



*Delays in Processing Net Operating Loss
Cases Resulted in Millions of Dollars in
Unnecessary Interest Payments*

September 17, 2012

Reference Number: 2012-40-111

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 | 202-622-6500

E-mail Address | TIGTACommunications@tigta.treas.gov

Website | <http://www.tigta.gov>



HIGHLIGHTS

DELAYS IN PROCESSING NET OPERATING LOSS CASES RESULTED IN MILLIONS OF DOLLARS IN UNNECESSARY INTEREST PAYMENTS

Highlights

Final Report issued on
September 17, 2012

Highlights of Reference Number: 2012-40-111 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

Taxpayers who encounter significant financial losses could be in a situation where their deductions exceed their income, creating a net operating loss (NOL) that can be applied against prior year taxes. Interest is paid to the taxpayer if the IRS does not process an NOL case within 45 days. The IRS pays millions of dollars in interest payments annually because many NOL cases are not processed within 45 days. This interest is costly to the Government and creates a burden to taxpayers when their refunds are delayed.

WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether the IRS was processing NOL cases timely to minimize interest payments and taxpayer burden.

WHAT TIGTA FOUND

A test of a statistical sample of 334 of 86,483 NOL carryback tax abatements that posted to individual taxpayer accounts during Calendar Year 2010 showed 64 (19 percent) were not processed within 45 days. TIGTA estimates that the IRS could pay approximately \$334 million of avoidable interest payments and delay payment to more than 74,000 individual taxpayer accounts in the next five years due to delays with processing NOL cases.

There were multiple reasons contributing to cases not being processed within 45 days, including the following:

- Cases were reassigned multiple times before closure.
- Cases were not given the proper priority code on the system used to track and monitor the cases.
- Manual refunds were not always issued when required.

Additionally, current performance measures are not ensuring that NOL cases are timely worked. Neither interest paid on NOL cases nor the 90-day statutory time period for processing tentative applications is monitored to help determine if the IRS is timely processing NOL cases.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS analyze the cause of excessive case reassignments, pursue programming to correct computer coding issues, and reevaluate certain case dollar criteria. TIGTA also recommended that the IRS create processes to monitor interest dollars paid and adherence to the 90-day statutory time period for processing tentative applications.

IRS management agreed with our recommendations and plans to take appropriate corrective actions.

IRS management did not agree with the outcomes discussed in our report. The basis of their disagreement was that the calendar year from which our samples were drawn had an unusually high volume of NOL carrybacks due to legislation that took effect for that year. The IRS believes that our samples were representative of what occurred in Calendar Year 2010, but are not representative of future years. However, because of the unusually high volumes in Calendar Year 2010, TIGTA adjusted its estimate using the volume of carryback transactions posted in Calendar Year 2011.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 17, 2012

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael E. McKenney
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Delays in Processing Net Operating Loss Cases
Resulted in Millions of Dollars in Unnecessary Interest Payments
(Audit # 201140022)

This report presents the results of our review to determine whether the Internal Revenue Service was processing net operating loss cases timely to minimize interest payments and taxpayer burden. This audit is included in our Fiscal Year 2012 Annual Audit Plan and addresses the major management challenge of Providing Quality Taxpayer Service Operations.

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

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Augusta R. Cook, Acting Assistant Inspector General for Audit (Returns Processing and Account Services), at (770) 617-6434.



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Abbreviations

IRS	Internal Revenue Service
NOL	Net Operating Loss
TIGTA	Treasury Inspector General for Tax Administration



Delays in Processing Net Operating Loss Cases Resulted in Millions of Dollars in Unnecessary Interest Payments

Background

Taxpayers who have encountered significant financial losses from business activities or natural disasters could find their deductions exceed their income for the tax year,¹ resulting in a net operating loss (NOL). When this happens, taxpayers can opt to carry back a loss to earlier tax years and obtain a refund of taxes paid in those prior years.

Generally, NOLs can be carried back to the two tax years prior to the year of the loss. Any remaining loss can then be carried forward for up to 20 years after the year the NOL occurred. The carryback period is longer for certain types of losses, including losses from casualties such as natural disasters (three years), losses attributable to a Federally declared disaster for qualified small businesses² (three years), and losses from farming (five years).

If taxpayers' deductions are more than their income for the year, they may have an NOL that can be used by deducting it from income in another year or years.

Regardless of the type of loss incurred, the full amount of the loss is carried back to the earliest carryback year, with the remainder carried to the next earliest year and so forth. The year in which the loss originates is referred to as the 'loss year,' while the years to which the loss is applied are referred to as 'gain years.'

