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TAX ADMINISTRATION

Advance Tax Refund Program Was a Major Accomplishment, but Not Problem Free

G A O

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Abbreviations

CSR	customer service representative
DFAS	Defense Finance and Accounting Service
FMS	Financial Management Service
IRS	Internal Revenue Service
ITIN	Individual Taxpayer Identification Number
NAP	National Account Profile
SSN	Social Security number
TAS	Taxpayer Advocate Service
TIGTA	Treasury Inspector General for Tax Administration

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United States General Accounting Office
Washington, DC 20548

August 2, 2002

The Honorable Max Baucus
Chairman
The Honorable Charles E. Grassley
Ranking Minority Member
Committee on Finance
United States Senate

For tax years beginning after 2000, the Economic Growth and Tax Relief Reconciliation Act of 2001,[1] signed into law on June 7, 2001, applied a new 10-percent income tax rate to a portion of an individual's income that was previously taxed at 15 percent. To stimulate the economy more rapidly than would be achieved if taxpayers had to wait until they filed their tax year 2001 return to realize the full impact of this rate reduction, the act provided for eligible taxpayers to receive an advance tax refund in 2001.[2] The amount of the refund was to be based on the filing status and amount of taxable income on the taxpayer's 2000 return. The Internal Revenue Service (IRS) was to identify eligible taxpayers and the Department of the Treasury's Financial Management Service (FMS) was to issue the checks on behalf of IRS, with the first checks scheduled to be received during the week of July 23, 2001, about 6 weeks after the act became law.

Taxpayers who were eligible to receive an advance tax refund in 2001 but who (1) did not receive a check because IRS did not have their current address or (2) did not have enough taxable income in 2000 to qualify for the maximum amount allowable, may have been entitled to a rate reduction credit when filing their tax year 2001 returns.[3] In addition, taxpayers who were not eligible for an advance tax refund, such as those who did not have taxable income in 2000, may have been entitled to a rate reduction credit provided they had taxable income in 2001.

In response to your request for information on IRS's efforts to implement this provision of the Economic Growth and Tax Relief Reconciliation Act of 2001, this report includes information on (1) the number and dollar

[1]Pub. L. No. 107-16, 115 Stat. 38.

[2]Internal Revenue Code Section 6428.

[3]A rate reduction credit would reduce a taxpayer's 2001 tax liability and could result in a tax refund once the 2001 return was filed.

amount of advance tax refund checks issued and the costs to IRS and FMS for administering this program; (2) implementation of the advance tax refund program, including various problems encountered during implementation; (3) the effect of the advance tax refunds and related rate reduction credit on the 2002 tax filing season; and (4) observations that we believe IRS may find useful if it is required to issue advance tax refunds or encounters a similar management challenge in the future. As agreed with your office, we collaborated with the Treasury Inspector General for Tax Administration (TIGTA) on this review and included information on the results of TIGTA's work in this report.

Results in Brief

Between July and December 2001, IRS, through FMS, mailed about 86 million advance refund checks totaling about $36.4 billion.[4] According to IRS and FMS officials, (1) IRS incurred costs of about $104 million during fiscal year 2001 to administer the advance tax refund program, including staffing costs for such activities as computer programming and responding to taxpayer inquiries as well as costs for contracts, postage, and printing, and (2) FMS incurred about $34 million in costs to issue the checks. IRS expected to incur at least $12 million in additional costs during fiscal year 2002.[5]

Overall, IRS and FMS did a good job implementing the advance tax refund program. For example, most taxpayers received accurate and timely notification of their advance refunds, and advance refunds were accurately calculated and issued to eligible taxpayers. Given the relatively short time in which the program had to be implemented, this was a significant accomplishment. However, TIGTA's work[6] and ours identified

[4]These figures as well as the figures for undeliverable checks discussed later include some regular refunds mailed during this period. The amount of regular refunds included in the figures is unknown. However, because most regular refunds would have been paid before the advance tax refund checks were issued, the amount of regular refunds included in the advance tax refund figures should be relatively small in relation to the total.

[5]We did not specifically test the accuracy of the cost information provided; however, our audits of IRS's annual financial statements have raised concerns regarding IRS's ability to identify all costs associated with a given program or activity. See U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2001 and 2000 Financial Statements*, GAO-02-414 (Washington, D.C.: Feb. 27, 2002).

[6]*While Most Taxpayers Received Accurate and Timely Notification of Their Advance Refunds, Millions Did Not* (TIGTA, 2002-40-016, Oct. 24, 2001) and *Advance Refunds Were Accurately Calculated and Issued to Eligible Taxpayers, But Some Undelivered Refunds Were Unnecessarily Delayed* (TIGTA, 2002-40-116, June 26, 2002).

the following problems related to the implementation of this program in 2001.

- A computer programming problem resulted in 523,000 taxpayers receiving notices indicating that they would receive larger advance refunds than they were entitled to receive. IRS corrected the programming before any advance tax refunds were issued and sent correction notices to the affected taxpayers.
- About 5.3 million taxpayers who had filed their tax returns by the April 16, 2001, filing deadline received untimely advance refund notices due to a combination of (1) IRS's procedures for processing returns, which give priority to returns filed by taxpayers who are due to receive a refund, and (2) the way programming was developed to generate these notices. This delay only affected the notices, not the timely mailing of the advance refund checks.
- About 548,000 advance refund checks valued at about $174 million were returned undeliverable due to incorrect addresses. As of late October 2001, IRS had identified about 34,000 of these checks that, because of issues related to IRS's computer programming and research done by IRS employees, were not reissued in a timely manner even though IRS had updated address information.
- Taxpayers who called IRS between July and September 2001, when most advance refund notices and checks were mailed out, had greater difficulty reaching IRS assistors than did taxpayers who called during the same 3 months in 2000 or during the 2001 tax return filing season. IRS data suggest that the decline in telephone service was caused by the significant demand for advance refund-related telephone assistance.

The advance tax refunds and related rate reduction credit had the following effect on the 2002 tax filing season.

- As of May 31, 2002, over 7 million individual returns, or 6.5 percent of all individual returns processed, had errors related to the rate reduction credit. Some taxpayers who had received an advance refund and thus were not entitled to a credit claimed one anyway, while others who were entitled to the credit either failed to claim it or computed the credit amount incorrectly. Overall, more than one-half of all returns identified with errors during IRS processing had errors related to the credit.
- IRS data suggest that significant demand for telephone assistance related to the rate reduction credit negatively affected telephone service, especially in mid- to late-February 2002 when the greatest number of taxpayers called with questions about the credit.
- Various problems were identified early in the filing season. For example, TIGTA identified two problems that, if IRS had not corrected them, could

have (1) provided about $50 million in rate reduction credits to about 217,000 taxpayers who were not entitled and (2) provided erroneous automated telephone information to about 35 million taxpayers concerning whether they had received an advance tax refund.[7]

- IRS originally did not correct errors made by taxpayers who underclaimed the credit by less than a specified amount. After TIGTA discussed this policy with IRS, IRS said it would allow the underclaimed credit and any interest to the affected taxpayers (as many as 2.5 million) by the end of calendar year 2002.

We have some observations based on our work and TIGTA's that IRS may find useful if faced with similar challenges in the future. For example, an independent review of computer programming necessary to implement a major effort like the advance tax refund program might avoid potential problems that could negatively affect taxpayers and/or create unnecessary work for IRS, and greater attention to the clarity of information in the tax return instructions when there has been a major change to the tax return might reduce the number of returns filed in error.

To identify the full range of challenges IRS faced with respect to the advance tax refunds and rate reduction credit and any changes in procedures or processes that might be warranted if faced with similar types of challenges in the future, we are recommending that IRS assess and document its overall performance with respect to the advance tax refunds and related rate reduction credit. In commenting on a draft of this report, the Commissioner of Internal Revenue agreed with our recommendation.

Background

To be eligible for an advance tax refund in 2001, taxpayers (1) had to have a federal income tax liability on their tax year 2000 return, (2) could not be claimed as a dependent on someone else's tax year 2000 return, and (3) could not be a nonresident alien.[8] The amount of advance tax refund that taxpayers could receive depended on their filing status and the amount of taxable income shown on their tax year 2000 return. The maximum refund amount was $600 for a married couple filing jointly or a

[7] *Despite Some Problems, the Internal Revenue Service Properly Identified Returns With Rate Reduction Credit Errors During the 2002 Filing Season* (TIGTA, 2002-40-142, Aug. 2002).

[8] IRS identified about 34 million taxpayers who were ineligible for an advance tax refund.

qualified widow(er), $500 for a head of household, and $300 for a single individual or married person filing separately.

Before issuing the advance tax refund checks, IRS was to send every individual who filed a return for tax year 2000 a notice either informing them of the refund amount they were to receive and the week in which they were to receive it or telling them that they were ineligible for a refund and why.[9] Prior to sending a disbursement request to FMS, IRS was to reduce the amount of the refunds for any delinquent federal taxes owed by the taxpayers. FMS then issued the advance refund checks for IRS with assistance from the Defense Finance and Accounting Service (DFAS).[10] Before issuing these checks, FMS was to reduce the amount of the checks by the amount of certain other debts owed by the taxpayers, such as delinquent child support. These reductions by IRS and FMS are referred to as "offsets."

IRS sent out the initial advance tax refund notices to 112 million taxpayers by mid-July 2001. Most advance refund checks were then to be issued over a 10-week period from the week of July 23, 2001, through the week of September 24, 2001, based on the last two digits of a taxpayer's Social Security number (SSN). For example, taxpayers with 00 through 09 as the last two digits of their SSN were to receive their checks the week of July 23, 2001, while taxpayers with 90 through 99 as the last two digits of their SSN were to receive their checks the week of September 24, 2001. Taxpayers who filed their tax year 2000 returns after April 16 were to receive their advance tax refund checks later in the fall.[11] All checks were to be issued by December 31, 2001.

