



*Combat Zone Indicators on Taxpayer
Accounts Are Frequently Inaccurate*

September 23, 2009

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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.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 23, 2009

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Combat Zone Indicators on Taxpayer Accounts
Are Frequently Inaccurate (Audit # 200940015)

This report presents the results of our review of the Internal Revenue Service (IRS) processing of Combat Zone indicators. The overall objective of this review was to assess the IRS actions to ensure the accuracy of Combat Zone indicators. This audit was conducted as part of the Treasury Inspector General for Tax Administration Fiscal Year 2009 Annual Audit Plan related to the major management challenge of Taxpayer Protection and Rights.

Impact on the Taxpayer

In recognition of the dangers that members of the military face and the sacrifices they make on behalf of the United States, special Federal income tax benefits are extended to members of the military. These benefits include the exclusion of combat pay from taxation and extension of time to file tax returns and pay taxes. While civilian employees supporting the military in combat zones are not entitled to the Combat Zone military pay exclusion, they are entitled to other benefits, such as extensions of time to file and pay. To identify these taxpayers, the IRS places Combat Zone indicators on their tax accounts. However, we found that Combat Zone indicators are often inaccurate, which can result in taxpayers not receiving the benefits to which they are entitled or continuing to receive special tax benefits to which they are no longer entitled.

Synopsis

The Treasury Inspector General for Tax Administration has previously identified problems with the accuracy of Combat Zone indicators. Despite the IRS implementing a number of actions to help ensure the accuracy of Combat Zone indicators, there are still significant problems with inaccurate indicators. Our review identified that Combat Zone indicators are inaccurate because



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the IRS is incorrectly updating Combat Zone indicators to active status when a military member self-identifies on their tax return that they served in a combat zone. Our analysis showed 339,027 taxpayers had an active Combat Zone indicator in Tax Year 2007 but were no longer in a combat zone. The IRS initially reversed the Combat Zone indicator for the 339,027 taxpayers based on the exit date received from the Department of Defense (DOD) indicating that these individuals were no longer in a combat zone. However, the 339,027 taxpayers subsequently filed tax returns¹ and annotated “Combat Zone” on the tax returns. The IRS reactivates the Combat Zone indicator to active status when a taxpayer annotates “Combat Zone” on the tax return even though the taxpayer is no longer in a combat zone.

***We estimate at least
339,000 Combat Zone indicators
could be inaccurate.***

In addition, Combat Zone indicators used by the IRS do not distinguish between military and civilian taxpayers. As a result, civilians can receive Combat Zone tax relief benefits to which they are not entitled. The IRS also cannot identify for married individuals filing a joint tax return which individual(s) is/are in the military. This again results in the IRS not ensuring the accuracy of tax benefits being provided.

Further, unpostable conditions are not accurately resolved when there is a problem posting the entry/exit dates provided by the DOD. Our review of 5 months of DOD Combat Zone transactions for Tax Year 2007 identified 1,720 (1 percent) of 185,685 military members’ Social Security Numbers did not match an IRS tax account; therefore, no indicator could be activated. Although the IRS has the ability to identify these unpostable records, it has not established a process to resolve them. As a result, Combat Zone indicators are not being placed on an individual’s account when they enter a combat zone and/or are not being reversed when they exit a combat zone.

Finally, actions are not taken at the time an individual self-identifies to validate Combat Zone service. A taxpayer can identify that he or she is in a combat zone by annotating their tax return or calling or emailing the IRS. The IRS requires no documentary evidence to support an individual’s self-identification that they are serving in a combat zone.

The IRS established a Combat Zone Task Force in November 2008 to evaluate processing concerns relating to combat pay exclusions. The Task Force is comprised of various divisions within the IRS to address issues with Combat Zone processing. The goal of the Task Force is to analyze the current process for handling Combat Zone taxpayers and identify areas for improvement.

¹ These may include individuals who leave the military and then become employed as a contractor working in a combat zone. However, the IRS does not have the data to make this determination.



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Since establishing the Combat Zone Task Force, a number of actions have been initiated in an attempt to improve the program. For example, IRS management indicated that Filing Season 2009 guidelines were revised to include a process to identify individuals who are incorrectly excluding Combat Zone pay. In addition, the IRS is coordinating with the DOD to obtain a list of contractors serving in a combat zone and is exploring options to prevent returns that have “Combat Zone” annotated on them from posting to the taxpayer’s account when the account shows current DOD activity.

Recommendations

We recommended that the Commissioner, Wage and Investment Division, develop processes to distinguish military taxpayers from civilian taxpayers, properly identify individuals who are in the military that file a joint tax return, and ensure indicators are properly reversed. The IRS should also discontinue providing the option to self-identify by annotating a tax return. Further, the IRS should review the accounts of individuals not filing a tax return as the result of an inaccurate indicator, identify and resolve unpostable records from the DOD, validate Combat Zone service at the time an individual self-identifies, and develop a secure fillable form with the required data fields to improve electronic self-identification.

Response

The Commissioner, Wage and Investment Division, agreed with or agreed to take action on 9 of 10 recommendations. These actions include working with the IRS Modernization and Information Technology Services organization to improve the existing process that identifies which individual(s) is/are in a combat zone, particularly if a taxpayer files jointly with their spouse. The IRS is also working with the Modernization and Information Technology Services organization to ensure the accurate reversal of Combat Zone indicators when an exit date is received from the DOD for those individuals who file a joint tax return but do not maintain the same order of primary and secondary taxpayer. While the IRS is considering several alternatives to the existing self-identification process, self-identification on tax returns will be discontinued only after the IRS is certain other means of identification are adequate. The IRS will consider the option of establishment of a secure fillable form for self-identification by email. Other actions by the IRS include developing solutions to address incorrect reactivation of Combat Zone indicators, reviewing 475 nonfiler accounts through its transcript process, developing a process to capture dropped records, and establishing resolution procedures when records do not post. The IRS will also take corrective actions to resolve the 458 Combat Zone transactions that posted to invalid Social Security Numbers.

The Commissioner, Wage and Investment Division, disagreed with our recommendation to develop a process to distinguish military taxpayers from civilian taxpayers. The IRS believes that it already has a means for distinguishing between military and civilian taxpayers and the



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creation of an additional process to distinguish military taxpayers from civilian taxpayers would not assist it in determining the benefits to which the taxpayer may be entitled. The IRS implemented new procedures in Fiscal Year 2009 for processing returns to ensure only taxpayers entitled to Combat Zone income exclusions receive that benefit. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment

IRS management indicated that they have the ability to distinguish between military and civilian taxpayers. We acknowledge that the IRS can identify military individuals via the information received monthly from the DOD. However, as our report details, the IRS uses the same indicator for both military and civilian taxpayers. Once this indicator is set on the accounts of civilian taxpayers, it could allow the civilian taxpayers to inappropriately exclude income without action by the IRS because the IRS will not review accounts with unreported income if a Combat Zone indicator is present. We cannot comment at this time on management's assertion that new procedures were implemented to ensure accuracy of income reporting by individuals in a combat zone because these procedures were implemented subsequent to our review.

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 (Returns Processing and Account Services), at (202) 622-5916.



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Abbreviations

DOD	Department of Defense
FY	Fiscal Year
IMF	Individual Master File
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
MITS	Modernization and Information Technology Services
SSN	Social Security Number
TIGTA	Treasury Inspector General for Tax Administration
U.S.	United States
W&I	Wage and Investment



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Background

In recognition of the dangers that members of the military face and the sacrifices they make on behalf of the United States (U.S.), special Federal income tax benefits have been extended to members of the military since the inception of modern taxation. Section (§) 112 of the Internal Revenue Code (I.R.C.)¹ excludes from gross income compensation paid to noncommissioned U.S. Armed Forces personnel serving in a combat zone and excludes a portion of the compensation paid to commissioned officers of the U.S. Armed Forces.

In recognition of the dangers that members of the military face and the sacrifices they make on behalf of the United States, special Federal income tax benefits have been extended to members of the military since the inception of modern taxation.

Civilian contractors and other civilian employees working in a combat zone are not eligible for the Combat Zone tax exclusion provided by I.R.C. § 112. While civilian employees' pay is taxable, I.R.C. § 7508² postpones certain tax-related acts for individuals serving in the U.S. Armed Forces or serving in support of the Armed Forces in a combat zone. These benefits are generally extended for the period of time the individual is in a combat zone and are further extended for other reasons including periods of hospitalization due to injury or illness received while in a combat zone.

