

**Taxpayers Identified As Serving in Combat
Zones Were Properly Afforded Tax Benefits,
but Account Identification and Maintenance
Processes Need Improvement**

April 2005

Reference Number: 2005-40-077

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

April 28, 2005

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Handwritten signature of Pamela J. Gardiner in cursive.

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Taxpayers Identified As Serving in Combat Zones Were Properly Afforded Tax Benefits, but Account Identification and Maintenance Processes Need Improvement (Audit # 200440012)

This report presents the results of our review of the Internal Revenue Service (IRS) handling of Combat Zone tax accounts.¹ The overall objective of this review was to determine whether the IRS is correctly handling the accounts and tax returns of taxpayers who have been deployed in a Combat Zone. Since the inception of the first modern income taxation in the United States in 1913, the Congress has granted special Federal income tax benefits for members of the Armed Forces in World War I, World War II, Korea, Vietnam, the Persian Gulf, Bosnia, Kosovo, and now Afghanistan and Iraq. These benefits include extensions of time to file tax returns or pay taxes and the suspension of any audit or collection activities. The IRS also provides these benefits to civilian taxpayers supporting military operations.

To get these special benefits, both military and civilian taxpayers had to notify the IRS they were serving in a Combat Zone. This could be done by writing "Combat Zone" on the tax return when it was filed or contacting the IRS via telephone, correspondence, or email using a special email address set up solely for use by Combat Zone taxpayers. In 2003, the IRS coordinated with the Department of Defense (DOD) to receive payroll information on military service members who had entered or exited a Combat Zone. This information allows the IRS to update tax account information on a more current basis and with less burden on the military taxpayers. Civilians serving in a Combat Zone still need to notify the IRS directly to get the special benefits.

¹ See Appendix IV of the report for a listing of designated Combat Zones.

In summary, the IRS is providing tax benefits to taxpayers identified on the IRS Master File² as being in a Combat Zone. When the IRS is notified a taxpayer is serving in a designated Combat Zone, it places an indicator³ on the taxpayer's account that extends the due dates for filing returns and paying taxes, suppresses any notices, and suspends audit and collection activities. This Combat Zone active indicator remains on the taxpayer's account until the IRS receives information the taxpayer is no longer in a Combat Zone, at which time the indicator changes from active to historical and normal processing of the account resumes.

While taxpayers who were identified on the IRS Master File as serving in a Combat Zone received the benefits and special treatment they are entitled to, we identified a processing issue that affects the accuracy of the Combat Zone indicators and the overall effectiveness and efficiency of the Combat Zone program.

Our sample results indicate over 58 percent of the 520,000 taxpayers with an active Combat Zone indicator are incorrect (i.e., the taxpayers are no longer serving in a Combat Zone). An incorrect, active Combat Zone status allows taxpayers to receive special tax treatment they are no longer entitled to receive, such as filing late, not being audited, or having collection action suspended.

The inaccurate indicators were caused by weaknesses in the account identification and maintenance processes. The IRS was not identifying and correcting error records created when attempting to update the Master File with DOD information. These errors could occur for various reasons, such as missing information or mismatches between names or Social Security Numbers. In addition, the Combat Zone indicators were not being reviewed annually to identify and correct inaccurate indicators. Another impact of these conditions is that taxpayers who are serving in a Combat Zone may not have the indicators input on their Master File accounts and would be at risk of not getting the Combat Zone benefits they deserve. Unfortunately, the error records were not kept by the IRS, so we could not determine the extent, if any, of this condition.

We discussed these issues with the IRS during the course of our audit, and it has taken steps to correct the conditions we identified. The IRS is working to improve the process of updating of the Master File with the DOD information and has indicated that the problem with the missing Combat Zone exit dates has been corrected. In addition, the IRS is developing a computer program to automatically analyze and correct inaccurate Combat Zone indicators on an annual basis, which it plans to implement in May 2005. To further help ensure Combat Zone indicators are correct, we recommended the Commissioner, Wage and Investment Division, continue to work on perfecting the information on Combat Zone participation that is used to update the Master File, such as identifying and correcting other types of error records than those missing exit dates; develop a quality review program to ensure the accounts being analyzed for inaccurate

² The Master File refers to the IRS Individual Master File database that maintains transactions or records of individual tax accounts.