For example, a taxpayer may file tax returns reporting income from a small business in Tax Years 2009 and 2010 but then have an NOL in Tax Year 2011. In this case, the taxpayer:

- Files a Tax Year 2011 tax return reporting the NOL. This is the loss year.
- Files amended tax returns to carry back the loss two years and apply it to positive income reported for Tax Years 2009 and 2010. The taxpayer would then receive a tax refund for the taxes paid on those two tax returns. These are gain years.
- Would be eligible to carry forward the remaining loss to Tax Year 2012 and beyond.

Figure 1 provides a very simplified example of an NOL. Computing an NOL and the application of the loss to prior years is complicated and requires using multiple worksheets.

¹ A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

² A qualified small business is a sole proprietorship or a partnership that has average net annual gross receipts of \$5 million or less during the three-year period ending with the NOL tax year.



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Figure 1: Example of a Net Operating Loss

Tax Year	Income As Filed	NOL	Tax As Filed	Tax After NOL Applied	NOL Remaining for Carryover
2011 (Loss Year)	(\$150,000)	(\$150,000)	\$0	N/A	(\$150,000)
2009 (1st Gain Year)	\$50,000	N/A	\$10,000	\$0	(\$100,000)
2010 (2nd Gain Year)	\$55,000	N/A	\$11,000	\$0	(\$45,000) (to be claimed on future tax return(s))

Source: Hypothetical example developed by the Treasury Inspector General for Tax Administration (TIGTA).

Taxpayers can claim an NOL on a prior year tax return by using either an Internal Revenue Service (IRS) Form 1045, *Application for Tentative Refund*, or a Form 1040X, *Amended U.S. Individual Income Tax Return*.³ The filing requirements for these forms differ, but the end result is essentially the same. See Figure 2 for the differences between each of the forms.

Figure 2: Differences Between Forms 1045 and 1040X

Form	When to File	Years a Loss Can Be Applied	Interest Payment Rules	Type of Refund
Form 1045	Within one year from the end of the loss year.	One form can be used to apply the loss to multiple years.	No interest is paid to the taxpayer if processed within 45 days of receipt.	Refunds are considered “tentative.” The IRS can assess and collect tax immediately if the refund is later found to be in error.
Form 1040X	Up to three years after the due date of the loss year return. ⁴	Must file a separate Form 1040X for each year the loss is to be applied.	No interest is paid to the taxpayer if processed within 45 days of receipt.	The claim is considered correct when the refund is issued, and an audit is required to recover any tax.

Source: IRS Forms 1045 and 1040X instructions and Publication 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*.

Form 1045 is used to “apply” for a quick refund; it is a tentative application, *i.e.*, it can be processed and the resulting refund(s) issued even though the tax return reporting the NOL has not been processed. The Form 1045 is manually verified once the IRS accepts the tax return reporting the NOL and it posts to the taxpayer’s account. If the IRS later determines there is a

³ In this report, when we refer to “claims” we are referring to Forms 1040X; when we refer to “tentative applications” we are referring to Forms 1045; and when we refer to “cases” we are referring to both Forms 1040X and Forms 1045.

⁴ Including any extensions of time granted to file the tax return.



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discrepancy, any adjustments made because of the Form 1045 can be reversed without requiring a formal audit. In contrast, refunds issued based on the filing of a Form 1040X require the IRS to initiate a formal audit of the taxpayer to reassess the prior tax abatement based on the claim.

Interest paid to taxpayers on carryback cases

Tax refunds resulting from an NOL have special rules regarding the payment of interest to the taxpayer. If the IRS processes a Form 1045 or Form 1040X claiming an NOL within 45 days of receipt, then no interest will be due to the taxpayer. However, if either form is not processed within the 45-day time period,⁵ interest will be paid to the taxpayer (computed from the due date of the loss year tax return).⁶ The determination of whether the 45-day processing time period was met is calculated by comparing the date the IRS received the case to the date the overpayment was refunded to the taxpayer.

These rules contrast with 'regular' claims⁷ for tax abatement, for which interest is always paid to the taxpayer on the amount refunded. In these cases, there is no interest-free period, and the interest will be computed from the later of the due date or the actual received date of the return to the date the IRS received the claim.

There is a statutory requirement that Forms 1045 (tentative applications) be processed within 90 days,⁸ while there is no statutory requirement that Forms 1040X be processed within a certain amount of time. The statutory 90-day processing time is not related to how interest is paid on carryback cases, and the IRS can be required to pay interest, *i.e.*, if it exceeded the 45-day time period, while still meeting the 90-day processing requirement.

This review was performed at the Accounts Management function in Fresno, California, and with IRS Accounts Management function personnel at the Wage and Investment Division Headquarters in Atlanta, Georgia, during the period September 2011 through June 2012. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

⁵ I.R.C. § 6611(e)(1) and § 6611(f)(1).

