

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



The IRS's Inability to Timely Process Noncorporate Applications for Refund of Net Operating Losses Under the CARES Act Delayed Taxpayer Refunds and Cost Millions of Dollars in Additional Interest

September 7, 2022

Report Number: 2022-36-048

Why TIGTA Did This Audit

This audit was initiated to assess the IRS's efforts to ensure individual taxpayers' compliance with the net operating loss (NOL) provisions associated with the Coronavirus Aid, Relief, and Economic Security (CARES) Act and Form 1045, *Application for Tentative Refund*.

Impact on Tax Administration

The CARES Act was passed to financially assist individual and business taxpayers through the pandemic. Sections 2303 and 2304 of the CARES Act, signed into law on March 27, 2020, made several modifications that temporarily repealed certain restrictions imposed by the Tax Cuts and Jobs Act. Although the temporary repeal provided an opportunity for taxpayers to carry back losses, which were previously limited, challenges in processing a substantial increase in applications for refund associated with these carrybacks has cost the Federal Government at least \$42 million in accumulated interest for Fiscal Years 2020 and 2021.

What TIGTA Found

In spite of initial actions to promote more efficient processing of applications for tentative refunds, including the ability to e-fax these applications, the IRS was unable to timely process the large volume of applications and accumulated a large backlog. The IRS is statutorily required to process tentative refund applications within 90 days. However, the number of Forms 1045 considered over-aged (*i.e.*, not processed within 90 days) increased from 900 in Fiscal Year 2020 to 7,585 in Fiscal Year 2021. The cases remaining in ending inventory (*i.e.*, not processed by the end of the fiscal year) went from 1,626 in Fiscal Year 2020 to 8,974 in Fiscal Year 2021. The overall impact has been negative for both taxpayers, whose potential refunds have been delayed, as well as the Federal Government, which must pay the accumulated interest due to taxpayers on these delayed refunds.

IRS officials stated that CARES Act changes presented a different compliance risk because they were generally more favorable to the taxpayer. As such, they believed compliance risk was not as high as in other areas and made no effort to update examination plans to ensure that taxpayers complied with the provisions of the CARES Act.

Finally, the IRS did not change the criteria it used to identify potentially noncompliant cases during NOL processing that would require further scrutiny by the IRS's Examination functions despite the large volume of cases and, at times, significant losses being carried back under the CARES Act.

What TIGTA Recommended

TIGTA made four recommendations to the Commissioner, Small Business/Self-Employed Division, and the Commissioner, Wage and Investment Division, that included: 1) devoting additional resources to process applications for tentative refunds faster to reduce the accumulation of interest; 2) completing the evaluation of filing tentative refunds by e-fax; 3) developing contingency plans, specific to the processing of Forms 1045, so that taxpayers are not adversely affected by a future cessation of operations; and 4) evaluating compliance strategies to determine if they match the risks presented by the CARES Act.

IRS management agreed with three recommendations and disagreed with the fourth, stating that they had evaluated the risks associated with changes to the NOL deduction provisions and completed training, publication of materials, and Internal Revenue Manual updates. However, the statute of limitations for tax returns involving CARES Act NOL provisions will not expire until Calendar Year 2024 at the earliest. Therefore, TIGTA maintains that it would be prudent for the IRS to consider the risks associated with CARES Act NOL provisions for the Tax Years 2018 through 2020 returns it will be examining in the coming years.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20024

September 7, 2022

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

FROM:

Heather Hill

Heather M. Hill
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – The IRS’s Inability to Timely Process Noncorporate Applications for Refund of Net Operating Losses Under the CARES Act Delayed Taxpayer Refunds and Cost Millions of Dollars in Additional Interest (Audit # 202130622)

This report presents the results of our review to assess the Internal Revenue Service’s efforts to promote noncorporate business taxpayer compliance with tentative refund applications and claims under Section 2303 and 2304 Net Operating Loss provisions of the Coronavirus Aid, Relief, and Economic Security Act.¹ This review is part of our Fiscal Year 2022 Annual Audit Plan and addresses the major management and performance challenge of *Responding to the COVID-19 Pandemic*.

Management’s complete response to the draft report is included as Appendix II.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).

¹ Pub. L. No. 116-136, 134 Stat. 281 (codified as amended in scattered sections of 2, 5, 12, 15, 20, 21, 29, 42, and 45 U.S.C.).

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Background

Fluctuations in income and expenses can cause a taxpayer to have substantial profits in one tax year and losses in another. A Net Operating Loss (NOL) might occur when a taxpayer's allowable deductions exceeds its gross income for a tax year, resulting in negative income. A taxpayer with an NOL potentially does not owe any income taxes for the tax year generating the loss and, prior to the passage of the Tax Cuts and Jobs Act (TCJA), may have been able to carry back the loss to offset income reported in earlier tax years, which could result in a refund of taxes already paid.¹ Any loss remaining after applying the NOL to preceding tax years may be carried forward and applied to taxable income in future tax years. However, for NOLs arising in tax years beginning after 2017, the TCJA generally removed the option for most entities to carry back an NOL and limited the amount of an NOL that could be carried forward to 80 percent of taxable income.