Military tax benefits for those serving in a combat zone include exclusion of Combat Zone wages from taxation and postponement of filing tax returns, paying taxes, filing claims for refunds, enforcement activities,³ and other actions. Civilians who support the U.S. Armed Forces, such as Red Cross employees, industrial technicians, accredited correspondents, and Federal Government specialists can qualify for some Combat Zone tax benefits. This would include extensions of time to file tax returns, pay taxes, and claim refunds; suspension of enforcement activities; and suppression of notices. The main difference between military and civilian benefits is that ***civilians are not entitled to the Combat Zone military pay exclusion.***⁴

Once the Internal Revenue Service (IRS) receives notification that an individual is in a combat zone, a Combat Zone indicator⁵ is placed on the taxpayer's account extending the due dates for filing tax returns and paying taxes, etc. The indicator stays active on the taxpayer's account until

¹ I.R.C. § 112 (2008).

² I.R.C. § 7508 (2008).

³ Enforcement activities include examinations and actions to collect outstanding taxes.

⁴ Civilians are not entitled to the Combat Zone military pay income tax exclusion, but still may be able to exclude income under the Foreign Earned Income Exclusion if they meet the requirements.

⁵ An indicator is placed on the taxpayer's account to alert IRS employees the taxpayer is or has been in a combat zone.



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the IRS receives notification the taxpayer is no longer in a combat zone, at which time the indicator is deactivated and normal processing of the account resumes.

The IRS is alerted of a taxpayer's Combat Zone status by notification from the Department of Defense and/or self-identification

The IRS is notified of individuals serving in a combat zone from:

- **Department of Defense (DOD)** – The DOD sends monthly electronic extracts to notify the IRS when a military taxpayer enters or leaves a combat zone and which combat zone the taxpayer is serving. Specific entry and exit dates are provided by the DOD. Based on the DOD information, the IRS updates an individual's tax account by adding or reversing the Combat Zone indicator.
- **Self-identification** – There are three ways a taxpayer may self-identify:
 - Taxpayers can write "Combat Zone" on their paper tax return or enter "Combat Zone" in a special field on the electronically filed tax return. On receipt of such a tax return, the IRS inputs a transaction to the taxpayer's account to update the Combat Zone indicator so that the individual receives Combat Zone tax relief benefits.
 - Taxpayers can call the IRS toll-free telephone number used specifically for disaster and Combat Zone calls. During Fiscal Years (FY) 2006 and 2007, the IRS received more than 210,000 calls on this special toll-free telephone number. The toll-free telephone line also provides taxpayers with answers to Combat Zone tax questions and account-related inquiries.
 - Taxpayers can send notification using a unique email address of combatzone@irs.gov. As with calls to the toll-free telephone line, an IRS employee inputs the Combat Zone indicator to the taxpayer's account and also adds the entry/exit dates. Also similar to the service provided by the toll-free telephone line, taxpayers can receive answers to Combat Zone general tax questions.

A prior review identified control weaknesses resulting in inaccurate Combat Zone indicators

A prior Treasury Inspector General for Tax Administration (TIGTA) review⁶ found that more than 58 percent of the 520,000 taxpayer accounts with active Combat Zone indicators were incorrect (i.e., the taxpayers were no longer serving in a combat zone). Errors created when updating the DOD information on taxpayers' accounts were not resolved. These errors occurred for various reasons, such as missing information or mismatches between Social Security

⁶ *Taxpayers Identified As Serving in Combat Zones Were Properly Afforded Tax Benefits, but Account Identification and Maintenance Processes Need Improvement* (Reference Number 2005-40-077, dated April 28, 2005).



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Numbers (SSN) and names. In addition, the IRS ceased running the annual Combat Zone verification program to periodically review the accounts with Combat Zone indicators to ensure accuracy.

In response to our prior review, the IRS indicated that it had corrected the programming for downloading entry and exit dates received from the DOD. The program now checks a taxpayer account for a corresponding entry date and posts the exit date to that module (a module is for a specific tax year) and includes a verification check of entity data prior to the download. The IRS also initiated a one-time cleanup by systemically identifying and reversing the indicator on 203,485 accounts with an entry date more than 3 years old and no exit date.

The IRS continues to recognize the need to improve its Combat Zone program. In November 2008, the IRS established a Combat Zone Task Force. The Task Force is comprised of various divisions within the IRS to address issues with Combat Zone processing. The goal of the Task Force is to analyze the current process for handling Combat Zone taxpayers and identify areas for improvement. For example, IRS management indicated that Filing Season 2009 guidelines were revised to include a process to identify individuals who are incorrectly excluding Combat Zone pay. In addition, the IRS has approved other initiatives that are still in process, such as working with the DOD to obtain a Combat Zone file for contractors serving in a combat zone. Further, the IRS is considering other proposals to improve the Combat Zone program. For instance, the IRS is exploring options to prevent returns that have "Combat Zone" annotated on them from posting to the taxpayer's account when the account shows current DOD activity.

This review was performed at the offices of the IRS Wage and Investment (W&I) Division Compliance function in Atlanta, Georgia, and Accounts Management worksites in Andover, Massachusetts, and Ogden, Utah, during the period January through July 2009. Our review included a discussion with the DOD Defense Manpower Data Center.⁷ 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.

⁷ The Defense Manpower Data Center collects, archives, and maintains accurate, readily available manpower and personnel data, as well as financial databases for the DOD.



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Results of Review

Our review identified that the IRS cannot differentiate between military and civilian taxpayers in combat zones because they use the same Combat Zone indicator in both cases. As a result, civilians can receive Combat Zone tax relief benefits to which they are not entitled (i.e., exclusion of income). Also, Combat Zone indicators continue to be inaccurate. For example, of the approximately 845,000 taxpayers with an active Combat Zone indicator on their tax account for Tax Year⁸ 2007, we estimate approximately 339,000 (40 percent) of the taxpayers' Combat Zone indicators could be inaccurate. In addition, the IRS does not verify the accuracy of individuals self-identifying that they are in a combat zone. The inaccuracy of the indicators continues despite the IRS' actions to ensure the accuracy of Combat Zone indicators. These actions included:

***We estimate at least
339,000 Combat Zone
indicators could be
inaccurate.***

- ***Initiating a one-time cleanup of accounts with a Combat Zone entry date more than 3 years old and no exit date.*** The IRS identified accounts with a Combat Zone entry date more than 3 years old and no exit date. The IRS had not worked transcripts for 3 years and a one-time cleanup in May 2005 was performed to turn off the Combat Zone indicators of accounts with an entry date more than 3 years old and no exit date. The IRS identified and reversed the Combat Zone indicators on 203,485 of the 520,000 taxpayer accounts with an active indicator at that time.
- ***Restarting the process of generating Combat Zone transcripts.***⁹ In May 2005, the IRS elected to restart the process of generating annual Combat Zone transcripts so that taxpayers' accounts with Combat Zone indicators would be reviewed and corrected as needed. The IRS mails letters to taxpayers requesting their Combat Zone service dates to determine whether the taxpayers qualify for Combat Zone tax benefits and, if not, deactivates their Combat Zone indicators so that IRS collection/compliance activities are no longer restricted.

The IRS has also proposed actions to take place at the end of FYs 2009 and 2010 that will further assist in maintaining the accuracy of Combat Zone indicators. These include:

- ***Automating Combat Zone programming.*** The IRS has initiated actions to automate Combat Zone programming, effective October 1, 2009. Proposed actions include

⁸ Tax Year is the period of time for which a tax return is filed.

⁹ Combat Zone transcripts refer to a list of tax accounts with Combat Zone indicators where the Combat Zone entry dates are more than 3 years old and have no Combat Zone exit date.



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automating the issuance of Request for Combat Zone Service Dates (Letter 2761C) when Combat Zone transcripts are generated. The Letter 2761C is a notice sent to the taxpayer who has an active indicator older than 3 years, and beginning in FY 2010 older than 2 years. The computer-generated letter is mailed to the taxpayer to find out the dates of their Combat Zone service. The IRS anticipates the automation will reduce the volume of Combat Zone transcripts and thus require fewer resources.

- **Modifying the generation of Combat Zone transcripts.** Beginning in FY 2010, the IRS will generate transcripts monthly rather than annually and will begin issuing transcripts of accounts with unreversed Combat Zone entry dates 2 years and older instead of 3 years and older.

The Combat Zone Indicator Used by the Internal Revenue Service Does Not Distinguish Between Military and Civilian Taxpayers

The IRS cannot differentiate between military and civilian taxpayers because it uses the same Combat Zone indicator for both. Figure 1 provides a comparison of benefits to which military members and civilians working in a combat zone are entitled.

Figure 1: Comparison of Combat Zone Tax Relief Benefits Afforded to Military Service Members and Civilians

COMBAT ZONE BENEFITS	MILITARY SERVICE MEMBER		CIVILIAN
	Enlisted Member, Warrant Officer, Commissioned Warrant Officer	Commissioned Officer	
Exclusion of military pay for service in a Combat Zone	YES	YES (partial wages)	NO
Extension of filing deadlines for service in a Combat Zone	YES	YES	YES
Include nontaxable Combat Zone pay to qualify for Earned Income Tax Credit	YES	YES	NO
Forgiveness of decedent's tax liability due to Combat Zone activity	YES	YES	NO (Non-Federal Civilian Employee)

Source: The IRS Armed Forces' Tax Guide (Publication 3), Internal Revenue Manual Section 5.19.1.4.10, and the IRS web site (IRS.gov).