[9]IRS's issuance of these notices was consistent with guidance in the conference report on the Economic Growth and Tax Relief Reconciliation Act of 2001. In the hope of decreasing the number of telephone calls to IRS, the conferees said that they anticipated IRS would send notices about 1 month after the law's enactment informing taxpayers "of the computation of their checks and the approximate date by which they can expect to receive their check."

[10]Due to the large volume of advance tax refund checks expected to be issued each week, FMS arranged for DFAS to assist in issuing these checks. DFAS regularly issues payments on behalf of the Department of Defense for military and civilian pay, military retirement, and contractor and vendor payments.

[11]Because April 15, 2001, fell on a Sunday, the deadline for filing tax year 2000 individual income tax returns was extended to April 16, 2001.

Taxpayers who received an advance refund check for the full $600, $500, or $300 based on their tax year 2000 filing status, as well as taxpayers who would have received these amounts except for having all or part of their check offset, were not eligible for a rate reduction credit on their 2001 return. However, taxpayers who were entitled to an advance refund check but either did not receive a check because IRS did not have their current address, for example, or did not receive the maximum amount for their filing status because they did not have enough taxable income in 2000, may have been eligible for a rate reduction credit on their tax year 2001 return. In addition, taxpayers who were not entitled to an advance tax refund, such as those who did not have taxable income in 2000, may have been entitled to a rate reduction credit provided they had taxable income in 2001.

Scope and Methodology

We obtained, from IRS and FMS, statistical information on the number and dollar amount of advance tax refund checks issued, the number and dollar value of refund checks that were offset for federal tax debts and for debts other than federal taxes, and the cost to IRS and FMS for administering the program. We did not independently verify the statistical and cost data provided by IRS and FMS. However, as discussed later, a sampling of advance tax refund transactions done as part of our audit of IRS's fiscal year 2001 financial statements indicated that there were no material errors requiring audit adjustments.[12] In addition, based on sampling done during its review of the advance tax refund program, TIGTA concluded that IRS had accurately calculated and issued advance refunds to eligible taxpayers.

To assess implementation of the advance tax refund program, we

- collaborated with TIGTA staff who reviewed various aspects of the program, such as the accuracy of IRS's computer programming and taxpayer eligibility for advance refunds;[13]

[12]U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2001 and 2000 Financial Statements*, GAO-02-414 (Washington, D.C.: Feb. 27, 2002).

[13]According to TIGTA, its objectives with respect to the advance tax refund program were to (1) determine whether IRS timely and accurately notified taxpayers about their advance refunds; (2) determine whether IRS accurately calculated and issued advance refunds to eligible taxpayers; and (3) evaluate IRS's actions to prevent issuance of advance refunds after the December 31, 2001, legislative deadline.

- analyzed advance tax refund procedures, including IRS procedures for meeting expected increases in telephone demand and FMS procedures for handling undeliverable refund checks, refund offsets, and claims for nonreceipt of refunds;
- discussed with officials of IRS's Office of the Taxpayer Advocate, that office's involvement in the advance tax refund program; and
- obtained statistics on undeliverable advance refund notices and checks; taxpayer contacts with IRS concerning advance tax refunds and the level of telephone service provided by IRS during the advance tax refund period; claims for nonreceipt of refunds; and duplicate, altered, and counterfeit advance tax refund checks.

To determine the effect of the advance tax refunds and related rate reduction credit on the 2002 tax filing season, we

- collaborated with TIGTA staff who determined if IRS properly identified and referred for correction returns with rate reduction credit errors during the 2002 filing season;
- reviewed information on the rate reduction credit on IRS's Web site and in the instructions IRS provided taxpayers for preparing income tax returns to be filed in 2002;
- analyzed statistics on (1) the number and type of rate reduction credit errors on tax returns filed in 2002, (2) the demand for telephone assistance during the 2002 filing season, and (3) the level of telephone service provided by IRS during that period; and
- discussed with IRS officials their procedures for handling rate reduction credit errors and responding to any increased demand for telephone assistance.

We used the results of our work and TIGTA's to identify observations that IRS may find useful if it is required to issue advance tax refunds or encounters a similar management challenge in the future.

We did our work at IRS's National Office in Washington, D.C.; the IRS campuses in Atlanta, Ga., and Philadelphia, Pa.; IRS's Wage and Investment Division and Joint Operations Center in Atlanta, Ga.; and FMS's National Office in Washington, D.C. Our work was done between July 2001 and May 2002 in accordance with generally accepted government auditing standards. We obtained written comments on a draft of this report from the Commissioner of Internal Revenue and the Commissioner of FMS. Their comments are discussed near the end of this report and are in appendixes IV and V, respectively.

Over $36 Billion in Advance Tax Refunds Were Issued at a Cost of at Least $138 Million

Between July and December 2001, about $36.4 billion in advance tax refunds were issued to about 86 million taxpayers.[14] Another $3 billion in advance tax refunds was offset for various debts owed by taxpayers, most of which was for delinquent federal taxes. According to IRS and FMS officials, this initiative was accomplished at a cost of at least $138 million.

Billions of Dollars in Advance Tax Refunds Sent to Millions of Taxpayers

IRS, through FMS, mailed out advance tax refunds according to a schedule that called for taxpayers to begin receiving checks the week of July 23, 2001. Altogether, almost 92 million taxpayers were to receive about $39 billion in advance tax refunds, with most of the checks to be received during the first 10 weeks of the program. However, primarily because some checks were offset to recover past debts and, to a lesser extent, because other checks were returned undeliverable, about 86 million taxpayers received about $36.4 billion in advance refunds.

The notice IRS sent to taxpayers who were eligible to receive an advance tax refund included a statement that the amount of the refund could be reduced by any outstanding debt owed, such as past due federal and state income taxes or child support. In that regard, for any taxpayer whose account involved a federal tax debt, IRS was to offset the advance tax refund, either in whole or in part, to collect the debt. In addition, FMS was to offset the advance tax refunds to collect other types of debt via the Treasury Offset Program.[15] Taxpayers whose advance refunds were offset, either in whole or in part, were to receive a notice explaining the offset. Because IRS and FMS have no effective way of associating notices from IRS with checks issued by FMS, notices regarding IRS offsets would have been sent to taxpayers separate from the advance refund checks.[16] On the other hand, notices regarding FMS offsets could be mailed with the checks.

[14]Two taxpayers who filed a joint return are considered one taxpayer for this discussion because they would have been sent one check.

[15]The Treasury Offset Program involves a centralized database of delinquent debts referred to FMS for offset against federal payments and includes federal nontax debts, state tax debts, and child support debts.

[16]IRS is currently testing a procedure whereby IRS notices can be associated with the related check and thus mailed with the check.

According to data obtained from IRS and FMS, the two agencies offset the advance tax refunds by almost $3 billion to collect various types of taxpayer debt. IRS offset about $2.5 billion to recover delinquent federal tax, and about 5.4 million taxpayers had their entire advance tax refund offset due to a federal tax delinquency. FMS offset about $468 million for the following reasons:

- $261.5 million for delinquent child support.
- $190.8 million for federal debts other than delinquent taxes.
- $15.7 million for delinquent state taxes.

Some taxpayers also had their advance tax refunds offset by as little as 1 cent for interest that was owed. According to IRS, this resulted from its failure to include accrued interest in computer programming that IRS implemented in January 2001 to write off small dollar amounts of tax owed. An IRS official said that the computer programming has since been corrected. However, according to the official, IRS did not track the number of taxpayers who were affected.

IRS and FMS Incurred Costs of at Least $138 Million for Implementing the Advance Tax Refund Program

According to an IRS official, it cost IRS about $104 million to administer the advance tax refund program through the end of fiscal year 2001. Included in these costs were $36 million for contract costs, $33 million for postage, $30 million for labor, and $5 million for printing.[17] According to an FMS official, FMS incurred about $34 million in costs to issue the checks on behalf of IRS, including the assistance provided by DFAS.

In order to administer the advance tax refund program, IRS, among other things, had to

- develop the computer programming necessary to determine taxpayer eligibility for a refund and the amount of refund, including any related federal tax offset;
- arrange for printing and mailing notices informing taxpayers whether or not they would receive a refund;

[17]IRS also expected to incur at least $12 million in costs during fiscal year 2002 to handle undelivered advance tax refund checks, identify and correct rate reduction credit errors made on tax year 2001 returns, and respond to taxpayer calls for assistance related to the rate reduction credit. This estimate did not include the costs of programming and testing for the 2002 filing season or the addition of the rate reduction credit line on the individual income tax forms. According to an IRS official, since there was time to include the rate reduction credit in the regular programming and forms changes for the 2002 filing season, it would be difficult to separate out the costs for the rate reduction credit.

- respond to telephone calls and correspondence from taxpayers concerning the refund;
- resolve undelivered and returned refund checks; and
- prepare adjustment notices for refunds that were offset due to federal tax debts.

According to an IRS official, it took about 3 months between March and June 2001 to develop the necessary computer programming to implement the advance tax refund program and to arrange for printing and mailing advance tax refund notices. IRS temporarily reassigned staff from other functions to assist with taxpayer telephone calls and correspondence related to the advance tax refunds. For example, IRS recalled furloughed staff at its forms distribution centers to assist taxpayers who called IRS with questions about the advance refund that were relatively easy to answer. In addition, IRS used submission processing staff from its Philadelphia campus to help respond to over 90,000 written inquiries from taxpayers concerning the advance tax refunds.