Due to the Coronavirus Disease 2019 pandemic, the Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020 included tax measures to provide assistance to individual taxpayers.² Section 2303 of the CARES Act amended Internal Revenue Code (I.R.C.) § 172 concerning NOLs, and § 2304 of the CARES Act amended I.R.C. § 461(l) concerning Excess Business Losses (EBL). Figure 1 shows a summary of the legislative changes for NOLs and EBLs.

Figure 1: Legislative Changes for NOLs and EBLs

	NOLs	EBLs
TCJA Section	13302	11012
CARES Act Section	2303	2304
Major Changes	Carrying Time and Limiting to Percentage of Taxable Income	Establish and Implement EBL
Taxpayers Impacted	All	Individuals
Required to Amend	Optional ³	Mandatory
Method(s) to Amend	Form 1040-X or Form 1045	Form 1040-X

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of the TCJA and the CARES Act. Form 1040-X, Amended U.S. Individual Income Tax Return. Form 1045, Application for Tentative Refund.

¹ Pub. L. No. 115-97, 131 Stat. 2054 (2017). Officially known as "An act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for Fiscal Year 2018."

² Pub. L. No. 116-136, 134 Stat. 281 (codified as amended in scattered sections of 2, 5, 12, 15, 20, 21, 29, 42, and 45 U.S.C.).

³ A taxpayer could elect to forgo the carryback; however, the time frame associated with making this election has passed.

Net Operating Losses

As shown in Figure 2, both the TCJA and the CARES Act changed the tax law regarding the use of NOLs. The changes involved altering the rules regarding carrybacks and carryforwards and limiting NOLs to a certain percentage of taxable income.⁴

Figure 2: NOL Carryback and Carryforward Rules Due to the CARES Act

	Carryback Period	Carryforward Period	Limitation on NOL Utilization in Carryforward Period		
			Tax Years Before TY 2018	TYs 2018 - 2020	Tax Years After TY 2020
Pre-2018 NOLs	2 years	20 years	Not limited	Not limited	Not limited
TYs 2018 - 2020 NOLs	5 years	Indefinite	N/A	Not limited	80% limitation
Post-2020 NOLs (TCJA)	N/A (no carryback)	Indefinite	N/A	N/A	80% limitation

Source: TIGTA analysis of the TCJA and the CARES Act.

The TCJA represented the most significant tax code overhaul in more than three decades. Section 13302 of the TCJA repealed the carryback periods for NOLs incurred in tax years ending after December 31, 2017, while allowing for the carryback of certain NOLs.

Specifically, Section 13302 of the TCJA modified the rules governing NOL deduction as follows:

- The NOL deduction was limited to 80 percent of taxable income for NOLs arising in tax years beginning after December 31, 2017. In other words, the NOL can only reduce taxable income by 80 percent, even if the NOL was large enough to reduce it by more (with an exception for farms and non-life insurance companies).
- Repealed the two-year and other specified carryback provisions for NOLs arising in tax years ending after December 31, 2017, with the exception of certain losses incurred in the trade or business of farming and non-life insurance companies.⁵

The CARES Act of 2020 was intended to provide fast and direct economic assistance for American workers, families, small businesses, and industries. Section 2303 of the CARES Act made several modifications that temporarily repealed certain restrictions imposed by the TCJA affecting NOLs as well as altering other NOL rules. In particular, the CARES Act made the following changes to rules for NOLs arising in tax years beginning after December 31, 2017, and before January 1, 2021 (*i.e.*, Tax Years (TY) 2018 through 2020):

- Repealed the 80 percent of taxable income limitation for NOLs claimed in tax years prior to 2021. However, for TY 2021 and later, the 80 percent limitation applies to NOLs arising in TY 2018 and later.

⁴ Farming and non-life insurance companies have unique NOL rules. The changes and rules discussed in this report are focused on the general NOL rules applicable to all other types of taxpayers.

⁵ Section 13302 also allowed an indefinite carryforward of NOLs, with the exception of farming and non-life insurance companies (which can carry forward an NOL for 20 tax years), and allowed taxpayers to waive the carryback period.

The IRS's Inability to Timely Process Noncorporate Applications for Refund of Net Operating Losses Under the CARES Act Delayed Taxpayer Refunds and Cost Millions of Dollars in Additional Interest

- Repealed the disallowance of NOL carrybacks for NOLs arising in TYs 2018 through 2020 originally imposed by the TCJA.
- Created a five-year carryback period for NOLs arising in TYs 2018 through 2020 rather than the two-year carryback period which had existed before the TCJA.

These temporary repeals were intended to allow more taxpayers to carry back losses to profitable tax years to generate refunds of previously paid taxes. Section 2303 requires a taxpayer with an NOL arising in TYs 2018, 2019, or 2020 to carry back that loss to each of the five taxable years preceding the taxable year of the loss unless the taxpayer elects to waive the entire carryback period.

