The 2007 Tax Filing Season Was Generally Successful, and Most Returns Were Timely and Accurately Processed

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FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 21, 2007

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The 2007 Tax Filing Season Was Generally Successful, and Most Returns Were Timely and Accurately Processed (Audit #200740027)

This report presents the results of our review to evaluate whether the Internal Revenue Service (IRS) timely and accurately processed individual paper and electronic tax returns[1] during the 2007 Filing Season.[2] The audit focused on the implementation of new tax law and administrative changes that affected Tax Year 2006 returns.[3] In addition, we reviewed the corrective actions taken for the conditions identified in our review of the 2006 Filing Season[4] to determine whether they were adequate.

Impact on the Taxpayer

Each year, legislated tax law changes create complexities for both the IRS and individual taxpayers. Overall, the IRS implemented these changes correctly with no significant delays in the processing of tax returns during the 2007 Filing Season. Through June 1, 2007, the IRS had processed approximately 123.7 million individual income tax returns and timely issued approximately $223 billion in refunds to more than 99 million taxpayers.

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[1] U.S. Individual Income Tax Returns (Form 1040 and Form 1040A) and Income Tax Returns for Single and Joint Filers With No Dependents (Form 1040EZ).

[2] The filing season is the period from January through mid-April when most individual income tax returns are filed.

[3] See Appendix V for an overview of the tax law provisions and administrative changes examined during this review.

[4] *Individual Tax Returns Were Timely Processed in 2006, but Opportunities Exist to Improve Verification of Certain Tax Deductions* (Reference Number 2006-40-164, dated October 10, 2006).

Synopsis

The 2007 Filing Season was demanding for the IRS. Before the 2007 Filing Season began, the IRS Commissioner told Congress the IRS was at high risk due to high-profile administrative changes such as the Telephone Excise Tax Refund and the Split Refund option. Late enactment of the Tax Relief and Health Care Act of 2006[5] added additional risk to this Filing Season.

In spite of the additional risks, the IRS generally had a successful 2007 Filing Season. Most key tax law changes were correctly implemented, and the IRS timely processed returns and issued refunds within the required 45 calendar days of the April 17, 2007, due date.[6] Electronically filed returns increased almost 9 percent over the same time last year. The largest increase came from taxpayers filing online from home computers (11 percent).[7] However, use of the Free File Program decreased by 2 percent. Additionally, more than 99 million refunds totaling approximately $223 billion were issued. Of these refunds, almost 60 million (60 percent) were directly deposited to taxpayer bank accounts, an increase of 8 percent compared to 2006.

While the IRS timely and accurately processed individual tax returns and refunds, there were some areas in which taxpayers did not take full advantage of the benefits the tax law and administrative changes provided or improperly claimed benefits to which they were not entitled.

- Millions of taxpayers did not claim the Telephone Excise Tax Refund.
- Taxpayers made only limited use of the Split Refund option.
- Some taxpayers improperly claimed additional exemptions for housing Hurricane Katrina displaced individuals.
- Taxpayers older than age 70½ continued to claim improper Individual Retirement Arrangement (IRA) deductions.
- Many eligible taxpayers missed the opportunity to claim the sales tax deduction.
- Taxpayers continued to claim a "dual benefit" for both the tuition and fees deduction and the Education Credit.

Recommendations

We recommended the Commissioner, Wage and Investment Division:

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[5] Pub. L. No. 109-432, 120 Stat. 2922 (2006).
[6] Internal Revenue Code Section 6611 (e) (2005).
[7] A volume for filing online from home computers includes Free File Program returns and Non-Free File Web/Home-Prepared returns. The Free File Program is an online tax preparation and electronic filing program offered through a partnership agreement between the IRS and the Free File Alliance, LLC.

- Revise the IRA worksheet in all tax instructions in which this worksheet is used to clearly state that taxpayers over age 70½ cannot take the IRA deduction.
- Develop a communication strategy to inform taxpayers they are eligible for a sales tax deduction, if they itemize and do not claim a State income tax deduction, and clearly outline that these taxpayers may be eligible to file amended returns for the past 3 years if they itemized deductions and did not claim any State or local income or sales tax deductions for any of the past 3 tax years.
- Ensure the new Tuition and Fees Deduction (Form 8917) is finalized prior to the start of the 2008 Filing Season and required for all taxpayers claiming the deduction for Tax Year 2007.

Response

IRS management agreed with all of our recommendations. Management will add a statement to the top of the IRA worksheet instructing taxpayers age 70½ or older that they cannot take the deduction and will clarify the requirement by revising the wording on the worksheet. Management will also develop a communication strategy to inform taxpayers they are eligible for a sales tax deduction if they itemize and do not claim a State tax deduction; specialized information will be provided advising how taxpayers can claim this tax benefit by filing an amended return. Form 8917 has been developed for the 2008 Filing Season and should be available to the public by December 15, 2007. Management's complete response to the draft report is included as Appendix VII.

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 E. McKenney, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 622-5916.

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Abbreviations

IRA	Individual Retirement Arrangement
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
TETR	Telephone Excise Tax Refund
TY	Tax Year

Background

The IRS expects to receive more than 136 million TY 2006 individual income tax returns in 2007.

The Internal Revenue Service (IRS) expects to receive more than 136 million Tax Year (TY) 2006 individual income tax returns[1] in 2007,[2] with the vast majority being received and processed during the 2007 Filing Season.[3] The filing season is a critical time for the IRS because it is during this time that most individuals file their income tax returns and contact the IRS if they have questions about specific tax laws or filing procedures. One of the complexities the IRS encounters in processing these returns is the correct implementation of tax law and administrative changes.

Before a filing season begins, the IRS must identify new tax law and administrative changes; revise the affected tax forms, instructions, and publications; and reprogram its computer systems to ensure tax returns are accurately processed. The 2007 Filing Season presented additional demands for the IRS. Before the Filing Season began, the IRS Commissioner told Congress the IRS was operating at maximum capacity to get ready, and the 2007 Filing Season was already high risk due to high-profile administrative changes such as the Telephone Excise Tax Refund (TETR) and the Split Refund option. Late enactment of the Tax Relief and Health Care Act of 2006,[4] which extended many expiring tax benefits, added risk to this Filing Season.

- The TETR was a one-time refund designed to return previously collected Federal excise taxes on long-distance telephone service. It was available to anyone who paid for long-distance services on landline, cell phone, or Voice over Internet Protocol service billed after February 28, 2003, and before August 1, 2006. Taxpayers could request this refund when they filed their TY 2006 income tax returns.
- Beginning in 2007, individual taxpayers could elect to have their income tax refunds split and electronically deposited into up to three accounts, such as checking, savings, or Individual Retirement Arrangement (IRA). In addition, the accounts could be with up to three different financial institutions, including banks, brokerage firms, and credit unions.

[1] U.S. Individual Income Tax Returns (Form 1040 and Form 1040A) and Income Tax Returns for Single and Joint Filers With No Dependents (Form 1040EZ).
[2] All references are to calendar years unless otherwise noted.
[3] The filing season is the period between January 1 and April 15 when most tax returns are filed. However, the 2007 Filing Season was extended to April 17 because April 15 was a Sunday and April 16 was Emancipation Day in the District of Columbia.
[4] Pub. L. No. 109-432, 120 Stat. 2922 (2006).

- The Tax Relief and Health Care Act of 2006 included extension of the tuition and fees deduction, the State and local sales tax deduction, and the deduction for educator expenses. This legislation was passed in late December 2006, so the IRS was unable to include these deductions on the TY 2006 tax forms and related instructions.

During the 2007 Filing Season, the IRS processed individual income tax returns in six Wage and Investment Division Submission Processing sites[5] located throughout the country. All of the six sites processed paper individual income tax returns, and all but the Atlanta Submission Processing Site processed electronic individual income tax returns.

Both paper and electronic tax returns and related schedules are processed through the IRS computer systems and recorded on each individual's tax account at the Submission Processing sites. The IRS computer systems are made up of a complex series of processing subsystems that are linked and programmed nationally to check the validity and math accuracy of the return data provided. If an error is found, the taxpayer is sent a notice that asks for additional information or explains any change that is made to the amount of tax due or to the refund.

This review was performed at the Wage and Investment Division Headquarters in Atlanta, Georgia; the Submission Processing function offices in Lanham, Maryland, and Cincinnati, Ohio; and the Austin Submission Processing Site during the period January through July 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.

[5] Submission Processing sites process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts. They are located in Andover, Massachusetts; Atlanta, Georgia; Austin, Texas; Fresno, California; Kansas City, Missouri; and Philadelphia, Pennsylvania.

