

**Processing Changes Would Improve Service
and Reduce Unnecessary Interest Paid on
Refunds to Taxpayers That File Amended
Individual Income Tax Returns**

July 2005

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

July 22, 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 - Processing Changes Would Improve Service and Reduce Unnecessary Interest Paid on Refunds to Taxpayers That File Amended Individual Income Tax Returns (Audit # 200440049)

This report presents the results of our review of Internal Revenue Service (IRS) processing of amended individual income tax returns. The overall objective of this review was to determine whether the IRS timely and properly processes amended individual tax returns (Amended U.S. Individual Income Tax Return (Form 1040X)). The review was included in the Treasury Inspector General for Tax Administration's (TIGTA) Fiscal Year 2005 Annual Audit Plan for the IRS Wage and Investment (W&I) Division and supports the TIGTA's audit program to assess areas related to the IRS' strategic goal to improve taxpayer service.

Taxpayers file Forms 1040X primarily to correct individual income tax returns previously filed. Tax examiners in the Code and Edit functions at the IRS Submission Processing sites¹ screen Forms 1040X to identify those that can be processed at the sites and those meeting criteria for referral to other functions where more complex issues are handled. Approximately two-thirds of all Forms 1040X received by the Submission Processing sites during Calendar Year 2004 were referred to the Accounts Management Adjustment function for processing.

Our review focused on Forms 1040X referred to and processed by the Accounts Management Adjustment function between January and June 2004. During this period, the Austin Campus² was implementing the Correspondence Imaging System. This

¹ Submission Processing sites process paper and electronically submitted tax returns and supplemental documents, account for tax revenues, and issue refunds and tax notices.

² The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

system was used to scan Forms 1040X into digital images, code the referral records to the taxpayers' accounts, and assign the Forms 1040X to Accounts Management Adjustment function employees for processing. The Correspondence Imaging System has subsequently been implemented at three other campuses.

In summary, Forms 1040X referred to the Accounts Management Adjustment function were not always processed timely, resulting in the payment of additional interest to some taxpayers that filed Forms 1040X for refund. Submission Processing function procedures require that the referral record, which indicates the Form 1040X was referred to another function, be input to the taxpayer's account within 11 workdays from the received date of the Form 1040X. This processing requirement was changed to 12 calendar days in November 2004. Accounts Management Adjustment function procedures generally require that cases be worked within 45 calendar days. IRS procedures require that all refundable tax returns be processed and refunds issued within 45 calendar days to avoid interest payments.

We reviewed a statistical sample of 357 Forms 1040X randomly selected from the population of 1,052,964 Forms 1040X received by the IRS and processed by the Accounts Management Adjustment function between January and June 2004. We found that referral records for 146 Forms 1040X (41 percent) were not timely input to the taxpayers' accounts and 49 Forms 1040X (14 percent) were not timely closed by the Accounts Management Adjustment function. We also determined that the refunds for 120 Forms 1040X (34 percent) were not issued within 45 calendar days and resulted in payment of additional interest.

Based on the sample results, we estimated that 430,623 Forms 1040X in the population were not timely referred to the Accounts Management Adjustment function for processing and that 144,524 were not timely closed by the Accounts Management Adjustment function. We also estimated that refunds were not timely issued for 353,937 Forms 1040X in the population and resulted in unnecessary interest payments of over \$3 million.

Untimely processing of Forms 1040X occurred for several reasons. The unit that scans Forms 1040X into the Correspondence Imaging System does not prioritize Forms 1040X for scanning to ensure the referral records are input to the taxpayers' accounts within 11 workdays. This unit is aligned under the Accounts Management Adjustment function, whereas the 11-workday processing requirement is a Submission Processing function procedure. In addition, Forms 1040X for refund are not prioritized for processing to ensure the refunds are issued within 45 calendar days to avoid the payment of unnecessary interest. Another reason for the processing delays is "reroutes." These are documents that are routed to the Accounts Management Adjustment function from other functions, field offices, campuses, and Lockbox sites.³ Reroutes will never be totally eliminated because IRS procedures require a certain

³ A lockbox site is a commercial bank designated by the Financial Management Service (FMS) to process Federal tax payments. Source documents are processed and forwarded to the Submission Processing sites. The FMS is the bureau within the Department of the Treasury responsible for outside contracting and cash management.

amount of routing when special skills are needed to resolve a case or when another function has an open issue on the case.

We believe several processing changes could improve taxpayer service and reduce unnecessary interest payments. We recommended the Director, Customer Account Services, W&I Division, ensure the Submission Processing function's change to a 12-calendar day processing time period for Forms 1040X was effectively implemented; ensure the campuses conduct periodic reviews of Forms 1040X receipts that are aged 30 or more days to identify problem areas or trends causing processing delays; revise procedures so Forms 1040X for refunds are given priority for processing; and ensure the various functions' procedures for processing Forms 1040X are consistent, compatible, and comprehensive.

Management's Response: IRS management agreed with three of our four recommendations. For Recommendations 1 and 2, the W&I Division will develop procedures to require campuses to review the Image Control Team Units to identify processing delays, their causes, and appropriate corrective measures. In addition, the campuses will be required to sample receipts that are aged 30 or more days and review them to determine possible trends and develop strategies to improve timeliness. The campuses will be required to conduct these reviews at least twice per fiscal year.

For Recommendation 4, the W&I Division reviewed and clarified its Internal Revenue Manual⁴ (IRM) procedures for processing Form 1040X. The Submission Processing function IRM⁵ was revised to only include Form 1040 series refund returns received and processed by Submission Processing as being subject to the 45-calendar day interest-free period.