Implementation of Section 2303 of the CARES Act

Individual taxpayers with an NOL have a choice of two methods to carry back their loss, each with separate rules.⁶ A taxpayer may:

- File a Form 1045, *Application for Tentative Refund*, which generally must be filed within one year after the end of the tax year with the NOL. A taxpayer can file one Form 1045 to carry back their loss to all applicable preceding gain years. The primary advantage of filing an application for a tentative refund using Form 1045 is that the original return with the NOL does not have to be completely processed by the Internal Revenue Service (IRS) before the refund can be approved, thus making the refund “tentative.” This means the refund can be issued prior to verification of the posted tax return. Additionally, a tentative refund can be processed prior to potential referral of the tax return for examination. Notice 2020-26 granted a six-month extension for taxpayers to file Form 1045 to apply for a tentative refund from the carryback of an NOL that arose in a taxable year that began during Calendar Year 2018 and ended on or before June 30, 2019.⁷
- File an amended return using Form 1040-X, *Amended U.S. Individual Income Tax Return*. Unlike the tentative refund, Form 1040-X has to be filed for each carryback year and must generally be filed within the statutory period of three years from the due date of the loss year return.

While the IRS is statutorily required to process tentative refund applications within 90 days, interest must be paid on refunds if they are not issued within 45 days. The same rules for paying interest on refunds not processed within 45 days apply for amended returns. However, the IRS is not statutorily required to process amended return carryback claims within 90 days.

EBLs

Section 11012 of the TCJA created the EBL limitation under I.R.C. § 461(l). Prior to the TCJA, there was no general limit on the amount of business losses that most noncorporate taxpayers could use to reduce their nonbusiness income if the taxpayer was a material participant in the business. The creation of I.R.C. § 461(l) under the TCJA limited the use of such losses to \$250,000 (or \$500,000 for joint returns), with the amounts adjusted for inflation each year. Losses above this limit were classified as EBLs and treated as an NOL carryforward.

⁶ Rev. Proc. 2020-24.

⁷ Notice 2020-26, *Extension of Time to File Application for Tentative Carryback Adjustment* (April 2020).

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Noncorporate taxpayers were required to report EBLs on the newly created Form 461, *Limitation on Business Losses*. The TCJA's EBL limitation was temporary, applying to TYs 2018 through 2025. However, the America Rescue Plan Act of 2021 extended the EBL limitation through TY 2026.⁸

Section 2304 of the CARES Act retroactively eliminated the EBL limitation for TYs 2018 through 2020. As a result, noncorporate taxpayers with an EBL in TY 2018 or 2019 were required to amend their tax returns for the applicable years. Because the CARES Act was passed in March 2020, taxpayers had no requirement to report any EBL for TY 2020 (filing year 2021).

Figure 3: EBL Changes From the TCJA and the CARES Act

Time Period	Applicability of EBLs
Before the TCJA	Did Not Exist
TCJA	EBLs Applicable to TYs 2018 Through 2026 ⁹
CARES Act	EBLs Applicable to TYs 2021 Through 2026 ¹⁰

Source: TIGTA analysis of the TCJA and the CARES Act.

Section 2304 of the CARES Act also clarified previous areas of ambiguity that arose when taxpayers attempted to calculate EBLs. Section 2304 amended I.R.C. § 461(l) to specify that the following are not taken into account when calculating EBLs:

- Deductions under I.R.C. § 172 (NOL).
- Deductions under I.R.C. § 199A (Qualified Business Income).
- Deductions, gross income, and gains from employee services.
- Capital losses.

Implementation of Section 2304 of the CARES Act

The only method for taxpayers to apply the retroactive changes in I.R.C. § 461(l) was to amend their TY 2018 or 2019 returns. Individual taxpayers could not use Form 1045 because it is used to apply for a refund resulting from the carryback of an NOL. The retroactive change to I.R.C. § 461(l) requires applying a previously disallowed loss within the same year that the loss arose.

The deadline to file Form 1040-X is three years (including extensions) after the date that the taxpayer filed the original return or two years from the date that the taxpayer paid their tax, whichever is later. A return filed before the unextended deadline is considered filed on the unextended deadline (generally April 15). Figure 4 shows the deadlines to file Forms 1045 and 1040-X.

⁸ H.R. 1319, 117th Congress (2021–2022).

⁹ The America Rescue Plan Act of 2021 extended the TCJA EBL limitation through TY 2026.

¹⁰ The America Rescue Plan Act of 2021 extended the CARES Act EBL limitation through TY 2026.

Figure 4: Deadlines to File Forms 1045 and 1040-X

TY	Form 1045 (only available for NOLs)	Form 1040-X (available for both NOLs and EBLs)
2018	June 30, 2020	April 15, 2022 (unless extended)
2019	December 31, 2020	April 15, 2023 (unless extended)

Source: TIGTA analysis of IRS Notice 2020-26.