Results of Review

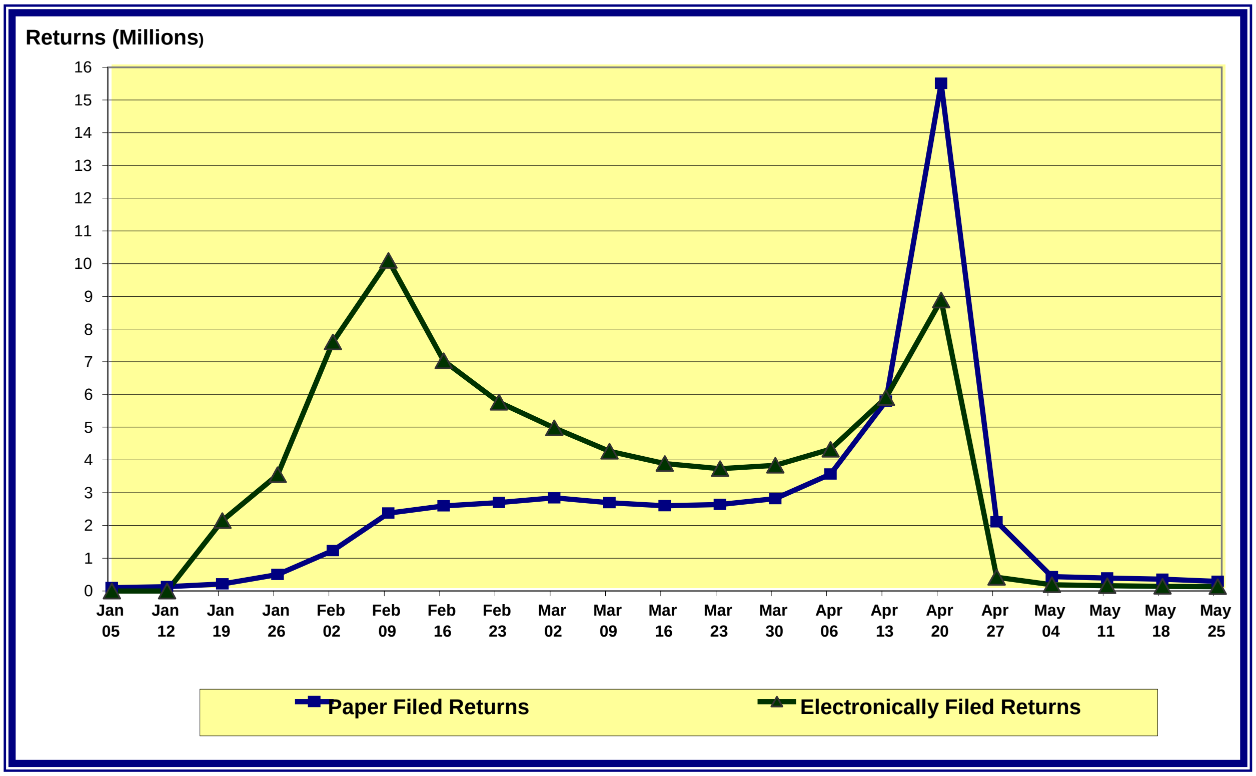
The 2007 Filing Season Was Timely Completed, and Most Returns Were Accurately Processed

The IRS received more than 129.2 million individual income tax returns (about 77.2 million electronic and about 52 million paper) during the 2007 Filing Season and timely completed processing returns and issuing refunds within the required 45 calendar days[6] of the April 17, 2007, due date. Because of a computer problem with 1 of the major electronic software providers, more than 200,000 taxpayers were unable to electronically file their tax returns by the April 17 due date. The IRS provided an extension until April 19 to allow these taxpayers to timely file their tax returns.

As shown in Figure 1, there were two significant peaks for electronically filed tax returns–in early February and around the April 17 due date. Paper returns were received and processed on a more gradual trend, with the peak reached in mid-April. Because paper tax returns take longer to process, those received by the April 17 due date may have taken several weeks to process.

[6] Internal Revenue Code Section (§) 6611 (e) (2005).

Figure 1: Volumes of Tax Returns Filed During the 2007 Filing Season



Source: Our analysis of returns processed data.

There continues to be a substantial growth in electronic filing, and total volumes increased almost 9 percent in 2007. Through June 1, 2007, the IRS had processed approximately 123.7 million individual income tax returns, including 77.2 million (62 percent) processed electronically. The largest increase came from taxpayers filing online from home computers (11 percent). However, use of the Free File Program decreased by 2 percent.[7]

The IRS continues to experience substantial growth in electronic filing, with 62 percent of individual tax returns being processed electronically.

Additionally, more than 99 million refunds totaling approximately $223 billion were issued. Of these refunds, nearly 60 million (60 percent) were directly deposited to taxpayer bank accounts, an increase of 8 percent compared to 2006. Figure 2 provides comparative Filing Season statistics for 2006 and 2007.

[7] The Free File Program is an online tax preparation and electronic filing program offered through a partnership agreement between the IRS and the Free File Alliance, LLC.

Figure 2: Comparative Filing Season Statistics As of June 1, 2007

Cumulative Filing Season Data:	2006 Actual	2007 Actual	Change
Receipts (000s):			
Total Individual Returns Received[8]	126,263	129,280	**2.39%**
Paper Returns Received	55,283	52,070	**-5.81%**
Electronic Returns Received	70,981	77,210	**8.78%**
Filed Through Tax Practitioner	50,926	55,119	**8.23%**
Filed From Home Computer (includes Free File)	19,964	22,191	**11.16%**
Taxpayers Using Free File	3,872	3,810	**-1.60%**
Refunds:			
Total Number (000s)	95,113	99,204	**4.30%**
Total Dollars (in millions)	$208,766	$223,195	**6.91%**
Average Refund Amount	$2,195	$2,250	**2.50%**
Total Number Directly Deposited (000s)	55,463	59,950	**8.09%**

Source: IRS 2007 Filing Season Weekly Reports. Totals may not compute to those presented due to rounding.

Overall, the IRS correctly implemented the key tax law and administrative changes for the 2007 Filing Season. In addition to the provisions related to the TETR, Split Refund, and tax credit and deduction extensions in the Tax Relief and Health Care Act of 2006, the IRS properly applied these additional tax law changes:

- New tax incentives for individual taxpayers to conserve and use alternative energy resources.
- Modifications to the exclusions for foreign earned income and foreign housing costs for citizens living abroad.
- The expansion of the IRA deduction.
- Increases in the Earned Income Tax Credit, the standard deduction, and the exemption amounts.

While the IRS was able to overcome the high risks and timely and accurately process most tax returns, there were some areas in which taxpayers did not take full advantage of the benefits the tax law and administrative changes provided.

[8] These volumes do not include approximately 704,000 Requests for Refund of Federal Telephone Excise Tax (Form 1040EZ-T).

Millions of taxpayers did not claim the TETR

Individual taxpayers could take a standard TETR amount ranging from $30 to $60 based on the number of exemptions claimed on their tax returns. Individuals choosing a standard amount could simply fill in the amount on the various individual income tax returns.[9] People who were not required to file an income tax return could use the Request for Refund of Federal Telephone Excise Tax (Form 1040EZ-T) to choose a standard amount. Individuals who decided not to use a standard amount had to compute their refunds using the actual amounts of taxes they had paid. To choose this option, taxpayers filled out the Credit for Federal Telephone Excise Tax Paid (Form 8913) and attached it to their regular income tax returns.

The IRS estimated between 145 million and 165 million individuals would be eligible to receive this refund, including 22 million "new" filers that had no other tax obligations but would be eligible to make a claim using Form 1040EZ-T. It estimated 49 percent of the 22 million new Forms 1040EZ-T would be filed electronically and 51 percent would be filed on paper. The IRS expected the total amount of the refunds to be about $8 billion.

Through the week ending June 9, 2007, only 87.6 million individual taxpayers had claimed the TETR for a total of $3.8 billion. Of these taxpayers, more than 99.5 percent claimed a safe harbor (standard) amount between $30 and $60. However, the IRS identified more than 35 million individual taxpayers who did not claim the TETR on their tax returns. Figure 3 shows TETR statistics as of June 9, 2007.

Figure 3: TETR Statistics for Individual Taxpayers

Number of Forms 1040EZ-T Filed	675,796
Number of Tax Returns Claiming the TETR	87,600,000
Percentage of Tax Returns Claiming the TETR	71.5%
Percentage of Tax Returns Claiming the Standard TETR Amount	99.5%
Amount of TETR Claimed	$3,800,000,000
Number of Tax Returns Not Claiming the TETR	35,000,000

Source: IRS TETR Performance Measures Reports.

[9] Form 1040, Form 1040A, Form 1040EZ, or U.S. Nonresident Alien Income Tax Return (Form 1040NR).

The number of claims received for the one-time TETR was lower than expected, especially the number expected from taxpayers who were not otherwise required to file tax returns. Based on this trend, the IRS revised its projection of Form 1040EZ-T receipts to approximately 637,000 through May 4, 2007.[10] By June 9, 2007, the IRS had received only 675,796 Forms 1040EZ-T, which is substantially fewer than the 22 million it had originally expected to receive by that time. However, we identified an additional 549,553 returns filed using the various U.S. Individual Income Tax Returns (Form 1040 series) on which the refunded amount was equal to the TETR amount and the taxpayers did not meet the criteria that required a return to be filed in accordance with the Form 1040 instructions.[11]

The IRS expected to receive 22 million Forms 1040EZ-T; however, it had received only 675,796 by June 9, 2007. We identified an additional 549,553 returns filed using various Forms 1040 that only claimed the TETR.