⁶ Or the tax return received date, whichever is later.

⁷ Taxpayers can amend their return after it is filed; for example, to claim additional deductions or credits that could result in a subsequent refund. These are generally filed on Form 1040X.

⁸ I.R.C. § 6411 (b).



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Results of Review

The Internal Revenue Service Continues to Pay Significant Interest on Net Operating Loss Cases

A test of a statistical sample of 334 of 86,483⁹ NOL carryback tax abatements that posted to individual taxpayer accounts during Calendar Year 2010 showed 64 (19 percent)¹⁰ were not processed within the 45-day interest-free period. This resulted in the IRS paying \$1.6 million in interest on the refunds. We project that the IRS paid approximately \$97 million of avoidable interest on more than 21,000 carryback tax abatements processed during Calendar Year 2010. From this, we estimate that approximately \$334 million¹¹ in interest could be paid in the next five years.

Processing NOL cases more timely can reduce taxpayer burden and save interest payments.

A prior TIGTA review of individual carryback cases filed between August 1, 2004, and July 30, 2005, also found that the IRS was not always timely processing NOL cases and that significant interest was being paid that could have been avoided.¹² The prior report stated that the IRS paid individual taxpayers approximately \$20 million in interest on NOL case refunds between August 1, 2004, and July 30, 2005, because the cases were not processed within the 45-day interest-free time period.

Untimely processing of NOL cases also burdens taxpayers because of delays they experience when receiving their refunds. Legislation changing the carryback period was passed in Calendar Year 2009¹³ to provide relief to small businesses suffering financial hardships by allowing refunds of prior taxes paid. Any delay these taxpayers experience in receiving valid refunds as a result of their losses can increase their financial hardship and, by extension, increase burden on the taxpayers. We estimate there were more than 21,000 cases exceeding the 45-day interest-free period in Calendar Year 2010, thereby burdening taxpayers. From this, we estimate that

⁹ This number represents the population of NOL carryback adjustments greater than \$9,999 that posted to taxpayer accounts in Calendar Year 2010. See Appendix IV for more information.

¹⁰ The principal amount for these 64 cases totaled \$41,559,408 and interest paid totaled \$1,610,531.

¹¹ This includes our projection for Calendar Year 2010 of \$97 million.

¹² TIGTA, Ref. No. 2006-40-139, *Untimely Processing of Taxpayer Carryback Loss Claims Resulted in Significant Interest Costs* (Aug. 2006).

¹³ The American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat 115.



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approximately 74,000¹⁴ individual taxpayer accounts could be affected over the next five years. The average time to issue refunds for the 64 cases with interest was 81 days.

An analysis of the 64 NOL cases where interest was paid showed there were multiple reasons contributing to cases not being processed within 45 days, including the following:

- Cases were reassigned multiple times before closure.
- Cases were not given the proper priority code on the Correspondence Imaging System.¹⁵
- Manual refunds were not always issued when required.

A number of the cases with delays had multiple causes that affected the overall case processing time.

Cases were reassigned multiple times before closure

More than 30 percent (21 cases) of the 64 cases not processed timely were assigned to three or more employees (and in one case, eight employees) before being closed. The Correspondence Imaging System is used to control and assign NOL cases to employees. After creation, the NOL case is generally assigned to a processing site, where a local inventory control manager will reassign the case to a specific employee based on priority and the employee's skill and workload.

Although there are valid reasons for reassigning a case to another employee or function, for these 21 cases we could not identify the reason for many of the reassignments. Although multiple reassignments alone may not be responsible for a delay in processing a case, each additional employee who 'touches' the case could increase case processing time. In 12 of the 21 cases, an employee other than the one who closed the case had it in his or her inventory for more than 10 days. It was not apparent why the cases had been reassigned or why there had been no activity on the cases.

Histories for two of the 21 cases noted they were reassigned because the employees had not received the training needed to work NOL cases. Employees using the Correspondence Imaging System are assigned skill levels based on what types of cases they are trained to work, including carryback cases. These two cases were assigned to employees without the proper skills because they were not identified correctly as carrybacks when they were initially created. They were eventually assigned to an employee with the correct skill; however, even before the problem was identified, the cases were assigned multiple times for no obvious reason. These two cases were for more than \$1 million each.

¹⁴ This includes our projection for Calendar Year 2010 of 21,000 instances of cases exceeding the 45-day interest-free period.

¹⁵ The Correspondence Imaging System is a modern digital image-based system for processing taxpayer correspondence.



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Cases were not appropriately prioritized on the Correspondence Imaging System

Three (5 percent) of the 64 cases not processed timely had either an incorrect priority code or no priority code assigned. Although this is a small percentage of our exception cases, each of the three cases had aggregate refunds of more than \$1 million. The amount of interest paid on those three cases totaled more than \$190,000.