Results of Review

The CARES Act was passed to financially assist individual and business taxpayers through the pandemic. However, the IRS was unable to timely process the large volume of tentative refund applications associated with the carryback NOLs that were filed as a result of the change in the tax law. In addition to the abrupt reversal in tax law, the IRS's lack of resources during the pandemic caused a backlog for taxpayers applying for a quick refund. Also, the IRS's Examination functions did not consider changing their approach to ensuring taxpayer compliance with CARES Act provisions, even though this reversed tax law associated with the TCJA. Finally, the IRS did not change the criteria it used to identify potentially noncompliant cases during NOL processing that would require further scrutiny by the IRS's Examination functions despite the large volume of cases and, at times, significant losses being carried back under the CARES Act.

A Significant Number of Tentative Refund Applications Submitted Under the CARES Act Remain in Inventory

From Fiscal Year (FY) 2020 to FY 2021, the IRS accumulated a large backlog of applications for tentative refunds. Specifically, the number of Forms 1045 considered to be over-aged (*i.e.*, not processed within 90 days) increased by more than 743 percent, from 900 in FY 2020 to more than 7,500 in FY 2021. The number of cases remaining in ending inventory (*i.e.*, not processed by the end of the fiscal year) increased by 452 percent, from 1,626 in FY 2020 to 8,974 in FY 2021. In addition, although the IRS was unable to provide the specific cycle time associated with Forms 1045, it did provide cycle times associated with processing both individual and business carryback adjustments, which showed that the overall cycle time to process all carrybacks increased substantially, from 79 days in FY 2020 to 155 days in FY 2021.¹¹ Figure 5 shows the tentative case dispositions during FYs 2020 and 2021.

More concrete steps should be taken to mitigate additional interest and costs to taxpayers.

¹¹ Cycle time is a measure associated with elapsed calendar days.

Figure 5: Statistical Comparison of Applications for Tentative Refunds Filed on Form 1045 in FYs 2020 and 2021

FY	Actual Closures	Ending Inventory	Over-Aged Inventory
2020	23,326	1,626	900
2021	42,190	8,974	7,585

Source: FY 2021 Accounts Management Carryback Inventory Report.

Our review of a judgmental sample of 15 cases that included tentative refund applications determined that all appeared to have been processed correctly.¹² The IRS's quality review process has previously determined that 94 percent of the tentative refund application cases it reviewed were processed accurately. However, TIGTA recently reported that 150 tentative refund applications may have been processed erroneously.¹³ In TIGTA's report, the IRS agreed that these 150 applications were submitted after the filing deadline of July 15, 2020, associated with Notice 2020-23.¹⁴

TIGTA also reported that the IRS established temporary procedures to accept eligible carryback refunds through dedicated e-fax lines on April 17, 2020. Only carryback refunds on Form 1139, *Corporation Application for Tentative Refund*, and Form 1045 could be submitted via the dedicated e-fax line. This process was put in place to enable the customer service representatives to review and process these applications while working remotely during the pandemic. In addition, the IRS updated its internal processing procedures for carrybacks and issued these updates to the customer service representatives in an effort to properly implement the new legislative changes.

IRS officials stated that Forms 1045 were permitted to be filed via e-fax for only a short period of time. The temporary procedures to e-fax the Form 1139 or Form 1045 were no longer operational after December 31, 2020. When we questioned IRS officials about the decision to discontinue the use of e-fax, they reiterated that the procedures were intended to mitigate delivery issues for processing sites that were closed. They conveyed that there was significant manual effort required to load NOL refund applications submitted via e-fax into the Correspondence Imaging System. They also said some taxpayer submissions included multiple faxes that were not complete or were forms other than those associated with Forms 1139 or 1045. In addition, they indicated that taxpayers submitted forms other than Form 1045 through the dedicated e-fax line.

Despite the negative attributes of e-fax submission of NOL refund applications cited by the IRS, the IRS has begun an assessment to evaluate the overall efficiency of the process. The evaluation will consider expansion of e-fax services for inventory receipts. The overall impact

¹² A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population. The population included taxpayers that filed Forms 461, *Limitation on Business Losses*, and also submitted either a Form 1040-X or a Form 1045. We used the Form 461 in our match to identify potential filers that were claiming a business loss.

¹³ TIGTA, Report No. 2021-46-035, *Assessment of Processes to Verify Tentative Carryback Refund Eligibility* (Mar. 2021).

¹⁴ Notice 2020-23, *Additional Relief for Taxpayers Affected by Ongoing Coronavirus Disease 2019 Pandemic* (April 2020).

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has been negative for taxpayers submitting tentative refund applications whose potential refunds have been delayed as well as for the Federal Government because of the accumulated interest due to taxpayers on these delayed refunds. Figure 6 shows the accumulation of interest due to taxpayers in FYs 2020 and 2021.