The Commissioner, W&I Division, did not agree with Recommendation 3. The Accounts Management Adjustment function will continue to use the first-in, first-out (FIFO) inventory control method to ensure all taxpayers submitting requests for service are treated equitably. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment: Although we are pleased the Commissioner, W&I Division, has agreed to implement three of our four recommendations, we are concerned that the disagreement to Recommendation 3 has prevented the corrective action taken on Recommendation 4 from being effectively implemented as intended.

In Recommendation 3, we suggested that all Forms 1040X for potential refund be given priority processing in lieu of the FIFO method used by the Accounts Management Adjustment function. In Recommendation 4, we suggested the W&I Division review and revise procedures to ensure consistent and compatible processing of Forms 1040X by W&I Division functions. However, the corrective action taken does not do that. Instead, it allows processing procedures for Forms 1040X to continue being inconsistently applied among W&I Division functions.

⁴ The IRM contains the policies, procedures, and guidelines for IRS operations.

⁵ See the explanation of IRM 3.30.123.2.2 in the first bullet on page 10.

We believe the disagreement to Recommendation 3 reflects an inconsistent application of the IRS' policy on priority processing for refundable tax returns. For example, within the W&I Division, the Submission Processing function processes Forms 1040X in accordance with IRM guidelines requiring refunds to be issued within 45 calendar days to ensure timely refunds and to avoid unnecessary interest payments. These are the same guidelines used each year to process refundable tax returns during the filing season⁶ in an effort to reduce costs and ensure the timely issuance of taxpayer refunds. In contrast, by allowing the Accounts Management Adjustment function to process Forms 1040X using a FIFO method, taxpayer equity is compromised rather than ensured because of the inconsistent guidelines between these functions in addition to incurring costs for the payment of unnecessary interest due to the untimely issuance of refunds.

We have concluded that processing Forms 1040X refunds using the IRS' 45-day interest-free guideline should be consistently applied since the Form 1040X is characteristic of a refundable tax return rather than a taxpayer request for service. Using the 45-day interest-free guideline benefits both the taxpayer by ensuring refunds are expedited as well as the IRS by preventing the payment of unnecessary interest. While we still believe Recommendation 3 is worthwhile, we do not intend to elevate our disagreement concerning it to the Department of the Treasury for resolution.

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.

⁶ The period from January through mid-April when most individual income tax returns are filed.

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Background

An Amended U.S. Individual Income Tax Return (Form 1040X) is filed by an individual taxpayer primarily to correct an income tax return previously filed. Forms 1040X are received throughout the year at seven Wage and Investment (W&I) Division Submission Processing sites located throughout the country.¹ Currently, Forms 1040X must be filed on paper because electronic filing is not yet available for this type of tax return.

Forms 1040X can contain a variety of issues that range from simple to complex. For example, one Form 1040X might contain a correction to wages due to an additional or corrected Wage and Tax Statement (Form W-2), while another could contain a net operating loss carryback to a prior tax year. Forms 1040X that are missing information required to process the returns may be returned to the taxpayers with a notice asking for the missing information.

Tax examiners in the Submission Processing sites' Code and Edit functions screen Forms 1040X to identify those meeting criteria for referral to other functions and those that can be worked within the Submission Processing site. Referrals to other functions are necessary because the different functions perform different activities and work specific and/or more complex issues.² When a Form 1040X is referred to a function outside of the Submission Processing function, the taxpayer's account is coded to

¹ Andover, Massachusetts; Atlanta, Georgia; Austin, Texas; Fresno, California; Kansas City, Missouri; Memphis, Tennessee; and Philadelphia, Pennsylvania, Submission Processing Sites. These sites process paper and electronically submitted tax returns and supplemental documents, account for tax revenues, and issue refunds and tax notices.

² For example, the Internal Revenue Service Accounts Management Adjustment function changes taxpayer accounts based on information it receives from taxpayers and other IRS departments. The Collection function secures past due payments and returns. The Statute Control function addresses issues regarding the Statute of Limitations. The Examination function reviews tax returns to ensure they comply with the tax laws.

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establish a referral record that the Form was referred to the other function.³

In November 2003, the Internal Revenue Service (IRS) Austin Campus⁴ began piloting and implementing the new Correspondence Imaging System (CIS). The CIS scans Accounts Management Adjustment function receipts such as Forms 1040X, internal transcripts, notices, and correspondence into digital images. Forms 1040X that are referred to the Accounts Management Adjustment function are placed on carts and delivered daily to the Image Control Team (ICT) Unit where they are scanned into the CIS. During scanning, the referral record is systemically coded to the taxpayer's account. After scanning, the CIS assigns the imaged Forms 1040X to Accounts Management Adjustment function employees for processing.

With the CIS, the Accounts Management Adjustment function will move from a paper-intensive system to a modern, digital, image-based system. When the CIS is fully implemented at the other campuses,⁵ employees in the Accounts Management Adjustment function will have universal access to electronically imaged cases. Some of the benefits of the CIS include:

- There are no source documents to be associated or filed because the case documents are stored as electronic images.
- The need to physically move paper cases from one location to another is eliminated because the imaged cases can be transferred electronically.

³ The referral record consists of Transaction Code (TC) 971 and a three-digit Action Code (AC). The AC identifies the function to which the amended return was routed or the action taken. For example, input of TC 971 with AC 010 indicates a Form 1040X was referred to the Accounts Management Adjustment function for processing.