To prioritize NOL carryback work, the IRS assigns priority codes to each carryback case created on the Correspondence Imaging System. A case's priority code is determined by the total dollar amount of the case. For example, cases for \$1 million or more receive Priority Code 1. Processing instructions require a priority code to be assigned to every Correspondence Imaging System carryback case. However, assigning priority codes is a manual process that requires close attention to detail to ensure the proper code is assigned.

The process of assigning priority codes to carryback cases is designed to ensure high-dollar cases are identified and assigned timely to IRS employees so they can be processed before those for lower dollar amounts. A hypothetical example illustrates the importance of identifying and processing high-dollar cases timely:

The IRS receives two NOL carryback cases; one is for \$50,000 and one is for \$1 million. Both cases take the same number of days to process, and both cases exceed the 45-day interest-free period by the same amount of time, resulting in interest due the taxpayer. The \$50,000 case would receive more than \$450 in interest, while the \$1 million case would be entitled to more than \$9,000 in interest.¹⁶

Although incorrect or missing priority codes on the three cases may not be the sole reason interest was paid, the amount of interest could have been reduced or avoided if the correct priority code had been assigned. The IRS indicated that these cases had been misidentified or miscoded during initial creation and that it was impossible to change the priority code after it has been assigned.

Additionally, the dollar ranges for each priority code are very broad. The four priority codes are:

- Priority Code 1 – \$1 million and over.
- Priority Code 2 – from \$50,000 to \$999,999.
- Priority Code 3 – from \$5,000 to \$49,999.
- Priority Code 4 – from \$0 to \$4,999.

The current range of priority codes results in a \$60,000 case having the same priority as a \$900,000 case. Priority Code 2 especially includes a broad range of cases. Approximately

¹⁶ Based on a hypothetical situation where the credit availability date was April 15, 2010, and the actual refunds for the carryback claims were issued on July 9, 2010.



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34,000 of our sample population of 86,483 abatements fell within this range. In addition, there were more than 50 abatements that were more than \$10 million. An additional priority code for higher dollar cases may be warranted.

Manual refunds were not always issued when required

Eight (13 percent) of the 64 cases not processed timely met the criteria for a manual refund, but employees did not issue manual refunds. The IRS paid more than \$20,000 in interest on these eight cases. If employees had issued manual refunds as required, the amount of interest might have been reduced or avoided.

Issuing manual refunds is an important way to ensure interest is not paid or is limited on NOL cases. A manual refund can be input directly to a taxpayer's account when certain criteria are met, historically saving up to two weeks of processing time to issue the refund.¹⁷ This can make a significant difference when there are only 45 days available to process the case.

IRS procedures require that a manual refund be issued on any carryback case of more than \$1 million and on any case over a specified dollar amount for which the 45-day interest-free period is in jeopardy or has already expired (to minimize interest paid). During the prior audit, we determined that 37 percent of the exception cases met the criteria for a manual refund, but manual refunds were not issued as required.

After discussing this issue with IRS management, they immediately issued an employee-wide alert reinforcing the importance of utilizing manual refunds to eliminate or reduce interest on NOL cases. We believe that this action adequately addressed the issue and, therefore, we are making no formal recommendation related to manual refunds.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Analyze Correspondence Imaging System case reassignments to identify trends and determine the reason for the reassignments and their effect on timely case completion.

Management's Response: IRS management agreed with this recommendation. The IRS will perform analysis on a statistically valid sample of cases to ascertain reasons for reassignment and evaluate how reassignment affected timely case completion.

¹⁷ While it has generally taken around two weeks to post an abatement to a taxpayer account, the IRS is currently deploying a new computer system which should result in faster processing. Once this system is fully operational, the time periods for posting should be reduced significantly.



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Recommendation 2: Modify the Correspondence Imaging System to enable a priority code to be either revised or added after a case is created.

Management's Response: IRS management agreed with this recommendation. The IRS submitted a Maintenance Update Request on August 1, 2012, for functionality to add a missing priority code or modify an existing priority code on an open case in the Correspondence Imaging System.

Recommendation 3: Reevaluate the dollar ranges for the NOL Carryback Priority Codes to verify that they accomplish their intended purpose.

Management's Response: IRS management agreed with this recommendation. The IRS will develop new dollar ranges based on priority codes available in the Correspondence Imaging System and ensure that the applicable Internal Revenue Manuals and training materials are updated.

