



*Amended Tax Return Filing and
Processing Needs to Be Modernized
to Reduce Erroneous Refunds,
Processing Costs, and Taxpayer Burden*

April 25, 2014

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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.

Redaction Legend:

1 = Tax Return/Return Information

2 = Risk Circumvention of Agency Regulation or Statute

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

April 25, 2014

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

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

SUBJECT: Final Audit Report – Amended Tax Return Filing and Processing
Needs to Be Modernized to Reduce Erroneous Refunds, Processing
Costs, and Taxpayer Burden (Audit # 201240043)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) has controls in place to ensure that claims for refunds on amended tax returns are appropriate. This audit is included in our Fiscal Year 2014 Annual Audit Plan and addresses the major management challenge of Fraudulent Claims and Improper Payments.

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

Copies of this report are also being sent to the IRS managers affected by the report recommendations. If you have any questions, please contact me or Russell P. Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services).



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Abbreviations

e-file(d), e-filing	Electronically file(d), electronic filing
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration



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Background

When taxpayers make an error on their originally filed Form 1040, *U.S. Individual Income Tax Return*, they can file an amended tax return.¹ Taxpayers can add, delete, update, or change income, exclusions, deductions, credits, filing status, *etc.*, reported on their original tax return, including claiming tax credits and deductions that were not previously claimed. Taxpayers can also file an amended return to change amounts previously adjusted by the Internal Revenue Service (IRS), make a claim for a carryback due to a loss or unused credit, and make certain elections after the prescribed deadline.

Taxpayers use Form 1040X, *Amended U.S. Individual Income Tax Return*,² to amend their original tax return. Form 1040X is separate from the Form 1040 and can only be filed after a taxpayer files an original Form 1040. Taxpayers normally must file an amended tax return within three years from the time the original tax return was filed or two years from the time the tax was paid, whichever is later. The IRS indicated that more than 4 million amended tax returns were received in Fiscal Year³ 2012.

Amended tax return processing

The IRS only allows amended tax returns to be filed on paper. When an amended tax return is received in an IRS Submission Processing site, it is routed to either the Submission Processing function or the Accounts Management function to be worked. The process for working an amended tax return is primarily manual. IRS employees who work amended tax returns must verify math computations, ensure that required documentation is provided, verify eligibility for any deductions or credits claimed, *etc.* Once the employee has completed all the necessary research, the employee uses the IRS's Integrated Data Retrieval System⁴ to input the accepted adjustments to the taxpayer's tax account. The IRS will then send the taxpayer a letter notifying him or her of the adjustment, the reason the adjustment was made, and the amount adjusted.

¹ The 1040X is used to amend Forms 1040, 1040A, 1040EZ, 1040NR, or 1040NR-EZ. For the purposes of this report, we are referring to the Form 1040 series when we reference Forms 1040.

² See Appendix V for a copy of Form 1040X.

³ A 12-consecutive-month period ending on the last day of any month. The Federal Government's fiscal year begins on October 1 and ends on September 30.

⁴ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



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Previous reports identified problems with IRS processes for verifying tax refunds claimed on amended tax returns

TIGTA has previously reported concerns with the adequacy of the IRS's processes for verifying tax refund claims filed on amended tax returns. Since June 2011, TIGTA has issued the following three reports that identified weaknesses related to the processing of amended tax returns, which resulted in taxpayers receiving potentially erroneous tax benefits, including refunds:

- ***Control Weaknesses Over Amended Returns Allowed Some Inappropriate Claims for the First-Time Homebuyer Credit to Be Allowed*** (Ref. No. 2011-41-057, issued June 2011) – IRS errors in processing amended tax returns allowed taxpayers to inappropriately avoid the repayment of their First-Time Homebuyer Credit and receive multiple refunds for the credit.
- ***Processes to Address Erroneous Adoption Credits Result in Increased Taxpayer Burden and Credits Allowed to Nonqualifying Individuals*** (Ref. No. 2012-40-065, issued June 2012) – The IRS allowed an estimated \$8.9 million in Adoption Credits claimed on amended tax returns for which the taxpayers did not provide the required documentation to support their claim.
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This review was performed in the Wage and Investment Division's Accounts Management function in Atlanta, Georgia, and the Submission Processing Headquarters in Cincinnati, Ohio, during the period August 2012 through August 2013. We conducted this 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. However, limitations related to the specific information captured on Form 1040X and the information input from Forms 1040X into IRS computers limited our ability to fully evaluate the extent of erroneous claims that result from deficiencies in IRS controls. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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Results of Review