Overall, IRS Did a Good Job Implementing the Advance Tax Refund Program; but Several Problems Were Encountered

In its reports on IRS's implementation of the advance tax refund program in 2001, TIGTA concluded that (1) most taxpayers received accurate and timely notification of their advance refunds, (2) advance refunds were accurately calculated and issued to eligible taxpayers,[18] and (3) IRS took proper actions to prevent the issuance of advance tax refunds after December 31, 2001. Similarly, our review of a sample of 80 advance tax refund transactions disclosed no material errors requiring adjustments in the advance refund sample. We determined that all of the taxpayers in our sample were eligible for the advance refund, all of those refunds were calculated correctly, there were no instances where a taxpayer had a debt recorded in the Treasury Offset Program that should have been offset but was not, and there were no instances in which the taxpayer had an outstanding tax debt that should have been offset by IRS but was not. Based on our sample results, we estimate that the number of errors

[18]According to TIGTA, it analyzed a 0.1 percent sample of tax year 2000 individual tax accounts and "did not identify any ineligible taxpayers who received a rebate and found that 99.9 percent of the advance refunds were calculated correctly."

requiring adjustment in the population of all advance tax refunds was 0 ± 4.5 percent.[19]

Despite this significant accomplishment, TIGTA's work and ours identified the following problems related to implementation of the advance tax refund program in 2001:

- A computer programming problem resulted in 523,000 taxpayers receiving inaccurate advance refund notices.
- About 5.3 million taxpayers received untimely advance refund notices because of IRS's procedures for processing returns and the way programming was developed to generate advance refund notices.
- Over 2 million advance refund notices and about 548,000 advance refund checks valued at about $174 million were returned undeliverable due to incorrect addresses. As of late October 2001, IRS had identified about 34,000 of these checks that were not reissued in a timely manner even though it had updated address information.
- Taxpayers who called IRS during the first 3 months of the advance tax refund period (July through Sept.) had greater difficulty reaching IRS assistors than did taxpayers who called during the same timeframe in 2000 or during the 2001 tax filing season.

Programming Error Resulted in Some Inaccurate Advance Refund Notices

As noted earlier, the maximum amount of a taxpayer's advance refund was to be $600, $500, or $300 depending on the taxpayer's filing status. However, the actual amount of the advance refund was limited to the lesser of (1) 5 percent of the taxable income on the taxpayer's tax year 2000 return and (2) the net income tax from the tax year 2000 return after subtracting nonrefundable credits, such as the credit for child and dependent care expenses, child tax credit, credit for the elderly, and education credit. TIGTA found that IRS had initially erred in developing its computer program for the advance tax refunds by not limiting the refund amounts to the net income tax after nonrefundable credits. As a result, TIGTA determined that about 523,000 taxpayers had been sent inaccurate notices indicating that they would receive larger advance refund checks than they were entitled to receive.

[19]This does not mean that every advance refund issued during the year fully complied with all of the criteria we tested for. Our test was designed to identify whether or not IRS was substantially compliant with the Economic Growth and Tax Relief Reconciliation Act of 2001 for advance refunds issued in fiscal year 2001. As such, we selected our sample using a stratified classical variable sampling approach with a confidence level of 95 percent.

TIGTA informed IRS of this programming error on July 3, 2001, and IRS was able to correct the programming before any erroneous advance tax refunds were issued—thus avoiding overpayments of about $118 million. IRS also sent corrected notices to the affected taxpayers. According to TIGTA, IRS management determined that the error arose because testing of the programming only verified that the computer output matched the programming logic. The testing did not verify that the programming logic was in accordance with the requirements of the law.

About 5 Million Taxpayers Received Untimely Advance Refund Notices

TIGTA also determined that about 5.3 million taxpayers who had filed their tax year 2000 returns by the April 16, 2001, filing deadline would have delays of from 1 week to 9 weeks in receiving their advance refund notices.[20] According to TIGTA, this delay prevented taxpayers from being timely notified of their advance refunds and may have caused additional calls to IRS from taxpayers wanting to know when they would receive their advance refund.

TIGTA attributed the delays to the following two reasons:

- IRS's normal procedure is to process income tax returns filed by taxpayers who are due to receive a tax refund before processing income tax returns filed by other taxpayers. Thus, many nonrefund returns filed by April 16, 2001, had not been processed by the time IRS prepared the initial list of taxpayers who were to receive advance tax refund notices.
- When IRS developed the programming to generate the advance tax refund notices for taxpayers whose returns had yet to be processed when the initial list was prepared, it decided to mail the notices to these taxpayers just before they were to receive their advance tax refund checks, rather than mailing the notices as soon as their tax returns were processed.

In response to TIGTA's finding, IRS issued a news release explaining that some taxpayers might experience a delay in receiving their advance tax refund notices.

[20]This delay only affected the notices; it did not affect timely mailing of the refund checks.

A Small Percentage of Advance Refund Notices and Checks Were Undeliverable

One challenge that IRS encountered throughout the implementation of the advance tax refund program involved undeliverable advance tax refund notices and checks due to incorrect addresses. Undeliverable advance refund notices were to be returned to IRS's Philadelphia campus, and undeliverable advance refund checks were to be returned to the FMS payment center from which they were issued.

Through December 31, 2001, over 2 million advance tax refund notices were returned undeliverable to IRS (about 1.6 percent of 125 million notices sent), including about 1.2 million notices sent to taxpayers who were to receive an advance refund and about 900,000 notices sent to taxpayers who were ineligible for an advance refund. According to an IRS official, the undeliverable notices were sorted and counted by type of notice and then destroyed. Because these notices were sent to taxpayers via first class mail, the Postal Service was to forward notices for which taxpayers had provided an address change. Therefore, IRS decided that it would not be cost-effective to follow up on the undeliverable notices. According to IRS officials, if a notice was undeliverable, a check would still have been sent to the same address, unless IRS had received an updated address from the taxpayer.

According to FMS, about 580,000 advance tax refund checks had been returned as of December 31, 2001, the last date that IRS was authorized to make advance payments. About 548,000 of those checks (less then 1 percent of the advance refund checks sent) valued at about $174 million were returned undeliverable due to problems with the taxpayer's address, according to IRS.[21] The percentage of checks returned undeliverable (less than 1 percent) was less than the approximate 4-percent rate that an FMS official indicated was the normal rate for undeliverable tax refunds.

According to an FMS official, undeliverable advance refund checks, like other tax refund checks that are returned undeliverable, were cancelled and information concerning the cancelled checks was provided to IRS. IRS was to research a taxpayer's account to determine if there was an updated address to which another check could be sent. IRS updates taxpayer addresses each week through a National Change of Address Database maintained by the Postal Service. Taxpayers can also update their addresses with IRS by submitting an IRS Form 8822 "Change of Address."

[21]According to FMS, (1) some checks are correctly delivered but returned by the payees for various reasons and (2) IRS may issue a stop payment that causes the check to be returned.

In addition, for purposes of the advance tax refunds, IRS revised its normal procedures by authorizing its customer service representatives to accept change of address information over the telephone from taxpayers. Officials at IRS's Philadelphia campus said that much of the written correspondence they received during the period that the advance tax refund payments were being made involved address changes from taxpayers who wanted to ensure that they would receive their checks.

TIGTA found that some undeliverable advance refund checks were not reissued even though IRS had updated address information. According to TIGTA, this occurred because

- IRS did not program its computer system to automatically reissue undelivered refunds for all types of address changes made to taxpayers' accounts and
- IRS employees did not always perform adequate research on IRS computer systems necessary to identify current addresses and reissue the refunds.

TIGTA brought this to IRS's attention, and as of late October 2001, IRS had identified about 34,000 taxpayers for whom refunds had not been reissued even though updated addresses were available. TIGTA estimated that the 34,000 refunds totaled over $10 million and had been delayed for an average of 8 weeks. According to TIGTA, in late December 2001, IRS reissued refunds for taxpayers for which IRS had a more current address. However, because this issue goes beyond the advance tax refunds and affects refunds in general, TIGTA recommended that IRS (1) revise its computer programming to automatically reissue undelivered refunds for any address changes after the refunds are initially issued and (2) eliminate the need for IRS employees to perform certain IRS computer system research to identify a more current address because the recommended programming revision would enable the computer to perform this research. IRS agreed with both recommendations and plans to initiate both the programming and procedural changes necessary to implement them.

Besides having to deal with undeliverable advance refund checks, FMS also had to deal with a relatively small number of duplicate, altered, and counterfeit checks. This issue is discussed in appendix I.

Taxpayers Calling IRS During the First 3 Months of the Advance Refund Period Had Problems Reaching an Assistor, but Access Later Improved

IRS's telephone assistance performance measures for the first 3 months of the advance tax refund period (July through Sept.)—when notices were mailed out and checks were mailed to most taxpayers—show that taxpayers had problems reaching an IRS assistor. Overall, when compared with the same 3-month period in 2000, the accessibility of IRS's telephone assistance generally declined. According to IRS officials, accessibility declined because the demand for assistance, driven by taxpayer questions about the advance refund, exceeded the capacity of available telephone equipment and staffing to answer the calls. However, during the last 3 months of the refund period (Oct. through Dec.), accessibility improved compared with the first 3 months of the refund period and the same 3-month period in 2000.

Problems reaching an IRS assistor may have caused some taxpayers to call the Taxpayer Advocate Service with questions about the advance refund. Appendix II has information on taxpayer contacts with the Taxpayer Advocate Service concerning advance tax refunds.