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The IRS has not established a process to distinguish between members of the military and civilians serving in combat zones. As a result, civilians can receive Combat Zone tax relief benefits to which they are not entitled.

Recommendation

Recommendation 1: The Commissioner, W&I Division, should develop a process to distinguish military taxpayers from civilian taxpayers.

Management's Response: IRS management disagreed with this recommendation. The IRS already has a means for distinguishing between military and civilian taxpayers. When the IRS receives information from the DOD, Transaction Code 500 posts to the account with the number "8" or "9" in the 6th through 13th positions of the Document Locator Number of that transaction. If there is no "8" or "9," the IRS knows the taxpayer self-identified or made contact with the IRS and is not currently serving in the U.S. Armed Forces.

Management stated that the creation of an additional process to distinguish military taxpayers from civilian taxpayers would not assist the IRS in determining the benefits to which the taxpayer may be entitled. The IRS implemented new procedures in FY 2009 for processing returns to ensure only taxpayers entitled to Combat Zone income exclusions receive that benefit. Wage and Tax Statements (Form W-2) are checked for a military payor when income is excluded and a math error notice is generated to disallow the exclusion if the taxpayer makes an inappropriate claim. Revising the IRS' initial returns processing procedures to exclude inappropriate Combat Zone income exclusion claims minimizes the need for more costly and time consuming case analysis after the return has been processed.

Office Audit Comment: IRS management indicated that they have the ability to distinguish between military and civilian taxpayers. We agree that the IRS can identify military individuals via the information received monthly from the DOD. However, as our report details, the IRS uses the same indicator for both military and civilian taxpayers. Once this indicator is set on the accounts of civilian taxpayers, it could allow the civilian taxpayers to inappropriately exclude income without action by the IRS because the IRS will not review accounts with unreported income if a Combat Zone indicator is present. We cannot comment at this time on management's assertion that new procedures were implemented to ensure accuracy of income reporting by individuals in a combat zone because they were implemented subsequent to our review.



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Combat Zone Indicators Are Not Always Accurate for Married Military Couples

The IRS cannot identify for married individuals filing a joint tax return which individual(s) is/are in the military. As a result, the IRS cannot ensure the accuracy of tax benefits being provided or that the Combat Zone indicator is properly reversed when necessary.

The Combat Zone indicator does not indicate which spouse is in the combat zone on joint-filed tax returns

Military couples including the spouse not serving in a combat zone are entitled to tax relief benefits. However, the income exclusion applies only to the individual serving in a combat zone. Since the IRS is unable to identify which spouse is in a combat zone, it cannot ensure the accuracy of tax benefits are provided.

*In Tax Year 2003, a military couple files their tax return with a filing status of “married filing jointly” with the **wife** listed on the name line of the tax return as the **first** taxpayer and the **husband** as the **second** taxpayer. In Tax Year 2004, the military couple also files “married filing jointly” but the **wife** is now listed on the name line of the tax return as the **second** taxpayer and the **husband** as the **first** taxpayer. In this scenario, only the husband served in a combat zone. The DOD supplies the IRS with the Combat Zone entry/exit dates for the husband’s Combat Zone tour and provides no Combat Zone information for his wife because she was not in a combat zone. The wife as a spouse is entitled to Combat Zone tax benefits; however, her income is taxable. To address the spouse’s Combat Zone tax benefits, the IRS enters DOD Combat Zone information not only on the husband’s tax account but also on the wife’s tax account. While the husband’s tax account and the wife’s tax account each have a Combat Zone indicator, the use of the same codes for their Combat Zone indicators prevents the IRS from determining whether the husband, wife, or both served in a combat zone.*

Scenario

Combat Zone indicators are not accurately reversed for married individuals filing a joint tax return

Our judgmental sample of 50 taxpayers from the 26,846 taxpayers with military Combat Zone service on the Cycle 43 Combat Zone Transcript Listing issued October 19, 2008, identified for 27 (54 percent) of the 50 taxpayers the Combat Zone indicator was not correctly reversed based on notification from the DOD. These errors resulted from the IRS’ inability to accurately identify the individual(s) for whom the Combat Zone indicator was originally assigned. Part of the problem is due to whether taxpayers on a joint return are shown as the primary or secondary taxpayer, which is solely based on who is listed first and second on the tax return. The following scenario provides an example of the problem:



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Scenario

Married individuals jointly file their Tax Year 2003 tax return with the husband listed as the **second** taxpayer and the wife listed as the **first** taxpayer on the name line of the tax return. The husband is in the military and deployed to a combat zone. Although his wife is not in a combat zone, she is entitled to the Combat Zone tax benefits except for the income exclusion. The DOD provides the IRS with his Combat Zone entry date and the IRS posts that date to the husband's and wife's tax accounts to activate their Combat Zone indicators. The couple then jointly files their Tax Year 2004 tax return. However, for this filing the couple is in a different order with the wife now listed as the **second** taxpayer and the husband listed as the **first** taxpayer on the tax return. The DOD subsequently provides the IRS with an exit date of when the husband leaves the combat zone. However, because the couple was listed in a different order than when the indicator was established, the IRS is unable to reverse their Combat Zone indicators.

The IRS stated that programming of Combat Zone transactions for military married couples is based on the order of the husband's and wife's names/SSNs on their tax return, not on the DOD Combat Zone status of the spouse in the combat zone. In past conflicts, the IRS did not receive Combat Zone data from the DOD for military members; rather, it relied exclusively on military members to alert the IRS of their Combat Zone service by annotating "Combat Zone" on their tax returns. However, this process did not work well because the IRS only knew that a military member was in a combat zone and had no way of knowing when they exited the combat zone. This weakness prompted the IRS to obtain Combat Zone entry/exit dates directly from the DOD for military members. When military taxpayers jointly file a tax return and alternate the order of the first taxpayer and second taxpayer on the tax return, this prevents the Combat Zone indicator from being deactivated to reflect the spouse's exit from the combat zone.

Recommendations

The Commissioner, W&I Division, should:

Recommendation 2: Improve the process for identifying joint filers serving in the military to properly identify which individual(s) is/are in a combat zone to ensure appropriate enforcement actions are taken.

Management's Response: IRS management agreed with this recommendation. The W&I Division is working with Modernization and Information Technology Services (MITS) organization to improve the existing process that identifies which individual(s) is in a combat zone, particularly if a taxpayer files jointly with his or her spouse. Once an agreeable solution is reached, the necessary Unified Work Request will be submitted to the MITS organization.



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Recommendation 3: Improve the process for ensuring that Combat Zone indicators are reversed when an exit date is received from the DOD for those individuals who file a joint tax return but do not maintain the same order of primary and secondary taxpayer.

Management's Response: The IRS agreed with this recommendation. The W&I Division is working with the MITS organization to ensure the accurate reversal of Combat Zone indicators when an exit date is received from the DOD for those individuals who file a joint tax return, regardless of whether they maintain the same order of primary and secondary taxpayer. Once an agreeable solution is reached, the necessary Unified Work Request will be submitted to the MITS organization.

Combat Zone Indicators for Taxpayers Serving in the Military Are Inaccurate

Our review identified that Combat Zone indicators are not accurate for military members. Inaccurate indicators result from processes not being established to ensure:

- Indicators are not updated to an active status based on taxpayers self-identifying that they are in a combat zone by an annotation on their tax returns.
- Unpostable conditions are accurately resolved resulting from the IRS being unable to post entry/exit dates provided by the DOD.

Inaccurate Combat Zone indicators can result in military taxpayers not receiving the benefits to which they are entitled or continuing to receive special tax benefits to which they are no longer entitled.

Indicators are incorrectly updated based on self-identification

Many Combat Zone indicators are inaccurate because the IRS is incorrectly updating Combat Zone indicators to active status when a military member self-identifies on their tax return that they served in a combat zone. Our analysis showed 339,027 had an active Combat Zone indicator in Tax Year 2007 but were no longer in a combat zone. The IRS initially reversed the Combat Zone indicator from an active status for the 339,027 taxpayers based on the exit date received from the DOD indicating that these individuals were no longer in a combat zone. However, the 339,027 taxpayers subsequently filed tax returns¹⁰ and annotated "Combat Zone" on their tax returns. As a result of the taxpayer annotating "Combat Zone" on their tax return, the IRS incorrectly reactivates the Combat Zone indicator to an active status even though the taxpayer is no longer in a combat zone.

¹⁰ These may include individuals who leave the military and then become employed as a contractor working in a combat zone. However, the IRS does not have the data to make this determination.