³ An indicator is placed on the taxpayer's account to alert IRS employees and programs the taxpayer is or has been in a Combat Zone.

indicators by the new computer program are processed correctly; and conduct the account review on an annual basis.

Management's Response: IRS management is pleased with our finding that the IRS is properly providing the appropriate tax benefits to taxpayers serving in Combat Zones. The IRS agrees with our recommendations and has initiated corrective action. Specifically, the IRS stated it corrected its programming for downloading entry and exit dates from the DOD. In addition, to correct other types of error records beyond missing exit dates, management stated a verification program will be run, prior to the download, during which various account information is verified prior to the posting of the exit date.

Management stated a one-time cleanup computer program will be implemented May 31, 2005, to identify any accounts with an entry date that is greater than 3 years old and no exit date. This cleanup will help ensure Combat Zone indicators are accurate. A sample review will be conducted on the cases identified by the cleanup to ensure they accurately reflect the exit date of 3 years from the entry date.

Management's complete response to the draft report is included as Appendix V.

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

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Taxpayers Identified As Serving in Combat Zones Were Properly Afforded Tax Benefits, but Account Identification and Maintenance Processes Need Improvement

Background

Since the inception of the first modern income taxation in the United States (U.S.) in 1913, the Congress has granted special Federal income tax benefits for members of the Armed Forces in World War I, World War II, Korea, Vietnam, the Persian Gulf, Bosnia, Kosovo, and now Afghanistan and Iraq.¹ These benefits include additional time to file tax returns or pay taxes and the suspension of any audit or collection activities. The Internal Revenue Service (IRS) also provides these benefits to civilian taxpayers supporting military operations.

Figure 1: Soldier in Combat Zone



Source: United States Budget Report 2005.

Personnel serving in a Qualified Hazardous Duty² Area receive the same tax treatment under the Internal Revenue Code as personnel serving in a Combat Zone. The Congress has designated certain countries as Qualified Hazardous Duty Areas and has specified that each designated country will lose its status as a Qualified Hazardous Duty Area when the Department of Defense (DOD) stops paying members either imminent danger or hostile fire pay. Thus the DOD, by controlling the payment of imminent danger or hostile fire pay to military members, can also control when military members will no longer be entitled to the special tax benefits.

Any income earned by members of the U.S. Armed Forces in a Combat Zone is not taxable and is reflected as such on their Wage and Tax Statements (Form W-2).

¹ See Appendix IV for a listing of designated Combat Zones.

² Hazardous duty is defined as extraordinarily arduous living conditions, excessive physical hardship, or unhealthful conditions.

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Figure 2: Example of Form W-2 Showing Nontaxable Combat Wages

a Control number		22222		void <input type="checkbox"/>		For Official Use Only OMB No. 1545-0088	
b Employer identification number		1 Wages, tips, other compensation		2 Federal income tax withheld		\$ 8,000.00	
c Employer's name, address, and ZIP code		3 Social security wages		4 Social security tax withheld		\$ 18,000.00	
DFAS – DE/F JPC		5 Medicare wages and tips		6 Medicare tax withheld		\$	
		7 Social security tips		8 Allocated tips		\$	
d Employee's social security number		9 Advance EIC payment		10 Dependent care benefits		\$	
e Employee's first name and initial		Last name		11 Nonqualified plans		12a See instructions for box 12	
G I Joe		Doe		13a See instructions for box 12		\$	
f Employee's address and ZIP code		13a See instructions for box 12		13b See instructions for box 12		\$	
		14 Other		13c See instructions for box 12		\$	
APO AE 09603		13d See instructions for box 12		13e See instructions for box 12		\$	
		Q 10,000.00		13f See instructions for box 12		\$	
15 State		16 State wages, tips, etc.		17 State income tax		18 Local wages, tips, etc.	
\$		\$		\$		\$	
19 Local income tax		20 Locality name		\$		\$	

W-2 Wage and Tax Statement (99) 2003

Department of the Treasury - Internal Revenue Service
For Privacy Act and Paperwork Reduction Act Notice, see separate instruction

Source: Information based on our review of sample cases. Taxable wages in Box 1 are reduced by the Combat Zone pay indicated by the “Q” code in Box 14.

