TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Evaluation of the Characteristics of Unnecessarily Filed Individual Income Tax Returns

August 17, 2007

Reference Number: 2007-40-130

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.

Phone Number | 202-927-7037
Email Address | Bonnie.Heald@tigta.treas.gov
Web Site | http://www.tigta.gov

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

August 17, 2007

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Evaluation of the Characteristics of Unnecessarily Filed Individual Income Tax Returns (Audit # 200640037))

This report presents the results of our review to determine the steps the Internal Revenue Service (IRS) has taken or plans to take to reduce the number of unnecessary tax returns filed, including the means used to notify and educate taxpayers that they may no longer be required to file tax returns. This audit was included in our 2007 Annual Audit Plan.

Impact on the Taxpayer

Unless exempt, every individual with gross income that equals or exceeds certain limits for a taxable year is required to file a Federal income tax return. However, many people who do not meet the filing requirements still file Federal income tax returns, either to obtain a refund of taxes already paid or because they do not understand the law. To reduce the cost to taxpayers who file these tax returns, the IRS should direct them to free electronic filing (*e-filing*).

Synopsis

Our evaluation of a statistical sample of tax returns filed for Tax Years 2003 through 2005 showed more than 8 million individual income tax returns each year were filed unnecessarily. For the purposes of this report, an unnecessary tax return is defined as a return filed either to obtain a refund of taxes already paid or because the individual did not understand the tax law, even though the individual's income did not meet the filing threshold. Collectively, taxpayers spent an average of $390 million and 75 million hours per year preparing and filing these unnecessary tax returns. The cost to taxpayers includes both time and money to prepare and file the tax returns (including fees paid to preparers). In turn, the IRS spent an average of $11 million to process the unnecessary tax returns filed each year.

Taxpayers may file unnecessary tax returns only to obtain a refund of taxes already paid or because they do not understand the tax law. Fifteen percent of the unnecessary tax returns filed did not generate a refund, while 85 percent of these returns were filed to obtain a full refund of withheld taxes. More than one-half of those filing to obtain a refund were under age 21, and 76 percent of those under age 21 indicated they could be claimed as dependents on other taxpayers' returns. These taxpayers would have been exempt from tax withholding because they earned less income than the amount required to file a return *and* they could be claimed as dependents on other taxpayers' return. More than 60 percent of the unnecessary tax returns were filed on paper.

Due to concerns about the potential negative consequences of advising taxpayers to claim exemption from withholding, we are making no related recommendations at this time. Nevertheless, the IRS could, at a minimum, reduce its burden if taxpayers moved from preparing and submitting their returns on paper to *e-filing*.

The IRS has a legally mandated goal to have 80 percent of Federal tax and information returns electronically filed (*e-filed*) by 2007.[1] It costs more to process a paper tax return than an *e-filed* return. Fewer mistakes are made by both taxpayers and the IRS with *e-filed* tax returns, further reducing processing time and costs. Generally, all the taxpayers filing these unnecessary tax returns would qualify to use the IRS Free File Program, which is a free Federal tax preparation and *e-filing* program for eligible taxpayers. The Free File Program may offer the best opportunity to direct taxpayers from paper filing to *e-filing*. We previously recommended the IRS expand the marketing of the Free File Program by directing promotional materials to taxpayers who are eligible for the Free File Program but have filed their returns on paper.[2]

Response

We made no recommendations in this report. However, key IRS management officials reviewed it prior to issuance and agreed with the facts and conclusions presented.

Copies of this report are also being sent to the IRS managers affected by the report conclusions. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 622-5916.

[1] IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).
[2] *Additional Action Is Needed to Expand the Use and Improve the Administration of the Free File Program* (Reference Number 2007-40-105, dated June 28, 2007).

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Abbreviations

e-file(d);e-filing	Electronically file(d); electronic filing
IRS	Internal Revenue Service

Background

Unless exempt, every individual with income that equals or exceeds certain limits is required to file a Federal income tax return. However, many people file tax returns only to obtain a refund of taxes already paid or because they do not understand the tax law.

To determine whether a Federal tax return must be filed for a particular tax year, a taxpayer must consider three factors: filing status, age at the end of the tax year, and amount of gross income.[1] Figure 1 shows the Tax Year 2006 filing requirements for most individuals.