IRS generally projects demand for telephone assistance based on historical data. Because IRS did not have previous experience with an initiative of the type and scope of the advance tax refund to provide historical data, IRS did a speculative analysis in June 2001 to project the volume of advance refund-related calls it would receive. The analysis projected that IRS would receive 53.2 million additional calls during the advance refund period.[22] This would have been a 275-percent increase over the 19.4 million calls IRS received in the same 6-month period in 2000 and about a 129-percent increase over the 41.2 million calls IRS received in the 2001 filing season (Jan. through July 14, 2001), which is traditionally IRS's busiest time of the year for telephone assistance. According to the text of the analysis, the assumptions on which the analysis was based were risky, and IRS officials had limited confidence in the results.

Although IRS lacked a reliable projection of advance refund-related demand for telephone assistance, IRS officials said that they expected demand to be significant based on previous general experience with refunds and changes in the tax law. However, according to IRS officials,

[22]The analysis was based on assumptions about June 2001 call demand and an analysis of historical data on the effect of previous offset notices on call demand. The analysis projected that IRS would receive about 37.9 million additional call attempts during the first 3 months of the advance refund period and about 15.3 million additional calls during the last 3 months.

IRS did not plan for nor expect to meet a dramatic increase in telephone assistance demand during the advance refund period, but, instead, had a two-pronged approach for responding to as much as possible of the increased demand given the telephone equipment and the staff resources that were available. The first prong of IRS's strategy was to handle as many calls as possible through automation, thereby freeing up assistors to handle calls that required live assistance. To accomplish this, IRS publicized its TeleTax telephone number in the notices sent to taxpayers and through an announcement played on IRS's main telephone assistance line.[23] The TeleTax line had recorded information on the advance tax refund program and an interactive service that told the taxpayer the expected date the check would be mailed based on the last two digits of the SSN entered by the taxpayer. IRS data show that many taxpayers called for this information—from July 1 through December 31, 2001, IRS received about 36.6 million calls on TeleTax compared with 1.8 million calls received on TeleTax during the same months in 2000.

The second prong of IRS's strategy was to devote more staffing to answering refund-related calls. IRS's forms distribution centers recalled about 450 employees from furlough and trained them to handle simpler calls related to the advance tax refund. Also, IRS devoted more staffing to its regular telephone operations compared to the previous year—during the first 3 months of the refund period, IRS expended 1,952 staff years in its toll-free telephone operation, 179 more staff years than during the same 3-month period in 2000, or about a 10-percent increase. According to IRS officials, total staffing increases do not fully reflect the extent of the staffing for answering refund-related calls because IRS directed resources from other toll-free work, such as answering calls from taxpayers about their accounts, to answer refund calls. IRS estimates that of the 1,952 total staff years expended during the first 3 months of the advance refund period, 493, or 25 percent, were expended answering advance refund-related calls.

Despite IRS's efforts to meet the increased demand for telephone assistance, taxpayers had greater difficulty in accessing that assistance during the first 3 months of the advance refund period as compared with the same time period in 2000. IRS has four measures for judging its performance in providing access to telephone assistance. As shown in

[23]TeleTax provides automated account information and recorded information on about 150 tax topics.

table 1, during the first 3 months of the refund period—when notices were mailed out and checks were mailed to most taxpayers—IRS's telephone performance declined for all four measures compared with the same time period in 2000. However, as also shown in table 1, performance improved during the last 3 months of the refund period (when, as discussed later, the demand for assistance decreased) and was better than in the same 3-month period in 2000.

Table 1: Accessibility of IRS's Telephone Assistance during the Advance Tax Refund Period

Measure	7/1/01 through 9/30/01	7/1/00 through 9/30/00	10/1/01 through 12/31/01	10/1/00 through 12/31/00
Customer service representative level of service[a]	47%	64%	63%	55%
Assistor response level[b]	37%	38%	50%	36%
Abandon rate[c]	18%	12%	15%	18%
Average speed of answer[d]	408 seconds	260 seconds	276 seconds	394 seconds

[a]This measure is intended to show IRS's effectiveness in providing callers with access to an assistor. It includes callers who received automated service when the assistor service queue was full.

[b]This measure shows the percentage of callers that waited 30 seconds or less to speak to an assistor.

[c]This measure shows the percentage of callers that hung up while waiting to speak to an assistor.

[d]This measure shows the average number of seconds taxpayers waited to speak to an assistor.

Source: IRS data.

According to IRS officials, (1) a significant increase in the demand for telephone assistance caused the decline in accessibility during the first 3 months of the advance tax refund period, (2) this increase was driven by taxpayer questions about the advance tax refund, and (3) the demand for assistance exceeded IRS's capacity for handling it given IRS's available equipment and staff resources. As we previously reported, demand for assistance is one of the key factors that can affect level of service.[24] As demand increases, for example, level of service would typically decline

[24]U.S. General Accounting Office, *IRS Telephone Assistance: Quality of Service Mixed in the 2000 Filing Season and Below IRS' Long-Term Goal*, GAO-01-189 (Washington, D.C.: Apr. 6, 2001).

because, other factors being held constant, IRS would likely answer a lesser percentage of the calls.

Table 2 has information on the demand for telephone assistance during the 6-month advance tax refund period and the same 6-month period in 2000. The table shows that the increase in demand during the first 3 months of the advance tax refund period was especially significant.

Table 2: Increase in Demand for Telephone Assistance during Advance Tax Refund Period

			Increase	
Measure of demand[a]	**2000**	**2001**	**Amount**	**Percent**
Call attempts (in millions)[b]				
July through September	11.4	23.8	12.4	108%
October through December	7.9	11.8	3.8	48%
Total	**19.3**	**35.6**	**16.2**	**84%**
Unique numbers (in millions)[c]				
July through September	7.1	13.3	6.2	88%
October through December	6.5	7.5	1.1	16%
Total	**13.5**	**20.8**	**7.3**	**54%**

[a]Data are for IRS's three main toll-free telephone lines and do not include calls to TeleTax. Totals and increase amounts may not compute due to rounding.

[b]Call attempts includes repeat calls and is the sum of calls answered, calls abandoned by the caller before receiving assistance, and calls that received a busy signal.

[c]The unique numbers measure is IRS's estimate of the number of taxpayers who called, rather than the number of calls. It measures the number of calls from identifiable telephone numbers and counts all call attempts from each telephone number as one call until the caller reaches IRS and is served or until a 1-week window expires.

Source: GAO analysis of IRS's data.

Although table 2 shows that demand during the last 3 months of the advance tax refund period was higher than during the same 3 months in 2000, table 1 showed that accessibility to telephone assistance improved compared to 2000. According to IRS officials, accessibility improved despite the increase in demand because of (1) improvements in the routing of calls, (2) changes in the types of calls received, and (3) more staff time devoted to telephone assistance.

Several Problems Related to the Rate Reduction Credit Arose During the 2002 Tax Filing Season

The 2002 tax filing season was adversely affected by several problems related to the rate reduction credit. Most significant were the substantial number of returns filed with errors related to the credit and a degradation of telephone service in February 2002 that was likely due to an increase in demand for assistance related to the credit.

Other problems were avoided when TIGTA identified computer programming errors related to the credit that IRS was able to resolve before any taxpayers were affected. However, two other issues were identified too late to avoid affecting taxpayers—one involved a programming problem that resulted in some taxpayers getting credits to which they were not entitled, the other involved an IRS policy that resulted in some taxpayers not getting credits to which they were entitled.

IRS Took Some Steps after the Start of the 2002 Filing Season in Response to a Large Volume of Errors

To help ensure that taxpayers correctly dealt with the rate reduction credit on the returns they filed in 2002, IRS built checks into its computer system that enabled it to verify the amount of the rate reduction credit claimed and to adjust incorrectly claimed credit amounts accordingly. Using those checks, IRS identified a substantial number of errors related to the rate reduction credit on returns prepared both by taxpayers and paid tax return preparers. As shown in table 3, IRS had identified over 7 million individual returns with rate reduction credit errors as of May 31, 2002, which represented 57.3 percent of returns with errors and 6.5 percent of total returns processed at that time.

Table 3: Individual Returns Processed with Rate Reduction Credit Errors as of May 31, 2002

Returns prepared by	Number of returns processed	Number of returns with errors	Percentage of returns with errors	Number of returns with rate reduction credit errors	Percentage of returns with rate reduction credit errors	Rate reduction credit errors as a percentage of returns with errors
Taxpayers	44,877,542	7,420,342	16.5%	3,724,556	8.3%	50.2%
Tax return preparers	63,777,960	4,825,559	7.6%	3,291,220	5.2%	68.2%
Totals	**108,655,502**	**12,245,901**	**11.3%**	**7,015,776**	**6.5%**	**57.3%**

Source: GAO analysis of IRS's data.

Taxpayers and return preparers made various types of errors related to the rate reduction credit during the 2002 tax filing season.

- Over 4.4 million taxpayers who were entitled to a credit failed to claim the credit on their tax year 2001 return.

- Almost 1.8 million taxpayers who had received the maximum advance tax refund in 2001 and thus were not entitled to a credit claimed the amount of their advance refund as a credit on their 2001 return.
- Over 800,000 taxpayers who were entitled to and claimed a credit incorrectly computed the amount to which they were entitled.