Some of the TETR claims were identified as obviously incorrect or potentially abusive. For many of these excessive claims, the taxpayers' long-distance telephone bills would have to have amounted to more than 25 percent of the taxpayers' total annual incomes to justify the TETR claims. The IRS responded to this potential abuse by creating new compliance selection criteria for the TETR cases and establishing a weekly review of incoming cases. The TETR issues and the IRS' corrective actions are covered in more detail in another of our audit reports.[12]

Taxpayers made only limited use of the Split Refund option

Beginning in 2007, individual taxpayers could elect to have their Federal income tax refunds split and electronically deposited into up to three accounts, such as checking, savings, or IRA. This change gives taxpayers more options for managing their refunds along with the speed and safety of direct deposit. The IRS estimated taxpayers would choose to split their refunds on approximately 3.8 million returns this year.

Taxpayers can continue to use the direct deposit line on Form 1040 to electronically send their refunds to one checking or savings account or use the new Direct Deposit of Refund to More Than One Account (Form 8888) to split their refunds among two or three different accounts/financial institutions. The IRS will electronically deposit refunds to the accounts

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[10] The "Lower" projection showed the IRS receiving only 315,208 Forms 1040EZ-T; the "Most Likely" projection showed 637,030; the "Optimistic" projection showed 7,347,546.

[11] Our computer analysis identified 549,553 additional returns (other than Form 1040EZ-T) that were filed through June 9, 2007, and met the following criteria: (1) the tax refund was equal to the TETR amount based on income and/or filing status, and (2) if not for the TETR refund, the taxpayer would not have been required to file a return. In a separate internal computer analysis, the IRS identified 2.4 million returns (other than Form 1040EZ-T) that were filed through August 16, 2007, and met the following criteria: there was a tax refund equal to the TETR amount, a zero tax liability, and a zero amount of other tax due.

[12] *Although Strong Efforts Were Made, a Significant Amount of the Telephone Excise Tax Overcollected From Individual Taxpayers May Never Be Refunded.* (Audit # 200630036, draft report issued August 8, 2007).

designated by the taxpayer if the taxpayer supplies accurate account and routing numbers and the financial institutions accept direct deposits for the types of accounts designated.

The IRS decided to offer this option to taxpayers for many reasons. First, several Congressional representatives and Earned Income Tax Credit partners asked the IRS to offer more direct deposit options that allowed taxpayers to turn their refunds into assets. A study conducted by researchers at the Harvard Business School and the University of Kansas supported this–one in three taxpayers opted to direct part of their refunds to savings. Second, the technology was in place to implement this program and the electronic options continue to grow. Finally, this was another opportunity to reduce taxpayers' burden by making it easier for them to make financial decisions and direct where their refunds are deposited when they file.

While the majority of taxpayers are choosing to have their refunds directly deposited to their checking or savings accounts (60 percent of refunds issued through June 1, 2007, were direct deposits), the number of taxpayers choosing to split their refunds among 2 or 3 different accounts was much lower than anticipated. Only 80,673 Forms 8888 used to split refunds had been received as of June 4, 2007, representing only one-tenth of 1 percent of the direct deposits. The split refunds totaled $284.2 million, an average of $3,523 per refund.

Taxpayers are not taking advantage of the split refund option. Only one-tenth of 1 percent of all direct deposits have been split.

The minimal use of the split refund option may not be solely due to lack of interest. According to the IRS, two of the largest providers of tax preparation software did not offer the split refund option in their software. Millions of taxpayers use this software. One of the software companies stated the change came too late to program this option; however, there was significant advance notice–the IRS announced this program in May 2006. The other software company decided not to offer the option after determining there was not much customer demand.

Late passage of the extension of certain tax deductions caused a delay in processing some tax returns

The Tax Relief and Health Care Act of 2006 extended the college tuition and fees deduction, the State and local sales tax deduction, and the deduction for educator expenses. This legislation was passed in late December 2006, so the IRS was unable to include these deductions on the 2006 Form 1040 and related instructions. Cautions notifying taxpayers of pending legislation were included in the appropriate tax products.

The IRS did not begin processing tax returns claiming the educator expense, tuition and fees, and State sales tax deductions until February 3, 2007, to ensure the computer programming updates were working as intended. It stated this delay would not affect the vast majority of taxpayers because only about 930,000 of the tax returns filed by February 1, 2007, had a claim for any of these 3 deductions. Through June 1, 2007, we had identified more than 10.5 million of these deductions on taxpayers' returns.

While the IRS had a successful Filing Season overall, we did identify opportunities to improve the processing and accuracy of tax returns containing the following tax provisions:

- Taxpayers improperly claimed additional exemptions for housing Hurricane Katrina displaced individuals.
- Taxpayers older than age 70½ continued to claim improper IRA deductions.
- Many eligible taxpayers missed the opportunity to claim the sales tax deduction.
- Taxpayers continued to claim a "dual benefit" of both the tuition and fees deduction and the Education Credit.

Some Additional Exemptions for Housing Hurricane Katrina Displaced Individuals Were Improperly Claimed for 2 Years

The Katrina Emergency Tax Relief Act of 2005[13] was signed into law on September 23, 2005, and contained $2.6 billion in estimated tax relief for Fiscal Year 2007. Included in this legislation was a provision to assist taxpayers who provided housing for Hurricane Katrina displaced individuals. Taxpayers could claim an additional exemption of $500 for each Hurricane Katrina displaced individual for whom they provided housing. The exemption was limited to up to 4 displaced individuals for a maximum benefit of $2,000, could be claimed only 1 time for each individual, and applied to either TY 2005 or TY 2006. Taxpayers use the Exemption Amount for Taxpayers Housing Individuals Displaced by Hurricane Katrina (Form 8914) for claiming the additional exemptions.

Our analysis identified some taxpayers who claimed the same displaced individual for both TYs 2005 and 2006. As of June 1, 2007, we had identified 4,062 taxpayers who claimed 6,097 dependents as an additional exemption for TY 2006. These taxpayers also had claimed the same 6,097 dependents in TY 2005, for a total of approximately $3 million in improper exemptions. Assuming all taxpayers received an improper tax benefit from only the additional exemptions, the estimated loss of tax revenue is $457,275.[14]

The 2006 instructions for Form 8914 clearly state that displaced individuals included on this Form for TY 2005 should not be entered on the Form for TY 2006. They also instruct taxpayers to claim an exemption amount only one time for a specific individual. The IRS did not program its computer systems to identify these improper exemptions. Because this was the last year taxpayers could claim this additional exemption and due to the relatively small number of affected tax returns, we are making no related recommendation.

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[13] Pub. L. No. 109-73, 119 Stat. 2016 (to be codified in scattered sections of 26 U.S.C.).

[14] We used the tax rate of 15 percent to compute the estimated tax benefit (i.e., 15 percent times $3,048,500 in exemptions equals a tax benefit of $457,275).

Taxpayers Continue to Claim Improper Individual Retirement Arrangement Deductions

The IRA deduction was increased for TY 2006 to $5,000 if a taxpayer is age 50 or older at the end of 2006. However, the Internal Revenue Code (I.R.C.)[15] states that no deduction will be allowed as a benefit to any individual who is age 70½ before the end of the taxable year for which the contribution is made.

During the 2006 Filing Season, we reported that 1,826 taxpayers over age 70½ improperly claimed more than $4 million in IRA deductions for an estimated loss of revenue of $601,423.[16] The TY 2005 instructions for Forms 1040 and 1040A informed taxpayers to use the worksheet in the instructions to calculate the amount of their IRA deductions but to read a list that followed before preparing the worksheet. This list included the information that, if a taxpayer was age 70½ or older at the end of 2005, he or she could not deduct any contributions made to a traditional IRA for 2005. However, the IRA worksheet instructed taxpayers to enter $4,000 or $4,500 if age 50 or older at the end of 2005. This wording was used three different times in the worksheet and implied there was no age limit for this deduction. A taxpayer who had not read the instructions prior to preparing the worksheet could assume the deduction was proper.

We previously recommended the IRA worksheet be revised in all the tax instructions where this worksheet was used to clearly state that taxpayers over age 70½ could not take the IRA deduction. The IRS did not agree with our recommendation; however, it did revise the worksheet for TY 2006 to emphasize the importance of reading the list in the instructions by including this at the top of the worksheet.

We were concerned taxpayers would continue to improperly claim this deduction; as of June 1, 2007, we had identified 1,693 taxpayers over age 70½ that had improperly claimed more than $3.5 million in IRA deductions.[17] Assuming all taxpayers received an improper tax benefit from only the IRA deduction, the estimated loss is $530,099.[18] The change to the instructions last year may have helped to decrease the number of taxpayers who improperly claimed this deduction; however, we still believe the worksheet should be revised to ensure there is no misunderstanding.

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[15] 26 U.S.C. § 219 (2004).
[16] We used the tax rate of 15 percent to compute the estimated tax benefit (i.e., 15 percent times $4,009,485 of IRA deductions equals a tax benefit of $601,423).
[17] These exceptions did take into account the age of the spouse if the taxpayers filed as married filing jointly.
[18] We used the tax rate of 15 percent to compute the estimated tax benefit (i.e., 15 percent times $3,533,993 of IRA deductions equals a tax benefit of $530,099).

Recommendation

Recommendation 1: The Commissioner, Wage and Investment Division, should revise the IRA worksheet in all tax instructions where this worksheet is used to clearly state that taxpayers over age 70½ cannot take the IRA deduction.