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*****2*****

The IRS sends original tax returns through extensive systemic verifications in an attempt to ensure the accuracy of tax refunds claimed. *****2*****
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*****2*****. For example, our review of a statistical sample of 259 amended tax returns claiming tax refunds of \$500 or more in Fiscal Year 2012 identified 44 (17 percent) tax returns for which the IRS issued potentially erroneous tax refunds totaling \$103,270.⁵

The errors we identified on the 44 tax returns included mathematical errors by both taxpayers as well as IRS employees processing the amended tax return, deductions and credit claims made without the required tax form attached to the tax return, and claims for deductions and/or credits for which the IRS did not receive third-party information substantiating the validity of the deduction/credit claimed. For example, we identified claims for the Education Credit for individuals for whom the IRS did not receive a Form 1098-T, *Tuition Statement*, supporting the fact that the individual claimed attended a post-secondary institution.

*****2*****
*****2*****
*****2*****. Depending on the nature of the errors identified, the IRS may correspond with the taxpayer in an attempt to obtain information needed to substantiate the validity of the refund claimed. *****2*****
*****2*****
*****2*****. These checks also identify conditions that may require further scrutiny. For example, if an individual files an amended tax return and claims a dependent that was previously claimed on another tax return, the system verifications used to process an original tax return would identify this occurrence, which could result in the tax return being sent to the IRS Examination function for review or the IRS notifying the taxpayer of the duplicate dependent use.

⁵ The 44 amended tax returns may have contained more than one error.



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However, as we reported, the original tax return verification processes are not used to process amended tax returns and, as a result, the IRS did not identify the errors associated with the 44 tax returns we identified as questionable. As such, the IRS took no actions to ensure that the tax benefits associated with the errors we identified were valid before the refund was paid. For example, for those tax returns we identified with deductions and credits claimed without the required tax form attached to the tax return, the IRS did not identify the missing form and therefore did not correspond with the taxpayer to obtain the information needed to ensure that the deduction or credit claim was valid. Based on the results of our sample, we estimate that the IRS may have issued more than \$439 million⁶ in potentially erroneous tax refunds claimed on 187,421⁷ amended tax returns during Fiscal Year 2012. We forecast that the IRS could issue more than \$2.1 billion in potentially erroneous tax refunds claimed on amended tax returns over the next five years.⁸

As previously mentioned, the IRS requires amended tax returns to be filed on paper. As such, the IRS is *****2*****. E-filed tax returns benefit the IRS and taxpayers because both processing costs and error rates are lower than those for paper returns. To help achieve this level of accuracy, the IRS's *****2*****. *****2*****. *****2*****. *****2*****. *****2*****. *****2*****. *****2*****. Figure 2 compares the processes used to verify the accuracy of tax refunds claimed on an original paper tax return with those used for an amended tax return.

⁶ The point estimate projection is based on a two-sided 95 percent confidence level. We are 95 percent confident that the point estimate is between \$280,084,500 and \$599,684,006.
⁷ The point estimate projection is based on a two-sided 95 percent confidence level. We are 95 percent confident that the point estimate is between 136,874 tax returns and 237,969 tax returns.
⁸ See Appendix IV. The five-year forecast is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change. The actual amount of revenue protected is contingent upon the IRS implementing an effective process to identify questionable amended tax returns and on the extent that taxpayers can adequately substantiate their claims once contacted by the IRS.



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Figure 2: Comparison of Processes Used to Verify the Accuracy of Tax Refunds Claimed on an Original Paper Tax Return and an Amended Tax Return

Original Paper Tax Return Refund Verification Process	Amended Tax Return Refund Verification Process
Taxpayer completes and mails Form 1040 to the IRS.	Taxpayer completes and mails Form 1040X to the IRS.
The IRS assigns the Form 1040 a control number used to identify and locate the return. The Form 1040 is then sent to the Document Perfection function, which makes the return acceptable for processing systems.	The Form 1040X is not sent to the Document Perfection function to make it acceptable for electronic processing systems. Instead, it is sent to the IRS Submission Processing or Accounts Management function for manual processing.
An IRS employee reviews the Form 1040 to ensure that it is signed and that all required supporting schedules are attached.	An IRS employee reviews the Form 1040X to ensure that it is signed and that all required supporting schedules are attached.
An IRS employee enters selected information from the Form 1040 into the IRS tax return processing systems.	*****2***** *****2*****
Systemic verifications are performed using the information entered into the IRS tax processing systems to ensure accuracy of the refund claimed. Errors identified are sent to IRS employees for further review.	*****2***** *****2***** *****2***** *****2***** *****2***** However, the tools do not make a determination as to the accuracy or validity of a taxpayer's claim.
The IRS computer system mathematically verifies the Form 1040. Once verification is completed with no errors identified, the tax return is posted to the Master File. ⁹	An IRS employee mathematically verifies the Form 1040X and uses the IRS's Integrated Data Retrieval System to manually input the accepted adjustments into the taxpayer's tax account on the Master File.
If the processing of the return results in a tax refund, the tax refund is sent to the taxpayer as a paper check or deposited electronically into the taxpayer's bank account.	If the adjustment based on the amended tax return results in a tax refund, the tax refund is sent to the individual as a paper check.