Figure 1: Tax Year 2006 Filing Requirements for Most Individual Taxpayers

If the Taxpayer's Filing Status Is . . .	And at the End of 2006, the Taxpayer Was . . .	Then File a Tax Return if the Gross Income Was at Least . . .
Single	Under 65	$8,450
	65 or Older	$9,700
Married Filing Jointly	Under 65 (Both Spouses)	$16,900
	65 or Older (One Spouse)	$17,900
	65 or Older (Both Spouses)	$18,900
Married Filing Separately	Any Age	$3,300
Head of Household	Under 65	$10,850
	65 or Older	$12,100
Qualifying Widow(er) With Dependent Child	Under 65	$13,600
	65 or Older	$14,600

Source: Your Federal Income Tax for Individuals, For Use In Preparing 2006 Returns (Publication 17).

[1] Gross income is all income received in the form of money, goods, property, and services that is not exempt from tax, including any income from sources outside the United States.

Depending on filing status and age, if a taxpayer's gross income is less than the standard deduction amount plus the personal exemption (these sums are shown in the last column of Figure 1), he or she may not have to file a Federal income tax return. The standard deduction amount depends on filing status, whether the taxpayer is 65 or older or blind, and whether the taxpayer's personal exemption can be claimed by another taxpayer. The standard deduction is higher for taxpayers who are 65 or older or blind.

If the standard deduction and the personal exemption exceed income, a taxpayer may not be required to file a tax return. For example, when filing a 2006 tax return, a single taxpayer has a standard deduction amount of $5,150 and a personal exemption of $3,300. As shown in Figure 1, the taxpayer may not need to file if his or her income is not above $8,450 ($5,150 plus $3,300).

However, taxpayers are required to file tax returns, even if they owe no tax, in the following instances:

- To report any special taxes (such as Alternative Minimum Tax, Household Employment Tax, or Social Security or Medicare tax on tips not reported to the employer).
- To report the receipt of Advance Earned Income Tax Credit. The Earned Income Tax Credit is a refundable Federal tax credit for low-income working individuals and families. The Advance Earned Income Tax Credit allows those taxpayers who expect to qualify for the Credit and have at least one qualifying child to receive part of the Credit in each paycheck during the year in which the taxpayer qualifies for the Credit.
- To report self-employment income of more than $400.
- To report wages of $108.28 or more from a church or qualified church-controlled organization that is exempt from employer Social Security and Medicare taxes.
- To report the sale of a principal residence.

If an individual does not meet the filing status, age, and income criteria specified, he or she does not need to file a tax return but may want to file to get withheld tax back. The Internal Revenue Service (IRS) states on IRS.gov (its public Internet web site) that many people will file a 2006 Federal income tax return although the income on the tax return is below the filing requirement. IRS.gov provides assistance to help taxpayers determine if they need to file or if they need to stop or adjust their tax withholding, so they will not have to file an unnecessary tax return in the future.

This review was performed at the Wage and Investment Division Headquarters office in Atlanta, Georgia, and the Wage and Investment Division Submission Processing office in New Carrollton, Maryland, during the period August 2006 through May 2007. 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.

Results of Review

Filing Unnecessary Tax Returns Creates Burden for Taxpayers and the Internal Revenue Service

Our evaluation of a statistical sample of tax returns filed for Tax Years 2003 through 2005 showed more than 8 million individual income tax returns each year were filed unnecessarily. For the purposes of this report, an unnecessary tax return is defined as a return filed either to obtain a refund of taxes already paid or because the individual did not understand the tax law, even though the individual's income did not meet the filing requirement (or threshold). Figure 2 shows the projected number of unnecessary tax returns based on our statistical sample of 310 tax returns.[2]

Figure 2: Projected Number of Unnecessary Tax Returns Filed (Tax Years 2003-2005)

Tax Year	Total Returns Filed	Estimated Number of Unnecessary Tax Returns	Percentage of Unnecessary Tax Returns
2003	130,043,000	8,262,083	6.4%
2004	130,583,000	8,278,095	6.3%
2005	132,105,000	8,537,837	6.5%
Total	392,731,000	25,078,015	6.4%

Source: IRS Data Books[3] and our analysis of IRS Master File[4] data.