> ***Management's Response:*** IRS management agreed with this recommendation. Management will add a statement to the top of the IRA worksheet instructing taxpayers age 70½ or older that they cannot take the deduction and will clarify the requirement by revising the wording on lines 1b and 6 of the worksheet.

Many Eligible Taxpayers Missed the Opportunity to Claim the Sales Tax Deduction

The American Jobs Creation Act of 2004[19] was enacted in October 2004 and allowed taxpayers who itemize deductions the option of deducting either State and local sales taxes or State and local income taxes from their Federal income taxes. This legislation allowed the deduction in TYs 2004 and 2005 and was most advantageous for taxpayers living in the seven States that do not have a State income tax.[20] The deduction was extended beyond TY 2005 in the late passage of the Tax Relief and Health Care Act of 2006.

Despite the fact that *any* taxpayer in *any* State who itemizes deductions and did not claim an income tax deduction is eligible for a sales tax deduction, many eligible taxpayers continue to miss the opportunity to claim this deduction.

Missed opportunities for claiming the sales tax deduction have increased each year the deduction has been available

We reported for both the 2005 and 2006 Filing Seasons that a significant and increasing number of eligible taxpayers missed the opportunity to claim the sales tax deduction.[21] This year, the number continued to rise, with almost 2.1 million eligible taxpayers failing to claim the sales tax deduction.

Although the sales tax deduction is most advantageous to taxpayers living in the seven States with no State income tax (because they paid no State income tax and therefore would otherwise

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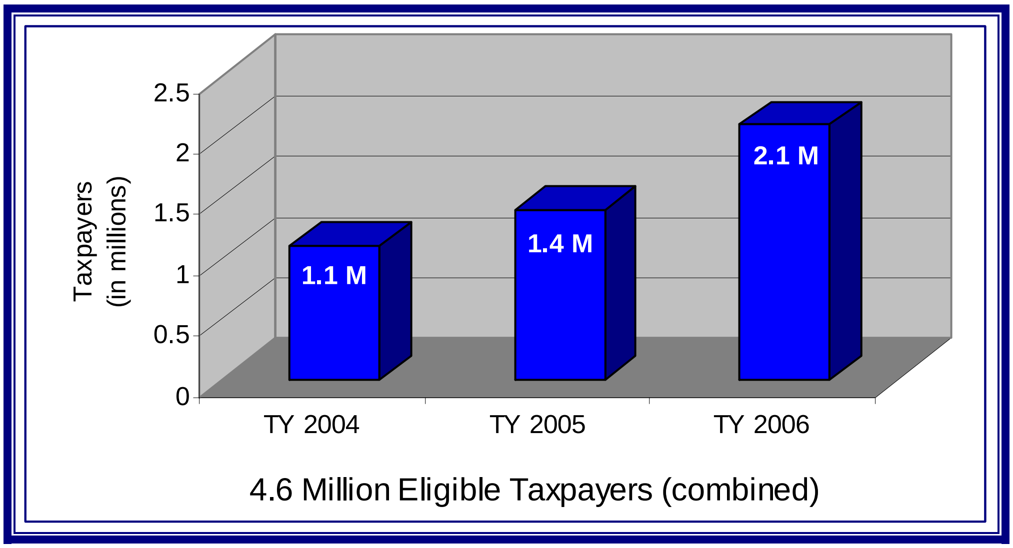
[19] Pub. L. No. 108-357, 118 Stat. 1418 (2004).
[20] Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.
[21] *Individual Income Tax Returns Were Timely Processed in 2005; However, Implementation of Tax Law Changes Could Be Improved* (Reference Number 2006-40-024, dated December 2005) and *Individual Tax Returns Were Timely Processed in 2006, but Opportunities Exist to Improve Verification of Certain Tax Deductions* (Reference Number 2006-40-164, dated October 10, 2006).

be unable to take any deduction for taxes paid), any taxpayer who itemizes deductions and does not claim a State income tax deduction is eligible to take the sales tax deduction.

Figure 4 illustrates the steady rise from TY 2004 to TY 2006 in the number of taxpayers missing the opportunity for this deduction. In TY 2006, 2.1 million eligible taxpayers missed the opportunity to claim the sales tax deduction. This was a 50 percent increase over TY 2005, for which 1.4 million taxpayers missed the opportunity, and more than a 90 percent increase over TY 2004, for which 1.1 million taxpayers missed claiming the deduction. Combined, 4.6 million taxpayers[22] who were eligible to claim the sales tax deduction have not claimed it thus far.

Figure 4: Number of Eligible Taxpayers That Missed the Opportunity to Claim the Sales Tax Deduction for TYs 2004-2006



Source: Our electronic analysis of returns processed with the State and local sales tax deduction for TYs 2004, 2005, and 2006.

The average amount of the sales tax deduction claimed on the tax returns on which we were able to identify the sales tax deduction being claimed[23] was $1,718 for TY 2006. By applying that average to the 2.1 million eligible taxpayers who missed taking the deduction, we determined they are entitled to potentially $3.6 billion in missed deductions. Using a conservative estimate of a 15 percent tax rate, these taxpayers are entitled to potentially $534 million[24] in tax refunds.

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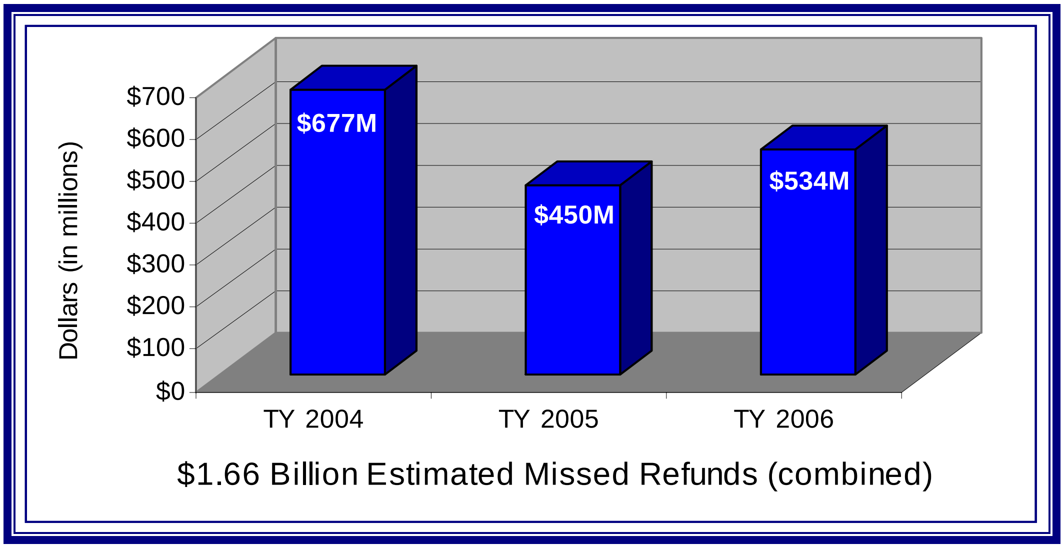
[22] Taxpayers who missed the opportunity to claim the sales tax deduction may have not claimed the deduction in more than 1 year.

[23] For States with a State income tax, we cannot positively differentiate between the State income tax deduction and sales tax deduction in TY 2006. For consistency, the average for all 3 years was obtained using the results of sales tax deduction claims made in the 7 States that have no State income tax.

[24] The $534 million in tax refunds is rounded. Appendix VI contains the unrounded amounts.

Figure 5 shows the estimated refunds owed for each year to eligible taxpayers that missed the opportunity to claim the sales tax deduction.

Figure 5: Estimated Tax Refund Dollars Available to Eligible Taxpayers Who Failed to Claim the Sales Tax Deduction for TYs 2004-2006



Source: Our electronic analysis of returns processed with the State and local sales tax deduction for TYs 2004, 2005, and 2006.

Fortunately for these taxpayers, it is not too late to get the benefits of the deductions for which they are eligible. These taxpayers have the right to file amended tax returns and claim the missed deduction. Given that 4.6 million taxpayers may be entitled to as much as $1.66 billion in tax refunds, we believe the IRS should notify these taxpayers that they appear eligible for this deduction and may want to file amended tax returns.

Late legislative changes may have added to taxpayer burden and resulted in eligible taxpayers failing to claim the deduction

The original legislation that created the sales tax deduction allowed the deduction for only TYs 2004 and 2005, so the sales tax deduction was set to expire for TY 2006. Subsequent legislation extended this deduction through TY 2007. Because this legislation was not passed until late December 2006, the IRS had already removed guidance on how to take the sales tax deduction from the overall instructions for Form 1040 Itemized Deductions (Schedule A). In addition, the IRS had removed the checkboxes on line 5 separating State and local income taxes from sales taxes. Line 5 was now simply “State and local income taxes.” The timing of this legislation did not allow the IRS to change tax forms or instructions.

> **State and local general sales taxes** You can no longer deduct state and local general sales taxes instead of state and local income taxes.
>
> CAUTION
>
> *At the time these instructions went to print, Congress was considering legislation that would extend the deduction for state and local general sales taxes that expired at the end of 2005. To find out if this legislation was enacted, and for more details, go to* www.irs.gov, *click on* More Forms and Publications, *and then on* What's Hot in forms and publications, *or see Pub. 553.*

Source: 2006 Instructions for Schedules A and B.