Source: TIGTA analysis of IRS tax return processing procedures and instructions.

⁹ The IRS database that stores various types of taxpayer account information. This database contains individual, business, and employee plans and exempt organizations data.



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computations required on an original tax return to recompute their tax benefits to be entered on the Form 1040X. As a result, many taxpayers who file an amended tax return complete a revised Form 1040 in addition to the Form 1040X. Of the 259 amended tax returns we reviewed, 126 (49 percent) included a revised Form 1040 with their amended tax return.

Significant processing cost savings could be achieved by modifying Form 1040 and enabling taxpayers to e-file their amended tax return. For example:

- The IRS estimates that it costs \$4.98 to *****2*****
*****2***** Using the IRS's estimated costs, we determined that the IRS could have potentially saved more than \$6 million during Fiscal Year 2012 if taxpayers were able to use a modified Form 1040 when filing their amended tax returns.
- The IRS could achieve an even greater savings if it allowed taxpayers to e-file the modified Form 1040 to correct their original tax return. According to the IRS, taxpayers e-filed 81.7 percent of Form 1040 individual income tax returns during Fiscal Year 2012, and the IRS estimates that it costs \$0.15 to process an e-filed Form 1040. Based on the IRS's estimated e-file cost and filing rate, the IRS could have potentially saved more than \$17 million during Fiscal Year 2012 if it had allowed taxpayers to e-file a modified Form 1040.

It should be noted that of the 259 amended tax returns we reviewed, 207 (80 percent) taxpayers e-filed their original tax return, which shows both a familiarity and preference to file their tax returns using this method. In addition, in many States taxpayers can amend their State tax returns using the same tax form used to file their original tax return and can e-file their amended tax return. For example, 18 of the 43 States that have an individual income tax allow taxpayers to use the original tax form to correct their State tax return. In addition, 18 of the 43 States allow taxpayers to e-file amended tax returns. Figure 5 illustrates how taxpayers in Utah indicate that the tax return being filed is an amended return.

Figure 5: Utah Individual Income Tax Return

40201 [Redacted]
9998 [Redacted]

Utah State Tax Commission
Utah Individual Income Tax Return 2012
All State Income Tax Dollars Fund Education TC-40
incometax.utah.gov

Start Here-> ● FOR AMENDED RETURN - ENTER CODE (1 - 5) from page 5

SSN: NO dashes or blank spaces (USE ALL CAPS IN NAME AND ADDRESS FIELDS)

Your Social Security number
Spouse's Social Security number

Your first name Last name
Spouse's first name Last name

Mailing address Telephone number
City State ZIP + 4 Foreign country (if not U.S.)

IMPORTANT!
Social Security Number(s) Required

Source: Form TC-40, Utah Individual Income Tax Return.



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Representatives from New York and Utah informed us that they generally process an amended tax return the same as an original tax return. For example, when taxpayers amend their State tax return, it becomes the new return of record and is input into the State's tax system, replacing the original return. The amended return generally goes through the same validation and verification processes as the original return. These representatives also stated that the original return information is kept in case the information is ever needed.

When we discussed the benefits of modernizing the amended tax return process with IRS management, they informed us that there are currently no plans to improve the filing and processing of amended tax returns. IRS management stated that they do not offer e-filing or *****2***** due to the cost of computer programming changes and testing that would be necessary to implement this type of change. However, management could not provide any associated cost/benefit analysis nor has management conducted any tests or studies to determine the feasibility of changing its manual amended tax return processing procedures.

Moreover, management's position on this issue does not appear to consider the *****2*** *****2***** **2***. The IRS continues to invest significant time and resources to modernize e-filing and expand and improve its verification processes for original paper-filed returns in an effort to prevent the erroneous issuance of refunds. Finally, because of the lack of action to improve amended tax return filing and processing, there is continued additional burden on taxpayers and inefficient use of resources by the IRS to process paper-filed amended tax returns. Given the losses that result from the erroneous issuance of refunds, which we estimate total more than \$439 million each year, it does not appear to be prudent for the IRS to take no action to modernize the processing of amended tax returns.

Recommendations

To reduce processing costs and taxpayer burden as well as *****2***** *****2***** that amended tax return refund claims are valid, the Commissioner, Wage and Investment Division, should:

Recommendation 1: Revise Form 1040 to enable taxpayers to amend their original tax return using this form.