Office of Audit Comment: IRS management did not agree with the outcomes discussed in our report. The basis of their disagreement was that the calendar year from which our samples were drawn had an unusually high volume of NOL carrybacks due to legislation that took effect for that year. The IRS believes that our samples were representative of what occurred in Calendar Year 2010, but are not representative of future years. However, because of the unusually high volumes in Calendar Year 2010, we adjusted our estimate using the volume of carryback transactions posted in Calendar Year 2011.

Current Performance Measures Are Not Ensuring Net Operating Loss Cases Are Timely Worked

Neither interest paid on NOL cases nor the 90-day statutory time period for processing Forms 1045 is used as a performance measure to determine if the Accounts Management function is timely processing NOL cases. Management closely monitors inventories and has standards for overage cases including NOL cases, but NOL cases are not a significant portion of that inventory. However, although NOL inventories may be a small part of the Accounts Management function inventory, high-dollar cases can result in significant interest if not processed timely.

Interest paid is not monitored

A judgmental sample of 37 of the highest dollar tentative applications identified only three (8 percent) for which the IRS paid interest. Nevertheless, interest paid on these three cases was approximately \$1.5 million.¹⁸

¹⁸ This \$1.5 million is included in our projected sample results discussed previously.



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In the prior TIGTA report, we recommended and the IRS agreed to use a report to evaluate the timeliness of processing carryback cases. The report provided both the number of refunds on which interest was paid and the total interest paid on refunds for carryback cases. However, management is currently not monitoring interest paid. IRS management stated that dollar amounts are not included in determining the success of the program, that all carrybacks are treated as priority work, and that inventory monitoring reports are sufficient to identify issues or problems. However, test results show interest paid on NOL cases increased nearly five-fold since our prior review.

IRS management also stated that the year our sample cases were processed (Calendar Year 2010) was not a normal year due to legislation affecting NOLs. During Calendar Year 2009, legislation was passed¹⁹ that changed the rules for certain types of carrybacks. The new law included a provision to extend the NOL carryback period from two years to five years for eligible small businesses. The intention was to provide relief for small businesses suffering current economic hardships by allowing them to recover taxes paid in previous years. These benefits were expanded and extended by additional legislation²⁰ later that year. These changes resulted in a significant increase in the volume of carryback cases that had to be worked in Calendar Year 2010.²¹

This reinforces the need to monitor the amount of interest paid on carryback cases. While interest paid could have been the result of many factors, monitoring the interest paid would allow the IRS to identify when cases are not being worked timely or prioritized correctly.

The 90-day statutory time period for processing Forms 1045 is not monitored

The IRS is required by law²² to process Forms 1045 within 90 days of receipt, although this requirement does not affect whether interest is paid on the refund. However, the IRS does not currently monitor compliance with the law.

Of the 334 NOL cases sampled, 137 were Forms 1045. Of the 137, 10 (7 percent) were not processed within the 90-day statutory time period. The average processing time for the 10 cases was 141 days. If the IRS does not monitor case processing time periods for Forms 1045, it cannot determine whether it is in compliance with the law and, if not, what improvements are needed to ensure the cases are worked in the time prescribed by law.

¹⁹ The American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat 115.

²⁰ The Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, 123 Stat 2984.

²¹ IRS inventory reports indicate the number of carryback cases increased from approximately 290,000 in Fiscal Year 2009 (October 1, 2008, to September 30, 2009) to approximately 434,000 in Fiscal Year 2010 (October 1, 2009, to September 30, 2010).

²² I.R.C. § 6411(b).



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Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 4: Create a process to monitor and track interest paid on carryback cases.

Management's Response: IRS management agreed with this recommendation. The IRS submitted a Unified Work Request on June 8, 2012, for programming to generate monthly carryback interest reports, which will be used to monitor and track interest paid. Because the requested action will be subject to funding and resource prioritization by the Information Technology organization, submission of the Unified Work Request will complete the corrective action.

Recommendation 5: Create a process to monitor the adherence to the 90-day statutory time period for processing Forms 1045.

Management's Response: IRS management agreed with this recommendation. The IRS will use the Correspondence Imaging System report information to monitor time periods for Form 1045 processing.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS was processing NOL cases timely to minimize interest payments and taxpayer burden. The audit focused on individual carryback cases processed during Calendar Year 2010.

We verified the reliability of the electronic data used in this review by scanning the data extracts for blank, incomplete, illogical, or improper data. In addition, to ensure accuracy, we traced a judgmental sample from our dataset to IRS source files by using the Integrated Data Retrieval System.¹

To accomplish our objective, we:

- I. Determined the overall number of NOL adjustments that resulted in credit interest paid to the taxpayer.
 - A. Identified and evaluated the data available on the TIGTA Data Center Warehouse² related to NOL adjustments, and then performed queries to extract and download individual taxpayer accounts with carryback transactions posted during Calendar Year 2010.
 - B. Performed basic validity checks to identify potential problems with the data. This included matching a judgmental sample of 50 cases with abatements back to the original Individual Master File³ source data looking for inconsistent or incomplete data.
 - C. Used the validated data obtained in Step I.A. and selected a statistically valid sample from a population of 86,483 NOL carryback abatements that posted to individual taxpayer accounts during Calendar Year 2010. Our sampling plan broke the transactions into four strata based on dollar amount and form type (see Appendix IV). The sample was based on a 95 percent confidence level, a precision factor of ± 7 percent, and an expected error rate of either 10 or 20 percent, depending on the stratum.