However, the IRS took action to inform taxpayers that Congress was considering extending the legislation. Specifically, the 2006 Instructions for Schedule A and Interest and Dividend Income (Schedule B) contained an alert (pictured left) that explained to taxpayers the sales tax deduction could no longer be claimed but Congress was considering extending it. The alert instructed taxpayers to use the IRS web site (IRS.gov) to determine the status of this late legislation. Some taxpayers may not have been inclined to interrupt the completion of their income tax returns with a check of IRS.gov to evaluate whether this additional benefit applied to them.

The IRS also sent *State and Local General Sales Taxes* (Publication 600) to all taxpayers who received the Form 1040 tax package via mail. However, this Publication was mailed separately and arrived several weeks after the Form 1040 for most taxpayers. This year the IRS also provided the Sales Tax Calculator on IRS.gov to assist taxpayers in calculating their deductions.

We believe the substantial increase in taxpayers not claiming the sales tax deduction this year directly relates to the elimination of the separate checkbox and guidance for the sales tax deduction on Form 1040 Schedule A and its related instructions when this deduction was not timely extended. The difficulty of reviewing the various alerts and updates, along with the removal of the separate line (checkbox) for the sales tax deduction, may have caused additional taxpayer burden that resulted in numerous taxpayers failing to claim the deduction at all this year. In previous years, we also reported that various factors may have increased taxpayer burden and made it more difficult for taxpayers to claim the deduction.

Recommendation

Recommendation 2: The Commissioner, Wage and Investment Division, should develop a communication strategy to inform taxpayers they are eligible for a sales tax deduction if they itemize and do not claim a State income tax deduction. This strategy could be directed to segments of taxpayers who are not taking advantage of the sales tax deduction or could be broader in nature. Regardless of approach, the strategy should also clearly outline that these taxpayers may be eligible to file amended returns for the past 3 years if they itemized deductions and did not claim any State or local income or sales tax deductions for any of the past 3 tax years.

Management's Response: IRS management agreed with this recommendation. Management will develop a communication strategy to inform taxpayers they are eligible for a sales tax deduction if they itemize and do not claim a State tax deduction. As part of the IRS filing season communication, management will emphasize the availability of the State and local sales tax deduction and point out the new law extended this deduction through 2007. Form 1040 Schedule A will clearly show the availability of the State and local income tax deduction. Specialized information will be provided to media spokespersons; Stakeholder Partnerships, Education, and Communication function partners; and FedState/Governmental Liaisons advising how taxpayers can claim this tax benefit by filing an Amended U.S. Individual Income Tax Return (Form 1040X). Localized news releases with similar content will be issued in the seven States with no State income tax.

Taxpayers Continue to Claim a "Dual Benefit" for Both the Tuition and Fees Deduction and the Education Credit

The Economic Growth and Tax Relief Reconciliation Act of 2001[25] created a new "above-the-line" deduction for tuition and fees that would be available to taxpayers beginning in TY 2003 and expiring at the end of TY 2005.[26] However, this was another provision extended beyond TY 2005 in the Tax Relief and Health Care Act of 2006. For TY 2006, taxpayers were allowed to take a deduction of up to $4,000 for qualified tuition and fees paid for the taxpayer, his or her spouse, or his or her dependent(s). Taxpayers who claim an Education Credit are required to complete Education Credits (Hope and Lifetime Learning Credits) (Form 8863) and identify by name and Social Security Number the student for whom the Education Credit is being claimed. Taxpayers who claim the tuition and fees deduction are not required to provide additional information other than what is already on the return to identify the student for whom the deduction is being claimed. However, taxpayers may not receive a dual benefit by taking both the tuition and fees deduction and the Education Credit for the same student in the same year. If the Education Credit is elected, the tuition and fees deduction is not allowed.

During the 2007 Filing Season, we identified 8,493 single taxpayers claiming no dependents that had claimed both the Education Credit and the tuition and fees deduction through May 25, 2007. We focused on single taxpayers claiming no dependents because it is clear that both the tuition and fees deduction and the Education Credit were claimed for the same individual, which is not allowable. Our audit analysis showed these taxpayers claimed Education Credits of more than $7 million and tuition and fees deductions of more than $19.8 million. Assuming all

[25] Pub. L. No. 107-16, 115 Stat. 38 (2001).

[26] An "above-the-line" deduction refers to a deduction that is taken directly on Form 1040 rather than on the Schedule A. Consequently, this type of deduction can be taken by taxpayers who do not itemize their deductions.

8,493 taxpayers received an erroneous tax benefit from only the tuition and fees deduction, the estimated loss of tax revenue is more than $2.97 million.[27]

This is the fifth year in which we have identified and reported this issue. When this issue was first identified during the 2003 Filing Season, the IRS included a cautionary statement on the Form 8863 specifically to alert taxpayers not to claim both the tuition and fees deduction and the Education Credit for the same student in the same year. Figure 6 provides a comparison of our results for this issue from the last five filing seasons.

Figure 6: Single Taxpayers With No Dependents Claiming Both the Education Credit and the Tuition and Fees Deduction

Filing Season	Tuition and Fees Deduction Claimed (millions)	Education Credit Claimed (millions)	Single Taxpayers With No Dependents	Average Deduction Taken
2003	77	24	42,058	$1,831
2004	30	11	16,979	$1,767
2005	39	13	18,776	$2,077
2006	34	11	15,250	$2,230
2007	20	7	8,493	$2,355

Source: Our electronic analysis of returns processed data for the 2003-2007 Filing Seasons.

We believe the decrease in the volumes this year directly relates to the elimination of the line for the tuition and fees deduction on Forms 1040 and 1040A when this deduction was not timely extended. After the late passage of legislation to extend this deduction, the IRS did not have time to add this line back to the Forms and provided taxpayers instructions on how to claim the deduction. Taxpayers were required to write in a "T" on a certain line on the Forms to claim the deduction. Additionally, the write-in information was, in some cases, not available to taxpayers.

The IRS issued three News Releases[28] and included updated information in the TY 2006 *Tax Benefits for Education* (Publication 970), in *Highlights of 2006 Tax Changes* (Publication 553), and on IRS.gov. However, Publication 553 was not available until March 2007, and the information on IRS.gov was not always easy to find. Additionally, the widely used TY 2006 Forms 1040 and 1040A instructions, and *Your Federal Income Tax For Individuals* (Publication 17), did not include the updated information. Taxpayers reading these Publications were directed to visit "What's Hot in forms and publications" on IRS.gov for more information.

[27] We used the tax rate of 15 percent to compute the estimated revenue loss (i.e., 15 percent times $19,820,813 of tuition and fees deductions equals $2,973,121).
[28] IR-2007-195 (12/22/06), IR-2007-03 (1/8/07), and IR-2007-26 (2/6/07).

However, once there, the taxpayer still had to search farther before finding the updated information.

The extent of the dual benefit problem may not be limited to single taxpayers with no dependents. A total of 210,082 taxpayers that filed as other than single had claimed both the tuition and fees deduction and the Education Credit in the 2007 Filing Season through May 25, 2007. These taxpayers claimed $559.7 million in tuition and fees deductions and $229.3 million in Education Credits. However, because taxpayers claiming the tuition and fees deduction are not required to provide additional information other than what is already on the return to identify the student for whom the deduction is being claimed, neither we nor the IRS can readily determine whether the taxpayers are claiming a "dual benefit" for the same student.

Management Action: As a result of our prior recommendations, the IRS has developed a new form for the Tuition and Fees Deduction (Form 8917), a draft version of which was made available in April 2007. The Form 8917 will require taxpayers to specifically identify by name and Social Security Number the student for whom the deduction is claimed and is similar to the Form 8863 now in use by taxpayers to claim certain education credits.

Recommendation

Recommendation 3: The Commissioner, Wage and Investment Division, should ensure Form 8917 is timely finalized prior to the start of the 2008 Filing Season and is required for all taxpayers claiming the deduction for TY 2007.

> ***Management's Response:*** IRS management agreed with this recommendation. Form 8917 has been developed for the 2008 Filing Season. Its release is on schedule, and the Form should be available to the public by December 15, 2007.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the review was to evaluate whether the IRS timely and accurately processed individual paper and electronic tax returns[1] during the 2007 Filing Season.[2] The audit focused on the implementation of new tax law changes and administrative changes[3] that affected TY 2006 tax returns. In addition, we reviewed the corrective actions for the conditions identified in our review of the 2006 Filing Season[4] to determine whether they were adequate. To accomplish our objective, we:

I. Determined whether the IRS correctly implemented new tax legislation that affected the processing of individual tax returns during the 2007 Filing Season.