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

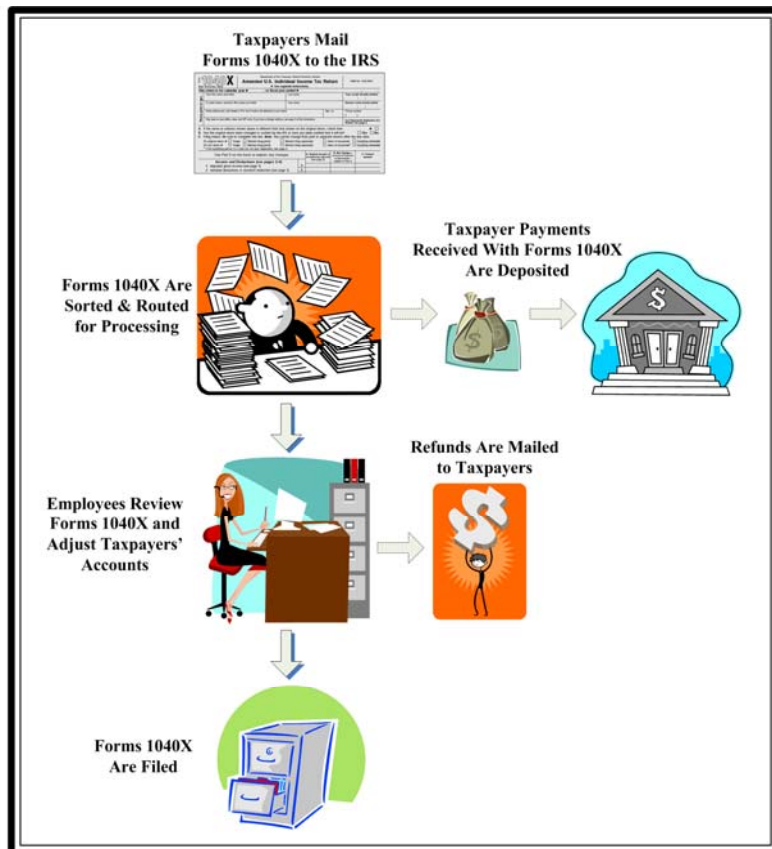
⁵ The CIS was implemented at the Atlanta Campus in the summer of 2004, the Kansas City Campus in the fall of 2004, and the Andover Campus in early 2005. The CIS is scheduled for implementation at the Fresno Campus in August 2005.

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- Casework will be distributed by document type and received date and can be prioritized based on a variety of adjustable criteria.
- Inventory, closure, and age reports will be generated automatically and available online.

Figure 1 shows the general flow of Forms 1040X routed to the Accounts Management Adjustment function for processing.

Figure 1: General Flow of Forms 1040X Routed to the Accounts Management Adjustment Function for Processing



Source: Form 1040X Instructions and IRS Internal Revenue Manual (IRM)⁶ procedures.

During Calendar Year 2004, the Submission Processing sites received approximately 3.1 million Forms 1040X and worked approximately 1.1 million of those returns. The

⁶ The IRM contains the policies, procedures, and guidelines for IRS operations.

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remaining 2 million Forms 1040X were referred to the Accounts Management Adjustment function for processing.

We performed this audit at the Austin Campus during the period August 2004 through March 2005. The audit work included Forms 1040X received at the seven W&I Division Submission Processing sites and routed to the sites' Accounts Management Adjustment functions for processing. 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.

Amended Individual Income Tax Returns Referred to the Accounts Management Adjustment Function Were Not Always Processed Timely

When a Submission Processing site refers a Form 1040X to the Accounts Management Adjustment function, the IRM requires that the referral record be input within 11 workdays⁷ from the received date of the Form 1040X. In addition, the Accounts Management Adjustment function time period for working a Form 1040X is generally 45 calendar days from the later of the Form 1040X received date or processible date⁸ to the date the Form 1040X is closed by the function. After 45 calendar days, the Form 1040X is considered over-age.

We analyzed the Individual Master File⁹ and identified 1,052,964 individual taxpayer accounts showing a Form 1040X routed to the Accounts Management Adjustment function and closed between January and June 2004. We reviewed a statistical sample of 357 Forms 1040X taken from the population and determined if the referral records were coded to the taxpayers' accounts within 11 workdays and the Accounts Management Adjustment function closed the Forms 1040X within 45 calendar days.

⁷ Workdays are defined as nonholiday Mondays through Fridays.

⁸ A return is processible by the IRS if it is filed on a permitted form; contains the taxpayer's name, address, identification number, and required signature; and contains sufficient information for mathematical verification of the amount shown on the claim.

⁹ The IRS database that maintains transactions or records of individual tax accounts.

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Our analysis showed that the Austin Campus had the highest number of untimely actions, due primarily to piloting and implementing the CIS. This campus experienced hardware and software problems that impacted workload processing and had to train and adjust staffing to accommodate the new system.

Forms 1040X were not timely routed to the Accounts Management Adjustment function

We found that the referral records for Forms 1040X routed to the Accounts Management Adjustment function were not input within 11 workdays for 146 Forms 1040X (41 percent) in our sample. The average number of workdays to input the referral records for the 146 Forms 1040X was 17 days, and the range was from 12 to 38 days. Using the 41 percent rate, we estimated that 430,623 of the Forms 1040X in the population did not meet the 11-workday requirement.¹⁰

The ICT Unit does not prioritize Forms 1040X for scanning into the CIS to ensure referral records are input to the taxpayers' accounts within 11 workdays. This Unit is aligned under the Accounts Management Adjustment function, whereas the 11-workday processing requirement is a Submission Processing function procedure.