Once IRS recognized that taxpayers and return preparers were having problems related to the rate reduction credit, it took immediate action. For example, as early as January 23, 2002, IRS posted information to its Web site and issued news releases informing the public that many early tax returns were being filed with rate reduction credit errors. In addition, IRS provided clarifying information to preparers who file returns electronically and, around the beginning of February, began rejecting electronic submissions that involved certain types of errors related to the credit. By rejecting these submissions, IRS required the taxpayer or return preparer to correct the error before IRS would accept the electronic return for processing. This is consistent with IRS's traditional practice of rejecting electronic submissions that contain other errors, such as incorrect SSNs. As of July 1, 2002, IRS had rejected over 300,000 electronic submissions with rate reduction credit errors.[25]

Despite IRS's efforts, the rate at which filed returns included errors related to the rate reduction credit did not drop significantly during the filing season. As of March 15, 2002, 6.8 percent of all returns filed included a rate reduction credit error; as of May 31, 2002, the error rate was 6.5 percent.

Demand for Telephone Assistance Related to the Rate Reduction Credit Likely Negatively Affected Level of Service in the 2002 Filing Season

IRS data suggest that demand for telephone assistance related to the rate reduction credit was significant during the 2002 filing season and that the demand negatively affected telephone level of service, especially in mid- to late-February when the greatest number of taxpayers called with questions about this credit.

As discussed earlier, the amount of demand for assistance is one of the key factors that can affect level of service, with an increase in demand being associated with a decrease in the level of service because, other factors being held constant, IRS would answer a lesser percentage of the

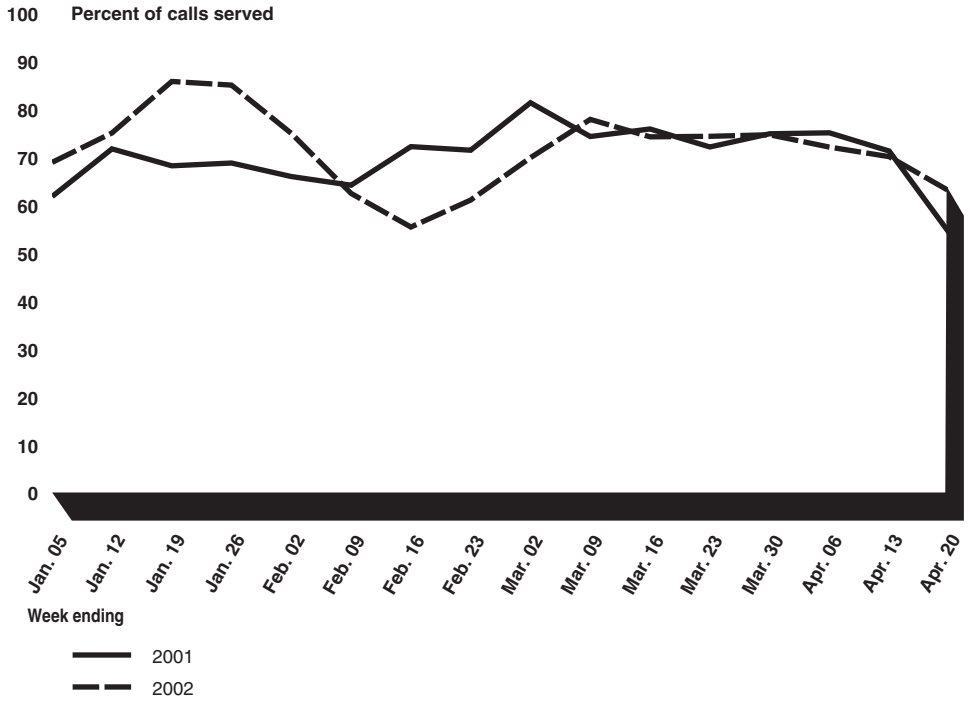
[25]Because these electronic submissions were rejected and thus never processed by IRS, these errors are not included in the statistics in table 3.

calls. The average time it takes assistors to handle calls is another factor that affects level of service, with a higher average handle time being associated with a decrease in level of service.[26] According to IRS officials, as the filing season progressed, demand for assistance related to the rate reduction credit increased significantly and unexpectedly, causing the level of service to decline. Officials said that taxpayer access to service began declining in early February as taxpayers called in response to notices IRS mailed them because of errors on their returns related to the credit. In that regard, data provided by IRS showed that taxpayers made about 1.5 million calls to IRS's accounts assistance telephone number during the 3 weeks ending March 2, 2002, compared with about 0.8 million such calls during the same 3-week period in 2001. Because these account-type calls take longer to handle, on average, than other types of calls, this increase in account-related demand increased the average handle time and lowered the level of service.

Figure 1 shows that customer service representative (CSR) level of service during the first 6 weeks of the 2002 filing season was significantly better than or about the same as the level of service during the first 6 weeks of the 2001 filing season but was significantly worse during the next 3 weeks (the 3 weeks ending March 2). In the remaining weeks of the filing season, CSR level of service returned to levels comparable to 2001 performance.

[26]Handle time is the total of the time (1) an assistor spends talking to the taxpayer, (2) the taxpayer is on hold, and (3) the assistor is in "wrap status," which is the time between when the assistor hangs up at the end of the call and when the assistor indicates readiness to receive another call.

Figure 1: CSR Level of Service in the 2001 and 2002 Filing Seasons



Source: IRS data.

The performance dip coincides with other data that indicate there was likely a significant increase in demand related to the rate reduction credit. For example, previous IRS studies have shown a strong relationship between the volume of certain types of notices IRS mails to taxpayers and the demand for telephone assistance. One such notice is the CP-12, which IRS sends to taxpayers notifying them of a math error on a return. The notice gives the taxpayer information about the error and includes one of IRS's main toll-free telephone numbers for the taxpayer to call for further information. According to IRS data, for the 4 weeks beginning February 3, 2002, IRS mailed over 1.6 million of these notices—about 5 times the number mailed over the same period in 2001. According to IRS officials, the bulk of this increase was due to taxpayer errors in completing the rate reduction credit line of the tax return.

Unlike the advance tax refund period in which IRS's plans for handling the increased telephone assistance demand included both automation and increased staffing, IRS's plans for handling the additional demand in the 2002 tax filing season focused on automated assistance. IRS implemented

an automated interactive telephone application that provided callers with the amount of their advance refund based on the SSN and personal identification data the caller input. According to IRS officials, when IRS began planning for staffing for the 2002 filing season—around June 2001—the potential effect of the rate reduction credit on the filing season was unknown. Officials said that although IRS planned for some increased staff time to handle potential demand to be generated by the rate reduction credit, the plans did not anticipate the level of demand that was caused by the error notices.

Various Problems Related to the Rate Reduction Credit Were Identified Early in the 2002 Filing Season

TIGTA identified and IRS corrected two problems related to the rate reduction credit that could have resulted in (1) taxpayers receiving a rate reduction credit to which they were not entitled or (2) taxpayers receiving erroneous information via IRS's TeleTax number concerning whether or not they received an advance tax refund. In addition, IRS identified another problem that may have resulted in as many as 15,000 taxpayers receiving as much as $4.5 million in erroneous refunds due to rate reduction credits to which they were not entitled.

One problem identified by TIGTA involved the lack of advance tax refund data in IRS's National Account Profile (NAP)[27] for certain taxpayers. The taxpayers involved were those who had filed joint returns for tax year 2000 with a deceased spouse on which the deceased spouse was the primary taxpayer and the surviving spouse was the secondary taxpayer.[28] In those cases, because of a computer programming oversight, no advance refund amount was placed on the surviving spouse's NAP account. Thus, if the surviving spouse filed a tax year 2001 return and correctly claimed no rate reduction credit, IRS's records would have erroneously indicated that the taxpayer had not received an advance refund, and IRS would have adjusted the taxpayer's return to include a credit. According to TIGTA, IRS corrected this problem by January 11, 2002, thus preventing about 217,000 taxpayers from receiving up to $50 million in rate reduction credits to which they were not entitled.

[27]NAP is an IRS database with information on taxpayers' names, addresses, and SSNs. To help determine whether taxpayers were correctly claiming the rate reduction credit on their 2001 tax returns, IRS was to include information on advance tax refund payments in the NAP.

[28]The primary taxpayer is the individual whose name is included first on a jointly filed individual tax return. The secondary taxpayer is the person whose name is listed second.

Another problem identified by TIGTA, which it attributed to a misinterpretation of programming requirements, involved IRS's failure to add information in the NAP for taxpayers who did not receive an advance tax refund. As a result, if these taxpayers called IRS's automated telephone system, they would have been told that no information was available regarding their advance tax refund, rather than being told that they did not receive an advance tax refund. According to TIGTA, it notified IRS of this problem, which could have affected as many as 35 million taxpayers, on January 8, 2002, and IRS made the necessary corrections by January 15.

During the filing season, IRS's computer system was generating rate reduction credits for some taxpayers who had already received the maximum advance tax refund. This occurred when a taxpayer received an advance tax refund based on a tax year 2000 return on which the taxpayer used a taxpayer identification number other than an SSN, such as an Individual Taxpayer Identification Number (ITIN),[29] and subsequently filed a tax year 2001 return using an SSN. Because IRS's records showed no advance tax refund associated with the SSN the taxpayer used on the 2001 return, IRS's computer system indicated that the taxpayer was entitled to a rate reduction credit on the 2001 return but had failed to claim it. Thus, the computer automatically generated a rate reduction credit for the taxpayer.

According to IRS officials, this problem was brought to IRS's attention by IRS field staff. They estimated that it would affect no more than about 15,000 taxpayers, who in a worst-case scenario may have received an additional $300 credit, for a total of $4.5 million in potentially erroneous rate reduction credits. According to the officials, IRS will not attempt to recover any erroneous payments resulting from this problem because it would not be cost-effective to do so. The officials noted, among other things, that since IRS , not the taxpayers, was at fault, IRS would have to attempt to recover the erroneous payments through civil court rather than tax court.