   A. Used 100 percent computer analysis of TY 2006 individual income tax returns processed nationally on the Individual Return Transaction File[5] between January 1 and June 1, 2007,[6] to identify returns affected by recent tax legislation and administrative changes. We used random sampling for some tests to ensure each return had an equal chance of being selected. We also used judgmental sampling if we needed to ensure the original returns could be quickly obtained to evaluate the accuracy of processing. To determine whether changes to tax products were correctly initiated and systemic controls at the Submission Processing sites[7] assured accurate processing of individual tax returns, we:

      1. Verified whether IRS publications, instructions, and applicable forms were accurately updated for the new Residential Energy Credits (Form 5695) and

[1] U.S. Individual Income Tax Returns (Form 1040 and Form 1040A) and Income Tax Returns for Single and Joint Filers With No Dependents (Form 1040EZ).
[2] The period from January through mid-April when most individual income tax returns are filed.
[3] See Appendix V for an overview of the tax law provisions and administrative changes examined during this review.
[4] *Individual Tax Returns Were Timely Processed in 2006, but Opportunities Exist to Improve Verification of Certain Tax Deductions* (Reference Number 2006-40-164, dated October 10, 2006).
[5] The Individual Return Transaction File contains data from the Individual Master File. The Individual Master File is the IRS database that maintains transactions or records of individual tax accounts.
[6] To assess the reliability of computer-processed data, programmers in the Treasury Inspector General for Tax Administration Office of Information Technology validated the extracted data, and we verified the appropriate documentation. Judgmental samples were selected and reviewed to ensure the amounts presented were supported by external sources. As appropriate, data in the selected data records were compared to the physical tax returns to verify the amounts were supported.
[7] Submission Processing sites process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

reviewed a random sample of 35 of the 2,585,246 returns processed with these credits through April 13, 2007, for processing accuracy.

2. Verified whether IRS publications, instructions, and applicable forms were accurately updated for the changes to the exclusions for foreign earned income and foreign housing costs and reviewed a random sample of 30 of the 2,476 returns processed with a Foreign Earned Income Exclusion (Form 2555-EZ) through February 16, 2007, for processing accuracy.
3. Monitored the volumes of returns claiming a TETR through June 9, 2007,[8] and identified an additional 549,553 returns files using various Form 1040 series returns other than a Request for Refund of Federal Telephone Excise Tax (Form 1040EZ-T) filed only to claim the TETR.[9]
4. Verified whether IRS publications, instructions, and applicable forms were accurately updated for the expansion of the IRA deduction.
5. Verified whether IRS publications, instructions, and applicable forms were accurately updated for changes to the Earned Income Tax Credit and reviewed a random sample of 30 of the 32,816 returns processed from January 19 through June 1, 2007, on which a taxpayer claimed an amount that exceeded the maximum credit based on filing status, number of qualifying children, and adjusted gross income[10] limits, to verify whether the returns were accurately processed.
6. Confirmed whether the correct standard deduction and exemption amounts were used by reviewing a judgmental sample of 35 returns filed early and processed at the Austin, Texas, Submission Processing site.[11]

B. Determined whether changes to tax products were correctly initiated and systemic controls at the Submission Processing sites assured accurate processing of additional issues.

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[8] We monitored volumes through June 9, 2007, to be consistent with the draft audit report entitled, *Although Strong Efforts Were Made, a Significant Amount of the Telephone Excise Tax Overcollected From Individual Taxpayers May Never Be Refunded* (Audit # 200630036, draft report issued August 8, 2007).

[9] Our computer analysis identified 549,553 additional returns (other than Form 1040EZ-T) that were filed through June 9, 2007, and met the following criteria: (1) the tax refund was equal to the TETR amount based on income and/or filing status, and (2) if not for the TETR refund, the taxpayer would not have been required to file a return. In a separate internal computer analysis, the IRS identified 2.4 million returns (other than Form 1040EZ-T) that were filed through August 16, 2007, and met the following criteria: there was a tax refund equal to the TETR amount, a zero tax liability, and a zero amount of other tax due.

[10] Adjusted gross income is calculated after certain adjustments are made but before standard or itemized deductions and personal exemptions are subtracted.

[11] Submission Processing sites process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

1. Verified whether IRS publications, instructions, and applicable forms were accurately updated for the new Direct Deposit of Refund to More Than One Account (Form 8888) and identified 80,673 Forms 8888 filed through June 4, 2007. We also reviewed the volume of error codes for Forms 8888 to evaluate the accuracy of the processing.
2. Identified a population of 4,062 taxpayer returns processed with an Exemption Amount for Taxpayers Housing Individuals Displaced by Hurricane Katrina (Form 8914) through June 1, 2007, who claimed 6,097 displaced individuals for an additional exemption in both TYs 2005 and 2006.

C. Determined the numbers of taxpayers affected by the new tax legislation and the additional issues identified above by counting the number of returns and dollar amounts of the applicable deductions or credits claimed by taxpayers.

II. Determined whether the IRS monitoring systems indicate that individual returns are being processed timely and accurately.

A. Monitored various Submission Processing site production reports, inventory reports, and return error inventories between January 26 and April 27, 2007, for key indicators of return processing and compared the statistics to those for the 2006 Filing Season.

B. Monitored the IRS Program Completion Date reports from April 30 through May 10, 2007, to determine whether the Submission Processing sites processed all returns timely.

C. Computer analyzed filing patterns to evaluate whether processing inventories were adversely affected by taxpayers filing returns at the wrong Submission Processing sites.

D. Monitored weekly 2007 Filing Season Wage and Investment Division Production meetings between January 24 and May 31, 2007, and monitored the IRS Submission Processing office web site, the IRS web site (IRS.gov), and other applicable web sites from February 9 through May 7, 2007, to identify potentially significant issues.

III. Determined whether the IRS had corrected problems identified in the 2006 Filing Season. From returns processed by the Submission Processing sites between January 1 and June 1, 2007, we electronically identified TY 2006 returns that met specific criteria.

A. Identified 1,693 returns through June 1, 2007, on which taxpayers were over the age limits for receiving the IRA deduction.

B. Identified 2.1 million returns processed through June 1, 2007, that did not claim the State sales tax deduction.

C. Identified 8,493 returns processed through June 1, 2007, filed by single taxpayers with no dependents who claimed both the Education Credit and the tuition and fees deduction.

Appendix II

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Appendix III

Report Distribution List

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Office of Internal Control OS:CFO:CPIC:IC
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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 Congress.

For all of the outcomes listed in this appendix, we conducted computer analyses of TY 2006 individual income tax returns.[1] The returns were processed by the IRS Submission Processing sites[2] between January 1, 2007, and June 1, 2007, and were posted to the Individual Master File.[3] We developed specific criteria to identify returns affected by the new tax law changes covered in this review.[4] We used further computer analysis and auditor evaluation of return data to determine if the IRS accurately processed individual tax returns during the 2007 Filing Season.[5]

Type and Value of Outcome Measure:

- Revenue Protection – Potential; $530,099 due to 1,693 taxpayers being improperly allowed the IRA deduction (see page 10).

Methodology Used to Measure the Reported Benefit:

We used computer analysis to identify 1,693 taxpayers over age 70½ that improperly claimed more than $3.5 million in IRA deductions.[6] Assuming all taxpayers received an improper tax benefit from only the IRA deduction, the estimated loss is $530,099.[7]

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; 4.6 million taxpayers, entitled to an estimated $1.66 billion in tax refunds, who missed the opportunity to claim the State sales tax deduction in TYs 2004 through 2006 (see page 11).

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[1] Paper and electronic U.S. Individual Income Tax Returns (Form 1040 and Form 1040A) and Income Tax Returns for Single and Joint Filers With No Dependents (Form 1040EZ).
[2] Submission Processing sites process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
[3] The IRS database that maintains transactions or records of individual tax accounts.
[4] See Appendix V.
[5] The period from January through mid-April when most individual income tax returns are filed.
[6] These exceptions did take into account the age of the spouse if the taxpayers filed as married filing jointly.
[7] We used the tax rate of 15 percent to compute the estimated tax benefit (i.e., 15 percent times $3,533,993 of IRA deductions equals a tax benefit of $530,099).

Methodology Used to Measure the Reported Benefit:

Our analysis over the past 3 filing seasons identified 4.6 million taxpayers who were eligible to claim the State sales tax deduction. These taxpayers had itemized their deductions but had not claimed the State income tax deduction. They are entitled to file amended returns and claim the State sales tax deduction. If these taxpayers file amended tax returns, they may be entitled to as much as $1.66 billion dollars in tax refunds.[8]

During our analysis of the 3 Tax Years, we found the average dollar amount of the State sales tax deduction claimed dropped from $4,157 in TY 2004 to $2,134 in TY 2005 to $1,718 in TY 2006. Using each Tax Year's specific average resulted in $1.66 billion in tax refunds. See calculation in Appendix VI.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; $2.97 million due to 8,493 single taxpayers with no dependents claiming more than $19.8 million in erroneous tuition and fees deductions (see page 15).

Methodology Used to Measure the Reported Benefit:

We focused on single taxpayers claiming no dependents because it is clear that both the tuition and fees deduction and the Education Credit were claimed for the same individual. Our analysis identified 8,493 single taxpayers with no dependents that claimed Education Credits of more than $7 million and tuition and fees deductions of more than $19.8 million. Assuming all 8,493 taxpayers received an erroneous tax benefit from only the tuition and fees deduction, the estimated loss of tax revenue is more than $2.97 million.[9] Because the tax law prohibits taxpayers from claiming both the tuition and fees deduction and the Education Credit for the same individual in the same year, the tuition and fees deduction is not allowable.

[8] For States with a State income tax, we cannot positively differentiate between the State income tax deduction and sales tax deduction in TY 2006. For consistency, the average for all 3 years was obtained using the results of sales tax deduction claims made in the seven States that have no State income tax.