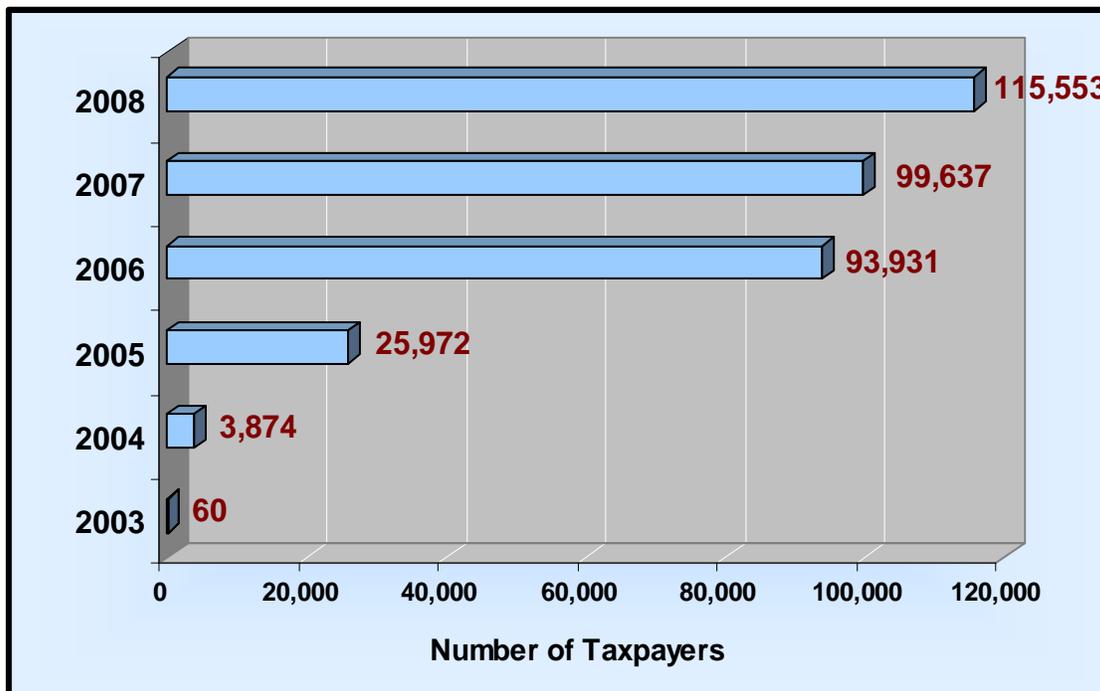
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Individuals serving in the military are directed to annotate “Combat Zone” on their tax returns. Specifically, in 2003, the IRS created a new section on its web site containing important information to help ensure members of the U.S. Armed Forces serving in a combat zone receive all of the tax benefits available to them. This section of the web site for the U.S. Armed Forces included the following instructions for filing a return:

When filing returns, mark “Combat Zone” at the top of the form along with the date of deployment.

Annotating the tax return is not necessary for individuals in the military because the DOD provides information to the IRS regarding the entry and exit dates from a combat zone. In fact, annotating the tax return is resulting in the IRS incorrectly reactivating the designation to an active status. Figure 2 shows the number of taxpayer accounts for which the Combat Zone indicator was incorrectly reactivated because the taxpayer annotated the return with “Combat Zone” (the figure shows the number of taxpayer accounts by Processing Year,¹¹ the total number for the 6 years is 339,027).

Figure 2: Number of Taxpayer Accounts in Which the Combat Zone Indicator Was Incorrectly Reactivated (by Processing Year)



Source: TIGTA analysis of the self-identifying returns filed by 339,027 taxpayers.

¹¹ Processing Year is the calendar year in which the return was processed by the IRS.



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In an attempt to ensure the accuracy of Combat Zone indicators, each year the IRS generates a list of Combat Zone transcripts of those accounts with active Combat Zone indicators and an entry date 3 years or older. Tax examiners then communicate with these individuals to confirm whether they are still in an active combat zone. Our review of the list generated on October 19, 2008, identified that 32,440 (33 percent) of the 99,432 accounts were added as a result of the IRS reactivating the Combat Zone indicator based on the taxpayer filing a tax return and annotating “Combat Zone.” The IRS expended \$437,000¹² to resolve these cases.¹³ If the IRS does not initiate actions to ensure Combat Zone indicators are not reactivated, it could expend an estimated \$2.2 million over 5 years to resolve accounts that were added to the list because of inaccurate updates based on self-identification.

Incorrect reactivation of Combat Zone indicators causes improper tax benefits

The 339,027 taxpayers¹⁴ with a Combat Zone indicator which was incorrectly reactivated received tax benefits to which they were not entitled. For example:

- 1,960 taxpayers had 2,360 tax modules that were identified by the Nonfiler Program¹⁵ as potentially not reporting their income. However, because the Combat Zone indicator had been incorrectly reactivated, these individuals were not contacted.
- 505 taxpayers in Tax Year 2006 or prior did not file a tax return for Tax Year 2006. Further, 475 of the 505 nonfilers in Tax Year 2006 earned wages totaling \$19,365,179 that were not reported. We estimate that 288 of 475 nonfilers potentially owe a total of \$1,100,702 in taxes¹⁶—15 of the taxpayers had taxable income of more than \$100,000 each.

Based on our analysis of the returns for Tax Year 2006, nearly all of the individuals who self-identified by annotating their tax return were military taxpayers, as illustrated by Figure 3.

¹² Dollar amount has been rounded to the nearest thousand.

¹³ Appendix IV shows the methodology for calculating the costs incurred for working the 32,440 transcripts.

¹⁴ Appendix IV shows the methodology for identifying the 339,027 taxpayers with a potentially erroneous reactivated Combat Zone indicator.

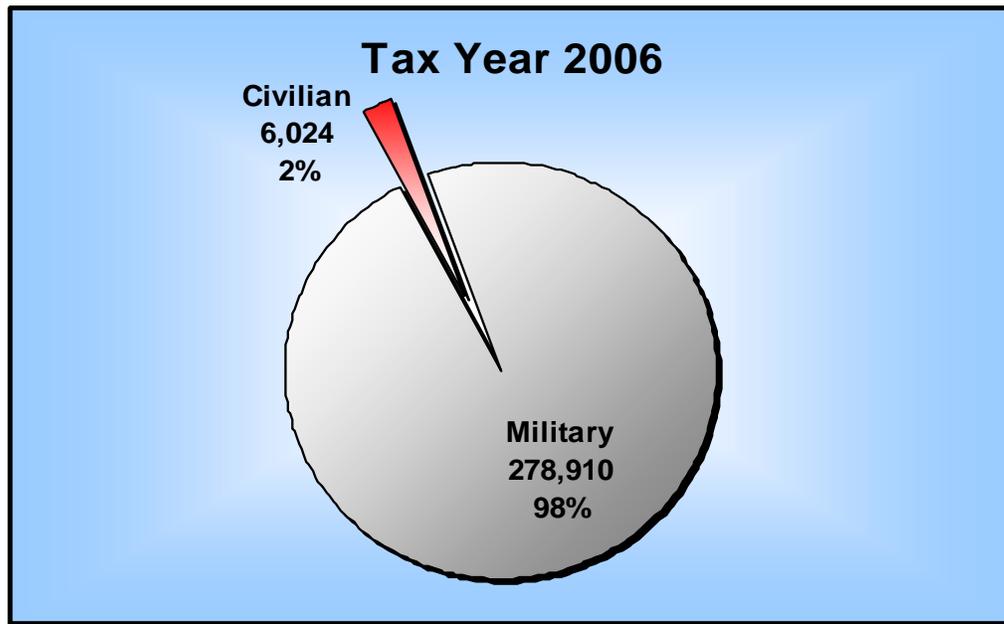
¹⁵ The Nonfiler Program identifies taxpayers who have not filed a tax return by the return due date or the extended due date.

¹⁶ We used this formula to compute potential tax owed by the 288 nonfilers: (Taxpayer’s wages on Tax Year 2006 Form W-2) – (Tax Year 2006 Standard Deduction for Single Taxpayer) – (Tax Year 2006 Exemption for Taxpayer Claiming Self) = Taxable Income. Using the Taxpayer’s Taxable Income, we calculated Tax Due using the 2006 Tax Table. (Tax Due) – (Federal Income Tax Withheld on Tax Year 2006 Form W-2) = Tax Owed.



*Combat Zone Indicators on Taxpayer Accounts
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Figure 3: Type of Taxpayer Self-Identifying “Combat Zone” Service



Source: TIGTA analysis of 284,934 taxpayers filing 2006 tax returns with “Combat Zone” annotated on them.

We recommend that the IRS discontinue providing the option of annotating tax returns with “Combat Zone.” The DOD provides information on entry and exit dates from a combat zone to the IRS on a monthly basis. In addition, it causes problems because military taxpayers file their tax returns after they return from a combat zone. By the time a military taxpayer files their tax return, the IRS has already updated the Combat Zone indicator based on information received from the DOD. The IRS should continue to provide individuals with the option of self-identifying by telephone or electronically.