Collectively, taxpayers spent an average of $390 million and 75 million hours per year preparing and filing these unnecessary tax returns, which consisted of the "Form 1040 series," including U.S. Individual Income Tax Return (Form 1040), U.S. Individual Income Tax Return (Form 1040A), and Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ). The cost to taxpayers includes both time and money to prepare and file the tax returns (including fees paid to preparers). Taxpayer monetary costs vary depending on the type of tax return filed and the method used to file the tax return. Taxpayer time includes all aspects of

[2] Our sample was selected from the population of tax returns that did not appear to meet the filing threshold and did not have any associated schedules, credits, or losses.
[3] The *IRS Data Book* (Publication 55B) is an annual publication that provides information about returns filed and taxes collected, enforcement, taxpayer assistance, and the IRS budget and workforce.
[4] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

filing a tax return, including recordkeeping, learning the tax law, and preparing and submitting the tax return.

The IRS spent an average of $11 million to process the unnecessary tax returns each year. According to the IRS, in Fiscal Year 2004, it cost $2.65 to process a paper tax return and $0.29 to process an electronically filed (*e-filed*) tax return; in Fiscal Year 2005, the costs were $2.87 and $.25, respectively.[5] The IRS costs are summarized as "Processing Costs" and exceed $33 million for the 3 years reviewed.

Figure 3 shows the costs of the unnecessary tax returns to both taxpayers and the IRS.

Figure 3: Costs of Filing Unnecessary Tax Returns (Tax Years 2003-2005)

Tax Year	IRS Processing Costs	Taxpayer Time in Hours	Taxpayer Monetary Costs
2003	$11,044,231	76,459,456	$396,092,431
2004	$11,700,800	79,287,713	$379,813,944
2005	$11,025,745	70,055,447	$394,901,076
Total	$33,770,776	225,802,616	$1,170,807,451

Source: Our analysis of cost data provided by the Wage and Investment Division Research and Customer Account Services functions.

Our analyses of a statistical sample of 310 Tax Year 2003 through 2005 tax returns identified 289 (93 percent) unnecessary tax returns. Projected to the entire population of tax returns as shown in Figure 2, this represents about 6 percent, or 8 million, unnecessary tax returns filed each year.[6] Additionally, test results on a second statistical sample of 271 unnecessary filers for Tax Years 2003 through 2005 showed 258 (95 percent) of these taxpayers were considered repeaters (i.e., the taxpayers had filed more than 1 unnecessary tax return in the 3 years tested); 26 percent had filed unnecessary tax returns in all 3 years.

Of additional significance is the population of unnecessary tax returns exhibits common characteristics or trends the IRS could use to help market its electronic filing (*e-filing*) products, modify taxpayers' filing behaviors, and reduce costs to both the IRS and taxpayers.

[5] These are weighted average costs that may be more heavily weighted toward the more complex tax returns. In a recent report, the Government Accountability Office stated that it could not independently verify IRS processing cost estimates and that the basis is unclear because the IRS' cost accounting system is unable to support preparation of such cost estimates. *Taxpayer Service: State Experiences Indicate IRS Would Face Challenges Developing an Internet Filing System with Net Benefits* (GAO-07-570, dated April 2007).
[6] Due to rounding, the percentages do not equal 100 percent.

Fifteen percent of the tax returns that did not meet the income threshold for filing generated no refunds

Of the 289 unnecessary tax returns tested, 42 (15 percent) did not generate refunds, and 30 (71 percent) of these 42 returns were filed by taxpayers over age 64. Almost one-half of the 42 returns were prepared by paid preparers, and 76 percent were filed on paper. Figure 4 provides the characteristics of the 42 returns that did not generate refunds.

Figure 4: Characteristics of Tax Returns That Did Not Generate Refunds (Tax Years 2003-2005)

Characteristic	Number of Returns per Tax Year 2003	2004	2005	Total	Percentage
Returns by Year	14	13	15	42	100%
Over Age 64	10	10	10	30	71%
Ages 21 to 64	4	2	4	10	24%
Under Age 21	0	1	1	2	5%
Filed Form 1040	7	6	4	17	41%
Filed Form 1040A	5	6	8	19	45%
Filed Form 1040EZ	2	1	3	6	14%
Used a Paid Preparer	7	5	7	19	45%
E-Filed	5	0	5	10	24%
Filed on Paper	9	13	10	32	76%
Pension As Main Source of Income	5	4	6	15	36%
Average Income	$5,781	$5,856	$5,499		

Source: Our analysis of IRS Master File data.