Additional Rate Reduction Credit to Be Allowed

According to IRS officials, an additional rate reduction credit will be allowed to as many as 2.5 million taxpayers. When IRS originally reviewed these taxpayers' returns, it was determined that the taxpayers had underclaimed the amount of their rate reduction credits. However, IRS did

[29]An ITIN is a 9-digit tax processing number issued by IRS to nonresident and resident aliens who do not have and are currently not eligible to get an SSN.

not correct the errors because the amount underclaimed was less than a specified amount. It is IRS's policy to not make a tax change based on correction of a credit either in favor of the taxpayer or the government if the tax change is less than a specified amount. According to IRS, this policy applies to all credits, not just the rate reduction credit, and was implemented both for budgetary reasons and to ensure timely return processing.

IRS had originally decided to follow this policy with respect to the rate reduction credit. However, during its review of the 2002 filing season, TIGTA pointed out that the policy seemed inequitable because the specified amount below which IRS did not issue an advance tax refund was substantially less than the specified amount below which IRS did not correct an underclaimed rate reduction credit.[30] As a result, some taxpayers could receive a small advance tax refund, while other taxpayers could not receive a similar small refund based on an underclaimed rate reduction credit on their 2001 tax return. IRS subsequently stated that it would allow the underclaimed credit and any interest to the affected taxpayers by the end of calendar year 2002.

Issues Encountered During the Advance Tax Refund Program Could Provide Useful Guidance for the Future

On the basis of our work and TIGTA's, we had some observations that IRS may find useful if faced with similar challenges in the future. For example, several problems related to the advance tax refunds and the rate reduction credit were avoided because TIGTA identified and quickly notified IRS of programming errors. While this may indicate deficiencies in IRS's process for testing program changes, the work needed to make that determination was beyond the scope of this report. What TIGTA's findings do indicate is the value of enlisting the assistance of an outside party, such as TIGTA, to review the programming for a major unplanned effort that has to be implemented in a short period of time. This would provide an independent review with an eye toward identifying any potential problems that could either negatively impact taxpayers or create unnecessary work for IRS.

Although IRS took several steps after the filing season began in response to the large number of rate reduction credit errors, some of those errors might have been prevented if the instructions for Forms 1040, 1040A, and 1040EZ had been more clear. In that regard, in April 9, 2002, testimony before the Subcommittee on Oversight of the House Committee on Ways

[30]These specified amounts are for IRS official use only.

and Means, the President and Chief Executive Officer of H&R Block (the largest tax preparation company in the U.S.), said the following:

> "This year's main problem is the Rate Reduction Credit, where multiple terms ('rebates,' 'advance payments,' 'refund advances,' 'rate reduction credits') and instructions that confused taxpayers and even tax preparers resulted in many rejected [electronic filings] and over three million errors."

Besides the confusing terminology mentioned by H&R Block, we identified the following three aspects of IRS's instructions that, in retrospect, could have been clearer:

- Because taxpayers might use their prior year's tax return as a guide in preparing their current year's return, it is important that changes to the tax form, such as the new line added for the rate reduction credit, be clearly highlighted. Although IRS mentioned the new credit on the front page of the tax form instructions, it was done in a way that we believe could easily be missed (see app. III for a copy of the front page with our highlighting of the language in question). What IRS emphasized was the fact that tax rates had changed, which is not information that taxpayers need to know in completing their returns since the effect of that change happens automatically when they use the tax table or tax rate schedules to compute their taxes. What was more important to emphasize was the fact that there was a new credit on the tax return that they might be eligible for.
- The tax form instructions indicate that if a taxpayer received "before offset" an advance tax refund of either $600, $500, or $300 based on his or her filing status, the taxpayer would not be entitled to a rate reduction credit. There is no further explanation in the instructions of the meaning of "before offset," a term that may not have been clear to all taxpayers. The instructions might have been clearer if IRS had included the explanation provided on its Web site. On the Web site, IRS explains that if taxpayers had their advance tax refund "offset" to pay back taxes, other government debts, or past due child support, they could not claim the rate reduction credit for the amount that was offset. Because many taxpayers may not have had access to the Web site or known of the extent of rate reduction credit information available, it would have been advantageous to include a similar explanation in the instructions.
- To its credit, IRS, expecting that many taxpayers would not remember the amount of their advance tax refund, established an interactive application as part of TeleTax that taxpayers could use to find out the amount of their advance. Although the instructions for Forms 1040, 1040A, and 1040EZ included reference to the interactive application, the reference was in a general section of the instructions dealing with TeleTax rather than in the

section of the instructions dealing with the rate reduction credit (see app. III for copies of the relevant pages in the Form 1040 instructions with our highlighting of the relevant data on those pages).

In addition to clearer instructions, an IRS official indicated that IRS could have done a better job of getting information on the rate reduction credit to the public before the filing season. In that regard, IRS had decided not to send notices to taxpayers reminding them of the amount of the advance tax refund they received due to cost considerations. Although sending such a notice would have resulted in additional cost, it may have lessened the confusion experienced by taxpayers when it came time to determine whether or not they qualified for the rate reduction credit and subsequently may have reduced the costs IRS incurred to identify and correct rate reduction credit errors, send error notices to the affected taxpayers, and provide related telephone assistance.

A final issue with respect to guidance for the future is IRS's lack of plans to do a "lessons learned" review of the advance tax refund initiative. According to IRS officials, other than a critique of the filing season, which is done annually and will no doubt include a review of problems that taxpayers experienced with the rate reduction credit, IRS has no plans to conduct a comprehensive analysis of the advance tax refund initiative. Both the Government Performance and Results Act of 1993[31] and IRS guidance stress that analysis is a key part of understanding performance and identifying improvement options. Such an analysis would benefit IRS management if it became necessary to deal with similar challenges in the future.

Conclusions

IRS and FMS should be commended for the extensive amount of work they accomplished in a short period of time to issue 86 million advance tax refund checks. While there are bound to be implementation issues in any effort of this magnitude, IRS responded to problems quickly so that only a small percentage of advance refund checks were affected. Although taxpayers experienced problems in reaching IRS by telephone, IRS probably did as good as it could considering the increased demand for assistance, the number of staff available, and the fact that the advance tax refund was a one-time event that made it unrealistic to hire and train additional staff.

[31]P.L. 103-62.

Although this report discusses various implementation issues related to the advance tax refund program and the rate reduction credit, we are not recommending any specific corrective actions related to those issues. Because our review focused on the advance tax refund program, we have no basis for knowing whether the identified issues were unique to that program or more widespread and, not knowing that, we have no basis for recommending specific changes to IRS's policies or procedures.

The various observations we identified in the prior section of this report should be useful to IRS if faced with similar challenges in the future. However, IRS staff who were involved in planning and implementing the advance tax refund program, including those aspects related to the rate reduction credit, are in an even better position than either us or TIGTA to assess IRS's performance and suggest alternative approaches for handling the challenges involved in such an effort. That kind of in-house assessment, while including the results of work done by us and TIGTA, could delve into details that we did not, such as IRS's testing of programming changes and its decision to not send notices to taxpayers reminding them of the amount of advance tax refund they received.

Recommendation for Executive Action

To help identify the full range of challenges IRS faced with respect to the advance tax refunds and rate reduction credit and any changes in procedures or processes that might be warranted if it faced similar challenges in the future, we recommend that the Commissioner of Internal Revenue convene a study group to assess IRS's performance with respect to the advance tax refunds and rate reduction credit. That assessment should include the results of work done by us and TIGTA, including the various observations identified in this report. To ensure that managers faced with similar challenges in the future have the benefit of this assessment, the results should be thoroughly documented.

Agency Comments

We requested comments on a draft of this report from IRS and FMS. We obtained written comments in a July 26, 2002, letter from the Commissioner of Internal Revenue (see app. IV) and in a July 24, 2002, letter from the Commissioner of FMS (see app. V).

The Commissioner of Internal Revenue said that the report "is an accurate and balanced reflection of our efforts in administering the new law" and that the "documentation provided by your report, and a series of reports by TIGTA, are a strong foundation for an assessment of lessons learned." The Commissioner said that he asked the Commissioner of IRS's Wage and Investment Division to conduct a brief review to identify lessons learned

and that "his synopsis will supplement the documentation already available and serve as a historic reference for future guidance." Such a review and documentation would be responsive to our recommendation.

The Commissioner of FMS expressed the belief that the advance tax refund program was a model initiative that demonstrated that federal agencies are capable of implementing major programs on short notice efficiently and cost-effectively.

We are sending copies of this report to the Chairman and Ranking Minority Member of the House Committee on Ways and Means. We are also sending copies to the Secretary of the Treasury; the Commissioner of Internal Revenue; the Commissioner of FMS; the Director, Office of Management and Budget; and other interested parties. In addition, the report will be available at no charge on GAO's Web site at http://www.gao.gov.

This report was prepared under the direction of David J. Attianese, Assistant Director. If you have any questions regarding this report, please contact Mr. Attianese or me at (202) 512-9110. Key contributors to this report were Robert C. McKay and Ronald W. Jones.

James R. White
Director, Tax Issues

Appendix I: Duplicate, Altered, and Counterfeit Advance Tax Refund Checks

Once the advance tax refunds were issued between July and December 2001, there were some problems identified involving duplicate, altered, and counterfeit checks. However, in light of the overall number of advance refund checks issued—about 86 million—these problems were relatively minor.