¹ The IRS computer system capable of retrieving or updating stored information; it works in conjunction with taxpayer account records.

² A collection of IRS databases containing various types of taxpayer account information that is maintained by the TIGTA for the purpose of analyzing data for ongoing audits.

³ The IRS database that maintains transactions or records of individual taxpayer accounts.



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- D. Reviewed the statistically valid sample of 334 NOL carryback transactions selected from Step I. C. to determine if credit interest was paid when the abatement posted.
- We verified that the dollar amount and date of the transactions matched the information we had from our data extract.
- For each case, we analyzed the taxpayer account using the Integrated Data Retrieval System to determine if the case was an exception or not. A case is an exception if the IRS exceeded the 45-day interest-free period and paid interest to the taxpayer. If so, we noted how much interest was paid and whether the IRS issued a manual refund or not.
- II. Determined if there was a valid reason why interest was paid for the exception cases identified in Step I.D.
- A. Researched each exception case using the Integrated Data Retrieval System and the Correspondence Imaging System and summarized the circumstances and time period involved.
- B. Analyzed each case summary and determined the cause(s) for the processing delay. We categorized the potential cause(s) for the delay, including at what stage of the process it/they occurred.
- C. Reviewed the sample results to determine what the most prevalent causes were that contributed to delays. We discussed these causes in conference calls with IRS personnel and reviewed the applicable procedures as needed.
- III. Determined if the IRS had effective controls for monitoring NOL inventories.
- A. Interviewed IRS personnel and performed walkthroughs to determine how information related to NOL carrybacks is monitored at various stages of the process. We also reviewed various monitoring reports and determined what each was based on, who prepared them, and what specifically they were monitoring, *e.g.*, age, dollars or both.
- B. Interviewed IRS management to identify their criteria for program success and how they monitor the criteria.
- IV. Determined if there were other significant conditions that could affect carryback processing (including fraud indicators).
- A. Determined whether the prior TIGTA audit recommendations were implemented.
1. Determined the status of corrective actions.
 2. For recommendations that were not implemented, discussed the reason(s) with IRS management.



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Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: Accounts Management function policies, procedures, and practices related to processing NOL carryback cases. We evaluated these controls by interviewing personnel working within the Accounts Management function, participating in walkthroughs, and analyzing actual carryback cases that were processed.



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Appendix II

Major Contributors to This Report

Augusta R. Cook, Acting Assistant Inspector General for Audit (Returns Processing and Account Services)

Kyle R. Andersen, Director

Roy E. Thompson, Audit Manager

Steven D. Stephens, Lead Auditor

Laura Paulsen, Senior Auditor

Mark V. Willoughby, Auditor

Joseph L. Katz, Ph.D., Contractor, Statistical Sampling Consultant



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Chief Financial Officer OS:CFO
Deputy Commissioner, Services and Operations, Wage and Investment Division SE:W
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:
 Chief, Program Evaluation and Improvement, Wage and Investment Division
 SE:W:S:PEI
 Senior Operations Advisor, Customer Account Services, Wage and Investment Division
 SE:W:CAS



Delays in Processing Net Operating Loss Cases Resulted in Millions of Dollars in Unnecessary Interest Payments

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 Congress.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; \$333,669,984 could be paid in avoidable interest on carryback cases over the next five years (see page 4).

Methodology Used to Measure the Reported Benefit:

We identified 86,483 tax abatement transactions from NOL carryback cases that posted to individual taxpayer accounts during Calendar Year 2010¹ that were greater than \$9,999.² These cases resulted from filed Forms 1045, *Application for Tentative Refund*, or Forms 1040X, *Amended U.S. Individual Income Tax Return*. We selected a statistically valid sample from this population of transactions to determine if interest was paid on the tax abatement, indicating it was not processed within the 45-day interest-free period.

Prior to selecting and reviewing our sample, we stratified our population into four different categories to ensure that a few high-dollar cases did not skew our results. These four categories (strata) are:

- Form 1045-based transactions from \$10,000 to \$1 million.
- Form 1045-based transactions over \$1 million.
- Form 1040X-based transactions from \$10,000 to \$1 million.
- Form 1040X-based transactions over \$1 million.