Recommendations

The Commissioner, W&I Division, should:

Recommendation 4: Discontinue providing the option to taxpayers of self-identifying by annotating a tax return with “Combat Zone” and continue to provide individuals with the option of self-identifying by telephone or electronically.

Management’s Response: IRS management partially agreed with this recommendation. The IRS allows taxpayers multiple options to self-identify as being in a combat zone to make sure it does not take inappropriate enforcement actions or inaccurately deny claimed tax benefits to which these taxpayers are entitled.



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The IRS is considering several alternatives to the existing self-identification process. While it is important to ensure only taxpayers that are entitled to the Combat Zone provisions of the Tax Code are given those tax advantages, it is also important that the IRS not deny anyone those benefits without proper handling of their account. The IRS will discontinue allowing taxpayers to self-identify on the returns only after it is certain that other means for identification are adequate.

Recommendation 5: Take action to correct the 339,027 taxpayers with inaccurate Combat Zone indicators that were incorrectly reactivated.

Management's Response: IRS management disagreed that all of the 339,027 taxpayers were incorrectly reactivated. The IRS will address these cases through its transcript process. However, the IRS is developing other solutions that may allow it to resolve this issue in a more expeditious manner. These solutions include reducing the amount of time before the IRS generates a transcript, updating Internal Revenue Manual procedures for transcript processing, developing automation tools to process the transcripts more efficiently/expeditiously, and tightening Submission Processing function procedures to identify incorrect exclusion of income when the return is received and processed.

Office Audit Comment: It is not clear why the IRS disagrees that all 339,027 taxpayers were incorrectly reactivated as no information was provided to support its disagreement. In fact, the Commissioner, W&I Division, plans to work all of these cases through the transcript process.

Recommendation 6: Review the 475 nonfiler accounts to determine if notification or compliance actions are needed.

Management's Response: IRS management agreed with this recommendation. The 475 nonfiler accounts are a subset of the 339,027 accounts cited in Recommendation 5. Thus, to the extent possible, the IRS will work these cases through its transcript process but, as noted above, the IRS is developing other, more expeditious means of solving these cases.

Unpostable Conditions for Entry/Exit Dates Provided by the Department of Defense Are Not Accurately Resolved

Our analysis of 5 months of DOD Combat Zone transactions for Calendar Year 2007¹⁷ identified that 1,720 (1 percent) of 185,685 military members' SSNs included in these files did not match

¹⁷ This was the most current information available at the time we conducted our testing.



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an IRS tax account and, as a result, no indicator could be activated.¹⁸ In May 2009, the IRS identified that 495 of 107,316 DOD Combat Zone transactions did not post for various reasons, such as the taxpayer not filing a tax return. Although the IRS has the ability to identify these unpostable records, the IRS has not established a process to resolve them. As a result, Combat Zone indicators are not being placed on an individual's account when they enter a combat zone and/or are not being reversed when the individual exits a combat zone.

When posting DOD Combat Zone transactions to an individual's tax account, the IRS drops those transactions that it is not able to post (entry or exit date) to an individual's tax account. The IRS does not maintain a record of those transactions that are dropped and no actions are initiated in an attempt to resolve the mismatch including notifying the DOD of the mismatch.

In addition, our analysis showed that 458 DOD Combat Zone entry/exit transactions after Tax Year 2001 were posted to the accounts of individuals using invalid SSNs.¹⁹ For example, a Combat Zone transaction for a taxpayer posted to a different taxpayer's account because both taxpayers used the same SSN when filing a tax return, creating a valid and an invalid account for that SSN. The IRS performs limited validation testing of DOD Combat Zone data prior to uploading the information to military taxpayer's accounts, only verifying military members' SSNs are nine-digit numbers. The IRS needs to revise its validation process to check the validity of the SSNs by performing a name control/SSN check and running the DOD data against the National Account Profile²⁰ to ensure information is being posted correctly.

Recommendations

The Commissioner, W&I Division, should:

Recommendation 7: Develop a process to identify and resolve unpostable records when entry and exit date information provided by the DOD is unable to be posted to an individual's tax account.

Management's Response: IRS management agreed with this recommendation and is working with the MITS organization and the Submission Processing function to develop a process to capture these dropped records and establish procedures to resolve why they could not post to the Master File.

¹⁸ The TIGTA analysis was performed by matching Combat Zone entry dates from Calendar Year 2007 DOD Combat Zone data against the IRS database of individuals' tax transactions based upon their SSNs.

¹⁹ An SSN on a tax return that does not pass validity checks on the IRS computer system is considered invalid.

²⁰ The National Account Profile is a compilation of selected taxpayer identifying information from various IRS Master Files. There is also Social Security Administration data and cross reference data on the National Account Profile, making it possible to verify taxpayers who have no primary Master File account. The Master File is the IRS database that stores various types of taxpayer account information.



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Recommendation 8: Take actions to resolve the 458 DOD Combat Zone transactions posted to invalid SSNs and revise the DOD validation process to ensure accurate posting of entry and exit date information.

Management's Response: IRS management agreed with this recommendation. The IRS is working with the Submission Processing function to take corrective actions to resolve the 458 DOD Combat Zone transactions that posted to invalid SSNs. The IRS is also working with the MITS organization and the Submission Processing function to examine the existing DOD validation process and make changes as needed.

The Accuracy of Information Is Not Verified From Individuals Who Self-Identify That They Are Serving in a Combat Zone

The IRS requires no documentary evidence to support an individual's claim of being in a combat zone at the time they self-identify. The following examples show that the IRS does not verify whether the individual is serving in a combat zone and is in fact entitled to special tax benefits.

Instructions for IRS employees processing a tax return with self-identification:

Take the following actions when a military operation is noted on the return:

If the taxpayer notes	And the Tax Year is	Then
"Combat Zone" or similar statement	2001 or later	Edit return with special code for Combat Zone

Instructions for IRS employees processing self-identification by telephone or email:

Employees are responsible for ensuring the transaction code with the appropriate entry date and closing code (if applicable) are input on an account identified as Combat Zone.

It does not matter whether the notification is received by phone or email but each action taken, why it was taken and what additional actions are/were required to resolve the case must be documented on Desktop Integration.²¹

If the taxpayer doesn't know the entry date, use the date of the phone call or email.

Similar to the processing of tax returns with a Combat Zone annotation, the IRS instructions for handling toll-free telephone calls and emails include no requirement to secure documentary evidence of a taxpayer's Combat Zone service. The IRS generally accepts a taxpayer's assertion

²¹ Desktop Integration provides multiple systems interfaces, using only one computer terminal, moving organizations towards an integrated desktop. Functionality includes inventory management, next case delivery, nationwide history, and followup.



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of Combat Zone service as acceptable proof that the taxpayer is entitled to the Combat Zone special tax treatment.

Establishing a secure fillable form to replace email could reduce taxpayer burden

We commend the IRS for offering an email option for taxpayers to self-identify that they are in a combat zone. However, our review of the process identified that the process does not provide one-stop service. In fact, the process requires a number of contacts between the IRS and the taxpayer. The following scenario provides an example:

Scenario

A taxpayer submits an email to inform the IRS of his or her presence in a combat zone, and includes his or her stateside address in the email. However, the information in the email is insufficient for the IRS to locate the taxpayer's tax account; therefore, it cannot update the tax account to show the Combat Zone extension. As a result, the IRS has to contact the taxpayer to request that he or she submit another email with his or her date of birth and date of deployment to the combat zone. If the IRS still cannot locate the taxpayer with this additional information, the IRS informs the taxpayer to submit a fax with their SSN.

Our review showed that for 70 (19 percent) of 360 emails submitted in Calendar Year 2007, the IRS was unable to locate the taxpayer's account and had to request additional information from the taxpayer. For privacy and security reasons, the IRS cannot answer taxpayers' email inquiries over the Internet if they require an SSN. When an SSN is needed, it has to be submitted via fax. The majority of the Calendar Year 2007 emails were from taxpayers to notify the IRS of their deployment to a combat zone.

The IRS could reduce taxpayer burden by creating a fillable form that could be accessed through the IRS web site and submitted directly to the IRS with all the necessary information to enable the activation of a Combat Zone indicator.

Recommendations

The Commissioner, W&I Division, should:

Recommendation 9: Develop a process to validate Combat Zone service at the time an individual self-identifies.

Management's Response: IRS management agreed with this recommendation. The IRS is considering several alternatives to the existing self-identification process. Obtaining additional validation information from the taxpayer, where needed, will be part of that process. While it is important to ensure only taxpayers that are entitled to the Combat Zone provisions of the Tax Code are given those tax advantages, it is also important that the IRS not impose unnecessary burden or deny anyone those benefits without proper handling of their account.



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Recommendation 10: Improve the process for individuals who self-identify their Combat Zone service by email with the establishment of a secure fillable form with the required data fields.