Management's Response: The IRS disagreed with this recommendation. However, the IRS stated it will consider the format and appearance of Form 1040X, *Amended U.S. Individual Income Tax Return*, in conjunction with the implementation of e-filing of amended returns. The IRS does not agree that revisions to Form 1040, *U.S. Individual Income Tax Return*, are warranted at this time. The recommended changes to Form 1040 could result in a substantial increase in reporting burden and complexity for taxpayers who file Form 1040 and related forms and schedules. Significant changes to existing



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systems would be necessary. A distinction would continue to exist between original and amended returns, regardless of form appearance, and processing would continue to follow existing procedures for adjusting the taxpayer's account.

Office of Audit Comment: Although the IRS did not agree to revise Form 1040 at this time, revising Form 1040X could improve the IRS's ability to verify claims filed on amended tax returns. Improvement will depend on whether the revision of Form 1040X captures sufficient information from the taxpayer to enable the IRS to process the amended tax returns using the same systemic verifications in place for original filed tax returns.

Recommendation 2: Expand e-filing to include amended tax returns.

Management's Response: The IRS agreed with this recommendation. The IRS stated the ability to e-file amended tax returns has been a long-term goal of the IRS for the Modernized e-File platform. The business vision and high-level requirements for the process are being developed and will be provided to the Information Technology organization by the end of the 2014 Filing Season for a feasibility study and cost estimate. However, the IRS indicated implementing an e-file option for amended returns will be dependent on the availability of funding for information technology resources and services, which is beyond the immediate control of the IRS. The IRS will consider the corrective action to be completed with the submission of the business needs analysis to the Information Technology organization.

Office of Audit Comment: Although the IRS agreed with our recommendation, the IRS disagreed with our outcome measure of \$17 million in potential processing cost savings on the basis that our analysis assumed e-filed returns would require no further processing or review prior to posting adjustments to taxpayers' accounts. Our outcome is based on e-file and paper tax return cost data provided by the IRS. The cost per tax return data includes costs that may be incurred resulting from further processing or review that may be needed prior to a tax return posting to a taxpayer's account.

Recommendation 3: Conduct a review of the 44 amended tax returns that TIGTA identified for which potentially erroneous refunds were issued to determine the proper tax liability.

Management's Response: The IRS agreed with this recommendation. The IRS reviewed the 44 accounts identified by TIGTA. Generally, the IRS agrees that procedures were not followed for those identified as having processing errors. However, the IRS disagrees that claims identified as being questionable were not processed correctly. None of the claims met criteria for forwarding to the Compliance function for further review and, in reviewing those cases, it appears that the initial questions were resolved with additional research.



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Office of Audit Comment: Although the IRS agreed with our recommendation, the IRS disagreed with our outcome measure of \$2.1 billion in potential revenue the IRS could protect by using the same systemic processes used to verify claims on originally filed tax returns to verify amended tax return claims. In its response, the IRS noted that it disagrees that the claims we identified as being questionable were not processed correctly and that the validity of the claim can only be determined by an examination. As stated in the report, the errors we identified included mathematical errors by both taxpayers as well as IRS employees processing the amended tax return, deductions and credit claims made without the required tax form attached to the tax return, and claims for deductions and/or credits for which the IRS did not receive third-party information substantiating the validity of the deduction/credit claimed. As also stated in the report, amended tax return processes did not identify these 44 tax returns as questionable, whereas the systemic processes the IRS uses to verify originally filed tax returns would have identified most of the 44 questionable tax returns as needing additional scrutiny before the refund was paid.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS has controls in place to ensure that amendments to tax returns resulting in tax refunds are appropriate. To meet this objective, we:

- I. Reviewed IRS procedures within the Submission Processing and the Accounts Management functions to determine the controls in place for the processing of amended tax returns. We also reviewed IRS procedures for identifying and referring questionable amended tax returns to the Examination function.
- II. Determined whether controls over the processing of individual amended tax returns claiming refunds are effective at identifying and preventing questionable tax refunds.

- A. Identified individual amended tax returns processed during Fiscal Year¹ 2012 that were issued a tax refund of \$500 or more. Using data from the TIGTA Data Center Warehouse² for Fiscal Year 2012, we identified 1,103,230 adjustments that indicate an amended individual income tax return with a refund of \$500 or more was processed.

We validated that the data we received were accurate and reliable by comparing the data to the IRS Master File³ throughout various steps of our data identification. We determined the data were accurate and reliable.