An individual serving in an official capacity in a Combat Zone will have the payment and collection of any Federal tax liability suspended during the period the individual is in the Combat Zone, plus any continuous period of hospitalization due to injury or illness received while in the Combat Zone, plus the next 180 days thereafter. The deadlines for filing tax returns, paying taxes, filing claims for refund, and taking other actions with the IRS are automatically extended for the same period.

These tax benefits are also provided by the IRS to members of the Merchant Marine, Red Cross personnel, and other civilian taxpayers who are supporting military operations. Nonmilitary individuals who worked in a Combat Zone must notify the IRS before they receive the special Combat Zone benefits. This notification or “self-identification” can be done by writing “Combat Zone” at the top of the tax return when it is filed, contacting the IRS via telephone or correspondence, or using a special email address the IRS has set up for Combat Zone participants.

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Figure 3: Example of Combat Zone Identification on U.S. Individual Income Tax Return (Form 1040)

The image shows a sample of a 2003 U.S. Individual Income Tax Return (Form 1040). The form is titled "U.S. Individual Income Tax Return 2003" and includes the Department of the Treasury—Internal Revenue Service logo. The form number "1040" is prominently displayed in the top left corner. The form is filled out with the following information:

- Label:** L A S E L H E R E
- For the year:** Jan. 1-Dec. 31, 2003, or other tax year beginning , 2003, ending , 20
- OMB No.:** 1545-0074
- Your first name and initial:** G.I. Joe
- Last name:** Doe
- Your social security number:** 000 ; 00 ; 0000
- If a joint return, spouse's first name and initial:** Jane
- Last name:** Doe
- Spouse's social security number:** 000 ; 00 ; 000A
- Home address (number and street):** APO AE
- City, town or post office, state, and ZIP code:** 09603
- ZIP code:** 09603
- City, town or post office, state, and ZIP code:** *** COMBAT ZONE ***
- Home address (number and street):** (If you have a P.O. box, see page 19.)
- Apt. no.:**
- City, town or post office, state, and ZIP code:** (If you have a foreign address, see page 19.)
- Presidential Election Campaign:** Do you, or your spouse if filing a joint return, want \$3 to go to this fund?
 - You: Yes No
 - Spouse: Yes No
- Filing Status:**
 - 1 Single
 - 2 Married (filing jointly even if only one had income)
 - 3 Widowed
 - 4 Head of household (with qualifying person. (See page 20) the qualifying person is a child but not your dependent, only this child's name here.)

Source: Information based on our review of sample cases.

In special situations, members of the Armed Forces will work in areas outside a Combat Zone but in support of Combat Zone actions. These Armed Forces members are also eligible to receive extensions of tax-related deadlines. The DOD codes the qualifying income of these individuals as combat pay, so they are receiving all the special tax-related benefits of Combat Zone activity instead of just deadline extensions. This relieves the IRS of having to determine what income qualifies for any special treatment.

Recently, the DOD began sending information to the IRS for military service members who have entered or exited a Combat Zone. The IRS began processing this information in late Calendar Year (CY) 2003 and early CY 2004; it should receive monthly updates of military Combat Zone activity, which will then be incorporated into the IRS Master File³ data. This monthly information from the DOD will allow the IRS to update its Master File records on a more current basis, which should result in less taxpayer burden for members of the Armed Forces. This will also allow the IRS to have a more automated process for granting deadline extensions and other special treatment to Combat Zone participants.

This review was performed using national data and was coordinated with the Wage and Investment (W&I) Division

³ The Master File refers to the IRS Individual Master File database that maintains transactions or records of individual tax accounts.