[9] We used the tax rate of 15 percent to compute the estimated revenue loss (i.e., 15 percent times $19,820,813 of tuition and fees deductions equals $2,973,121).

Appendix V

Overview of Tax Law Provisions and Administrative Changes Examined During the Review

The following information describes various tax law provisions and other changes that affected TY 2006 individual income tax returns processed during the 2007 Filing Season.[1] During our review, we determined whether returns affected by the various provisions were accurately processed, in accordance with the law.

Economic Growth and Tax Relief Reconciliation Act of 2001[2]

This Act contained the following provision:

Section 601 – Modification of IRA Contribution Limits. Provides that, for TY 2006, the maximum catchup contribution for individuals age 50 and over increased from $500 to $1,000.

Energy Policy Act of 2005[3]

This Act contained the following provisions:

Section 1333 – Credit for Certain Non-Business Energy Property. Amends I.R.C. § 25[4] to provide an individual a personal credit equal to the sum of:

a. Ten percent of the cost of his or her qualified energy efficiency improvements (such as insulation, doors, windows, and certain metal roofs) installed during the taxable year in a United States dwelling used by the taxpayer as his or her principal residence.

b. The amount of his or her residential energy property expenditures for the taxable year. These expenditures are for "qualified energy property" (such as heat pumps, air conditioners, qualified natural gas, propane or oil furnaces or hot water boilers, or an advanced main circulating fan) that is installed in a United States dwelling unit used by the taxpayer as his or her principal residence. The total credit is limited to $500 for the taxpayer's lifetime.

Section 1335 – Credit for Residential Energy Efficient Property. Provides a personal tax credit for the purchase of qualified photovoltaic property and qualified solar water heating property for

[1] The period from January through mid-April when most individual income tax returns are filed.
[2] Pub. L. No. 107-16, 115 Stat. 38 (2001).
[3] Pub. L. No. 109-58, 119 Stat. 594 (2005).
[4] 26 U.S.C. § 25B (2005).

use (other than for heating swimming pools and hot tubs) in a United States dwelling used by the taxpayer as a residence. The credit is equal to 30 percent of qualifying expenditures, limited to a $2,000 maximum credit for each of these systems. Qualified photovoltaic property uses solar energy to generate electricity for use in a dwelling unit. Qualifying solar water heating property heats water where at least one-half of the energy used by the dwelling unit for such purpose is derived from the sun. The credits are nonrefundable and reduce the taxpayer's basis in the property to which they relate.

Katrina Emergency Tax Relief Act of 2005[5]

This Act contained the following provision:

Section 302 – Additional Exemption for Housing Hurricane Katrina Displaced Individuals. Provides an additional exemption of $500 for each Hurricane Katrina displaced individual. The maximum additional exemption amount is $2,000 for married taxpayers filing jointly, $1,000 for married taxpayers filing separately, and $2,000 for all other taxpayers. The taxpayer may claim the exemption only one time for each displaced individual for all taxable years. A Hurricane Katrina displaced individual is a person (1) whose principal place of abode on August 28, 2005, was in the Hurricane Katrina disaster area; (2) who is displaced from such abode; (3) whose abode, if located within the disaster area but outside the core disaster area, must be damaged by Hurricane Katrina, or who was evacuated from the abode because of Hurricane Katrina; and (4) who is provided housing free of charge in the taxpayer's principal residence for a period of 60 consecutive days that ends in the taxable year in which the exemption is claimed. The displaced individual cannot be the taxpayer's spouse or dependent. The taxpayer cannot receive any compensation from any source for providing housing to the displaced individual. The taxpayer must provide the Taxpayer Identification Number of the displaced individual.

Tax Increase Prevention and Reconciliation Act of 2005[6]

This Act contained the following provision:

Section 515 – Modification of Exclusion for Citizen Living Abroad. Provides the following changes to the exclusions for foreign earned income and foreign housing costs beginning in TY 2006:

a. Indexing of the $80,000 cap on excludable foreign earned income is accelerated 2 years (from 2008 to 2006).

b. The base housing amount used in calculating the housing cost exclusion is changed to 16 percent of the cap on excludable foreign earned income. Except as otherwise

[5] Pub. L. No. 109-73, 119 Stat. 2016 (to be codified in scattered sections of 26 U.S.C.).
[6] Pub. L. No. 109-222, 120 Stat. 345 (2006).

provided by the Secretary in regulations, the base housing amount is limited to 30 percent of the taxpayer's foreign earned income exclusion.

c. The taxpayer's income in excess of the combined exclusions is taxed (for both the regular tax and the Alternative Minimum Tax) at the tax rates that would have applied to that income if the taxpayer had not elected to take the exclusions.

Tax Relief and Health Care Act of 2006[7]

This Act contained the following provisions:

Section 101 – Deduction for Qualified Tuition and Related Expenses. Extends the tuition and fees deduction that expired on December 31, 2005, for 2 years to TYs 2006 and 2007.

Section 103 – Deduction for State and Local General Sales Taxes. Extends the State and local sales tax deduction that expired on December 31, 2005, for 2 years to TYs 2006 and 2007.

Section 108 – Educator Expenses. Extends the deduction for certain expenses for elementary and secondary school teachers that expired on December 31, 2005, for 2 years to TYs 2006 and 2007.

IRS Administrative Changes

Expanded Options for Direct Deposit of Refund[8]

In an effort to encourage higher savings and more banking, the IRS created a new program for individual filers who use direct deposit. Beginning in TY 2006, individual taxpayers could elect to have their Federal income tax refunds split and electronically deposited into up to three accounts, such as checking, savings, or IRA. In addition, the accounts can be with up to three different United States financial institutions, including banks, brokerage firms, or credit unions. Taxpayers must complete Direct Deposit of Refund to More Than One Account (Form 8888).

Communications Excise Tax; Toll Telephone Service[9]

The TETR is a one-time refund designed to refund previously collected long-distance Federal excise taxes. It is available to anyone who paid long-distance taxes on landline, cell phone, or Voice over Internet Protocol service billed after February 28, 2003, and before August 1, 2006. Taxpayers can request this refund by completing Credit for Federal Telephone Excise Tax Paid (Form 8913) and attaching it to their TY 2006 income tax returns. Individual taxpayers can take a standard amount ranging from $30 to $60 based on the number of exemptions claimed on their tax returns, or they may compute their refunds using actual receipts. To allow everyone entitled

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[7] Pub. L. No. 109-432, 120 Stat. 2922 (2006).
[8] IRS News Release -IR-2006-85 (5/31/2006).
[9] Internal Revenue Bulletin 2006-25, p.1141 (2006).

to the credit to take it, the IRS designed Request for Refund of Federal Telephone Excise Tax (Form 1040EZ-T) for those not required to file income tax returns.

Cost-of-Living (Inflation) Adjustments for TY 2006

Revenue Procedure 2005-70[10] contained the following inflation-adjusted items:

Earned Income Tax Credit. For TY 2006, the earned income amounts,[11] maximum amounts of Earned Income Tax Credit, and threshold amounts for phaseout of the credit under I.R.C. § 32(b) were increased. For example, taxpayers filing as Single, Surviving Spouse, or Head of Household with earned income of less than $36,348 ($38,348 for joint returns) and 2 or more qualifying children can claim up to a maximum credit of $4,536. However, the amount of credit that can be claimed begins to phase out when the taxpayer's adjusted gross income (or earned income, if greater) reaches $14,810 ($16,810 for joint returns) and is completely phased out when the taxpayer's adjusted gross income (or earned income, if greater) reaches $36,348 ($38,348 for joint returns). Also, the investment income amount under I.R.C. § 32(i)(1) was increased to $2,800.

Standard Deduction. For TY 2006, the standard deduction amounts under I.R.C. § 63(c)(2)[12] were increased to $5,150 for Single or Married Filing Separately filing statuses, $7,550 for Head of Household filing status, and $10,300 for Married Filing Jointly or Surviving Spouse filing statuses. The standard deduction amount under I.R.C. § 63(c)(5) for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of $850 or the sum of $300 and the individual's earned income. The additional standard deduction amounts under I.R.C. § 63(f) for the aged and for the blind are $1,000 each or $1,250 each if the individual is also unmarried and not a surviving spouse.

Personal Exemption. For TY 2006, the personal exemption under I.R.C. § 151(d)[13] is $3,300.

[10] Rev. Proc. 2005-70, 2005-47 I.R.B. 979 (11-21-2005).
[11] The earned income amount is the amount of earned income at or above which the maximum amount of the Earned Income Tax Credit is allowed. Earned income generally includes wages, salaries, tips, and other employee compensation, plus net earnings from self-employment.
[12] 26 U.S.C. § 63 (2004).
[13] 26 U.S.C. § 151 (2004).