Our outcome measure projection is based on review of transactions from each of these strata. The statistical sample was selected using an attribute sampling method with a 95 percent confidence level and a precision factor of ± 7 percent. The expected error rate for the Form 1045

¹ These are transactions, not taxpayers. A taxpayer could have more than one adjustment per NOL; for example, if the loss was applied to more than one tax year. A tax year is a 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

² We chose this dollar cutoff in order to look at the more significant cases and to be consistent with the sampling methodology used in the prior TIGTA review.



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transactions was 10 percent, and the expected error rate for the Form 1040X transactions was 20 percent.

The number of cases reviewed and raw results for each stratum are as follows:

Sample Stratum	Transactions Reviewed	Number of Transactions With Interest Paid	Percentage of Transactions With Interest Paid	Total Sample Interest Amount Paid	Total Number of Transactions Per Stratum	Percentage of Total Population Per Stratum
Form 1045						
\$10,000 to \$1 million	70	18	26%	\$69,157	62,046	71.7%
Over \$1 million	67	7	10%	\$528,128	1,354	1.6%
Form 1040X						
\$10,000 to \$1 million	125	30	24%	\$125,021	22,912	26.5%
Over \$1 million	72	9	13%	\$888,225	171	.2%
Overall Adjustments	334	64	19%	\$1,610,531³	86,483	100%

Source: TIGTA review of a sample of carryback transactions posted during Calendar Year 2010.

We used the stratified sampling methodology to project a total of \$96,997,088 in avoidable interest on carryback cases in Calendar Year 2010. We are 95 percent confident that the total amount of interest falls within a dollar range of between \$45,095,515 and \$148,898,660.

We then quantified the results for five years; this would represent the potential future amount of funds put to better use if the condition is not corrected. Calendar Year 2010 (the year of our sample) had a large number of cases, so we adjusted our estimate using the volume of carryback transactions posted in Calendar Year 2011. Using the same criteria as previously stated, *i.e.*, all transactions over \$9,999, we determined that there were 52,764 transactions in Calendar Year 2011. This equates to a 39 percent decrease in the volume of transactions from Calendar Year 2010 to Calendar Year 2011. Accordingly, to compute our five-year dollar estimate, we took the \$96,997,088 for Calendar Year 2010 and added \$59,168,224 (61 percent of \$96,997,088) per year for the next four years, for a total of \$333,669,984.

³ The corresponding principal amount for these 64 cases totaled \$41,559,408.



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Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 74,360 individual taxpayer accounts⁴ affected over the next five years because refunds from carryback cases were not processed timely (see page 4).

Methodology Used to Measure the Reported Benefit:

We identified 86,483 tax abatement transactions from NOL carryback cases that posted to individual taxpayer accounts during Calendar Year 2010 that were greater than \$9,999. These cases resulted from filed Forms 1045 or Forms 1040X. We then selected a statistically valid sample from this population of transactions to determine if interest was paid on the tax abatement, indicating it was not processed within the 45-day interest-free period.

Prior to selecting and reviewing our sample, we stratified our population into four different categories to ensure that a few high-dollar cases did not skew our results. These four categories (strata) are:

- Form 1045-based transactions from \$10,000 to \$1 million.
- Form 1045-based transactions over \$1 million.
- Form 1040X-based transactions from \$10,000 to \$1 million.
- Form 1040X-based transactions over \$1 million.

Our outcome measure projection is based on review of transactions from each of these strata. The statistical sample was selected using an attribute sampling method with a 95 percent confidence level and a precision factor of ± 7 percent. The expected error rate for the Form 1045 transactions was 10 percent, and the expected error rate for the Form 1040X transactions was 20 percent.

The number of cases reviewed and raw results for each stratum are the same as that reported in the prior outcome measure. We used the stratified sampling methodology to project a total of 21,616 transactions that exceeded the 45-day interest-free period, and which, therefore, resulted in the taxpayer being burdened by the delay. We are 95 percent confident that the total number of these transactions falls within a range of 14,994 to 28,239.

We then quantified the results for five years; this would represent the potential future number of individual taxpayer accounts affected if the condition is not corrected. Calendar Year 2010 (the year of our sample) had a large amount of cases filed, so we chose to adjust our estimate using the volume of carryback transactions posted in Calendar Year 2011. Using the same criteria as previously stated, *i.e.*, all transactions over \$9,999, we determined that there were

⁴ This is the number of individual taxpayer accounts that could be affected, not unique taxpayers. For example, a single carryback case could result in transactions to multiple tax years. These transactions are what we based our sample on. The number of unique taxpayers affected would be a lower amount.