While pensions were the main source of income for these taxpayers, all but three taxpayers reported some form of income. Three taxpayers filed returns but had no income and claimed no refunds. In addition, 25 (60 percent) of the 42 taxpayers who had filed unnecessary tax returns had filed for more than 1 year: 11 (44 percent) had filed for 3 years, and 14 (56 percent) had filed for 2 years.

Collectively, taxpayers spent an average of $63.1 million and 11.6 million hours per year preparing and filing these unnecessary tax returns that did not generate a refund. The IRS spent an average of $2.2 million to process these returns each year. Figure 5 shows the costs of the unnecessary tax returns to both taxpayers and the IRS.

Figure 5: Costs of Filing Unnecessary Tax Returns That Did Not Generate Refunds (Tax Years 2003-2005)

Tax Year	IRS Processing Costs	Taxpayer Time in Hours	Taxpayer Monetary Costs
2003	$1,948,982	12,135,700	$64,706,922
2004	$2,753,901	9,975,228	$43,962,244
2005	$1,953,604	12,659,860	$80,526,658
Total	$6,656,487	34,770,788	$189,195,824

Source: Our analysis of cost data provided by the Wage and Investment Division Research and Customer Account Services functions.

Eighty-five percent of the tax returns that did not meet the income threshold for filing were filed to obtain refunds of all withheld taxes

For 247 (85 percent) of 289 unnecessary tax returns tested, the tax returns generated refunds. More than one-half of the taxpayers were under age 21 and filed a Form 1040EZ, which is the simplest form in the Form 1040 series. The main source of the refunds was over withholding.[7] Figure 6 provides the characteristics of the tax returns tested that generated refunds.

[7] Taxpayers who are wage earners pay Federal income tax by having it withheld from their pay during the year. This withholding is based on marital status and the number of allowances claimed when a taxpayer files an Employee's Withholding Allowance Certificate (Form W-4) with his or her employer. Employees meeting certain criteria are eligible to claim exemption from withholding (meaning no Federal income tax should be withheld from the wages).

Figure 6: Characteristics of Tax Returns That Generated Refunds (Tax Years 2003-2005)

Characteristic	Number of Returns per Tax Year 2003	2004	2005	Total	Percentage
Returns by Year	81	88	78	247	100%
Over Age 64	12	7	7	26	11%
Ages 21 to 64	21	30	24	75	30%
Under Age 21	48	51	47	146	59%
Filed Form 1040	21	14	15	50	20%
Filed Form 1040A	18	18	14	50	20%
Filed Form 1040EZ	42	56	49	147	60%
Used a Paid Preparer	30	32	26	88	36%
E-Filed	31	38	29	98	40%
Filed on Paper	50	50	49	149	60%
Wages As Main Source of Income	72	77	69	218	88%
Average Income	$4,022	$3,732	$4,071		
Average Refund	$251	$226	$237		

Source: Our analysis of IRS Master File data.

Collectively, taxpayers spent an average of $327 million and 64 million hours per year preparing and filing these unnecessary tax returns that generated refunds. The IRS spent an average of $9 million processing these unnecessary tax returns each year. Figure 7 shows the costs of the unnecessary tax returns to both taxpayers and the IRS.

Figure 7: Costs of Filing Unnecessary Tax Returns That Generated Refunds (Tax Years 2003-2005)

Tax Year	IRS Processing Costs	Taxpayer Time in Hours	Taxpayer Monetary Costs
2003	$9,095,249	64,323,756	$331,385,509
2004	$8,946,900	69,312,485	$335,851,700
2005	$9,072,141	57,395,587	$314,374,418
Total	$27,114,290	191,031,828	$981,611,627

Source: Our analysis of cost data provided by the Wage and Investment Division Research and Customer Account Services functions.

We analyzed the second statistical sample of 271 taxpayers to identify those who had filed unnecessary tax returns more than once and determined 258 (95 percent) had filed more than 1 unnecessary tax return for Tax Years 2003 through 2005. Of the 258 taxpayers, 106 (41 percent) were under age 21, and 28 (26 percent) of those under age 21 had filed unnecessary tax returns in all 3 years reviewed.