Figure 6: Carrybacks and Interest Paid in FYs 2020 and 2021

FY	Interest Due to Taxpayer ¹⁵	Generated Interest on Overpayment ¹⁶	Total
2020	\$6,038,405	\$3,501,736	\$9,540,141
2021	\$27,230,688	\$5,381,076	\$32,611,764
Total	\$33,269,093	\$8,882,812	\$42,151,905

Source: IRS Individual Master File Account Reports for Carryback Interest for FYs 2020 and 2021.¹⁷

The amount of interest accumulated due to the IRS's inability to process applications for tentative refunds in a timely manner totaled over \$42 million for FYs 2020 and 2021.¹⁸ IRS officials stated that they do not believe the amount of interest paid is a reliable or meaningful measure and stressed that the cost to the Government is mitigated because the Government has use of the funds while the applications are being processed, thus reducing the need for borrowing the funds. However, the interest rate the IRS pays on individual (noncorporate) refunds is three percentage points higher than the rate the Government pays for Federal short-term borrowing. In a recent report, the Government Accountability Office recognized that a portion of annual refund interest required to be paid is due to circumstances outside of the IRS's control but that managing returns with interest does fall under the IRS's purview and is an expense to the Department of the Treasury.¹⁹ It also reported that the IRS has not established a mechanism to effectively identify, monitor, and mitigate issues contributing to refund interest payments.

While the general intention of tax law changes associated with the CARES Act was to move money into the hands of taxpayers quickly, the backlog and interest costs do not include the opportunity cost that taxpayers experienced as a result of potential refunds not being processed timely. The IRS recently announced a surge initiative to have employees from other functions or operations, some with Accounts Management experience within the past two years, detailed back to those respective operations to assist with reducing the backlogs. The IRS did not confirm that employees were being moved to work the specific backlog of Forms 1045 but

¹⁵ Interest associated with an IRS Master File Transaction Code 770, which credits a tax period for interest on overpayment.

¹⁶ Interest due on overpayment associated with an IRS Master File Transaction Code 776, which credits a tax period for interest associated with overpayment.

¹⁷ Individual Master File is the IRS database that maintains transactions or records of individual tax accounts.

¹⁸ We calculated the \$42 million in interest by totaling the amounts reported by the IRS on an internal Individual Cumulative Report associated with tentative carrybacks. We totaled the amounts reported as interest due to taxpayer and interest due to overpayment, or transaction codes 770 and 776 respectively.

¹⁹ Government Accountability Office, *GAO-22-104938, Tax Filing, 2021 Performance Underscores Need for IRS to Address Persistent Challenges*, p. 25 (April 11, 2022).

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indicated that it was possible that some employees selected to assist with backlogs had worked in the area prior to leaving. Given the cost to taxpayers to date, more concrete steps should be taken to mitigate additional interest and costs to the extent possible.

The Commissioner, Small Business/Self-Employed Division, and the Commissioner, Wage and Investment Division, should:

Recommendation 1: Devote additional resources to process the tentative refunds faster and reduce interest payments.

Management's Response: IRS management agreed with this recommendation and stated that it has been implemented. On February 2, 2022, additional resources were devoted to all inventories, including tentative refunds.

Recommendation 2: Develop contingency plans, specific to the processing of Forms 1045, so that taxpayers are not adversely affected by a future cessation in operations.

Management's Response: IRS management agreed with this recommendation and stated that it has been implemented. As of October 1, 2021, Accounts Management customer service representatives are now classified as frequent teleworkers, and all who meet telework eligibility criteria are able to telework 100 percent of the time in the event of future cessation of operations.

The Commissioner, Wage and Investment Division, should:

Recommendation 3: Complete the evaluation of filing tentative refunds by e-fax to determine its effectiveness.

Management's Response: IRS management agreed with this recommendation and stated that they will complete an evaluation of the Carryback e-Fax initiative that was previously used as a temporary measure.

Risk Criteria and Examination Plans Were Not Changed With the Significant Change in Tax Law

Even though the law reversed some of the carryback loss provisions of the TCJA, the IRS did not make adjustments or update its Examination plan to ensure that taxpayers complied with the provisions of the CARES Act. IRS officials stated that they considered whether updates were necessary and determined that the plan did not require adjusting. We were provided a Compliance plan associated with Sections 2303 and 2304 of the CARES Act, but the risks detailed in the plan were substantially associated with characteristics of the TCJA.²⁰ Although this is a starting point for assessing risk associated with CARES Act changes, the compliance plan was dated May 2020 and officials stated that it has not been updated since then.

²⁰ As an example of the risks associated with the TCJA, the IRS estimated that 24,809 taxpayers filed Form 461 claiming \$32.5 billion in EBLs under the TCJA in TY 2018. TIGTA obtained data from 4,815 Forms 461 filed electronically and found that only 1,949 of the Forms 461 actually claimed losses, totaling \$1.5 billion in TYs 2018 and 2019. The remaining forms were filed even though the taxpayers did not have a loss.