Management's Response: IRS management partially agreed with this recommendation. Since the IRS agreed to reconsider its validation process in response to Recommendation 9, establishing a secure fillable form for the taxpayer to complete on IRS.gov may not be necessary and raises numerous security concerns. In addition, the IRS is not sure the information the taxpayer would provide in this manner will be sufficient to validate their presence in a combat zone. Nevertheless, the IRS will work with the MITS organization and the Cybersecurity Security Engineering function staff to consider this option.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to assess the IRS actions to ensure the accuracy of Combat Zone indicators. To accomplish our objective, we:

- I. Evaluated whether the agreed-upon recommendations from the TIGTA April 2005 review¹ were implemented.
 - A. Reviewed the Joint Audit Management Enterprise System² to determine if and when planned corrective actions were implemented.
 - B. Obtained documentation to support that the IRS corrected the programming for downloading entry and exit dates from the data received from the DOD.
 - C. Determined whether quarterly reviews are performed by the W&I Division to verify DOD's data are posting accurately to Combat Zone taxpayers' accounts.
 - D. Evaluated actions taken by the IRS since the TIGTA April 2005 review to improve the processing of taxpayers' accounts with Combat Zone indicators.
- II. Determined whether the IRS correctly updates Combat Zone accounts using the data received from the DOD on military members serving in a combat zone.
 - A. Obtained the DOD CDs received by the IRS for April, May, June, August, and January of Tax Year³ 2007. We performed a match of the population of 292,855 unique taxpayers on the DOD CDs received from Tax Year 2007 for April, May, June, August, and January against the Individual Master File⁴ (IMF) Entity Module⁵ for 2007 to determine whether the taxpayers had an account on the IMF and performed data checks of their Combat Zone entry/exit dates to verify validity of the data.
 - B. Interviewed management and analysts from the MITS organization; W&I Division Compliance, Accounts Management, and Submission Processing functions; and a

¹ *Taxpayers Identified As Serving in Combat Zones Were Properly Afforded Tax Benefits, but Account Identification and Maintenance Processes Need Improvement* (Reference Number 2005-40-077, dated April 28, 2005).

² An audit tracking and management control system.

³ Tax Year is the period of time for which a return is filed.

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

⁵ Entity Module is the portion of the Master File record which identifies the taxpayer. It contains the taxpayer name, address, tax period, and other identifying information. The Master File is the IRS database that stores various types of taxpayer account information.



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- private corporation engineer responsible for receipt and posting of the DOD Combat Zone data to the IMF to determine whether there were any unpostables or dropped transactions from the DOD data. We also obtained the volume of dropped transactions for May 2009 and identified whether there are procedures to resolve unpostable or dropped transactions.
- C. Determined the volume of Combat Zone transactions that posted to invalid SSNs⁶ for all Combat Zone transactions that posted after Tax Year 2001 on a computer extract containing Combat Zone transactions on taxpayers' Entity Modules with active Combat Zone indicators in Tax Years 2005, 2006, and 2007.
 - D. Ascertained whether the IRS generates managerial reports listing the unpostables or dropped transactions from the DOD data and evaluated whether the MITS organization and the W&I Division track or work unpostable/dropped transactions. We also determined whether corrective actions have been taken to address such occurrences.
 - E. Contacted responsible representatives in the DOD Defense Manpower Data Center⁷ to determine whether the IRS has contacted them to discuss the efficiency and effectiveness of the notification and resolution of the unpostable process.
- III. Determined whether the IRS correctly updates Combat Zone accounts for individuals that self-identify using email or telephone.
- A. Evaluated whether the IRS is updating taxpayers' Combat Zone indicators in response to taxpayers who notify the IRS by telephone or email of their service in a combat zone.
 - B. Selected a statistically valid sample of 360 Combat Zone emails from a population of 5,491 emails from a Calendar Year 2007 retention file to confirm whether the IRS updated the Combat Zone indicators when notified of a taxpayer's Combat Zone entry/exit, and to determine whether supporting documentation of service in a combat zone was secured prior to updating the Combat Zone indicators. Our sample size was determined based on a 95 percent confidence level, an expected error rate of 50 percent, and precision of ± 5 percent. A statistical sample was taken because we wanted to determine the number of emails in the population for which the Combat Zone indicators were not updated.
 - C. Interviewed W&I Division Accounts Management function staff to obtain the volume of calls pertaining to notification of Combat Zone service and to determine whether

⁶ An SSN on a tax return that does not pass validity checks on the IRS computer system is considered invalid.

⁷ The Defense Manpower Data Center collects, archives, and maintains accurate, readily available manpower and personnel data, as well as financial databases for the DOD.



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- supporting documentation of Combat Zone service is secured prior to updating the Combat Zone indicators.
- IV. Determined whether the IRS has a process to differentiate between military individuals and civilian individuals for the purpose that appropriate tax benefits are provided.
- A. Assessed how the IRS processes tax returns with the annotation “Combat Zone” to determine whether the IRS is updating the Combat Zone indicators on these taxpayers’ accounts, and determined whether supporting documentation of Combat Zone service is secured prior to updating the Combat Zone indicators.
1. Interviewed management and analysts from the MITS organization; W&I Division Compliance, Accounts Management, and Submission Processing functions; and a private corporation engineer, and also reviewed Internal Revenue Manual Section 5.19.1, *Collecting Process, Liability Collection, Balance Due*, to identify the procedures for processing self-identified Combat Zone tax returns and to ascertain how the IRS determines whether a self-identified Combat Zone tax return is attributable to a military member or U.S. civilian working for the U.S. Armed Forces in a combat zone.
 2. Obtained a computer extract⁸ with Transaction Code 500⁹ on taxpayers’ IMF Entity Modules with active Combat Zone indicators in Tax Years 2005, 2006, and 2007, developed criteria for the systemic issue identified with self-identifying returns, and applied the criteria to the computer extract to determine the number of taxpayers that fit the criteria of the systemic issue. The IMF data were extracted from the IRS mainframes and a run-to-run balancing was used, which involves documenting the records read in and written out at each step of the file processing, to ensure all records were received and loaded. We validated the accuracy of the data on the computer extract by comparing a randomly selected sample of 50 taxpayers on the computer extract to the IRS information residing on the Integrated Data Retrieval System.¹⁰
- B. Analyzed the taxpayers with an incorrect Combat Zone indicator due to a systemic issue with self-identifying returns to determine the number of taxpayers that did not file a tax return for Tax Year 2006 in Processing Year¹¹ 2007.

⁸ The computer extract was obtained from the TIGTA Office of Audit Electronic Data Processing group.

⁹ This transaction activates a taxpayer’s Combat Zone indicator when entering a combat zone and deactivates a taxpayer’s Combat Zone indicator when exiting a combat zone.

¹⁰ IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer’s account records.

¹¹ Processing Year is the calendar year in which the return was processed by the IRS.



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- V. Determined whether the list of Combat Zone transcripts is being generated annually as required.
- A. Ascertained whether the IRS generated the run of Combat Zone transcripts in Cycle 43 of Calendar Year 2008.
 - B. Obtained access to Combat Zone transcripts generated in Cycle 43 for Calendar Year 2008 and assigned the most recent Transaction Code 500 from the computer extract to the transcripts assigned to W&I Division employees to determine whether research was performed and corrective actions implemented. We also selected a judgmental sample of 50 taxpayers from a population of 26,846 taxpayers with transcripts and military service to determine whether married filing joint or married filing separate affects the accuracy of a Combat Zone indicator. We judgmentally selected the 50 taxpayers because, due to time constraints, we wanted to focus on those transcripts where taxpayers had military service.
 - C. Determined the volume of transcripts generated in Cycle 43 of 2008 because of the systemic issue with self-identifying returns and calculated whether the W&I Division expended unnecessary direct costs to work these transcripts.
 - D. Ascertained whether reports were issued to W&I Division Compliance and Accounts Management functions for the Combat Zone transcripts, and whether any issues identified from the reports required resolution. We determined whether W&I Division management addressed any of these issues and whether plans exist to balance the workflow processing of the Combat Zone transcripts.



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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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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.

Type and Value of Outcome Measure:

- Inefficient Use of Resources – Potential; \$2,183,935 in direct costs over 5 years from working Combat Zone transcripts generated due to the systemic condition identified with self-identifying returns (see page 9).

Methodology Used to Measure the Reported Benefit:

The DOD informs the IRS when a military taxpayer enters and exits a combat zone. Upon being notified by the DOD of a military taxpayer's entrance into a combat zone, the IRS activates the Combat Zone indicator. When the DOD informs the IRS that a military taxpayer has exited a combat zone, the IRS deactivates the Combat Zone indicator. A military taxpayer also has the option of self-identifying their Combat Zone service to the IRS by annotating "Combat Zone" on their filed return. If the return is filed after the IRS deactivates the Combat Zone indicator based on DOD exit information, the IRS systemically reactivates the Combat Zone indicator. Thus, a self-identifying return causes a military taxpayer's account to appear as though the taxpayer is eligible for Combat Zone tax benefits even though the taxpayer is no longer in a combat zone.