More than 50 percent of the unnecessary tax returns were filed by taxpayers under age 21

For 148 (51 percent) of the 289 unnecessary tax returns identified, the taxpayers were under age 21 and obtained refunds of *all* Federal taxes withheld.

- Income ranged from $34 to $10,011. Only 7 percent (11 of 148) had income more than $5,000.
- Refunds ranged from $3 to $753.
- Seventy-six percent (113 of 148) of those under age 21 indicated they could be claimed as dependents on other taxpayers' tax returns. They would have been exempt from tax withholding because they earned less income than that required to file a return *and* they could be claimed as dependents on other taxpayers' returns.

The IRS explains withholding and the requirements for it in various publications and on IRS.gov

The IRS explains withholding and the requirements for it in various publications, including *How Do I Adjust My Tax Withholding?* (Publication 919), and provides a "Withholding Calculator" on IRS.gov. The purpose of this Calculator is to help employees ensure they do not have too much or too little income tax withheld from their pay. The IRS states the Calculator is not a replacement for the Employee's Withholding Allowance Certificate (Form W-4), but most people will find it more accurate and easier to use than the worksheets accompanying Form W-4.

Employees may use the results of this program to help them complete a new Form W-4, which they will submit to their employers.

IRS.gov also includes a webpage entitled Tax Information for Students, which explains the requirements for withholding and advises taxpayers that, if their income is below the filing threshold for their age, filing status, and dependency status, they will not owe income tax on the income and will not have to file a tax return. They may choose to file if they have income tax withholding and want to have it refunded.

However, most students or first-time job seekers are asked to complete their Forms W-4 the first day at their new jobs. They may not research IRS publications or IRS.gov before filling out their forms, relying instead on the instructions on the Form itself for this information. Form W-4 is two pages long, including instructions and worksheets. IRS officials stated adding additional text to the Form would make it even more difficult to read.

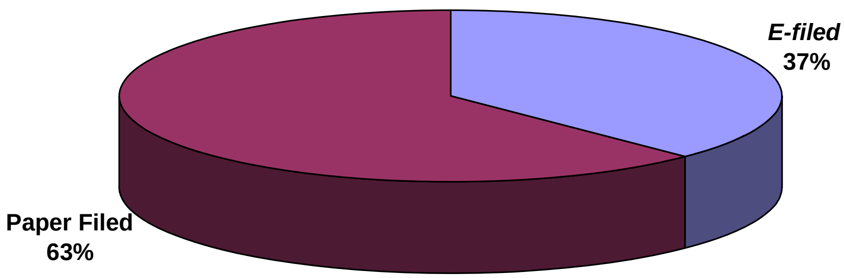
In addition, they are reluctant to advise taxpayers who may just be entering the job market to claim exemption from withholding at the risk of possibly owing taxes. Taxpayers could earn more than anticipated, resulting in taxes owed if the employers did not withhold taxes. Further, according to the IRS, some taxpayers prefer to receive refunds rather than face the possibility of owing taxes when the returns are filed. As such, some taxpayers use withholding as a means of accumulating savings.

There is merit to concerns about the potential negative consequences of advising taxpayers to claim exemption from withholding; consequently, we are making no related recommendations at this time. Nevertheless, the IRS could, at a minimum, reduce its burden if taxpayers moved from preparing and submitting their returns on paper to *e-filing*.

More than 60 percent of the unnecessary tax returns were filed on paper but would qualify for free e-filing through IRS.gov

As shown in Figure 8, 181 (63 percent) of the 289 unnecessary tax returns tested were prepared and submitted on paper. Sixty (33 percent) of the 181 paper returns were prepared using tax preparation software on a personal computer, then printed and submitted on paper.

Figure 8: Methods Used to File Unnecessary Tax Returns (Tax Years 2003-2005)



Source: Our analysis of IRS Master File data.

The law[8] established a goal for the IRS to have 80 percent of Federal tax and information returns *e-filed* by 2007. It costs more to process a paper return than an *e-filed* return. Fewer mistakes are made by both taxpayers and the IRS with *e-filed* tax returns, further reducing processing time and costs.

Generally, all the taxpayers filing these unnecessary tax returns would qualify to use the IRS Free File Program, which is a free Federal tax preparation and *e-filing* program for eligible taxpayers developed through a partnership between the IRS and a group of private-sector tax software companies. Taxpayers who meet certain criteria (for Tax Year 2006 returns, taxpayers with an Adjusted Gross Income[9] of $52,000 or less) can electronically file (*e-file*) their Federal tax returns for free through IRS.gov.