CARES Act provisions presented a different compliance risk, however, and IRS officials stated that the changes were generally more beneficial to the taxpayer. Due to these provisions, IRS officials believed that compliance risk was not as high in this area as in other areas and that issues would be more likely to arise in 2021 when NOLs become more restricted again. As a result, all of the returns filed after the tax law changes associated with the CARES Act would be evaluated with the same criteria as those returns filed under the TCJA. This is concerning because the CARES Act and the TCJA established different criteria for how taxpayers could claim NOLs. For example, the CARES Act reversed some TCJA provisions by removing the limits of individuals claiming NOL deductions and providing a mechanism to carry back the losses and offset past gains.

The IRS provided a summary of its implementation plans for Sections 2303 and 2304 of the CARES Act, as compiled in its Legislative Analysis, Tracking, and Implementation System.²¹ After reviewing entries in the system, we confirmed that there were no plans to change Examination plans as a result of the CARES Act and that the IRS will determine compliance with the CARES Act after the first returns are filed. The IRS established December 31, 2023, as the due date for its efforts to determine compliance with the CARES Act.

Criteria to refer applications for tentative refunds to Examination were not updated

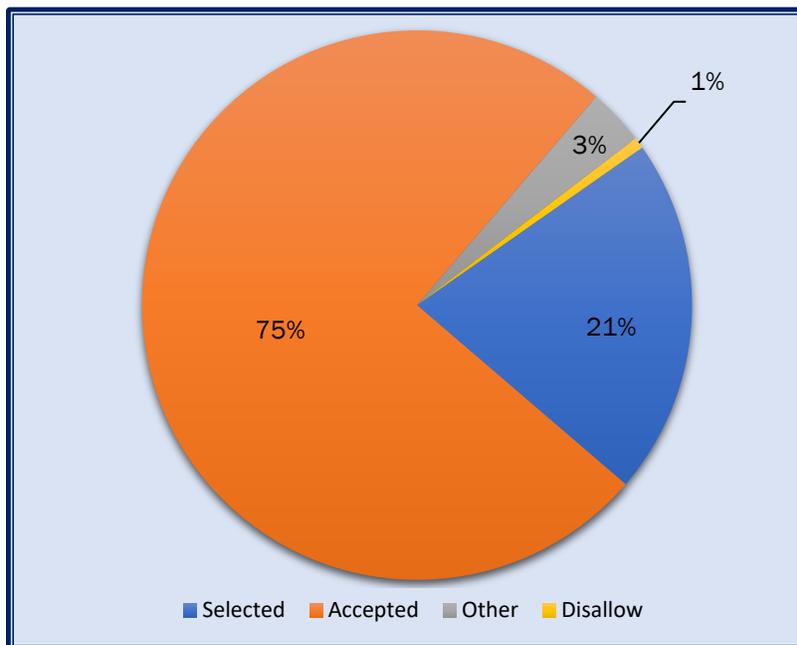
When processing a taxpayer's Form 1045, Accounts Management customer service representatives process the application for tentative refund using specific criteria known as "CAT-A" that directs them to refer cases to IRS examination functions for classification if they meet this criteria.²² We were informed that CAT-A criteria for issues related to Form 1045 had not been updated since 2009.

In FY 2021, 909 (5 percent) of the 17,469 Forms 1045 were referred for classification and 190 (1 percent) were ultimately selected for examination. In 154 (17 percent) of the 909 cases, the taxpayer was requesting a refund of more than \$2 million. Figure 7 provides the disposition of the 909 cases, which shows that 75 percent of the Forms 1045 were accepted by classification and sent forward for processing, while 21 percent were selected for further examination.

²¹ The Legislative Analysis, Tracking, and Implementation System is a legislative affairs system that manages, coordinates, and tracks actions taken by the IRS to implement legislation impacting the IRS.

²² Classification is a process in IRS examination operations intended to determine whether a return should be 1) Selected for Audit, 2) Accepted as Filed, 3) Fully or Partially Disallowed, or 4) Not Considered. Classifying returns should be based on an evaluation of the whole return as well as a consideration of individual line items found on the return. Evaluation of the whole return requires classifiers to make a judgment based on their knowledge and experience.

Figure 7: Disposition of Cases Referred to Examination Classification Using CAT-A Criteria



Source: IRS FY 2021 CAT-A data. Dispositions of cases not meeting CAT-A criteria and cases not considered are not reflected in the figure as they make up less than 1 percent of the total dispositions.

Recommendation 4: The Commissioner, Small Business/Self-Employed Division, and the Commissioner, Wage and Investment Division, should evaluate and update their compliance strategy associated with the CARES Act to determine if it matches the risks associated with reversing TCJA provisions.

Management's Response: IRS management disagreed with this recommendation and stated that the Small Business/Self-Employed Division Examination function evaluated the risks associated with changes to the NOL deduction provisions and completed training, publication of materials, and Internal Revenue Manual updates. It also stated that CARES Act provisions have since expired.

Office of Audit Comment: Tax returns involving CARES Act NOL provisions were submitted for TYs 2018 through 2020. The statute of limitations for these returns will not expire until Calendar Year 2024 at the earliest. Therefore, TIGTA maintains that it would be prudent for the IRS to consider the risks associated with CARES Act NOL provisions for the TY 2018 through TY 2020 returns it will be examining in the coming years.