*Delays in Processing Net Operating Loss Cases Resulted in
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52,764 transactions in Calendar Year 2011. This equates to a 39 percent decrease in the volume of transactions from Calendar Year 2010 to Calendar Year 2011. Accordingly, to compute our five-year dollar estimate, we took the 21,616 affected individual taxpayer accounts for Calendar Year 2010 and added 13,186 accounts (61 percent of 21,616) per year for the next four years, for a total of 74,360 individual taxpayer accounts.



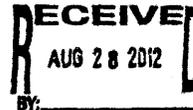
Delays in Processing Net Operating Loss Cases Resulted in Millions of Dollars in Unnecessary Interest Payments

Appendix V

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308



AUG 28-2012

MEMORANDUM FOR MICHAEL E. MCKENNEY
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Peggy Bogadi *Peggy Bogadi*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Delays in Processing Net Operating Loss Cases Resulted in Millions of Dollars in Unnecessary Interest Payments (Audit # 201140022)

We reviewed the subject draft report and agree with your findings. Timely processing of Net Operating Loss (NOL) claims is significant to the IRS due to the amount of potential interest to be paid on refunds and the taxpayer burden caused when the payment of claims for refund are delayed. While we have achieved significant improvements in our processes, implementation of program improvements is not yet complete. Additional planned program changes, as discussed in our attached statements of corrective actions, are intended to significantly reduce aged inventory and ensure taxpayers receive timely payment of their claims.

The sample of cases referenced in the report were selected from Calendar Year 2010 inventory. This was an unusual year due to passage of the American Reinvestment and Recovery Act of 2009 and the Worker, Homeownership, and Business Assistance Act of 2009, which extended the NOL carryback period from two years to five years for eligible small businesses. Due to this change in the law, the sample is representative of what happened in 2010, but is not representative of what will happen over the next five years. This is evidenced by the increase in our carryback case inventories from 296,000 cases in Fiscal Year (FY) 2009 to 439,000 cases in FY 2010. Our case inventories have since significantly decreased to 166,000 cases as of July 28, 2012. Thus, we believe the projection stated in the report is overstated.

Attached are our comments to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Peter J. Stipek, Director, Customer Account Services, Wage and Investment Division, at (404) 338-8910.

Attachment



Delays in Processing Net Operating Loss Cases Resulted in Millions of Dollars in Unnecessary Interest Payments

Attachment

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 1

Analyze Correspondence Imaging System case reassignments to identify trends and determine the reason for the reassignments and their effect on timely case completion.

CORRECTIVE ACTION

We agree with this recommendation. We will perform analysis on a statistically valid sample of cases to ascertain reasons for reassignment and evaluate how reassignment affected timely case completion.

IMPLEMENTATION DATE

May 15, 2013

RESPONSIBLE OFFICIAL

Director, Accounts Management, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

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

RECOMMENDATION 2

Modify the Correspondence Imaging System to enable a priority code to be either revised or added after a case is created.

CORRECTIVE ACTION

We agree with this recommendation. We submitted a Maintenance Update Request on August 1, 2012, for functionality to add a missing priority code, or modify an existing priority code, on an open case in the Correspondence Imaging System (CIS).

IMPLEMENTATION DATE

July 15, 2013

RESPONSIBLE OFFICIAL

Director, Accounts Management, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

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



Delays in Processing Net Operating Loss Cases Resulted in Millions of Dollars in Unnecessary Interest Payments

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RECOMMENDATION 3

Reevaluate the dollar ranges for the NOL Carryback Priority Codes to verify that they accomplish their intended purpose.

CORRECTIVE ACTION

We agree with this recommendation. We will develop new dollar ranges based on priority codes available in the CIS and ensure that the applicable Internal Revenue Manuals and training materials are updated.

IMPLEMENTATION DATE

May 15, 2013

RESPONSIBLE OFFICIAL

Director, Accounts Management, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

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

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 4

Create a process to monitor and track interest paid on carryback cases.

CORRECTIVE ACTION

We agree with this recommendation. We submitted a Unified Work Request (UWR) on June 8, 2012, for programming to generate monthly carryback interest reports, which will be used to monitor and track interest paid. Since the requested action will be subject to funding and resource prioritization by Information Technology, submission of the UWR will complete the corrective action.

IMPLEMENTATION DATE

Implemented

RESPONSIBLE OFFICIAL

Director, Accounts Management, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

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



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RECOMMENDATION 5

Create a process to monitor the adherence to the 90-day statutory time period for processing Forms 1045.

CORRECTIVE ACTION

We agree with this recommendation. We will use CIS report information to monitor time periods for Form 1045, *Application for Tentative Refund*, processing.

IMPLEMENTATION DATE

May 15, 2013

RESPONSIBLE OFFICIAL

Director, Accounts Management, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

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