The Austin Campus conducted two reviews of the ICT Unit's receipts during the summer and fall of 2004. The purpose of both reviews was twofold: to determine the time period between the date the IRS received the Forms 1040X and the date they were delivered to the ICT Unit and to identify the causes for delays. A total of 778 Forms 1040X were examined during the 2 reviews. The first review identified an average of 15 calendar days between the 2 dates. The second review showed that this average had dropped to 10 calendar days.

Both reviews identified "reroutes" as a cause for processing delays. Reroutes are documents that have been routed to the Accounts Management Adjustment function from other

¹⁰ The population estimate was calculated using the actual percentage rather than the rounded percentage that appears in the report.

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functions, field offices, campuses, and Lockbox sites.¹¹ The reviews indicated that reroutes would never be totally eliminated because IRS procedures require a certain amount of routing when special skills are needed to resolve a case or when another function has an open issue on the case.

However, the second review also found that it took the ICT Unit an average of 8 additional calendar days to scan the Forms 1040X into the CIS and an average of 3 more calendar days before the Forms 1040X were assigned to Accounts Management Adjustment function employees. The review did not address the reasons behind these additional time periods.

In our opinion, the combined average of 21 days between the date the IRS received the Forms 1040X and the date the Forms 1040X were assigned to Accounts Management Adjustment function employees is excessive. This is especially true in light of the CIS background information, which indicates that a taxpayer letter may be imaged, controlled, and assigned to an employee in the Accounts Management Adjustment function within 1 to 2 days of the IRS received date. We believe similar time periods will occur at the other campuses once they implement the CIS.

As a result of the reviews, some processing changes for Forms 1040X were implemented. For example, the 11-workday requirement was changed to 12 calendar days effective November 15, 2004. Still, we believe the IRS should do more to identify and address the causes for the processing delays.

Recommendation

1. The Director, Customer Account Services (CAS), W&I Division, should ensure follow-up reviews are conducted to determine if the change to a 12-calendar day processing time period for Forms 1040X was effectively implemented. In addition, causes for

¹¹ A lockbox site is a commercial bank designated by the Financial Management Service (FMS) to process federal tax payments. Source documents are processed and forwarded to the Submission Processing sites. The FMS is the bureau within the Department of the Treasury responsible for outside contracting and cash management.

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processing delays within the ICT Units should be identified and corrective actions should be implemented.

Management's Response: The IRS agreed with this recommendation. Reviews of the new 12-calendar day processing time period have been and will continue to be conducted at each campus. The results, thus far, indicate the change was effectively implemented. The W&I Division will develop procedures to require campuses to review the ICT Units to identify processing delays, their causes, and appropriate corrective measures. The campuses will be required to conduct these reviews at least twice per fiscal year.

Forms 1040X were not timely closed

We found that 49 (14 percent) of the 357 Forms 1040X in our sample were not closed by the Accounts Management Adjustment function within 45 calendar days and became over-aged. The average number of days to close the 49 cases was 56 days. Using the 14 percent rate, we estimated that 144,524 of the Forms 1040X in the population were not closed within 45 calendar days.¹²

Accounts Management Adjustment function personnel indicated there are exceptions to the 45-calendar day time period. They referred to reroutes as an example and added that improving the processing time period would be difficult because the Accounts Management Adjustment function has no control over other functions' processing time periods. As part of the Austin Campus' review of ICT Unit receipts during the fall of 2004, the Submission Processing Form 1040X Unit gathered information on Forms 1040X received that were aged 30 or more days. Appropriate feedback was to be provided to the sending areas. Subsequent to the initial test period, the Unit was to conduct periodic quarterly reviews and continue to provide feedback to the sending areas. Information from the test was also to be provided to a Submission Processing function Headquarters analyst.

We agree that reroutes cannot be totally eliminated and, as a result, the Accounts Management Adjustment function

¹² The population estimate was calculated using the actual percentage rather than the rounded percentage that appears in the report.

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cannot close every Form 1040X within 45 days. However, we believe a 14 percent over-aged rate is excessive and could have a negative impact on customer service and satisfaction.

Recommendation

2. The Director, CAS, W&I Division, should ensure the quarterly periodic reviews of Forms 1040X receipts that are aged 30 or more days are conducted at all W&I Division campuses that process Forms 1040X, that sufficient information is gathered and analyzed to identify problem areas or trends causing the processing delays, and that appropriate feedback is provided to the sending areas. In addition, results of the campus' reviews should be analyzed at the W&I Division level to determine if additional guidance or procedures should be issued to the various W&I Division functions that process Forms 1040X.

Management's Response: The IRS partially agreed with this recommendation. The IRS recognizes the need to periodically review receipts; however, the IRS believes this can be accomplished through sampling with less frequency than suggested. Campuses will be required to sample receipts that are aged 30 or more days and review them to determine possible trends and develop strategies to improve timeliness. The campuses will be required to conduct these reviews at least twice per fiscal year.

Office of Audit Comment: We agree with the alternate corrective action to conduct reviews at least twice per fiscal year.

Untimely Processing of Amended Individual Income Tax Returns Resulted In Unnecessary Interest Paid

In addition to the Accounts Management Adjustment function's 45-calendar day period to close cases, IRS procedures require that taxpayer refunds be issued within 45 calendar days to avoid the payment of unnecessary interest. For example, IRS procedures indicate that, when an amended return results in an overpayment and the refund is issued within 45 days of the received date of the processible amended return, no interest is allowed from the received date.