One problem identified within the first 2 weeks of the advance tax refund payment period and promptly corrected involved duplicate checks sent to taxpayers by one of the three Defense Finance and Accounting Service (DFAS) centers that assisted the Financial Management Service (FMS) in issuing the checks. This problem surfaced because two taxpayers who had received duplicate checks tried to cash the second check and a third taxpayer notified the Internal Revenue Service (IRS) about receiving duplicate checks. Once the problem was identified, FMS decided to no longer use the particular DFAS center from which the duplicate checks had emanated. As of May 2002, FMS had identified 27 instances of such duplicate checks.

According to an FMS official, of the 27 taxpayers who received duplicate checks, 24 taxpayers have either fully repaid the extra payment or have returned the duplicate check. As of May 1, 2002, 1 taxpayer had partially repaid the extra check, and FMS was in the process of recovering the duplicate payments from the other 2 taxpayers.

Another problem related to the advance tax refunds involved either altered or counterfeit checks. FMS's Check Reconciliation Branch detects altered and counterfeit checks during routine reconciliation of agency payment records with bank records. Other altered or counterfeit checks may be identified by banks when the checks are presented to be cashed.

According to FMS, as of March 1, 2002, there were 165 advance refund checks that were found to be either altered or counterfeit as follows:

- 47 altered checks with a combined value of $138,405 and
- 118 counterfeit checks with a combined value of $75,640.

According to FMS, 162 of the 165 altered and counterfeit checks were referred to the United States Secret Service for investigation. We do not know the results of any such investigations.

Appendix II: Taxpayer Advocate Service Involvement with the Advance Tax Refunds and Rate Reduction Credit

The Taxpayer Advocate Service (TAS), which helps taxpayers solve problems with the Internal revenue Service (IRS) and recommends changes that will prevent them, was involved in the advance tax refund program since its inception. Originally, when asked to comment on the notices that were to go out to taxpayers, TAS offered suggestions to improve notice clarity. Once the notices and refund checks were sent out, TAS handled telephone calls and correspondence from taxpayers and their congressional representatives concerning the refunds and the related rate reduction credit on the 2001 tax return. In some instances, TAS opened cases to address the taxpayers' concerns. However, before sending out the initial advance tax refund checks, IRS decided, after inquiry from TAS, that no checks would be sent to taxpayers ahead of their scheduled delivery date, even for cases involving potential hardship.

Although TAS had no nationwide data concerning the number of taxpayer calls related to the advance tax refunds, such data was tracked by eight local TAS offices, as well as by TAS offices in 5 of 10 IRS campuses. Through April 2002, these offices collectively had received over 4,200 calls from taxpayers related to the advance tax refunds. According to TAS officials, the most frequent questions asked by taxpayers who made these calls were as follows:

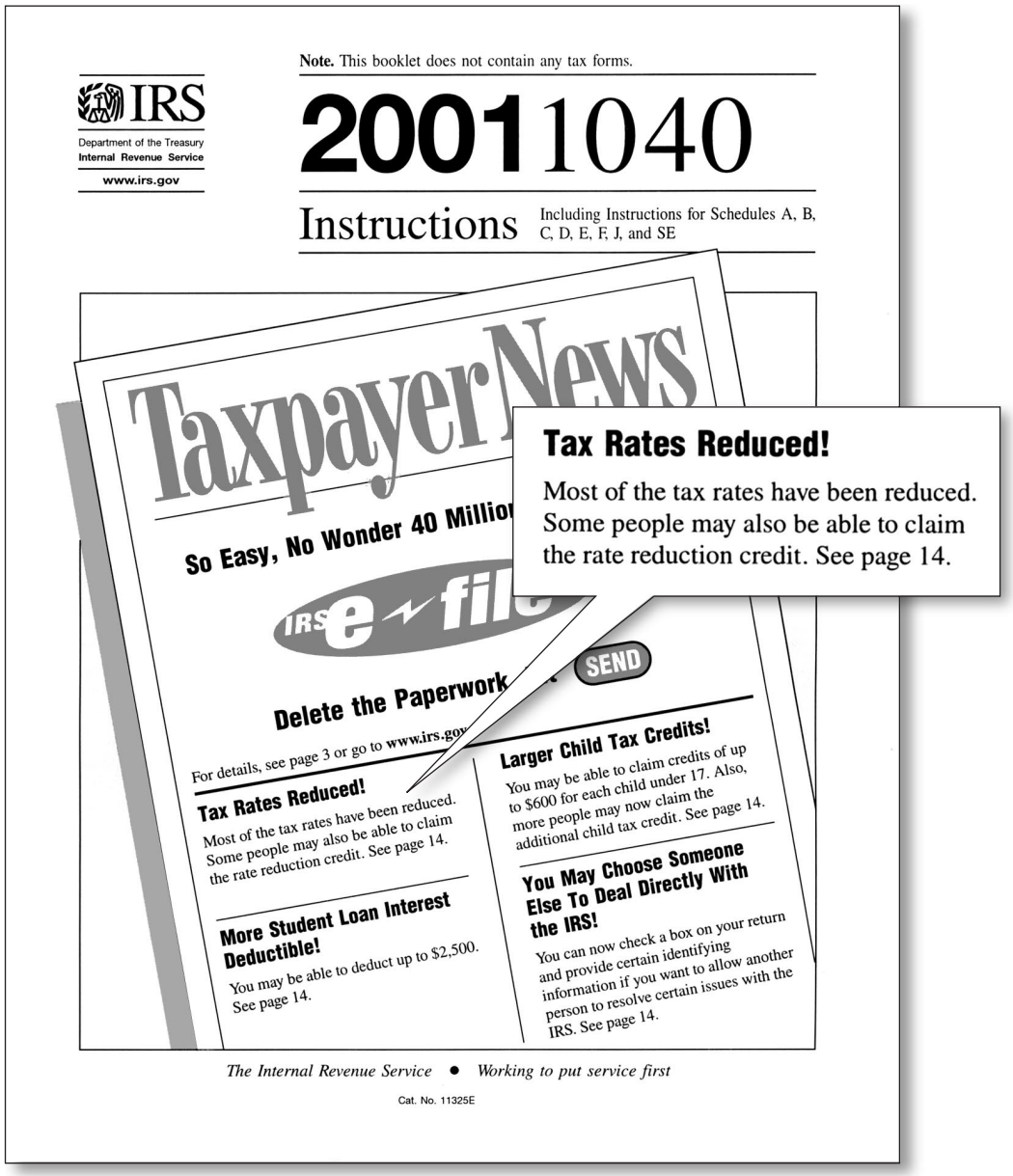
- When will I receive the advance payment? Am I eligible for an advance payment?
- What amount of advance payment will I receive?
- Why am I not going to receive an advance payment?
- Was this an advance payment or a rebate of tax already paid?
- Various questions concerning offsets for back taxes and child support, innocent spouse, etc.

According to TAS staff at one campus, some taxpayers told them that they had called TAS with these types of questions because they had difficulty reaching IRS's regular telephone assistors.

According to TAS national office staff, as of May 2002, TAS had opened a total of 3,246 cases nationwide related to the advance tax refunds and the subsequent rate reduction credit, about 500 of which had been opened since the start of calendar year 2002. Of the total cases opened, about 2,170 (67 percent) involved congressional contacts, which automatically result in the opening of a TAS case. Other cases that were opened involved either an injured spouse or a potential hardship situation.

In reviewing TAS cases at one of the IRS campuses, we found that taxpayers who had either no taxable income in 2000 or not enough taxable income to make them eligible for the full amount of the advance tax refund authorized by law were questioning why they had received no advance refund or less than the full amount. Other taxpayers had contacted TAS to provide a change of address or to check on the status of their advance refund check.

Appendix III: Excerpts from the Tax Year 2001 Form 1040 Instructions Related to the Rate Reduction Credit



Note. This booklet does not contain any tax forms.

IRS
Department of the Treasury
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2001 1040

Instructions Including Instructions for Schedules A, B, C, D, E, F, J, and SE

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For details, see page 3 or go to www.irs.gov

Tax Rates Reduced!

Most of the tax rates have been reduced. Some people may also be able to claim the rate reduction credit. See page 14.

More Student Loan Interest Deductible!

You may be able to deduct up to $2,500. See page 14.

Larger Child Tax Credits!

You may be able to claim credits of up to $600 for each child under 17. Also, more people may now claim the additional child tax credit. See page 14.

You May Choose Someone Else To Deal Directly With the IRS!

You can now check a box on your return and provide certain identifying information if you want to allow another person to resolve certain issues with the IRS. See page 14.

The Internal Revenue Service • Working to put service first

Cat. No. 11325E

Tax Rates Reduced!

Most of the tax rates have been reduced. Some people may also be able to claim the rate reduction credit. See page 14.

What Is TeleTax?

Call TeleTax at **1-800-829-4477** for:

- **Refund information.** Check the status of your **2001** refund.
- **Recorded tax information.** There are about 150 topics that answer many Federal tax questions.
- **2001 advance payment (rebate) information.** Find out the amount of your advance payment (before offset). You may need this information to complete the Rate Reduction Credit Worksheet on page 36.

How Do You Use Tele-Tax?

Refun

Refund i
least 4 w
weeks if
times is
Please wait at least 4 weeks from the date you filed before calling to check the status of your refund. Do not send in a copy of your return unless asked to do so.

Be sure to have a copy of your 2001 tax return available because you will need to know the first social security number shown

status of your refund and are not given the date it will be issued, please wait until the next week before calling back.

Recorded Tax Information

Recorded tax information is available

TeleTax topics are also available using a personal computer and modem (go to **www.irs.gov**).