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Compliance and Submission Processing functions in Atlanta, Georgia, and the Fresno, California, Compliance Site during the period April through September 2004. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Taxpayers Identified As Serving in Combat Zones Receive Special Treatment

The IRS is providing the tax benefits legislated by the Congress to taxpayers who have been identified on the IRS Master File as being in a Combat Zone. When the IRS receives the Combat Zone entry date from the DOD or the taxpayer, the IRS updates the Master File with an indicator⁴ on the taxpayer's account so the special benefits legislated by the Congress can be granted automatically. The current IRS processes extend the deadlines for filing tax returns and paying taxes, suppress any notices, prevent audit activities, and suspend collection actions (accumulation of interest and penalties). These tax benefits are extended for 180 days after the IRS is notified a taxpayer has exited a Combat Zone.

The IRS receives monthly updates of DOD information. The information consists of the entry date into and exit date from a Combat Zone, the Combat Zone location code, and the taxpayer's Social Security Number and name. Using this information, the IRS can compute tax return due dates and any applicable interest or penalty based on the additional time legislated because of Combat Zone activity.

The IRS also has other ways to assist taxpayers who serve in Combat Zones or Qualified Hazardous Duty Areas. Taxpayers who indicate their Combat Zone activity directly⁵ to the IRS will have their accounts coded in the same manner as the military taxpayers, allowing them to receive the appropriate tax benefits. The IRS has also created an email address so taxpayers in a Combat Zone can send

⁴ An indicator is placed on the taxpayer's account to alert IRS employees and programs the taxpayer is or has been in a Combat Zone.

⁵ Taxpayers who directly contact the IRS about their Combat Zone duty are referred to as "self-identified."

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notification of their Combat Zone deployment directly to the IRS.

While the IRS is providing the tax benefits legislated by the Congress to taxpayers identified on the Master File as being in a Combat Zone, we determined the Combat Zone indicators are not always accurate to identify taxpayers who have entered or exited a Combat Zone. We identified two areas in the account identification and maintenance processes that could be improved.

Inaccurate Combat Zone Indicators Are Not Being Corrected

The IRS was not identifying and correcting its Master File records to accurately reflect that individuals are no longer in a Combat Zone. The Combat Zone active indicator remains on a taxpayer's account until the IRS receives information the taxpayer is no longer in a Combat Zone, at which time the indicator changes from active to historical and normal processing of the account resumes. As of February 2004, the IRS Master File had over 520,000 taxpayer accounts with active Combat Zone indicators.

We sampled 200 of these active accounts and determined over 58 percent appear to be inaccurate based on available information (i.e., the taxpayers are no longer serving in a Combat Zone). These taxpayers will continue to receive special tax benefits they are no longer entitled to until the Master File records are corrected.

Another possible condition is taxpayer accounts that should, but do not, reflect current service in a Combat Zone because the information did not get recorded on the IRS Master File. Taxpayers whose accounts do not reflect current service in a Combat Zone are at risk of having penalties and interest charged when they are eligible for extensions of time to pay and file their tax returns. These taxpayers may also be subject to compliance actions, such as audits or collection activities, that should be suspended. Unfortunately, the error records were not kept by the IRS, so we could not determine the extent, if any, of this condition.

We identified two specific causes for the inaccurate Combat Zone indicators on the Master File.

Taxpayers Identified As Serving in Combat Zones Were Properly Afforded Tax Benefits, but Account Identification and Maintenance Processes Need Improvement

Errors created when updating DOD information to the Master File are not resolved

Recently, the DOD began sending information to the IRS for military service members who have entered or exited a Combat Zone. When the IRS processed this information, some of the data did not update to the Master File. These errors could occur for various reasons, such as mismatches between names or Social Security Numbers. Error records were created by the computer programs for those individuals whose information was not updated, but the IRS did not develop programs or procedures to correct these error records when it requested the DOD information.

To obtain the maximum benefit from the DOD information, the IRS needs to resolve the error records so taxpayer accounts accurately reflect Combat Zone service.

Master File accounts with Combat Zone indicators have not been periodically reviewed and corrected

Through 2001, the IRS would annually run a computer program that identified active Combat Zone accounts on the Master File. This program would generate a listing of taxpayers to whom the IRS would send letters to verify whether the taxpayers were still actively serving in a Combat Zone. Based on responses to the letters and other research, the IRS would either keep the active Combat Zone indicators on the taxpayer accounts or change the status to inactive.