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We analyzed the sample of 357 Forms 1040X and determined that 264 Forms 1040X resulted in taxpayer refunds. The refunds for 120 (34 percent of 357) of these Forms 1040X were not issued within 45 days of the processible date. The average number of days to issue the refunds for the 120 Forms 1040X was 60 days, and the range was from 46 to 124 days. Using the 34 percent rate, we estimated that refunds were not issued within the 45-day interest-free period for 353,937 Forms 1040X in the population.¹³ In addition, we estimated that the additional interest associated with the 353,937 Forms 1040X was \$3,085,185. While this additional interest is relatively small for the 6-month period reviewed, we believe if the 34 percent rate of occurrence persists, the additional interest could become significant.

We identified several contributing factors why refunds were not always issued within the 45-day interest-free period. For example, Forms 1040X for refund are not prioritized for processing over other types of Forms 1040X during Submission Processing function prescreening and sorting activities. In addition, Forms 1040X for refund are not prioritized for scanning into the CIS and are not given a priority code when they are scanned. As a result, they are not flagged as priority cases when they are assigned to Accounts Management Adjustment function employees.

IRS personnel informed us that the Accounts Management Adjustment function IRM does not specifically require that the function meet the 45-day interest-free period. They also believe the increased labor costs associated with trying to meet it for all Forms 1040X would make it economically unfeasible.

While the IRM for the Accounts Management Adjustment function may not specially require it, we believe the IRM procedures regarding the 45-day interest-free period apply to all IRS operations based on the following:

- The IRM that covers the administration and computation of overpayment interest indicates the procedures apply to all business operating divisions and functions:

¹³ The population estimate was calculated using the actual percentage rather than the rounded percentage that appears in the report.

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Appeals, Taxpayer Advocate, and Criminal Investigation.¹⁴ In addition, the IRM that identifies the 14 different IRS divisions and functions states that “All Operating Divisions & Functions” refers to all 14.¹⁵

- The IRM that covers the guidelines for processing timeliness specifically addresses the 45-calendar day interest-free period and indicates that all refundable tax returns must be processed so the refunds are issued within 45 calendar days to avoid interest payments.¹⁶
- The IRM that covers the processing period for a refund-due U.S. Individual Income Tax Return (Form 1040) indicates a refund must be issued within 45 calendar days to avoid interest payments.¹⁷

We also believe that, because many different W&I Division functions are involved in the processing of Forms 1040X, their procedures should be compatible and provide a comprehensive set of procedures for processing Forms 1040X.

¹⁴ IRM 20.2.4.

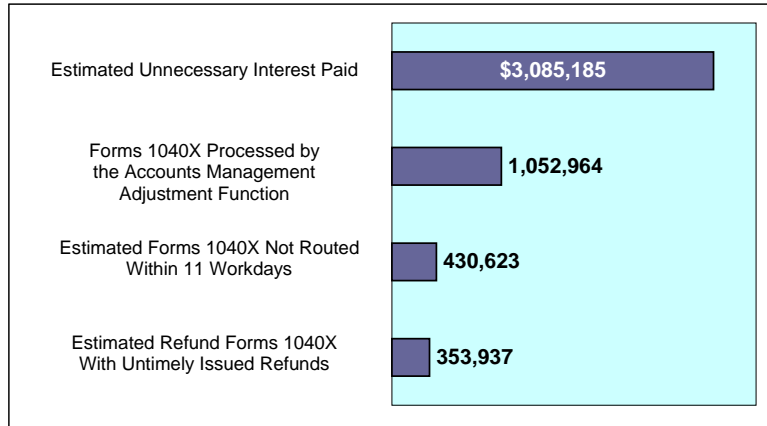
¹⁵ IRM 1.11.2.11.1.8.

¹⁶ IRM 3.30.123.2.2.

¹⁷ IRM 3.30.123.6.1.1.

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Figure 2: Summary of Audit Findings



Source: Analysis of our statistical sample of Forms 1040X.

Recommendations

3. The Director, CAS, W&I Division, should ensure the Submission Processing Code and Edit function procedures are revised to include the sorting and batching of Forms 1040X for potential refund and to flag the batches for priority processing by the ICT Unit. In addition, ICT Unit procedures should be revised so Forms 1040X for potential refund are prioritized for scanning and are assigned a priority code for working by Accounts Management Adjustment function employees.

Management's Response: W&I Division management did not agree with this recommendation and will continue to use the first-in, first-out (FIFO) inventory control method to ensure all taxpayers submitting requests for service are treated equitably.

Office of Audit Comment: The decision to allow the Accounts Management Adjustment function to continue using its FIFO method for processing Forms 1040X (rather than prioritizing those having potential refunds to prevent the payment of unnecessary interest) reflects an inconsistent application of the IRS' policy for refundable tax returns. For example, within the W&I Division, the Submission Processing function processes Forms 1040X in accordance with IRM guidelines requiring refunds to be issued within 45 calendar days to avoid interest payments.

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These are the same guidelines used each year during the filing season¹⁸ to process refundable tax returns in an effort to reduce costs and ensure the timely issuance of taxpayer refunds. In contrast, by allowing the Accounts Management Adjustment function to continue to process Forms 1040X using the FIFO method, taxpayer equity is compromised rather than ensured because of the inconsistent guidelines between these functions in addition to incurring costs for the payment of unnecessary interest due to the untimely issuance of refunds as identified in this audit.