Our analysis showed 32,440 (33 percent) of 99,432 accounts from the October 19, 2008, list of Combat Zone transcripts were generated due to the systemic issue described above. We determined the IRS will expend \$2,183,935 in direct costs working these transcripts; however, these direct costs could instead be utilized for other programs if the IRS discontinued the processing of self-identifying returns. The following shows our calculation of the direct cost expenditure:

- **Hourly Direct Cost for Processing Transcripts**

We calculated the hourly direct cost for processing Combat Zone transcripts using the following data:

- IRS "Cumulative Cost" for processing Combat Zone transcripts for FY 2009, as of May 2, 2009: **\$356,205.00**
- IRS "Cumulative Actual Hours" to process Combat Zone transcripts for FY 2009, as of May 2, 2009: **15,559 hours**



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Hourly Direct Cost = \$22.89¹

- Hours to Process Transcripts**

We calculated the number of hours required to process the 32,440 Combat Zone transcripts using the following data:

- Number of Combat Zone transcripts generated in October 2008 due to the systemic condition with self-identifying returns: **32,440 transcripts²**
- IRS “ Actual Rate” to process Combat Zone transcripts per hour for FY 2009, as of May 2, 2009: **1.7 transcripts per hour³**

Hours to Process 32,440 Transcripts = 19,082

- Direct Cost for Processing Transcripts Generated Due to the Systemic Condition**

We calculated the direct cost of processing Combat Zone transcripts generated due to the systemic condition with self-identifying returns, as follows:

<u>Hourly Direct Cost</u>	x	<u>Hours to Process 32,440 Transcripts</u>	=	<u>Direct Cost</u>
\$22.89		19,082		\$436,786.98

- Potential Direct Cost for 1 Year and Over 5 Years**

	1 Year	5 Years
Potential Direct Cost	\$436,786.98	\$2,183,934.90

Type and Value of Outcome Measure:

- Revenue Protection – Potential; 339,027 taxpayers’ accounts with inaccurate Combat Zone indicators inappropriately receiving tax benefits (see page 9).

Methodology Used to Measure the Reported Benefit:

A taxpayer qualifies for the Combat Zone tax benefits reserved for military members only during their period of service in a combat zone. The DOD routinely notifies the IRS of the date when military taxpayers exit a combat zone. Upon notification, the IRS changes these taxpayers’ Combat Zone indicators to inactive to reflect their exit from a combat zone. Subsequently, these military taxpayers self-identify their Combat Zone service when filing a tax return which

¹ Formula: Cumulative Cost divided by Cumulative Actual Hours = Hourly Direct Cost.

² Volume determined by the TIGTA analysis of the 2008 Combat Zone transcripts.

³ IRS calculated this rate by dividing the “Cumulative Actual Production” by the “Cumulative Actual Hours” for FY 2009, as of May 2, 2009.



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systemically causes the military taxpayers' Combat Zone indicators to be reactivated to active status. The reactivation of these military taxpayers Combat Zone indicators makes it appear that they are entitled to Combat Zone tax benefits even though they are no longer allowed such benefits due to their departure from a combat zone. We identified taxpayers with this systemic condition of inaccurate Combat Zone indicators using a computer extract containing 8,225,584 Combat Zone entry/exit transactions for military and civilian taxpayers that reside on the Entity Modules for taxpayers with an active Combat Zone indicator in Tax Years 2005, 2006, and 2007. The following steps were performed for our analysis:

- *Identified the unique SSNs on the computer extract.*
- *Filtered out the military Combat Zone exit transactions on or after January 1, 2000, sorted by cycle date in descending order.*
- *Filtered out the nonmilitary Combat Zone entry transactions, the transactions not generated by the DOD notifications, sorted by cycle date in ascending order.*
- *Retained the Combat Zone records where the cycle date of the nonmilitary Combat Zone entry transaction was greater than or equal to the cycle date of the military Combat Zone exit transaction, sorted by cycle date in ascending order.*
- *Eliminated nonmilitary Combat Zone entry transactions with a blank date, and eliminated any military Combat Zone exit transaction with an exit date greater than the date of a nonmilitary Combat Zone entry transaction.*
- *Matched the Combat Zone transactions file to a filed tax return file to identify the Combat Zone transactions systemically generated by a self-identifying tax return.*
- *Determined the number of taxpayers' accounts with an active Combat Zone indicator in Tax Year 2007.*

Our analysis showed 339,027 taxpayers' accounts with incorrect Combat Zone indicators due to the systemic condition with self-identifying returns erroneously received the benefits allowed under I.R.C. § 7508,⁴ which includes taxpayers in a combat zone not being subject to penalties or interest on taxable income.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$1,100,702 in taxes owed by 288 of 475 nonfilers with a potentially erroneously reactivated Combat Zone indicator in Tax Year 2006 or prior who did not file a tax return for Tax Year 2006 (see page 9).

⁴ I.R.C. § 7508 (2008).



Combat Zone Indicators on Taxpayer Accounts Are Frequently Inaccurate

Methodology Used to Measure the Reported Benefit:

We found taxpayers' Combat Zone indicators continue to be potentially inaccurate. Our analysis showed the Combat Zone indicators for 339,027 (40 percent) of approximately 845,000 taxpayers with an active Combat Zone indicator on their tax account for Tax Year 2007 were potentially inaccurate. We then determined 127,051 (37 percent) of 339,027 taxpayers' Combat Zone indicators were reactivated in Tax Year 2006 or prior. Of the 127,051 taxpayers, we ascertained that taxpayers erroneously received the following tax benefit:

- 505 of 127,051 taxpayers with an erroneously reactivated Combat Zone indicator in Tax Year 2006 or prior did not file a tax return for Tax Year 2006. Further, 475 of 505 nonfilers in Tax Year 2006 earned wages totaling \$19,365,179 that were not reported. Our analysis showed that the 288 of 475 nonfilers owe \$1,100,702 in taxes.

The following information illustrates the calculation we used to determine the amount of taxes owed by 288 of 475 nonfilers, using the assumption each taxpayer's filing status was single.

Tax Year 2006 Form 1040⁵	Calculation
Taxpayers' Wages on Tax Year 2006 Forms W-2 ⁶	\$ 15,162,351.00
Tax Year 2006 Standard Deduction for Single Taxpayer	(1,483,200.00)
Tax Year 2006 Exemption for Taxpayer Claiming Self	(944,680.00)
Taxable Income	\$ 12,734,471.00
Tax per 2006 Tax Table	\$ 2,374,395.00
Federal Income Tax Withheld for Tax Year 2006 Forms W-2	\$ 1,273,693.00
Amount of Tax Owed	\$ 1,100,702.00

⁵ U.S. Individual Income Tax Return (Form 1040).

⁶ Wage and Tax Statement (Form W-2) is issued annually to a taxpayer by the IRS.



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Appendix V

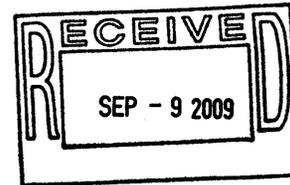
Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

SEP 9 2009



MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard Byrd, Jr. 
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Combat Zone Indicators on Taxpayer
Accounts Are Frequently Inaccurate (Audit #200940015)

I reviewed the subject draft report and agree that improvements are needed to ensure the accuracy of Combat Zone indicators. Our primary concern is to ensure that all members of our military, serving in a Combat Zone and protecting our freedom, are afforded all the tax benefits they are entitled to by law. As you mention in your report, these benefits include the exclusion of combat pay from taxation and extension of time to file tax returns and pay taxes. While civilian employees supporting the military in Combat Zones are not entitled to the Combat Zone military pay exclusion, they are entitled to other benefits, such as extensions of time to file and pay. We are working hard to ensure that happens, but we acknowledge that more work is needed.

As indicated in your report, we established a task force in late 2008, to address several issues related to our Combat Zone processing. The group identified several improvements and many of them have already been implemented or will be implemented in the near future. These changes include reducing the amount of time before we generate a transcript, updating our Internal Revenue Manual procedures for transcript processing, developing automation tools to process the transcripts more efficiently/expeditiously, and tightening our Submission Processing procedures to identify incorrect exclusion of income when the return is received and processed by the IRS. The group also recommended changes to the existing self-identification process and we are exploring other alternatives in this area as well.

We currently allow taxpayers to self-identify as being in a Combat Zone. A taxpayer can self-identify by writing "Combat Zone" on their return, writing a letter, calling our toll-free telephone line, or through the IRS.gov website. After a period of time, if the IRS has not received information that the taxpayer has left the Combat Zone, a transcript is generated and we attempt to contact the taxpayer to clarify their Combat Zone status.