Compared to other methods of filing, the Free File Program accounts for a small portion of individual tax returns filed. Only 3 percent of individual taxpayers used the Free File Program in 2006. We recently completed an audit of the Free File Program and reported[10] there are three main barriers to use of the Program: awareness, computer literacy, and tax return complexity. The Program's low participation rate may be an indicator that few taxpayers know about or understand they may be eligible for the Free File Program. The IRS recently conducted focus groups of taxpayers and also found awareness was one of the main challenges facing the Program.

[8] IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).
[9] Adjusted gross income is income less certain deductions and/or expenses.
[10] *Additional Action Is Needed to Expand the Use and Improve the Administration of the Free File Program* (Reference Number 2007-40-105, dated June 28, 2007).

<u>Defining the population of taxpayers who file unnecessary tax returns would help the IRS direct these taxpayers to less expensive and less burdensome filing methods</u>

Previously, the IRS had attempted to reduce the number of unnecessary tax returns filed by issuing notices to affected taxpayers but determined the notices were not effective in doing this. While issuing notices to taxpayers may not have been effective, other education and marketing tools have been successful.

The IRS directed its marketing efforts successfully in the past with the creation of the TeleFile Program.[11] It sent TeleFile Program packages to taxpayers who, based on their income and filing patterns, appeared to be eligible to use this Program. Such a direct-mail approach with the Free File Program may be the best avenue to reach eligible taxpayers and may also serve as a vehicle for providing information to taxpayers about tax withholding exemptions.

The Free File Program also may offer the best opportunity to direct taxpayers who file unnecessary tax returns from paper filing to *e-filing*. Because there is a risk associated with reducing tax withholdings, directing taxpayers to free *e-filing* could alleviate the cost and burden of unnecessary tax returns to both taxpayers and the IRS. By converting these taxpayers from paper filing to *e-filing*, the IRS could save an average of $9.1 million per year in processing costs.

freefile
Take the free way.

We previously recommended the IRS expand the marketing of the Free File Program by directing promotional materials to taxpayers who are eligible for the Free File Program but have filed their returns on paper, and the IRS agreed with the recommendation. Unnecessary filers are a defined population that should be included in these marketing efforts. Because we have already recommended expanding Free File Program marketing, we are making no additional recommendations at this time.

[11] The TeleFile Program, discontinued in Fiscal Year 2005, was a service that enabled taxpayers to file their Forms 1040EZ by telephone. Taxpayers called the IRS using a toll-free telephone number and, via automated prompts, entered the tax return information using their telephone keypads.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine the steps the IRS has taken or plans to take to reduce the number of unnecessary tax returns filed, including the means used to notify and educate taxpayers that they may no longer be required to file tax returns. To accomplish our objective, we:

I. Determined if the IRS has a strategy to reduce the number of unnecessary tax returns filed.

   A. Discussed with IRS officials their current and future plans for reducing unnecessary tax return filings and reviewed information available on IRS.gov.

   B. Discussed with IRS management prior studies and research on unnecessary tax return filings.

   C. Determined if the IRS is currently tracking/monitoring the number of unnecessary tax returns filed.

II. Identified the current and prior filing requirements as prescribed by law and IRS guidelines.

III. Determined the population of unnecessary tax returns filed, how many taxpayers filed unnecessary tax returns repeatedly, and how many returns had been previously identified by the IRS as unnecessary.

   A. Consulted our contract statistician and selected a statistical sample of potential unnecessary filers. We obtained a data extract from the Individual Master File[1] of all potentially unnecessary tax returns filed for Tax Years 2003 – 2005 using the income filing requirement criteria imposed on each taxpayer based on their filing status and age in the stated tax year.

   We further refined the population by eliminating those tax returns containing certain schedules associated with U.S. Individual Income Tax Return (Form 1040) including Itemized Deductions (Schedule A), Profit or Loss From Business (Schedule C), Capital Gains and Losses (Schedule D), Supplemental Income and Loss (Schedule E), and Profit or Loss From Farming (Schedule F). We also eliminated other Form 1040 series returns and returns where other criteria were met, such as:

[1] The Individual Master File is the IRS database that maintains transactions or records of individual tax accounts.