Procedures Did Not Ensure That Examinations of Individual Taxpayers Consider Losses Filed by Taxpayers Under the CARES Act

In a separate review of corporate applications for tentative refunds, TIGTA found that:

- Eight examinations of Forms 1120, *U.S. Corporation Income Tax Return*, closed by the Small Business/Self-Employed Division resulted in adjustments on five cases, with no change to the remaining three cases.
- In three of the five cases with an examination adjustment, part of the tentative refund issued should have been recaptured, but the examiner failed to do so.²³

In all three cases, the examination resulted in a smaller NOL amount available to carry back. However, when the examiners completed the Form 4549, *Report of Income Tax Examination Changes*, the examiners did not consider the impact on tax computations from refunds already issued based on the processed Forms 1139.

The IRS agreed with these findings and took the following actions in order to raise examiner awareness, detailed in an Interim Guidance Memorandum:

To help ensure all actions taken by the taxpayer are considered during the examination, examiners should ask the taxpayer if the loss was carried back, and review the Integrated Data Retrieval System (at the beginning of the examination and again during the preparation of the Revenue Agent Report (Form 4549)) for all eligible carryback years in search of category and/or transaction codes indicating the loss was carried back.

Once finalized, this guidance will be incorporated into the Internal Revenue Manual. The procedural changes apply to both the Small Business/Self-Employed Division and the Large Business and International Division, covering both individual and corporate NOL filings.

In our review, we identified 34 individual taxpayers examined by the IRS who had also filed a Form 1045. There was no assessment in 21 of the 34 cases, while three cases resulted in an assessment for which the taxpayer had to pay additional tax. Although our review of these cases did not find a similar condition associated with individual taxpayers, we agree with the IRS's efforts to expand controls to examinations concerning both corporations and individuals.

²³ TIGTA, Report No. 2022-35-049, *Compliance Efforts Are Needed to Address Refund Claims Reported on Form 1139 That Are Based on the CARES Act Net Operating Loss Carryback Provisions* (Sept. 2022).

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to assess the IRS's efforts to promote noncorporate business taxpayer compliance with tentative refund applications and claims under Section 2303 and 2304 NOL provisions of the CARES Act. To accomplish our objective, we:

- Determined whether the IRS established controls to ensure that the NOL amounts claimed on Form 1045 (Line 10) were accurate and complied with the pertinent provisions of the CARES Act.
- Evaluated, to the extent possible, a judgmental sample of Forms 1045 to determine if the IRS processed Forms 1045 in accordance with the provisions of the CARES Act while considering established controls.¹
- Determined whether those Forms 1045 received and processed under CARES Act procedures were associated with the EBL limitation provision of the TCJA.
- Assessed whether the IRS's examination coverage and methods associated with individual NOLs and carrybacks, prior to the TCJA and during the TCJA, were used to develop a strategy for CARES Act changes.

Performance of This Review

This review was performed with information obtained from the Large Business and International, Small Business/Self-Employed, and Wage and Investment Divisions located in Washington, D.C.; Lanham, Maryland; and Atlanta, Georgia, respectively, and in TIGTA offices located in Denver, Colorado, and Holtsville, New York, during the period May 2021 through May 2022. 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.

Major contributors to the report were Matthew Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations); Robert Jenness, Director; Curtis Kirschner, Audit Manager; John Chiappino, Lead Auditor; and Robert Steele, Auditor.

Validity and Reliability of Data From Computer-Based Systems

We performed tests to assess the reliability of data associated with Forms 1045 from the Correspondence Imaging System. Before relying on the data, we ensured that the files contained the specific data elements we requested. In addition, we selected data from the extract and verified that data in the extract reconciled to data captured in the Accounts Management Services system and within the Integrated Data Retrieval System. We also

¹ A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.

performed analyses to ensure the validity and reasonableness of our data. Based on our test results, we determined that the data were sufficiently reliable for purposes of this report.

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 that the following internal controls were relevant to our audit objective: the process for planning, organizing, directing, and controlling program operations for evaluating compliance with applications for tentative refunds and NOL carrybacks. We evaluated these controls by reviewing annual workplans; case processing; and examination procedures, metrics, and measures, as well as interviewing management and employees.

Appendix II

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D. C. 20224

August 15, 2022

MEMORANDUM FOR HEATHER M. HILL

DEPUTY INSPECTOR GENERAL FOR AUDIT

Amalia C.

Digitally signed by Amalia C.