Appendix VI

Detailed Analysis of the Missed State Sales Tax Deductions

Taxpayers Who Missed the Opportunity to Claim the State Sales Tax Deduction	
TY 2004 Missed Opportunities	1,085,228
TY 2005 Missed Opportunities	1,404,996
TY 2006 Missed Opportunities	2,071,952
Total Taxpayers Who Are Eligible for the State Sales Tax Deduction but Did Not Claim It (Itemized but Claimed No State Income Tax Deduction)	4,562,176
Calculation of Average State Sales Tax Deductions Claimed[1]	
Taxpayers Claiming State Sales Tax in TY 2004	4,607,561
Total State Sales Tax Dollars Claimed in TY 2004	$ 19,152,071,436
Average State Sales Tax Dollars Claimed per Return, TY 2004	$ 4,156.66
Taxpayers Claiming State Sales Tax in TY 2005	4,575,443
Total State Sales Tax Dollars Claimed in TY 2005	$ 9,763,462,020
Average State Sales Tax Dollars Claimed per Return, TY 2005	$ 2,133.88
Taxpayers Claiming State Sales Tax in TY 2006	4,183,751
Total State Sales Tax Dollars Claimed in TY 2006	$ 7,186,502,730
Average State Sales Tax Dollars Claimed per Return, TY 2006	$ 1,717.72

[1] For States with a State income tax, we cannot positively differentiate between the State sales tax deduction and the State income tax deduction in TY 2006. Therefore, for consistency, the averages for each year were obtained using the results of the State sales tax claims made in the seven States that have no State income tax. Using this method also avoids any issues where the identification of sales tax versus income tax was in error.

Total Tax Refund Dollars Missed by Not Claiming the State Sales Tax Deduction **(calculations based on each year's specific average as previously calculated)**[2]		
TY 2004 Missed Opportunities	1,085,228	
Average Sales Tax Dollars Claimed per Return, TY 2004	$ 4,156.66	
Total Sales Tax Deduction Dollars Missed	$ 4,510,925,450.66	
Times 15% Tax Rate Equals Tax Refund Dollars Missed, TY 2004		$ 676,638,818
TY 2005 Missed Opportunities	1,404,996	
Average Sales Tax Dollars Claimed per Return, TY 2005	$ 2,133.88	
Total Sales Tax Deduction Dollars Missed	$ 2,998,097,688.96	
Times 15% Tax Rate Equals Tax Refund Dollars Missed, TY 2005		$ 449,714,653
TY 2006 Missed Opportunities	2,071,952	
Average Sales Tax Dollars Claimed per Return, TY 2006	$ 1,717.72	
Total Sales Tax Deduction Dollars Missed	$ 3,559,028,418.38	
Times 15% Tax Rate Equals Tax Refund Dollars Missed, TY 2006		$ 533,854,263
Total Tax Refund Dollars Missed by Not Taking the Sales Tax Deduction, TYs 2004-2006		$ 1,660,207,734

[2] Calculations in this table were made using the actual unrounded figures for each step. Therefore, the specific individual calculations may differ from amounts calculated using the rounded figures presented (for example, total sales tax deduction dollars missed).

Appendix VII

Management's Response to the Draft Report

COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

RECEIVED
SEP 10 2007

September 10, 2007

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – The 2007 Tax Filing Season Was Generally Successful, and Most Returns Were Timely and Accurately Processed (Audit #200740027)

I reviewed the draft report and appreciate your acknowledgement of the enormity and complexity of preparing and delivering a successful filing season. I agree with your conclusion that we correctly implemented the tax law and administrative changes impacting Tax Year (TY) 2006 processing, and timely and accurately processed returns. This was one of our most successful filing seasons. Through August 10, 2007, we processed nearly 133 million returns, issued 102 million refunds totaling over $230 billion in refunds, and increased electronically filed returns by 9 percent.

We did have a computer problem with one of the major electronic providers and more than 200,000 taxpayers were unable to electronically file their tax returns by the due date of April 17, 2007. We allowed these taxpayers an extension to April 19, 2007, to give them additional time to file their tax returns and have not experienced any further problems.

Although we had an outstanding filing season, there were some concerns with the implementation of the Telephone Excise Tax Refund (TETR). As of August 6, 2007, the IRS had refunded $4.27 billion for 92.76 million TETR requests. More taxpayers claimed the standard amount for TETR than originally estimated, while the number of Form 1040 EZ-T (Claim for Refund of Federal Telephone Excise Tax) filers was much lower than estimated. For the 2007 tax year, we will include TETR language in tax packages and will provide similar language to tax software vendors that explain to taxpayers they may still request TETR by filing an amended 2006 return or filing a 2006 Form 1040 EZ-T, if eligible. The TETR will not be available on the 2007 tax forms. We also addressed the issue of potentially abusive TETR requests by implementing a rigorous compliance process. The TETR Compliance Review Council met weekly to review cases and discuss emerging trends. Cases were referred to the Criminal

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Investigation Division for research as necessary. More detailed information regarding the TETR is found in the response to your recent audit, *Although Strong Efforts Were Made, a Significant Amount of the Telephone Excise Tax Over collected From Individual Taxpayers May Never Be Refunded (Audit # 200630036).*

The late passage of key legislation is always a challenge and this year was no exception. The Tax Relief and Health Care Act of 2006 included an extension of the tuition and fees deduction, state and local sales tax deduction, and the deduction for the educator expenses. This legislation passed in late December 2006, so we were unable to include these deductions on the 2006 tax forms and related instructions. We did include cautions in the related tax products informing the taxpayers of the possibility this legislation would be passed and the deductions would be valid.

Even though we cautioned taxpayers of the possible late legislation-related changes, many taxpayers who were eligible did not claim the state and local sales tax deduction. We agree with your assertion that, "Late legislative changes may have added to taxpayer burden and resulted in eligible taxpayers failing to claim the deduction." To rectify this problem, we are actively pursuing your recommendation to develop a comprehensive communication strategy to inform taxpayers they may be eligible for the sales tax deduction if they itemized and did not claim a State income tax deduction. In addition, our Wage and Investment (W&I) Research Division has completed a study and identified locations for specialized outreach efforts.

Your report also discusses the limited use by taxpayers of the split refund option and suggests part of the reason for this was that two of the largest providers of tax preparation software did not offer this option. These providers did not offer the split refund option in 2007 for many reasons, including late programming requirements and low customer demand. For the 2008 filing season, these software providers have either indicated they will offer the option or they are seriously considering it.

We acknowledge that some taxpayers are improperly claiming both the Tuition and Fees Deduction and Education Credits for the same student. As noted in your report, we have developed Form 8917 (Tuition and Fees Deduction) which should be available for the 2008 filing season. This form addresses the "dual benefit" issue by requiring taxpayers to specifically identify by name and Social Security Number the student for whom the deduction is claimed.

In conclusion, we agree with the outcome measures reported in Appendix IV of the report. 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 Pete Stipek, Director, Customer Account Services, at (404) 338-8910.

Attachment

Attachment

RECOMMENDATION 1

The Commissioner, Wage and Investment Division, should revise the IRA worksheet in all tax instructions where this worksheet is used to clearly state that taxpayers over age 70½ cannot take the IRA deduction.

CORRECTIVE ACTION

We agree with this recommendation and will add a statement to the top of the IRA worksheet instructing taxpayers age 70½ or older they cannot take the deduction. We will also clarify the requirement by revising the wording on lines 1b and 6 of the worksheet.

IMPLEMENTION DATE

December 15, 2007

RESPONSIBLE OFFICIAL

Director, CARE Media and Publications, W&I Division

CORRECTIVE ACTION MONITORING PLAN

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

RECOMMENDATION 2

The Commissioner, Wage and Investment Division, should develop a communication strategy to inform taxpayers they are eligible for a sales tax deduction if they itemize and do not claim a State income tax deduction. This strategy could target segments of taxpayers who are not taking advantage of the sales tax deduction or could be broader in nature. Regardless of approach, it should also clearly outline that these taxpayers may be eligible to file amended returns for the past 3 years if they itemized deductions and did not claim any state or local income or sales tax deductions for any of the past 3 tax years.

CORRECTIVE ACTION

We agree with this recommendation and will develop a communication strategy to inform taxpayers they are eligible for a sales tax deduction if they itemize and do not claim a State tax deduction. We will take the following actions:

- As part of its filing season communications, IRS will emphasize the availability of the State and Local Sales Tax deduction for taxpayers who itemize and do not take the deduction for State and Local Income Tax - pointing out the new law extended this deduction through 2007.

- Form 1040, Schedule A (Itemized Deductions) will clearly show the availability of the State and Local Income Tax deduction.
- Specialized information will be provided to media spokespersons, SPEC partners and FedState/Governmental Liaisons advising how taxpayers can claim this tax benefit by filing an amended return, Form 1040X (Amended U.S. Individual Income Tax Return).
- Localized news releases with similar content will be issued in the seven states with no State income tax.

IMPLEMENTATION DATE
April 15, 2008

RESPONSIBLE OFFICIAL
Director, Communications, W&I Division

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 3
The Commissioner, W&I Division, should ensure the Form 8917 is timely finalized prior to the start of the 2008 Filing Season and is required for all taxpayers claiming the deduction for TY 2007.

CORRECTIVE ACTION
We agree with this recommendation. Form 8917 (Tuition and Fees Deduction) has been developed for the 2008 filing season. The release of the new form is on schedule and should be available to the public by December 15, 2007.

IMPLEMENTATION DATE
January 15, 2008

RESPONSIBLE OFFICIAL
Director, CARE, Media and Publications, W&I Division

CORRECTIVE ACTION MONITORING PLAN
We will monitor this corrective action as part of our internal management control system.