- B. Reviewed a statistically valid sample of 259 of 1,103,230 amended tax returns to determine if the tax deductions and tax credits claimed appeared reasonable and the tax return was processed correctly. A statistical sample was taken because we wanted to estimate the number of amended returns in the population that were processed incorrectly or had questionable refunds. Our sample size was based on a ± 5 percent precision, a 20 percent expected error rate, and a 95 percent confidence level. We also determined whether taxpayers attached a revised Form 1040 with their amended tax return. Our sampling methodology was verified by our contract statistician.
- C. Contacted two States to determine how they process individual amended tax returns. We judgmentally selected the States we contacted based on the size of the State and

¹ A 12-consecutive-month period ending on the last day of any month. The Federal Government's fiscal year begins on October 1 and ends on September 30.

² Centralized storage and administration of files (which provides access to IRS data).

³ The IRS database that stores various types of taxpayer account information. This database contains individual, business, and employee plans and exempt organizations data.



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the existence of a State income tax system.⁴ We selected a judgmental sample because we did not intend to project characteristics of the population of States.

- III. Determined whether the IRS's plans to accept amended tax returns electronically would change the way the IRS processes amended tax returns. We calculated the potential cost savings associated with systemically processing e-filed amended tax returns. We also determined the number of States that accept amended returns electronically.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the IRS's policies, procedures, and practices relating to the processing of amended tax returns and the identification of erroneous claims on amended returns. We evaluated these controls through interviews with IRS management, analysis of IRS policies and procedures, and review of amended income tax returns filed by taxpayers.

⁴ A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population.



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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

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



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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:

- Revenue Protection – Potential; \$439,884,253 (\$2,199,421,265¹ over five years) of erroneous refunds to 187,421 taxpayers filing questionable claims on amended returns (see page 3).

Methodology Used to Measure the Reported Benefit:

The IRS denotes an amended return claim with a Transaction Code 971 with an Action Code 010 or 120. The IRS denotes a tax refund with a Transaction Code 846. We conducted computer analysis of the Individual Master File² and identified 1,103,230 transactions indicating that an amended return was filed during Fiscal Year³ 2012 for which a refund of \$500 or more was issued to the taxpayer. We selected a statistically valid sample of 259 of the 1,103,230 amended return transactions. Our sample was selected using a 95 percent confidence level and a ± 5 percent precision.

Our analysis of the 259 amended return transactions identified 44 amended tax returns for which all or part of the refund issued was potentially erroneous. Our analysis also identified 13 transactions that were incorrectly coded by the IRS as amended tax returns when in fact the adjustments were not related to an amended tax return.

To estimate the total number of amended tax returns with potentially erroneous refunds, we first computed the error rate based on the 246 of the 259 transactions in our sample that represented an amended tax return ($44/246 = 17.89$ percent). We then computed the error rate based on the full sample of 259 transactions ($44/259 = 16.99$ percent). The difference between the error rate associated with an amended tax return and the error rate for all transactions in our sample,

¹ The five-year forecast for potential revenue protection is based on multiplying the base year by five and assumes, among other considerations, that economic conditions and tax laws do not change. The actual amount of revenue protected is contingent upon the IRS implementing an effective process to identify questionable amended tax returns and on the extent that taxpayers can adequately substantiate their claims once contacted by the IRS.

² The IRS database that stores various types of taxpayer account information. This database contains individual, business, and employee plans and exempt organizations data.

³ A 12-consecutive-month period ending on the last day of any month. The Federal Government's fiscal year begins on October 1 and ends on September 30.



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including those that are not associated with an amended tax return, represents the portion of the 1,103,230 transactions in our population that are likely not the result of an amended tax return. To ensure that our projection adequately reflected the potential number of transactions in our population that are not the result of an amended tax return, we multiplied the 1,103,230 amended tax return transactions by the adjusted error rate of 16.99 percent, resulting in an estimated 187,421⁴ amended tax returns with a potentially erroneous refund processed during Fiscal Year 2012.

To estimate the amount of potentially erroneous refunds issued, we computed the average erroneous refund amount associated with the 44 amended tax returns we identified with an erroneous refund. The 44 amended tax returns we identified had potentially erroneous refunds totaling \$103,269.51. We then divided the \$103,269.51 by the sample size of 259, resulting in a sample average of \$398.72.⁵ By multiplying \$398.72 by the population of 1,103,230, we project that the IRS could potentially issue \$439,884,253⁶ in erroneous refunds. We forecast the IRS could potentially issue \$2,199,421,265 in erroneous refunds over the next five years (\$439,884,253 x 5).

The computation of our statistical sample size was reviewed by our contract statistician. The projections of our audit results were computed by our contract statistician. In addition, the IRS was provided for review each of our 44 exception cases. The IRS agreed with our assessment that the errors we identified resulted in taxpayers potentially receiving an erroneous refund.