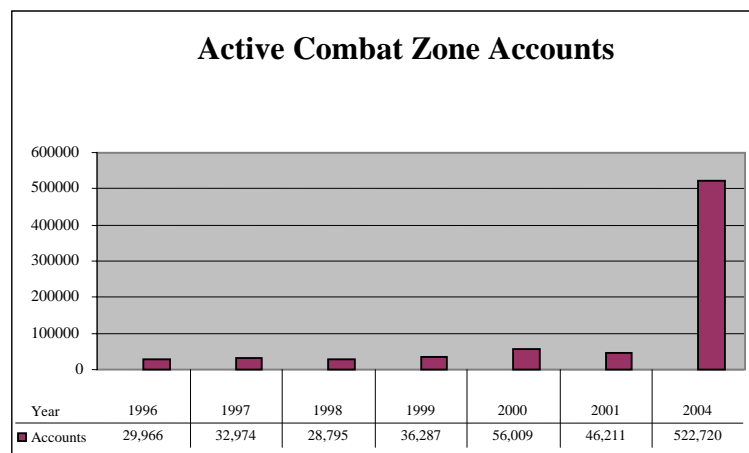
However, in December 2001, the IRS made a policy decision to stop running the annual Combat Zone verification program. This decision was made to minimize the number of sensitive situations in which verification letters might be received by military personnel serving in Afghanistan or the Persian Gulf.

In 2003, the IRS began working with the DOD to obtain Combat Zone entry and exit date information to further minimize the number of taxpayer contacts required to validate Combat Zone status. However, because of these decisions, the Combat Zone validation program was not run for CYs 2002 and 2003, and consequently, active Combat Zone accounts were not reviewed or corrected.

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During this time, the number of accounts in Combat Zone status grew tremendously. In CY 2001, there were a little over 46,000 accounts with active Combat Zone indicators on the Master File. As of February 2004, there were over 520,000 accounts with active Combat Zone indicators on the Master File. While the largest percentage of increase in active Combat Zone indicators was the increase in military personnel sent to Afghanistan and the Persian Gulf during this time, there were obviously a very large number of accounts with inaccurate indicators that had not been reviewed and corrected. Due to this increased number of active Combat Zone accounts, resources to work these accounts also became an issue.

Figure 4: Taxpayer Accounts With Active Combat Zone Indicators



Source: CYs 1996 through 2001 information from the IRS. No IRS data for CYs 2002-2003. CY 2004 information from our analysis of active Combat Zone accounts on the IRS Master File as of February 2004.

Our analysis of sample cases indicated the following conditions exist for inaccurate active Combat Zone indicators.

- Taxpayers have Combat Zone entry dates as far back as 1990 but have no exit dates.
- Married taxpayers do not have all the correct exit information posting to their accounts when one or both have served in a Combat Zone.

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- Military taxpayers file tax returns indicating Combat Zone activity after the DOD exit date information has already posted.
- Civilian taxpayers who self-identify have not been contacted by the IRS for the past 3 years for the exit dates.

The cumulative effect of not correcting these accounts on an annual basis is two-fold. First, some taxpayers, military and civilian, are being given special tax benefits when they are no longer eligible because their IRS accounts still indicate they are in a Combat Zone. Second, the number of taxpayers listed as active Combat Zone participants who self-identify about their Combat Zone activity will continue to grow each year because the IRS is not contacting them for the dates they left the Combat Zones.

Recent Management Actions: During and after the completion of our audit work, the IRS took or is planning actions that should help alleviate the conditions presented above.

- The Director, Compliance, W&I Division, was recently made responsible for the Combat Zone program. We believe having an IRS executive responsible for the program should help the IRS improve its processes and coordination efforts internally and with the DOD.
- The IRS indicated that, as of January 2005, it had corrected the missing exit date problem with the DOD information we identified during the audit. While the IRS has taken corrective action for missing exit dates, it is still not identifying and correcting other types of error records.
- The IRS stated it is in the process of developing a computer program that will analyze and correct the inaccurate Combat Zone account indicators. According to the IRS, the computer program is scheduled to be implemented in May 2005.