- **2001 advance payment (rebate) information.** Find out the amount of your advance payment (before offset). You may need this information to complete the Rate Reduction Credit Worksheet on page 36.

TeleTax Topics

All topics are available in Spanish.

Topic No.	Subject
	IRS Help Available
101	IRS services—Volunteer tax assistance, toll-free telephone, walk-in assistance, and outreach programs
102	Tax assistance for individuals with disabilities and the hearing impaired
103	Intro. to Federal taxes for small businesses/self-employed
104	Taxpayer Advocate program—Help for problem situations
105	Public libraries—Tax information tapes and reproducible tax forms
	IRS Procedures
151	Your appeal rights
152	Refunds—How long they should take
153	What to do if you haven't filed your tax return (Nonfilers)
154	Form W-2—What to do if not received
155	Forms and Publications—How to order
156	Copy of your tax return—How to get one
157	Change of address—How to notify IRS
158	Ensuring proper credit of payments

Topic No.	Subject
	Collection
201	The collection process
202	What to do if you can't pay your tax
203	Failure to pay child support and Federal nontax and state income tax obligations
204	Offers in compromise
205	Innocent spouse relief
	Alternative Filing Methods
251	Signing your return with a self-select PIN
252	Electronic filing
253	Substitute tax forms
254	How to choose a paid tax preparer
255	TeleFile
	General Information
301	When, where, and how to file
302	Highlights of tax changes
303	Checklist of common errors when preparing your tax return
304	Extensions of time to file your tax return
305	Recordkeeping
306	Penalty for underpayment of estimated tax
307	Backup withholding
308	Amended returns
309	Roth IRA contributions
310	Coverdell education savings accounts
311	Power of attorney information

Topic No.	Subject
	Filing Requirements, Filing Status, and Exemptions
351	Who must file?
352	Which form—1040, 1040A, or 1040EZ?
353	What is your filing status?
354	Dependents
355	Estimated tax
356	Decedents
	Types of Income
401	Wages and salaries
402	Tips
403	Interest received
404	Dividends
405	Refunds of state and local taxes
406	Alimony received
407	Business income
408	Sole proprietorship
409	Capital gains and losses
410	Pensions and annuities
411	Pensions—The general rule and the simplified method
412	Lump-sum distributions
413	Rollovers from retirement plans
414	Rental income and expenses
415	Renting vacation property and renting to relatives
416	Farming and fishing income
417	Earnings for clergy
418	Unemployment compensation
419	Gambling income and expenses
420	Bartering income

(Continued on page 12)

Form 1040—Lines 45 Through 47

the credit; $25,000 if married filing jointly and both spouses are eligible; $12,500 if married filing separately). See **Schedule R** and its instructions for details.

Credit Figured by the IRS. If you can take this credit and you want us to figure it for you, see the Instructions for Schedule R.

Line 46

Education Credits

If you (or your dependent) paid qualified expenses in 2001 for yourself, your spouse, or your dependent to enroll in or attend an eligible educational institution, you may be able to take an education credit. See **Form 8863** for details. However, you **cannot** take an education credit if **any** of the following apply.

- You are claimed as a dependent on someone's (such as your parent's) 2001 tax return.
- Your filing status is married filing separately.
- The amount on Form 1040, line 34, is $50,000 or more ($100,000 or more if married filing jointly).
- You (or your spouse) were a nonresident alien for any part of 2001 unless your filing status is married filing jointly.

Rate Reduction Credit Worksheet- Line 47 *Keep for Your Records*

Before you begin:

√ If you received (before offset) an advance payment of your 2001 taxes equal to the amount shown below for your 2001 filing status, **stop.** You cannot take the credit because you have received the maximum amount of the credit.

- Single or married filing separately — $300
- Head of household — $500
- Married filing jointly or qualifying widow(er) — $600

√ If you, or your spouse if filing a joint return, can be claimed as a dependent on another person's return, **stop.** You cannot take the credit.

√ If you received (before offset) an advance payment and you filed a joint return for 2000, you and your spouse are each considered to have received one-half of the payment.

TIP If you received Notice 1275, 1277, or 1278 have it available. The notice shows the amount of your advance payment (before offset).

1. Enter the amount from Form 1040, line 39. If line 39 is zero or blank, **stop;** you cannot take the credit . . . 1. _____
2. Enter the amount shown below for your filing status.
   - Single or married filing separately — $6,000
   - Head of household — $10,000
   - Married filing jointly or qualifying widow(er) — $12,000

   . . . . . 2. _____
3. Is the amount on line 1 less than the amount on line 2?

   No. Enter: $300 if single or married filing separately; $500 if head of household; $600 if married filing jointly or qualifying widow(er).

   Yes. Multiply the amount on line 1 by 5% (.05). Enter the result.

   . . . . . 3. _____
4. Enter the amount from Form 1040, line 42 . . . . . 4. _____
5. Add the amounts from Form 1040, lines 43 through 46. Enter the total . . . 5. _____
6. Subtract line 5 from line 4. If the result is zero or less, **stop;** you cannot take the credit . . . . . 6. _____
7. Enter the **smaller** of line 3 or line 6 . . . . . 7. _____
8. Enter the amount, if any, of your advance payment (before offset). If filing a joint return, include your spouse's advance payment with yours . . . . . 8. _____
9. **Rate reduction credit.** Subtract line 8 from line 7. Enter the result here and, if more than zero, on Form 1040, line 47. If line 8 is more than line 7, you do not have to pay back the difference . . . . 9. _____

Need more information or forms? See page 7.

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Appendix IV: Comments from the Internal Revenue Service

COMMISSIONER

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

July 26, 2002

Mr. James R. White
Director, Tax Issues
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. White:

I consider the successful implementation of the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the Act), as one of our most notable achievements of the past year. The Act's unique approach, designed to provide immediate tax relief and an economic stimulus, required us to respond quickly to the provisions. Our effort required extensive internal and external coordination to meet the mandated deadlines for issuing the advance refund checks, providing information to the public and accommodating the changes necessary for a successful 2002 filing season.

I have reviewed the draft report, "Advance Tax Refund Program Was a Major Accomplishment, but not Problem Free" and would like to commend you and your staff. I believe the report is an accurate and balanced reflection of our efforts in administering the new law. You recognized the scope and complexity of our effort and made meaningful observations. While your report recognizes the problems we encountered, it also highlights our quick response to correct or minimize their impact.

The collaborative efforts of the General Accounting Office and Treasury Inspector General for Tax Administration (TIGTA) were beneficial throughout our implementation and administration of the Act. I believe this mutual effort is a good example of government working at its best.

I agree the observations in the report are beneficial should we be responsible for administering a similar process in the future. I believe your recommendation has merit, and we will comply with it as I have outlined below.

Recommendation
To help identify the full range of challenges IRS faced with respect to the advance tax refunds and the rate reduction credits, and any changes in the procedures or processes that might be warranted if it faced similar challenges in the future, we recommend that the Commissioner of the Internal Revenue convene a study group to assess IRS' performance with respect to the advance tax refunds and the rate reduction credit.

2

That assessment should include the results of the work done by us and TIGTA, including the various observations identified in this report. To ensure that managers faced with similar challenges in the future have the benefit of this assessment, the results should be documented.

Response
Your report recognizes many of the unique challenges presented by the provisions of the Act. The documentation provided by your report, and a series of reports by TIGTA, are a strong foundation for an assessment of lessons learned. I asked the Commissioner, Wage and Investment Division to conduct a brief review to identify lessons learned. His synopsis will supplement the documentation already available and serve as a historic reference for future guidance.

If you have questions or comments about this letter, please call Floyd Williams, Director, Legislative Affairs, at (202) 622-3720.

Sincerely,

Charles O. Rossotti

Appendix V: Comments from the Financial Management Service

COMMISSIONER

DEPARTMENT OF THE TREASURY
FINANCIAL MANAGEMENT SERVICE
WASHINGTON, D.C. 20227

July 24, 2002

Mr. James R. White
Director, Tax Issues
General Accounting Office
441 G Street, NW
Washington, D.C. 20548

Dear Mr. White:

This letter is in response to your request to Secretary O'Neill for comments on the draft of the General Accounting Office (GAO) Report GAO-02-827, "Tax Administration - Advance Tax Refund Program Was a Major Accomplishment, but not Problem Free," dated August 2002.

The Financial Management Service (FMS) believes this was an extremely successful program. With the assistance of the Defense Finance and Accounting Service (DFAS), FMS issued over 86 million advance refund checks totaling $36.5 billion from July to December 2001. This extraordinary effort represented in excess of 30% of our routine check production volume, but was accomplished without any interruption of our normal workload.

The number of checks returned as undeliverable was less than 1 percent, well below the normal rate for tax refunds. FMS offset more than 1.4 million advance refund payments to cover debts owed by delinquent taxpayers with no reported instances of checks being offset inappropriately.

Page 3 of the report references 34,000 refund checks that were not reissued in a timely manner as of late October 2001, which implies that FMS had delayed issuing checks. It is suggested that the wording be revised to, "As of late October, IRS had identified about 34,000 of these checks which it had not recertified to FMS for reissuance."

Thank you for the opportunity to review the draft report. As the report did not specifically cite FMS for any weaknesses, we have no further comment other than to state we believe that the Advance Tax Refunds program was a model initiative which demonstrated Federal agencies are capable of implementing major programs on short notice efficiently and cost effectively.

Sincerely,

Richard L. Gregg

Richard L. Gregg

cc: Donald Hammond

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Jeff Nelligan, managing director, NelliganJ@gao.gov (202) 512-4800
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