Type and Value of Outcome Measure:

- Cost Savings (Funds Put to Better Use) – Potential; \$17,061,129 in costs to systemically process amended tax returns (see page 3).

Methodology Used to Measure the Reported Benefit:

The IRS processed 4,024,886 amended tax returns during Fiscal Year 2012. The IRS estimates that it costs \$4.98 to *****2*****
*****2*****
According to the IRS, taxpayers e-filed 81.7 percent of Form 1040 individual income tax returns during Fiscal Year 2012. We used the IRS's cost estimates and percentage of e-filed tax returns to estimate the cost savings the IRS could have potentially realized by systemically processing amended tax returns during Fiscal Year 2012.

⁴ Our projection is based on a 95 percent confidence level and a precision (range) of ± 50,548 (136,874 to 237,969 returns). Figures are rounded.

⁵ In some instances, only a portion of the refund claimed on the amended tax return was in error. Figure is rounded.

⁶ Our projection is based on a 95 percent confidence level and a precision (range) of ± \$159,799,753 (\$280,084,500 to \$599,684,006). Figures are rounded.



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- Estimated cost to process *****2*****
*****2*****.
- Estimated cost to systemically process *****2*****
*****2*****.
- Estimated cost to systemically process *****2*****
*****2*****.

Based on our computed cost estimates, we estimate that the IRS could have saved \$17,061,129 (\$20,043,932 - \$2,489,553 - \$493,250) if it had systemically processed amended tax returns during Fiscal Year 2012.



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Appendix V

*Form 1040X, Amended U.S.
Individual Income Tax Return*

Form 1040X <small>(Rev. December 2012)</small>	Department of the Treasury—Internal Revenue Service Amended U.S. Individual Income Tax Return <small>► information about Form 1040X and its separate instructions is at www.irs.gov/form1040x.</small>	OMB No. 1545-0074	
This return is for calendar year <input type="checkbox"/> 2012 <input type="checkbox"/> 2011 <input type="checkbox"/> 2010 <input type="checkbox"/> 2009 Other year. Enter one: calendar year or fiscal year (month and year ended):			
Your first name and initial		Last name	Your social security number
If a joint return, spouse's first name and initial		Last name	Spouse's social security number
Home address (number and street). If you have a P.O. box, see instructions.		Apt. no.	Your phone number
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).			
Foreign country name		Foreign province/state/county	Foreign postal code
Amended return filing status. You must check one box even if you are not changing your filing status. Caution. In general, you cannot change your filing status from joint to separate returns after the due date.			
<input type="checkbox"/> Single <input type="checkbox"/> Married filing jointly <input type="checkbox"/> Married filing separately <input type="checkbox"/> Qualifying widow(er) <input type="checkbox"/> Head of household (If the qualifying person is a child but not your dependent, see instructions.)			
Use Part III on the back to explain any changes			
Income and Deductions		A. Original amount or as previously adjusted (see instructions)	B. Net change— amount of increase or (decrease)— explain in Part III
1 Adjusted gross income. If net operating loss (NOL) carryback is included, check here <input type="checkbox"/>		1	
2 Itemized deductions or standard deduction		2	
3 Subtract line 2 from line 1		3	
4 Exemptions. If changing, complete Part I on page 2 and enter the amount from line 30		4	
5 Taxable income. Subtract line 4 from line 3.		5	
Tax Liability			
6 Tax. Enter method used to figure tax:		6	
7 Credits. If general business credit carryback is included, check here <input type="checkbox"/>		7	
8 Subtract line 7 from line 6. If the result is zero or less, enter -0-		8	
9 Other taxes		9	
10 Total tax. Add lines 8 and 9		10	
Payments			
11 Federal income tax withheld and excess social security and tier 1 RRTA tax withheld (if changing , see instructions)		11	
12 Estimated tax payments, including amount applied from prior year's return		12	
13 Earned income credit (EIC)		13	
14 Refundable credits from Schedule(s) <input type="checkbox"/> 8812 or <input type="checkbox"/> M or Form(s) <input type="checkbox"/> 2439 <input type="checkbox"/> 4136 <input type="checkbox"/> 5405 <input type="checkbox"/> 8801 <input type="checkbox"/> 8812 (2009-2011) <input type="checkbox"/> 8839 <input type="checkbox"/> 8863 <input type="checkbox"/> 8885 or <input type="checkbox"/> other (specify):		14	
15 Total amount paid with request for extension of time to file, tax paid with original return, and additional tax paid after return was filed		15	
16 Total payments. Add lines 11 through 15		16	
Refund or Amount You Owe (Note. Allow 8-12 weeks to process Form 1040X.)			
17 Overpayment, if any, as shown on original return or as previously adjusted by the IRS.		17	
18 Subtract line 17 from line 16 (if less than zero, see instructions)		18	
19 Amount you owe. If line 10, column C, is more than line 18, enter the difference		19	
20 If line 10, column C, is less than line 18, enter the difference. This is the amount overpaid on this return		20	
21 Amount of line 20 you want refunded to you		21	
22 Amount of line 20 you want applied to your (enter year): estimated tax 22		22	
Complete and sign this form on Page 2.			
For Paperwork Reduction Act Notice, see instructions.		Cat. No. 11360L	Form 1040X (Rev. 12-2012)