Taxpayers Identified As Serving in Combat Zones Were Properly Afforded Tax Benefits, but Account Identification and Maintenance Processes Need Improvement

Recommendations

To help ensure Combat Zone indicators are accurate, the Commissioner, W&I Division, should:

1. Continue working to further perfect the information on Combat Zone participation that is used to update the Master File, such as identifying and correcting other types of error records than those missing exit dates.

Management's Response: The IRS stated it corrected its programming for downloading entry and exit dates from the DOD. In addition, to correct other types of error records beyond missing exit dates, management stated a verification program is run, prior to the download, during which various account information is verified prior to the posting of the exit date.

2. Develop a quality review program to review a sample of the accounts that are closed automatically using the new program to ensure the reversal of the active Combat Zone indicator is correct. In addition, the plan should include a sample review of the remaining active accounts to verify the program is not missing any accounts that should be reversed. The program and the quality reviews should be conducted annually.

Management's Response: Management stated a one-time cleanup computer program will be implemented May 31, 2005, to identify any accounts with an entry date that is greater than 3 years old and no exit date. The system will automatically turn off the Combat Zone indicators that were set by an entry date or self-identified tax return. This cleanup, in combination with use of DOD entry and exit dates, will help ensure Combat Zone indicators are accurate. A sample review will be conducted on the cases identified by the cleanup to ensure they accurately reflect the exit date of 3 years from the entry date. Letters will be sent to civilians to ensure they are not still serving in a Combat Zone.

Taxpayers Identified As Serving in Combat Zones Were Properly Afforded Tax Benefits, but Account Identification and Maintenance Processes Need Improvement

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine whether the Internal Revenue Service (IRS) is properly handling the accounts and tax returns of taxpayers who have been deployed in a Combat Zone.¹ To accomplish our objective, we:

- I. Determined whether Combat Zone indicators and freeze codes were properly posted to the taxpayers' accounts.
 - A. Determined whether the Department of Defense (DOD) information sent to the IRS posted to taxpayers' accounts and set the Combat Zone indicator correctly.
 - B. Determined whether self-identified taxpayer information posted to the taxpayers' accounts set the indicator correctly.
 - C. Confirmed whether the appropriate Combat Zone freeze code (-C) was applied to the taxpayers' accounts.
- II. Reviewed a sample of active (currently in a Combat Zone) accounts for appropriate IRS activity.
 - A. Reviewed a statistically valid sample of 400 accounts (sample details below) with a Combat Zone indicator of "1" (Open) to analyze the tax account information and determine whether the IRS Submission Processing function is correctly processing designated Combat Zone returns (granting additional time to file tax return documents, not assessing interest or penalties during the additional filing and payment grace period, etc.).
 - B. Analyzed tax account information to determine whether the IRS Collection and Examination functions were correctly handling designated Combat Zone accounts (suspending collection actions, extending Collection Statute Expiration Date [the latest date the IRS is allowed to take collection action], closing or suspending examination activity, etc.).
- III. Reviewed a sample of historical (no longer in a Combat Zone) accounts for appropriate IRS activity.
 - A. Reviewed a statistically valid sample of 400 accounts (sample details below) with a Combat Zone indicator of "2" (Closed) to determine whether the IRS Submission Processing function correctly processed the tax returns (enforced normal due dates to file tax returns, assessed interest or penalties when appropriate, etc.).

¹ See Appendix IV for a listing of designated Combat Zones.

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- B. Analyzed tax account information to determine whether the IRS Collection and Examination functions correctly handled the accounts (resumed normal collection actions and examination activities).

The overall population of Combat Zone tax accounts was obtained from the IRS Master File² information as of February 2004 where the 'Combat Indicator' field was not blank or a "0." This produced a population of 522,720 accounts showing an active Combat Zone indicator (taxpayer is currently in a Combat Zone) and 1,071,272 accounts showing a historical Combat Zone indicator (taxpayer is no longer in a Combat Zone).

These population numbers were used to create 2 statistically valid samples of 400 cases each (400 for active and 400 for historical) to be used for our review. After we had reviewed about one-half of each sample, the IRS agreed with our findings and we stopped at 200 cases in each sample. This changed our confidence level from 95 percent \pm 5 percent at a 50 percent estimated error rate to 95 percent \pm 6.93 percent at a 50 percent estimated error rate.