Combat Zone Indicators on Taxpayer Accounts Are Frequently Inaccurate

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The length of our current military engagements has increased the difficulty of accurately analyzing these taxpayer accounts to determine their correct status. The process is often complicated because many taxpayers have entered and returned from a Combat Zone, often numerous times, or have retired from the military and reentered a Combat Zone as contractors. The change from military to civilian status results in disallowance of the right to exclude pay for service while in a Combat Zone. Without contacting the taxpayer (or their family), which may place undue burden on them, we cannot be certain of the current Combat Zone status of any taxpayer that self-identifies.

We are considering several alternatives to the existing self-identification process. While it is important to ensure only taxpayers that are entitled to the Combat Zone provisions of the tax code are given those tax advantages, it is also important that we do not deny anyone those benefits without proper handling of their account.

Contrary to what you reported, the IRS does have the ability to distinguish between military and civilian taxpayers. Procedures for processing returns as they are filed include provisions to ensure income exclusions are properly claimed. However, we are working with the Modernization and Information Technology Systems (MITS) area to improve the process to identify which spouse is in a Combat Zone based on a jointly filed return.

We are also working with MITS to reexamine the process for posting the Combat Zone entry and exit dates to a taxpayer's account. Additionally, we are working with MITS to establish a process for working accounts on the monthly Department of Defense updates that do not match our files.

Through these efforts, and the others we outline in the attachment, we are confident we can make improvements to the overall accuracy of Combat Zone indicators on our taxpayer accounts. We believe these efforts will avoid adding unnecessary burden for the deserving taxpayers involved, as well as minimize opportunities for inaccurate IRS denials of Combat Zone benefits.

We have reviewed the methodology you used to formulate the outcome measures described in Appendix IV. Your methodology appears sound and, as such, we have no reason to disagree with your outcome measures.

Attached are our comments to your specific recommendations. If you have any questions regarding this response, please call me at (404) 338-7060, or a member of your staff may contact Denice Vaughan, Director, Filing and Payment Compliance, Wage and Investment Division, at (404) 338-9116.

Attachment



Combat Zone Indicators on Taxpayer Accounts Are Frequently Inaccurate

Attachment

RECOMMENDATION 1

The Commissioner, W&I Division, should develop a process to distinguish military taxpayers from civilian taxpayers.

CORRECTIVE ACTION

We disagree with this recommendation. The IRS already has a means for distinguishing between military and civilian taxpayers. When the IRS receives information from the Department of Defense (DOD), a transaction code 500 posts to the account with the number "8" or "9" in the 6th through 13th positions of the document locator number of that transaction. If there is no "8" or "9", we know the taxpayer self-identified or made contact with the IRS and is not currently serving in the armed forces.

Contrary to the report, the creation of an additional process to distinguish military taxpayers from civilian taxpayers would not assist the IRS in determining the benefits to which the taxpayer may be entitled. We implemented new procedures in Fiscal Year 2009 for processing returns to ensure only taxpayers entitled to Combat Zone income exclusions receive that benefit. Forms W-2, *Wage and Tax Statements*, are checked for a military payor when income is excluded and a math error notice is generated to disallow the exclusion if the taxpayer makes an inappropriate claim. Revising our initial returns processing procedures to exclude inappropriate Combat Zone income exclusion claims minimizes the need for more costly and time consuming case analysis after the return has been processed.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

The Commissioner, W&I Division, should:

RECOMMENDATION 2

Improve the process for identifying joint filers serving in the military to properly identify which individual(s) is/are in a combat zone to ensure appropriate enforcement actions are taken.

CORRECTIVE ACTION

We agree with this recommendation. We are working with Modernization and Information Technology Systems (MITS) to improve the existing process that identifies which individual(s) is in a Combat Zone, particularly if a taxpayer files jointly with his/her



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spouse. Once we reach an agreeable solution, we will submit the necessary Unified Work Request (UWR) to MITS.

IMPLEMENTATION DATE

January 15, 2012

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored as part of our internal management control system.

RECOMMENDATION 3

Improve the process for ensuring that Combat Zone indicators are reversed when an exit date is received from the DOD for those individuals who file a joint tax return but do not maintain the same order of primary and secondary taxpayer.

CORRECTIVE ACTION

This recommendation is very similar to Recommendation 2 above. We agree and are working with MITS to ensure the accurate reversal of Combat Zone indicators when an exit date is received from DOD for those individuals who file a joint tax return, regardless of whether they maintain the same order of primary and secondary taxpayer. Once we reach an agreeable solution, we will submit the necessary UWR to MITS.

IMPLEMENTATION DATE

January 15, 2012

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored as part of our internal management control system.

The Commissioner, Wage and Investment Division, should

RECOMMENDATION 4

Discontinue providing the option to taxpayers of self-identifying by annotating a tax return with "Combat Zone" and continue to provide individuals with the option of self-identifying by telephone or electronically.



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CORRECTIVE ACTION

We partially agree with this recommendation. The IRS allows taxpayers multiple options to self identify as being in a Combat Zone to make sure we do not take inappropriate enforcement actions or inaccurately deny claimed tax benefits to which these taxpayers are entitled.

We are considering several alternatives to the existing self-identification process. While it is important to ensure only taxpayers that are entitled to the Combat Zone provisions of the tax code are given those tax advantages, it is also important that we not deny anyone those benefits without proper handling of their account. We will discontinue allowing taxpayers to self-identify on the returns only after we are certain that other means for identification are adequate.

IMPLEMENTATION DATE

January 15, 2012

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored as part of our internal management control system.

RECOMMENDATION 5

Take action to correct the 339,027 taxpayers with inaccurate Combat Zone indicators that were incorrectly reactivated.

CORRECTIVE ACTION

We disagree that all of the 339,027 taxpayers were incorrectly reactivated. We will address these cases through our transcript process. However, we are developing other solutions that may allow us to resolve this issue in a more expeditious manner. These solutions include reducing the amount of time before we generate a transcript, updating our Internal Revenue Manual procedures for transcript processing, developing automation tools to process the transcripts more efficiently/expeditiously, and tightening our Submission Processing procedures to identify incorrect exclusion of income when the return is received and processed by the IRS.

IMPLEMENTATION DATE

December 15, 2011

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division



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CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored as part of our internal management control system.

RECOMMENDATION 6

Review the 475 nonfiler accounts to determine if notification or compliance actions are needed.

CORRECTIVE ACTION

We agree with this recommendation. The 475 Nonfiler accounts are a subset of the 339,027 accounts cited in Recommendation 5. Thus, to the extent possible, we will work these cases through our transcript process but, as noted above, we are developing other, more expeditious means of resolving these cases.

IMPLEMENTATION DATE

January 15, 2010

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored as part of our internal management control system.

The Commissioner, Wage and Investment Division, should

RECOMMENDATION 7

Develop a process to identify and resolve unpostable records when entry and exit date information provided by the DOD is unable to be posted to an individual's tax account.

CORRECTIVE ACTION

We agree with this recommendation and are working with MITS and Submission Processing to develop a process to capture these dropped records and establish procedures to resolve why they could not post to the master file.

IMPLEMENTATION DATE

January 15, 2012

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored as part of our internal management control system.



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RECOMMENDATION 8

Take actions to resolve the 458 DOD Combat Zone transactions posted to invalid SSNs and revise the DOD validation process to ensure accurate posting of entry and exit date information.

CORRECTIVE ACTION

We agree with this recommendation. We are working with Submission Processing to take corrective actions to resolve the 458 DOD Combat Zone transactions that posted to invalid social security numbers. We are also working with MITS and Submission Processing to examine the existing DOD validation process and make changes as needed.

IMPLEMENTATION DATE

January 15, 2012

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored as part of our internal management control system.

The Commissioner, Wage and Investment Division, should

RECOMMENDATION 9

Develop a process to validate Combat Zone service at the time an individual self-identifies.

CORRECTIVE ACTION

We agree with this recommendation. We are considering several alternatives to the existing self-identification process. Obtaining additional validation information from the taxpayer, where needed, will be part of that process. While it is important to ensure only taxpayers that are entitled to the Combat Zone provisions of the tax code are given those tax advantages, it is also important that we not impose unnecessary burden or deny anyone those benefits without proper handling of their account.

IMPLEMENTATION DATE

December 15, 2011

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division



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CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored as part of our internal management control system.

RECOMMENDATION 10

Improve the process for individuals who self-identify their Combat Zone service by email with the establishment of a secure fillable form with the required data fields.

CORRECTIVE ACTION

We partially agree with this recommendation. Since we agreed to reconsider our validation process in response to Recommendation 9, establishing a secure fillable form for the taxpayer to complete on IRS.gov may not be necessary and raises numerous security concerns. Additionally, we are not sure the information the taxpayer would provide in this manner will be sufficient to validate their presence in a Combat Zone. Nevertheless, we will work with MITS and the Cybersecurity Security Engineering staff to consider this option.

IMPLEMENTATION DATE

January 15, 2012

RESPONSIBLE OFFICIAL

Director, Filing and Payment Compliance, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

This corrective action will be monitored as part of our internal management control system.