Colbert

FROM:

Lia Colbert

Colbert

Date: 2022.08.16 07:29:15

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Commissioner, Small Business/Self-Employed Division

SUBJECT:

Draft Audit Report – The IRS's Inability to Timely Process Noncorporate Applications for Refund of Net Operating Losses Under the CARES Act Delayed Taxpayer Refunds and Cost Millions of Dollars in Additional Interest (Audit #202130622)

Thank you for the opportunity to review and comment on the subject draft audit report. Congress passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020 to help taxpayers financially during the COVID-19 pandemic. The CARES Act included two provisions expanding the opportunity for noncorporate taxpayers to deduct net operating losses (NOL). These provisions retroactively repealed the NOL deduction limitations put in place by the Tax Cuts and Jobs Act (TCJA) of 2017, for tax years 2018, 2019, and 2020. Between 2017 and 2021, the tax law related to NOL deductions changed three times. At the time of this report, CARES Act provisions have expired and TCJA provisions are in place limiting the deductibility of NOLs for tax years beginning after December 31, 2020.

The inventory of tentative refund applications increased significantly during the pandemic. We used multiple approaches to address all inventories affected by the COVID-19 pandemic, including carryback cases. These approaches include a Treasury approved reduction in the fiscal year (FY) level of service, which allowed us to move all campus customer service representatives (CSRs) from phone work to focus full-time on inventory. We detailed former Accounts Management employees back to focus on inventories and used overtime throughout the FY. We also trained additional staff for the carryback inventory. These efforts resulted in an increase of more than 6,000 additional tentative refund application closures compared to the same January through June time period in FY 2021. Additionally, we developed a temporary process to allow for the submission of certain carryback cases via a dedicated e-fax line.

The IRS's Inability to Timely Process Noncorporate Applications for Refund of Net Operating Losses Under the CARES Act Delayed Taxpayer Refunds and Cost Millions of Dollars in Additional Interest

2

We diligently evaluated the audit compliance risk associated with the changes to NOL deductions with the enactment of the CARES Act, just as we did with the changes made under TCJA. The CARES Act merely changed the timing of NOL deductions. We concluded that there were already sufficient mitigations in place to address the timing issues. Examiners conduct multi-year reviews during each audit and probe for appropriate carrybacks. We also have procedures in place to address when changes are made to the amount of the carry over to future year filings. We updated our training plans for both revenue agents and tax compliance officers. We ensured a robust communication plan was in place for both internal and external stakeholders. Finally, we also continue to verify the accuracy of requests for refund as they are received, processed, and evaluated for audit potential.

Attached are our comments and proposed actions to your recommendations. If you have any questions, please contact me, or Scott Irick, Director, Examination, Small Business/Self-Employed Division.

Attachment

The IRS's Inability to Timely Process Noncorporate Applications for Refund of Net Operating Losses Under the CARES Act Delayed Taxpayer Refunds and Cost Millions of Dollars in Additional Interest

Attachment

RECOMMENDATION 1:

The Commissioner, Small Business/Self Employed Division, and the Commissioner, Wage and Investment Division, should devote additional resources to process the tentative refunds faster and reduce interest payments.

CORRECTIVE ACTION:

On February 2, 2022, we devoted additional resources to all inventories, including the tentative refunds.

IMPLEMENTATION DATE:

Implemented.

RESPONSIBLE OFFICIAL:

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

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 2:

The Commissioner, Small Business/Self Employed Division, and the Commissioner, Wage and Investment Division, should develop contingency plans, specific to the processing of Forms 1045, so that taxpayers are not adversely affected by a future cessation in operations.

CORRECTIVE ACTION:

As of October 1, 2021, the Accounts Management (AM) customer service representatives (CSRs) are now classified as frequent teleworkers, and all who meet the telework eligibility criteria are able to telework 100 percent of the time in the event of future cessation of operations. In the event of another cessation of operations due to not being able to come to the office, whether it be pandemic or weather-related, AM will be able to keep most of its CSRs working provided there are no widespread service outages in a particular location.

IMPLEMENTATION DATE:

Implemented.

RESPONSIBLE OFFICIAL:

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

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 3:

The Commissioner, Wage and Investment Division, should complete the evaluation of filing tentative refunds by e-fax to determine its effectiveness.

CORRECTIVE ACTION:

We will complete the evaluation on the Carryback e-Fax initiative that was previously used as a temporary measure.

IMPLEMENTATION DATE:

October 15, 2022

RESPONSIBLE OFFICIAL:

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

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 4:

The Commissioner, Small Business/Self-Employed Division, and the Commissioner, Wage and Investment Division, should evaluate and update their compliance strategy associated with the CARES Act to determine if it matches the risks associated with reversing TCJA provisions.

CORRECTIVE ACTION:

Examination evaluated the risks associated with changes to the NOL deduction provisions. We completed training, publication of materials, and IRM updates. Currently, TCJA provisions are in place governing NOL deductions, and the CARES Act provisions have since expired.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL:

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

Appendix III

Abbreviations

CARES	Coronavirus Aid, Relief, and Economic Security
EBL	Excess Business Loss
FY	Fiscal Year
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
NOL	Net Operating Loss
TCJA	Tax Cuts and Jobs Act
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year



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Treasury Inspector General for Tax Administration

P.O. Box 589

Ben Franklin Station

Washington, D.C. 20044-0589

Information you provide is confidential, and you may remain anonymous.