- U.S. Departing Alien Income Tax Return (Form 1040-C).
- U.S. Nonresident Alien Income Tax Return (Form 1040NR).
- U.S. Self-Employment Tax Return-Puerto Rico (Form 1040-PR).
- U.S. Self-Employment Tax Return (Including the Additional Child Tax Credit for Bona Fide Residents of Puerto Rico) (Form 1040-SS).
- Tax returns filed with Sales of Business Property (Form 4797).
- Tax returns where a credit was claimed.
- Tax returns claiming a loss on the "Other Income" line of Form 1040.

This resulted in 9.4 million records for Tax Year 2003, 8.9 million records for Tax Year 2004, and 8.6 million records for Tax Year 2005.

From this population of more than 26 million tax returns, we selected a statistically valid sample of 310 tax returns using a confidence level of 95 percent, a precision level of ±5 percent, and an estimated error rate of 28 percent. We determined the reliability of the data extract by comparing critical fields on a small number of cases to the same fields on the Individual Master File.

B. Selected a second statistical sample from the data extract in Step III.A of taxpayers who had filed more than one unnecessary tax return. We obtained an extract of all taxpayers who had filed repeat unnecessary tax returns for Tax Years 2003 – 2005 by identifying unique taxpayer identification numbers and performing a match to identify taxpayers with tax returns in at least more than 1 year. From this population of almost 6 million records, we selected a statistically valid sample of 271 tax returns, using a confidence level of 90 percent, a precision level of ±5 percent, and an estimated error rate of 50 percent.

IV. Determined the impact unnecessary tax returns have on taxpayers and the IRS.

A. Determined how many taxpayers used a paid preparer to prepare their tax returns and how many taxpayers *e-filed*.

B. Determined other costs associated with preparing and filing unnecessary tax returns, such as estimated time to prepare the tax return, mailing costs, and processing costs.

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs)
Augusta R. Cook, Director
Paula W. Johnson, Audit Manager
Sharon Shepherd, Lead Auditor
Jerome Antoine, Auditor
Patricia Jackson, Auditor
Geraldine Vaughn, Auditor
James Allen, Information Technology Specialist
Martha Stewart, Information Technology Specialist

Appendix III

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

Appendix IV

2007 Employee's Withholding Allowance Certificate (Form W-4)

Form W-4 (2007)

Purpose. Complete Form W-4 so that your employer can withhold the correct federal income tax from your pay. Because your tax situation may change, you may want to refigure your withholding each year.

Exemption from withholding. If you are exempt, complete **only** lines 1, 2, 3, 4, and 7 and sign the form to validate it. Your exemption for 2007 expires February 16, 2008. See Pub. 505, Tax Withholding and Estimated Tax.

Note. You cannot claim exemption from withholding if (a) your income exceeds $850 and includes more than $300 of unearned income (for example, interest and dividends) and (b) another person can claim you as a dependent on their tax return.

Basic instructions. If you are not exempt, complete the **Personal Allowances Worksheet** below. The worksheets on page 2 adjust your withholding allowances based on itemized deductions, certain credits, adjustments to income, or two-earner/multiple job situations. Complete all worksheets that apply. However, you may claim fewer (or zero) allowances.

Head of household. Generally, you may claim head of household filing status on your tax return only if you are unmarried and pay more than 50% of the costs of keeping up a home for yourself and your dependent(s) or other qualifying individuals.

Tax credits. You can take projected tax credits into account in figuring your allowable number of withholding allowances. Credits for child or dependent care expenses and the child tax credit may be claimed using the **Personal Allowances Worksheet** below. See Pub. 919, How Do I Adjust My Tax Withholding, for information on converting your other credits into withholding allowances.

Nonwage income. If you have a large amount of nonwage income, such as interest or dividends, consider making estimated tax payments using Form 1040-ES, Estimated Tax for Individuals. Otherwise, you may owe additional tax. If you have pension or annuity income, see Pub. 919 to find out if you should adjust your withholding on Form W-4 or W-4P.

Two earners/Multiple jobs. If you have a working spouse or more than one job, figure the total number of allowances you are entitled to claim on all jobs using worksheets from only one Form W-4. Your withholding usually will be most accurate when all allowances are claimed on the Form W-4 for the highest paying job and zero allowances are claimed on the others.