We believe processing Forms 1040X refunds using the IRS' 45-day guideline should be consistently applied within the W&I Division since the Form 1040X is characteristic of a refundable tax return rather than a taxpayer request for service. Using the 45-day guideline benefits both the taxpayer by ensuring refunds are expedited as well as the IRS by preventing the payment of unnecessary interest as quantified in the statistical analysis and outcome measure discussed in this report.

4. The Director, CAS, W&I Division, should ensure the various W&I Division functions' IRM procedures for processing Forms 1040X are consistent, compatible, and comprehensive.

Management's Response: The IRS agreed with this recommendation. The W&I Division reviewed and clarified its IRM and procedures for processing Form 1040X. The Submission Processing function IRM¹⁹ was revised to only include Form 1040 series refund returns received and processed by Submission Processing as being subject to the 45-calendar day interest-free period.

Office of Audit Comment: Although the W&I Division clarified its procedures, the corrective action taken does not ensure the guidelines for processing Forms 1040X are consistent and compatible within its various functions. As described in our comment to Recommendation 3, this action allows the Accounts Management Adjustment function to continue to process Forms 1040X inconsistently as

¹⁸ The period from January through mid-April when most individual income tax returns are filed.

¹⁹ See the explanation of IRM 3.30.123.2.2 in the first bullet on page 10.

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compared to the Submission Processing function. As clarified by management, Forms 1040X having potential refunds will only be subject to the 45-day guideline if processed by the Submission Processing function and not by the Accounts Management Adjustment function.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) timely and properly processes Amended U.S. Individual Income Tax Returns (Form 1040X). The audit focused on the Forms 1040X that were referred to the Accounts Management Adjustment function and closed between January and June 2004.

To accomplish our objective, we:

- I. Determined if the Submission Processing function properly identified and referred Forms 1040X to the Accounts Management Adjustment function.
 - A. Reviewed Treasury Inspector General for Tax Administration and Government Accountability Office reports for prior reviews of Form 1040X processing.
 - B. Reviewed the Internal Revenue Manual (IRM)¹ to identify the criteria for routing Forms 1040X to the Accounts Management Adjustment function.
 - C. Conducted walk-throughs of the Austin Campus² Submission Processing and Accounts Management Adjustment function areas to observe how Forms 1040X are processed and to gain an understanding of how managers monitor the processing of Forms 1040X.
 - D. Extracted a population of 1,512,695 Transaction Codes (TC) 971³ posted to Individual Master File⁴ (IMF) accounts between January and June 2004. We analyzed the population to identify the volumes and percentages of Forms 1040X routed to other functions. For each function, we determined the volumes and percentages of Forms 1040X that were routed within 11 workdays as required by IRM 3.30.123.6.5.
- II. Determined if the Forms 1040X were timely processed to minimize interest costs to the Federal Government.
 - A. Reviewed the IRM to identify the criteria for timely processing Forms 1040X for refunds to minimize the amount of interest paid to taxpayers.

¹ The IRM contains the policies, procedures, and guidelines for IRS operations.

² The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

³ Input of a TC 971 and three-digit Action Code (AC) indicates the taxpayer filed an amended return and begins an action trail for the document. The AC identifies the function to which the amended return was routed (e.g., Accounts Management Adjustment function (AC 010), Collection function (AC 012), Examination function (AC 013), Statute function (AC 014), Underreporter function (AC 015), and Philadelphia Submission Processing Center for all International claims (AC 016)). Each taxpayer account could contain one or more TC 971s.

⁴ The IRS database that maintains transactions or records of individual tax accounts.

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- B. Reviewed 2 Austin Campus reports for reviews of the Image Control Team Unit receipts for 1 week in June 2004 and for 9 weeks between September and November 2004.
- C. Analyzed the IMF extract and identified a population of 1,052,964 individual taxpayer accounts that contained a Form 1040X that was referred to the Accounts Management Adjustment function and closed between January and June 2004. We selected a random statistical sample of 357 taxpayer accounts from the population based on a 95 percent confidence level, an expected error rate of 50 percent, and precision of ± 5.2 percent. A statistical sampling method was used to make a projection about the population from which the sample was selected. We performed the following tests on the sample:
1. Determined if the referral records for the 357 Forms 1040X were properly input within the Submission Processing function's 11-workday processing criteria.
 - a) For each of the 357 Forms 1040X in our sample, verified the Form 1040X received date by examining the IRS received date stamp on the original Form 1040X and compared this date to the TC 971 transaction date to determine if the dates matched as required by IRM 3.11.6.3.7(1).
 - b) We projected the statistical sample result to the population.
 2. Determined if the 357 Forms 1040X were timely processed in accordance with the Accounts Management Adjustment function's 45-calendar day guideline for inventory aging.
 - a) For each of the 357 Forms 1040X in our sample, computed the number of days between the later of the received date or processible date and the date the Form 1040X was closed by the Accounts Management Adjustment function.
 - (1) Verified the later of the received date or processible date by examining the IRS received date stamp(s) on the original Form 1040X or other documentation contained in the case file. (A Form 1040X can contain multiple IRS received date stamps if it is returned to the taxpayer for missing information, then returned to the IRS again.)
 - (2) Determined the date the Accounts Management Adjustment function completed work on each Form 1040X by obtaining an audit trail for each taxpayer account. We manually compared the date of the adjustment transaction record on the audit trail to the Julian Date⁵ of the Document

⁵ The Julian Date Calendar assigns a sequential number (e.g., 1 through 365 (366 for leap years)) to each day of the calendar.

