line 60. For details on how to pay, see page 57 ▶ 72</p> <p>73 Estimated tax penalty (see page 58) 73</p>	
Third Party Designee		
Do you want to allow another person to discuss this return with the IRS (see page 58)? <input type="checkbox"/> Yes. Complete the following. <input type="checkbox"/> No		
Designee's name ▶		Phone no. ▶ ()
		Personal identification number (PIN) ▶ <input type="text"/>
Sign Here		
Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.		
Joint return? See page 20. Keep a copy for your records.	Your signature	Date
	Your occupation	Daytime phone number ()
	Spouse's signature. If a joint return, both must sign.	Date
	Spouse's occupation	
Paid Preparer's Use Only	Preparer's signature ▶	Date
	Firm's name (or yours if self-employed), address, and ZIP code ▶	Check if self-employed <input type="checkbox"/>
		Preparer's SSN or PTIN
		EIN
		Phone no. ()

Changes to Processing Procedures and Line Descriptions on the Form 1040
Would Reduce Erroneous Claims for Some Refundable Credits

Appendix VII

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

RECEIVED
MAY 19 2005

MAY 19 2005

MEMORANDUM FOR PAMELA J. GARDINER
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Changes to Processing Procedures and
Line Descriptions on the Form 1040 Would Reduce Erroneous
Claims for Some Refundable Credits (Audit No. 200430021)

We appreciate the detailed analysis that your staff has done on this issue. We are always interested in reviewing situations where our forms or procedures appear to cause confusion to taxpayers. I fully agree with your conclusion that the misreporting of estimated tax payments and other payments as refundable credits on Form 1040 is not widespread. In fact, for Tax Years 2002 and 2003 we processed over 179 million Forms 1040, and your computer extract identified only 703 tax returns which met your criteria. While the volume is exceedingly small, we do want to take steps to avoid incorrect credits.

We reviewed your recommendations for further reducing the number of incorrect credits and agree with your suggestion to improve our employee's awareness of this situation. We have already issued an "Alert" to our Submission Processing employees to increase their awareness of this condition and provide instructions for the actions needed to resolve unsupported credits shown on line 69, "Other payments from (a) Form 2439, (b) Form 4136, and (c) Form 8885" on Form 1040 for Tax Year 2004.

We disagree with your recommendation that the instructions should be revised to state what NOT to include on the line. This methodology could lead the taxpayers to assume that if the list of what not to include is limited, then there are unlisted items that can be included. In addition, it is difficult to justify substantive changes to a form that has such high use, taxpayer familiarity, and public acceptance, merely to address errors made by a few hundred taxpayers. We will, however, add limited clarifying language to line 69 to state that it should only be used to show credits resulting from either the forms listed or referenced in the instructions.

**Changes to Processing Procedures and Line Descriptions on the Form 1040
Would Reduce Erroneous Claims for Some Refundable Credits**

2

I believe that these actions will help deter taxpayer errors and detect incorrect credits shown on line 69. I agree with the outcome measure in Appendix IV of your report. We will not attempt to track the potential benefits due to the cost involved and the small annual revenue impact. Our comments to your recommendations are attached. If you have any questions, please call me at (404) 338-7060, members of your staff may contact David L. Medeck, Director, Customer Account Services, at (404) 338-8910.

Attachment

Changes to Processing Procedures and Line Descriptions on the Form 1040 Would Reduce Erroneous Claims for Some Refundable Credits

Attachment

RECOMMENDATION 1

The Director, Tax Forms and Publications, Wage and Investment (W&I) Division, whose mission is to create and improve tax forms, instructions, publications and other documents to help taxpayers understand and meet their tax responsibilities, should change the title of the "Other payments from:" line on Form 1040 to more accurately reflect that this line is to claim other refundable credits and not for claiming payments to the IRS.

CORRECTIVE ACTION

We agree conditionally with this recommendation. We believe that the current title for line 69: "Other Payments from: (a) Form 2439, (b) Form 4136, and (c) Form 8885" is descriptive of the intended use of this line on Form 1040. However, we will add clarification to the instructions for this line to reinforce that it is to be used only for payments or credits resulting from the use of these specific forms.

IMPLEMENTATION DATE

December 15, 2005

RESPONSIBLE OFFICIAL

Director, Media and Publications, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

The Form 1040 and its instructions are revised annually, and progress is tracked using the Oracle database maintained by Tax Forms and Publications. The database includes milestones during the revision cycle to ensure that the tax products are revised timely.

RECOMMENDATION 2

The Director, Tax Forms and Publications, W&I Division should state in the instructions for the refundable credit lines on Form 1040 or in a reminder on the form itself, that these lines are NOT for claiming estimated tax payments or any other payments made to the IRS.

CORRECTIVE ACTION

We disagree with this recommendation. We do not believe the instructions should be revised to state what NOT to include on line 69. This methodology could lead taxpayers to assume that if the list of what not to include is limited, then there are unlisted items that can be included. As stated in our response to Recommendation 1, we will add clarification to the instructions for this line to reinforce that it is to be used only for payments or credits resulting from the use of these specific forms.

Changes to Processing Procedures and Line Descriptions on the Form 1040 Would Reduce Erroneous Claims for Some Refundable Credits

2

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 3

The Director, Submission Processing, W&I Division, whose responsibility is providing oversight for the processing of paper and electronic individual returns, and related payments and refunds, should:

- Ensure employees follow instructions to correspond with taxpayers who claim refundable credits but do not indicate a form to which the credit applies.
- Ensure employees are aware of the acceptable "write-in" credits and accept only those specified.
- Change processing instructions to require employees researching taxpayer accounts for the amounts claimed on the "Other payments from:" line to look for a payment or combination of payments equaling the amount claimed as a refundable credit.

CORRECTIVE ACTION

We agree with this recommendation. We have issued clarifying instructions to Submission Processing employees using our "Alert" system. The "Alert" highlights the IRM requirements to initiate the required correspondence to taxpayers claiming the credit without indicating the source, delineates the credits that are acceptable, and advises employees researching the amounts claimed on line 69 to be mindful that the amount claimed may be a combination of payments.

IMPLEMENTATION DATE

Completed – March 18, 2005

RESPONSIBLE OFFICIAL

Director, Submission Processing, W&I CAS