In addition, a sample of the DOD data was obtained from the IRS to assist with the review of the active Combat Zone indicator cases. The sample we received from the IRS was for any DOD data that occurred in Calendar Year (CY) 2003 so we could compare CY 2003 IRS data to CY 2003 DOD data.

² The Master File refers to the IRS Individual Master File database that maintains transactions or records of individual tax accounts.

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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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 Senior Operations Advisor, Wage and Investment Division SE:W:S:W

Taxpayers Identified As Serving in Combat Zones Were Properly Afforded Tax Benefits, but Account Identification and Maintenance Processes Need Improvement

Appendix IV

Geographic Areas Considered Combat Zones¹

Combat Zones are designated by an Executive Order from the President as areas in which the United States Armed Forces are engaging or have engaged in combat. There are currently three such Combat Zones:

- Arabian Peninsula Areas, beginning January 17, 1991 – the Persian Gulf, Red Sea, Gulf of Oman, part of the Arabian Sea, Gulf of Aden, and the countries of Bahrain, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.
- Kosovo Area, beginning March 24, 1999 – Federal Republic of Yugoslavia (Serbia and Montenegro), Albania, the Adriatic Sea, and the Ionian Sea north of the 39th Parallel.
- Afghanistan, beginning September 19, 2001.

Three parts of the former Yugoslavia (Bosnia-Herzegovina, Croatia, and Macedonia) were designated as a Qualified Hazardous Duty Area, to be treated as if it were a Combat Zone, beginning November 21, 1995.

In addition, the Department of Defense designated the following locations as Combat Zones due to their direct support of Operations Enduring Freedom and Iraqi Freedom:

- Pakistan, Tajikistan, and Jordan – September 19, 2001.
- Incirlik Air Base, Turkey – September 21, 2001.
- Kyrgyzstan and Uzbekistan – October 1, 2001.
- Philippines (troops related to Operation Enduring Freedom) – January 9, 2002.
- Yemen – April 10, 2002.
- Djibouti – July 1, 2002.
- Turkey – January 1, 2003.
- Israel – January 1 through July 31, 2003.
- The Mediterranean Sea east of 30° East longitude – March 19 through July 31, 2003.
- Jordan – March 19, 2003.
- Egypt – March 19 through April 20, 2003.

¹ Information from the Internal Revenue Service web site (www.irs.gov) as of September 2004.

**Taxpayers Identified As Serving in Combat Zones Were Properly Afforded Tax Benefits,
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Appendix V

Management's Response to the Draft Report



WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

RECEIVED
APR 06 2005

APR 06 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: Taxpayers Identified as Serving in
Combat Zones Were Properly Afforded Tax Benefits, But
Account Identification and Maintenance Processes Need
Improvement (Audit #200440012)

We are pleased with your finding that the Internal Revenue Service (IRS) is correctly providing the tax benefits legislated by Congress to taxpayers that have been identified on the IRS Master File as being in a Combat Zone.

Shortly after the beginning of hostilities in Afghanistan in late 2001, IRS initiated a dialog with the Department of Defense (DOD) to develop communications and procedures to assure our troops receive the special Combat Zone tax benefits legislated by Congress. This led to development of a data exchange program to reduce the burden associated with these taxpayers needing to self-identify or to respond to subsequent IRS contacts regarding eligibility. This data exchange became operational in 2003 and allows IRS to update the Master File with DOD provided Combat Zone entry and exit dates so that these tax benefits are automatically granted and updated. While we do not receive the same information from DOD for civilian personnel in a Combat Zone, in accordance with the provisions of the Internal Revenue Code once they self-identify, they receive the same benefits.

Although not a direct focus of your review, IRS provides a number of other services for members of the armed forces serving in a Combat Zone. These include Military VITA; Publication 3, Armed Forces' Tax Guide; Tax Information for Members of the U.S. Armed Forces on IRS.gov; a dedicated Combat Zone e-mail address and a special toll-free telephone number. To maximize the troops' telephone access, the number is communicated exclusively through internal DOD channels.