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Locator Number⁶ for the adjustment record posted to each taxpayer account.

- b) We projected the statistical sample result to the population.
3. Analyzed the 357 Forms 1040X to identify ones that resulted in taxpayer refunds and determined if the refunds were issued within 45 calendar days to avoid the payment of unnecessary interest. We performed additional analysis on the taxpayer accounts to determine if the refunds for the 264 Forms 1040X that received refunds were issued within the 45-calendar day interest-free period in accordance with IRM 20.2.4.7.2.3 and IRM 3.30.123.2.2.
- a) For each of the 357 Forms 1040X in the sample, reviewed the original Forms 1040X and taxpayer accounts and identified 264 Forms 1040X for refund.⁷
 - b) For each of the 264 Forms 1040X for refund, computed the number of days between the processible date of the Form 1040X and the date the refund was issued to the taxpayer. We determined that refunds for 120 Forms 1040X were not issued within the 45-calendar day interest-free period.
 - c) Using the 34 percent rate,⁸ projected the statistical sample result to the population and estimated that refunds were not issued within the 45-day interest-free period for 353,937 Forms 1040X in the population.
 - d) Estimated the additional interest⁹ for each of the 120 Forms 1040X identified in Step II.C.3.b. The sum of the additional interest for the 120 Forms 1040X was \$1,045. We did not compute the actual additional interest for each of the 120 Forms 1040X because of audit resource and time constraints and the complexity of the interest calculations.
 - e) Used the information identified in Step II.C.3.d in statistical formulas for variables to estimate the additional interest cost of \$3,085,185 for the population.

⁶ A unique number assigned to every tax return to assist in controlling, identifying, and locating the return.

⁷ These 264 taxpayer accounts contained a TC 846 that is input to refund an overpayment to the taxpayer. The amount of the TC 846 matched the amount reported on the Form 1040X if there were no other corrections or adjustments on the account.

⁸ The 34 percent was computed by dividing the 120 Forms 1040X with untimely issued refunds by the 357 Forms 1040X in the sample.

⁹ The interest rate for noncorporate overpayments was 4 percent from January 1 through March 31, 2004, and 5 percent from April 1 through June 30, 2004. The average rate for these 2 periods is 4.5 percent. Since most of the refunds for the 264 Forms 1040X for refund in the sample were issued between January and June 2004, we used the average of 4.5 percent to compute the additional interest.

Major Contributors to This Report

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**Processing Changes Would Improve Service and Reduce Unnecessary Interest
Paid on Refunds to Taxpayers That File Amended Individual Income Tax Returns**

Appendix III

Report Distribution List

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Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Wage and Investment Division SE:W
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Audit Liaison: Acting Senior Operations Advisor, Wage and Investment Division SE:W:S

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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.

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 144,524 taxpayer accounts affected (see page 7).

Methodology Used to Measure the Reported Benefit:

The Accounts Management Adjustment function's criteria for working Forms 1040X is generally 45 calendar days. After 45 days in inventory, the Forms 1040X become over-aged. The 45-day period is computed from the later of the Form 1040X received date or processible date¹ to the Accounts Management Adjustment function closure date. For the 357 Forms 1040X in our sample, we computed the number of days between the later of the Form 1040X received date or processible date and the Accounts Management Adjustment function closure date. We found that 49 (14 percent) of the 357 Forms 1040X were not closed by the Accounts Management Adjustment function within 45 calendar days and became over-aged. Using the 14 percent rate, we estimated that 144,524 (\pm 3.6 percent) of the Forms 1040X in the population were not closed within 45 calendar days.²

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; \$3,085,185 interest associated with 353,937 taxpayer accounts (see page 8).

Methodology Used to Measure the Reported Benefit:

We analyzed our statistical sample of 357 Forms 1040X and identified 264 Forms 1040X for refund. We determined that refunds for 120 (34 percent of the 357) Forms 1040X were not issued within 45 days of the later of the received date or return processible date. Using the 34 percent rate, we estimated that refunds were not issued within the 45-day interest-free period for 353,937 (\pm 4.9 percent) of the Forms 1040X in the population.³

¹ A return is processible by the Internal Revenue Service if it is filed on a permitted form; contains the taxpayer's name, address, identification number, and required signature; and contains sufficient information for mathematical verification of the amount shown on the claim.

² The population estimate was calculated using the actual percentage rather than the rounded percentage that appears in this appendix.

³ The population estimate was calculated using the actual percentage rather than the rounded percentage that appears in this appendix.

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Since most of the refunds for the 120 Forms 1040X were issued between January and June 2004, we used the average interest rate of 4.5 percent⁴ and computed the additional interest for each of the 120 Forms 1040X. We used this information in statistical formulas for variables to estimate the \$3,085,185 (\pm \$1,233,400) additional interest cost for the population.

⁴ The interest rate for noncorporate overpayments was 4 percent from January 1 through March 31, 2004, and 5 percent from April 1 through June 30, 2004. The average rate for these 2 periods is 4.5 percent.

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Appendix V

Management's Response to the Draft Report

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COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

July 7, 2005

MEMORANDUM FOR PAMELA J. GARDINER
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard J. Morgante *Richard J. Morgante*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Processing Changes Would Improve
Service and Reduce Unnecessary Interest Paid on Refunds to
Taxpayers That File Amended Individual Income Tax Returns
(Audit No. 200440049)

I appreciate your review of Amended Individual Income Tax Returns (Form 1040X) processed by Accounts Management from January through June, 2004. I also appreciate your recognition that we experienced numerous challenges during the initial pilot implementation of the Correspondence Imaging System (CIS) at the Austin Campus. During the pilot implementation we encountered problems typical of a large and complex project. As a result of these difficulties, we experienced some processing delays which are reflected in your statistics. We gained from our experience and when CIS was implemented at other locations, we took actions to eliminate or mitigate many of the conditions that impacted Austin.