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Part I Exemptions

Complete this part **only** if you are:

- Increasing or decreasing the number of exemptions (personal and dependents) claimed on line 6d of the return you are amending, or
- Increasing or decreasing the exemption amount for housing individuals displaced by a Midwestern disaster in 2009.

See Form 1040 or Form 1040A instructions and Form 1040X instructions.

		A. Original number of exemptions or amount reported or as previously adjusted	B. Net change	C. Correct number or amount
23 Yourself and spouse. Caution. If someone can claim you as a dependent, you cannot claim an exemption for yourself	23			
24 Your dependent children who lived with you	24			
25 Your dependent children who did not live with you due to divorce or separation	25			
26 Other dependents	26			
27 Total number of exemptions. Add lines 23 through 26	27			
28 Multiply the number of exemptions claimed on line 27 by the exemption amount shown in the instructions for line 28 for the year you are amending	28			
29 If you are claiming an exemption amount for housing individuals displaced by a Midwestern disaster, enter the amount from Form 8914, line 6 for 2009	29			
30 Add lines 28 and 29. Enter the result here and on line 4 on page 1 of this form	30			
31 List ALL dependents (children and others) claimed on this amended return. If more than 4 dependents, see instructions.				

(a) First name	Last name	(b) Dependent's social security number	(c) Dependent's relationship to you	(d) Check box if qualifying child for child tax credit (see instructions)
				<input type="checkbox"/>

Part II Presidential Election Campaign Fund

Checking below will not increase your tax or reduce your refund.

Check here if you did not previously want \$3 to go to the fund, but now do.

Check here if this is a joint return and your spouse did not previously want \$3 to go to the fund, but now does.

Part III Explanation of changes. In the space provided below, tell us why you are filing Form 1040X.

▶ Attach any supporting documents and new or changed forms and schedules.

Sign Here
Remember to keep a copy of this form for your records.

Under penalties of perjury, I declare that I have filed an original return and that I have examined this amended return, including accompanying schedules and statements, and to the best of my knowledge and belief, this amended return is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information about which the preparer has any knowledge.

▶ Your signature _____ Date _____ ▶ Spouse's signature. If a joint return, **both** must sign. _____ Date _____

Paid Preparer Use Only

▶ Preparer's signature _____ Date _____ Firm's name (or yours if self-employed) _____

Print/type preparer's name _____ Firm's address and ZIP code _____

PTIN _____ Check if self-employed _____ Phone number _____ EIN _____

For forms and publications, visit IRS.gov. Form **1040X** (Rev. 12-2012)

Source: IRS.gov.



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Appendix VI

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

MAR 17 2014

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

FROM: Debra Holland *Debra Holland*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Amended Tax Return Filing and Processing
Needs to Be Modernized to Reduce Erroneous Refunds,
Processing Costs, and Taxpayer Burden (Audit # 201240043)

Thank you for the opportunity to review the subject draft report. As noted, taxpayers may file amended tax returns for reasons ranging from correcting errors discovered on original returns to electing certain economic relief provisions of the Internal Revenue Code. The ability to carry back some losses, such as net operating losses and casualty losses suffered in presidentially-declared disaster areas, to years in which taxable income was realized can provide much-needed financial relief to taxpayers in hardship situations.

We agree that automation of the amended return process, to the greatest extent possible, will result in improved efficiencies in taxpayer service and tax administration. In a previous audit¹, the Treasury Inspector General for Tax Administration (TIGTA) reported that the planned functionality for the Modernized e-File system (MeF) included the ability to electronically file amended individual income tax returns. As the MeF system has proven capable of serving as the sole platform for receiving electronically filed individual income tax returns, we are taking steps to move toward the desired future state of electronic amended return filing.

In April 2013, the IRS initiated a process to define the business vision of the electronic amended return process. Subject matter experts were assembled from affected business functions to develop the system's goals, objectives, and business requirements. The appearance, or format, of the amended income tax return is also being considered in conjunction with determining the system requirements and impacts to the existing systems. At the end of the 2014 Filing Season, the requirements will be documented and submitted to the Information Technology Division for an engineering study and cost estimate. As with any major initiative, funding is the critical component

¹ *System Errors and Lower Than Expected Tax Return Volumes Affected the Implementation of the Modernized System for Individual Tax Return Processing* (Reference Number 2010-40-111, Issued September 8, 2010).