Nonresident alien. If you are a nonresident alien, see the Instructions for Form 8233 before completing this Form W-4.

Check your withholding. After your Form W-4 takes effect, use Pub. 919 to see how the dollar amount you are having withheld compares to your projected total tax for 2007. See Pub. 919, especially if your earnings exceed $130,000 (Single) or $180,000 (Married).

Personal Allowances Worksheet (Keep for your records.)

A Enter "1" for **yourself** if no one else can claim you as a dependent . . . . **A** ______

B Enter "1" if:
- You are single and have only one job; or
- You are married, have only one job, and your spouse does not work; or
- Your wages from a second job or your spouse's wages (or the total of both) are $1,000 or less.

. . **B** ______

C Enter "1" for your **spouse**. But, you may choose to enter "-0-" if you are married and have either a working spouse or more than one job. (Entering "-0-" may help you avoid having too little tax withheld.) . . . . **C** ______

D Enter number of **dependents** (other than your spouse or yourself) you will claim on your tax return . . . . **D** ______

E Enter "1" if you will file as **head of household** on your tax return (see conditions under **Head of household** above) . **E** ______

F Enter "1" if you have at least $1,500 of **child or dependent care expenses** for which you plan to claim a credit . . **F** ______

(**Note.** Do not include child support payments. See Pub. 503, Child and Dependent Care Expenses, for details.)

G **Child Tax Credit** (including additional child tax credit). See Pub 972, Child Tax Credit, for more information.
- If your total income will be less than $57,000 ($85,000 if married), enter "2" for each eligible child.
- If your total income will be between $57,000 and $84,000 ($85,000 and $119,000 if married), enter "1" for each eligible child plus "1" additional if you have 4 or more eligible children. **G** ______

H Add lines A through G and enter total here. (**Note.** This may be different from the number of exemptions you claim on your tax return.) ▶ **H** ______

For accuracy, complete all worksheets that apply.
- If you plan to **itemize or claim adjustments to income** and want to reduce your withholding, see the **Deductions and Adjustments Worksheet** on page 2.
- If you have **more than one job** or are **married and you and your spouse both work** and the combined earnings from all jobs exceed $40,000 ($25,000 if married) see the **Two-Earners/Multiple Jobs Worksheet** on page 2 to avoid having too little tax withheld.
- If **neither** of the above situations applies, **stop here** and enter the number from line H on line 5 of Form W-4 below.

------------------------- Cut here and give Form W-4 to your employer. Keep the top part for your records. -------------------------

Form **W-4** — **Employee's Withholding Allowance Certificate** — OMB No. 1545-0074 — **2007**

Department of the Treasury
Internal Revenue Service

▶ **Whether you are entitled to claim a certain number of allowances or exemption from withholding is subject to review by the IRS. Your employer may be required to send a copy of this form to the IRS.**

1 Type or print your first name and middle initial.	Last name	2 Your social security number
Home address (number and street or rural route)	3 ☐ Single ☐ Married ☐ Married, but withhold at higher Single rate. Note. If married, but legally separated, or spouse is a nonresident alien, check the "Single" box.	
City or town, state, and ZIP code	4 If your last name differs from that shown on your social security card, check here. You must call 1-800-772-1213 for a replacement card. ▶ ☐	

5 Total number of allowances you are claiming (from line **H** above **or** from the applicable worksheet on page 2) **5**

6 Additional amount, if any, you want withheld from each paycheck . . . . **6** $

7 I claim exemption from withholding for 2007, and I certify that I meet **both** of the following conditions for exemption.
- Last year I had a right to a refund of **all** federal income tax withheld because I had **no** tax liability **and**
- This year I expect a refund of **all** federal income tax withheld because I expect to have **no** tax liability.

If you meet both conditions, write "Exempt" here . . . . ▶ **7**

Under penalties of perjury, I declare that I have examined this certificate and to the best of my knowledge and belief, it is true, correct, and complete.

Employee's signature
(Form is not valid
unless you sign it.) ▶ **Date** ▶

8 Employer's name and address (Employer: Complete lines 8 and 10 only if sending to the IRS.)	9 Office code (optional)	10 Employer identification number (EIN)

For Privacy Act and Paperwork Reduction Act Notice, see page 2. Cat. No. 10220Q Form **W-4** (2007)

Source: IRS.gov.