We have implemented CIS at the Atlanta, Kansas City, and Andover Campuses and will complete our first phase of roll-outs after we begin implementation at the Fresno Campus in July. Implementation of CIS allows us to better manage inventory through improved controls, the ability to balance workload among our sites, and move work to employees with the required skills. As a result of improved workload management, we will be able to increase our responsiveness to customers by reducing processing time.

I agree with two of your recommendations, partially agree with one and disagree with one. I partially agree with Recommendation 2. We acknowledge a need to review our aged inventory; however, we can accomplish this through sampling and with less frequency than suggested. I do not agree that we should prioritize Forms 1040X with potential refunds for special handling as recommended in Recommendation 3. We currently process our entire correspondence inventory which includes 1040X and other claims using a first-in, first-out control. This ensures that all taxpayers receive equitable treatment regardless of the nature of their request for service. While we strive to avoid unnecessary interest, we also recognize that due to peak periods of receipts and the

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complexity of some cases, some interest payments will be unavoidable. We will continue our efforts to improve our processing to minimize this expense.

I agree with the Outcome Measures as stated in Appendix IV; however, we will not track or report on Funds Put to Better Use since it is only an estimate and the benefit is small compared to the expense of trying to capture and report a potential benefit. Attached are our comments to your recommendations. If you have any questions, please call me at (404) 338-7060 or members of your staff may contact David L. Medeck, Director, Customer Account Services, at (404) 338-8910.

Attachment

Processing Changes Would Improve Service and Reduce Unnecessary Interest Paid on Refunds to Taxpayers That File Amended Individual Income Tax Returns

Attachment

RECOMMENDATION 1

The Director, Customer Account Services (CAS), Wage and Investment (W&I) Division, (a) should ensure follow-up reviews are conducted to determine if the change to a 12-calendar day processing time period for Forms 1040X was effectively implemented. In addition, (b) causes for processing delays within the Image Control Team (ICT) Units should be identified and corrective actions should be implemented.

CORRECTIVE ACTION

(a) We agree with this recommendation. Reviews of the new 12-calendar day processing time period have been and will continue to be conducted at each campus. Review results are discussed during monthly conference calls with the field Operation and Planning and Analysis Chiefs. Based on these reviews, we have determined that the change to the 12-calendar day period has been effectively implemented at each campus. (b) We will develop procedures to require sites to review the ICT Units to identify processing delays, their causes and appropriate corrective measures. Sites will be required to conduct these reviews at least twice per Fiscal Year (FY). This requirement will be incorporated in the FY 2006 Accounts Management Program Letter.

IMPLEMENTATION DATE

a. Completed – November 4, 2004

b. The FY 2006 Accounts Management Program Letter will be released prior to November 15, 2005.

RESPONSIBLE OFFICIAL

a) Director, W&I CAS, Submission Processing
b) Director, W&I CAS, Accounts Management

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 2

The Director, CAS, W&I Division, should ensure the quarterly periodic reviews of Forms 1040X receipts that are aged 30 or more days are conducted at all W&I Division campuses that process Forms 1040X, that sufficient information is gathered and analyzed to identify problem areas or trends causing the processing delays, and that appropriate feedback is provided to the sending areas. In addition, results of the campus' reviews should be analyzed at W&I Division level to determine if additional guidance or procedures should be issued to the various W&I Division functions that process Form 1040X.

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CORRECTIVE ACTION

We partially agree with this recommendation. We recognize the need to periodically review receipts that have aged to determine possible trends and develop strategies to improve timeliness. However, we can accomplish this through sampling and with less frequency than suggested. As a result, we plan to develop procedures to require sites to review a sample of 1040X receipts that have aged 30 days or more to determine the cause of delays and provide feedback or corrective measures as deemed appropriate. Sites will be required to conduct these reviews at least twice per fiscal year and share the results with the Headquarters program analyst. This requirement will be incorporated in the FY 2006 Accounts Management Program Letter.

IMPLEMENTATION DATE

The FY 2006 Accounts Management Program Letter will be released prior to November 15, 2005.

RESPONSIBLE OFFICIAL

Director, W&I CAS, Accounts Management

CORRECTIVE ACTION MONITORING PLAN

We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 3

The Director, CAS, W&I Division, should ensure that the Submission Processing Code and Edit function procedures are revised to include the sorting and batching of Forms 1040X for potential refund and to flag the batches for priority processing by the ICT Unit. In addition, ICT Unit procedures should be revised so that Forms 1040X for potential refund are prioritized for scanning and are assigned a priority code for working by AM Adjustment function employees.

CORRECTIVE ACTION

We disagree with this recommendation. To ensure that all taxpayers submitting requests for service are treated equitably we will continue to use our first-in, first-out method of inventory control.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

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CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 4

The Director, CAS, W&I Division, should ensure that the various W&I Division functions' IRM procedures for processing Forms 1040X are consistent, compatible, and comprehensive.

CORRECTIVE ACTION

We agree with this recommendation. We have reviewed the W&I IRM procedures for processing Form 1040X and clarified instructions. An Alert has been issued to IRM users noting the changes.

IMPLEMENTATION DATE

Completed on June 15, 2005

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A