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between design and implementation. In these challenging budgetary times, automation of the amended return filing process will compete for limited resources with other priority needs and will be dependent on the availability of adequate funding.

Manually processing amended returns is dependent on employee diligence and adherence to procedures. Because there is a risk of error, a suite of automated tools is available for employee use when processing adjustments to taxpayer accounts. These tools interface with the Master File and other supporting systems to ensure accounts are researched for potential issues that could affect the processing of the amended return and that adjustments are posted correctly. A tool specific for use with amended returns performs systemic checks similar to those performed during automated processing of original returns. It also provides employees with probe and response screens to assist them in determining if an amended return should be referred for review by the Examination function; provides checklist reminders for required documents, and ensures adjustment amounts are correct before posting to the taxpayer's account.

We are also concerned with the accuracy of claims submitted on amended returns. The IRS began a study in October 2012 to measure tax law compliance as it relates to amended returns. The study is currently exploring the issues that drive non-compliance. The next step will be to identify improvements to non-compliance treatment and mitigation strategies.

We disagree with the outcome measure of \$2.1 billion dollars in revenue protection over a five-year period. The TIGTA's analysis includes questionable claims in the computation of erroneous refunds paid. It is important to note that questionable claims do not summararily equate to erroneous claims. The validity of a claim can only be determined by an examination of the claim itself. The questionable claims identified in the TIGTA's sample did not meet the minimum criteria for referral to the Compliance function for additional review and possible selection for audit. Further, our review of the exception cases identified several where we disagree that procedural errors were made, or that the claims remain questionable after additional research was performed.

We also disagree with the outcome measure of \$17 million to be achieved from systemically processing amended tax returns. Electronic filing of amended tax returns will yield savings associated with the basic validity checks that can be performed by the MeF system; however, amended returns, like original returns, often reflect complex sets of facts and circumstances for which it is not practical to program validation routines. In those cases, even with electronic filing, returns are, and will continue to be, flagged for additional review. The TIGTA's analysis assumes electronically filed returns would require no further processing or review prior to posting adjustments to taxpayer accounts.



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

Attachment



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Attachment

Recommendations

To reduce processing costs and taxpayer burden as well as *****2*****
*****2*****to ensure that amended tax return refund
claims are valid, the Commissioner, Wage and Investment Division, should:

RECOMMENDATION 1

Revise the Form 1040 to enable taxpayers to amend their original tax return using this form.

CORRECTIVE ACTION

We will consider the format and appearance of Form 1040X, *Amended U.S. Individual Income Tax Return*, in conjunction with the implementation of electronic filing of amended returns. We do not agree that revisions to Form 1040, *U.S. Individual Income Tax Return*, are warranted at this time. The recommended changes to the Form 1040 could result in a substantial increase in reporting burden and complexity for taxpayers who file the Form 1040 and related forms and schedules. Significant changes to existing systems would be necessary. A distinction would continue to exist between original and amended returns, regardless of form appearance, and processing would continue to follow existing procedures for adjusting the taxpayer's account.

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIAL

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

Recommendation 2

Expand e-filing to include amended tax returns.

CORRECTIVE ACTION

The ability to electronically file amended tax returns has been a long-term goal of the IRS for the Modernized e-File platform. The business vision and high-level requirements for the process are being developed and will be provided to Information Technology (IT) by the end of the 2014 Filing Season for a feasibility study and cost estimate. Implementing an e-file option for amended returns will be dependent on the availability of funding for IT resources and services, which is beyond the immediate control of the IRS. We will consider the corrective action to be completed with the submission of the business needs analysis to the IT function.



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IMPLEMENTATION DATE

March 15, 2015

RESPONSIBLE OFFICIAL

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

CORRECTIVE ACTION MONITORING PLAN

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

Recommendation 3

Conduct a review of the 44 amended tax returns that TIGTA identified in which potentially erroneous refunds were issued to determine the proper tax liability.

CORRECTIVE ACTION

We have reviewed the 44 accounts identified by the Treasury Inspector General for Tax Administration. Generally, we agree that procedures were not followed for those identified as having processing errors. We disagree that claims identified as being questionable were not processed correctly. None of the claims met criteria for forwarding to the Compliance function for further review and, in reviewing those cases, it appears that the initial questions were resolved with additional research.

IMPLEMENTATION DATE

Completed, September 3, 2013

RESPONSIBLE OFFICIAL

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

CORRECTIVE ACTION MONITORING PLAN

N/A