Because of the sensitivity and importance of the Combat Zone Program, my Compliance staff led a multi-functional and in-depth review of the effectiveness of our

Taxpayers Identified As Serving in Combat Zones Were Properly Afforded Tax Benefits, but Account Identification and Maintenance Processes Need Improvement

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data exchange program with DOD. This review resulted in updated operational procedures and system programming to strengthen the program.

We appreciate your observations and agree with your recommendations. We are always looking for innovative ways to improve our program and ultimately the level of service that we provide to all taxpayers, especially those serving in harm's way in the defense of our Country. Your recommendations will help us accomplish these goals.

Attached is a detailed response outlining corrective actions we will take to address your recommendations. If you have any questions, please call me at (404) 338-7060, or members of your staff may contact Jeffrey C. Stetina, Director, Filing & Payment Compliance, at (404) 338-7058.

Attachment

Taxpayers Identified As Serving in Combat Zones Were Properly Afforded Tax Benefits, but Account Identification and Maintenance Processes Need Improvement

Attachment

To help ensure Combat Zone indicators are accurate, the Commissioner, W&I Division, should:

RECOMMENDATION 1

Continue working to further perfect the information on Combat Zone participation that is used to update the Master File, such as identifying and correcting other types of error records than those missing exit dates.

CORRECTIVE ACTIONS

Effective cycle 200504, January 31, 2005, the IRS corrected the programming for downloading entry and exit dates from the tapes received from the DOD. The program now checks the Individual Master File for a corresponding entry date and posts the exit date (Transaction Code 500 – TC500) to that module. In addition, to correct other types of error records beyond missing exit dates, a verification program is run prior to the download where the SSN, Names, Type of Accounts (joint, single, etc.) are verified prior to the posting of the TC500. The unpostables that we were receiving initially were all due to the programming of the exit date. These changes should eliminate the error and unpostable conditions.

IMPLEMENTATION DATE

Completed January 31, 2005

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

Headquarter analysts will perform a quarterly review of information provided by DOD to ensure accuracy of data posting to Combat Zone taxpayer's account.

RECOMMENDATION 2

Develop a quality review program to review a sample of the accounts that are closed automatically using the new program to ensure the reversal of the active Combat Zone indicator is correct. In addition, the plan should include a sample review of the remaining active accounts to verify the program is not missing any accounts that should be reversed. The program and the quality reviews should be conducted annually.

CORRECTIVE ACTIONS

1. W&I Filing and Payment Compliance submitted a Request for Information Services (RIS) to be implemented May 31, 2005. The RIS will identify any IMF accounts with an entry date that is greater than three years and has no exit date. The system will automatically turn off the Combat Zone indicators that were set by an entry date or self-identified tax return. This is a one-time clean up that in combination with use of

Taxpayers Identified As Serving in Combat Zones Were Properly Afforded Tax Benefits, but Account Identification and Maintenance Processes Need Improvement

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DOD entry and exit dates will help ensure Combat Zone indicators are accurate. When the RIS has been completed, a sample review by Headquarters will be conducted on the cases identified by the above mentioned RIS. This will ensure the cases identified in the clean up accurately reflect the exit date of three years from the entry date.

2. To facilitate the recommended annual quality review regarding civilians, MITS will begin to generate the cycle 43 Combat Zone clean-up transcripts October 31, 2005. Based on these transcripts, letters will be sent to civilians to ensure that they are not still serving in a combat zone. Headquarter analysts will review a sample of the accounts processed through the cycle 43 Combat Zone clean up transcripts for correct actions taken on accounts. The review will be completed on Combat Zone transcripts processed by Compliance Service Collection Operations (CSCO). This review will be completed annually by cycle 10 of each year. The first review will be scheduled for March 15, 2006, after the transcripts have been completed by CSCO.

IMPLEMENTATION DATE

1. July 15, 2005
2. May 15, 2006

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

These corrective actions will be monitored as part of our internal control monitoring system. The Combat Zone Program is specifically addressed during operational reviews and monthly program reviews. The Senior Manager, Payment Compliance, will keep the Director, Filing and Payment Compliance advised as to the status of this corrective action.

TOTAL P 05