Avoidable Interest Was Paid on Tentative Carryback Refunds Requested by Corporate Taxpayers

September 2004

Reference Number: 2004-30-171

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 10, 2004

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Avoidable Interest Was Paid on Tentative Carryback Refunds Requested by Corporate Taxpayers (Audit # 200330039)

This report presents the results of our review of refunds from Corporation Application for Tentative Refund (Form 1139). The overall objective was to determine whether refunds were timely issued to avoid the payment of interest and to satisfy taxpayer rights.

Corporate taxpayers file Forms 1139 to obtain refunds of tax by carrying back net operating losses, net capital losses, or unused general business credits to earlier years. The Internal Revenue Service (IRS) has 90 days to make any refund or credit but must issue any refunds within 45 days to avoid paying interest.[1]

In summary, the IRS paid corporate taxpayers an estimated $22.8 million in interest on an estimated 3,300 late refunds issued for amounts greater than $10,000 based on Forms 1139 processed in Calendar Year (CY) 2002. Interest was paid because the refunds were not issued within 45 days. We determined that the IRS could have taken actions to avoid payment of an estimated $12.6 million of this interest. We were unable to determine how much, if any, of the remaining $10.2 million could have been avoided, due to unavailable documents and other issues that may have contributed to the delays.

We recommended the Director, Customer Account Services (CAS), Small Business/Self-Employed (SB/SE) Division, ensure interest reports are maintained to reflect the circumstances that delayed Tentative Carryback Refunds beyond the 45-day interest-free period and ensure corrective action is taken when the volume of instances signifies that a problem exists.

[1] More specific details regarding the 90 day and 45 day requirements are included on page 1 of the report.

Management's Response: The IRS generally agreed with our recommendation. The Accounts Management (AM) Operation within CAS, SB/SE Division, will request an ad hoc report from the Net Tax Refunds Report to specifically identify Tentative Carryback Interest. The report will enable campuses to monitor refund and interest issued daily on Forms 1139. The AM Program Management/Process Assurance Staff and campuses will review data collected from the ad hoc reports through October 30, 2004, and provide recommendations, along with an assessment of the usefulness of the report, to the Deputy Director, AM, SB/SE Division, by November 15, 2004.

IRS management agreed with the avoidable interest paid for CY 2002, but believed that the measurable benefit on tax administration of $48.3 million, projected over 5 years, should be reduced to reflect current performance. The IRS experienced a 30 percent reduction in receipts and anticipates this will continue. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment: The computation of the measurable benefit on tax administration recognizes that interest paid on late refunds in CY 2003 was about 30 percent less than the amount paid in CY 2002. Our review of actual cases was limited to those processed in CY 2002. To estimate the avoidable interest paid in CY 2003, the CY 2002 ratio of avoidable interest to total interest paid on late refunds was applied to the total interest paid on late refunds in CY 2003. We used the lower CY 2003 estimate for each of 4 years in addition to the CY 2002 amount to arrive at our 5-year estimate of $48.3 million of interest that could have been avoided. The computations are included in Appendix IV.

Copies of this report are also being sent to the IRS mangers affected by the report recommendation. Please contact me at (202) 622-6510 if you have questions or Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (215) 516-2341.

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Background

Corporations are generally required to file a U.S. Corporation Income Tax Return (Form 1120) on an annual basis. In some years, corporations may have a net operating loss, net capital loss, or unused general business credit. In these situations, they may carry back these losses or credits to earlier tax years and obtain a refund of their taxes by filing a Corporation Application for Tentative Refund (Form 1139). The tax for those years is recomputed with the loss or credit, and the accounts are adjusted for the difference. The Internal Revenue Service (IRS) has 90 days from the latter of the date that the Form 1139 is filed or the last day of the month the loss year return is due (with extensions) to make any refund or credit.[1] However, the IRS must pay interest if the refund is not issued within 45 days.[2]

The Accounts Management Operation at the Cincinnati and Ogden Campuses processed approximately 133,000 adjustments to Form 1120 accounts, based on Forms 1139 (also known as "tentative carryback" adjustments), in Calendar Year (CY) 2002.[3] Almost 38,000 were for amounts in excess of $10,000, and an estimated 36,400 of these resulted in refunds.

This review was performed at the IRS Cincinnati and Ogden Campuses in Customer Account Services during the period October 2003 through March 2004. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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[1] I.R.C. § 6411(b) (1986).
[2] I.R.C. § 6611(f)(1) (1982). Interest is payable if the refund is not issued within 45 days from the date Form 1139 is received or the due date, without extensions, of the loss year return, whichever is later.
[3] The campuses are the data processing arms of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

The Payment of an Estimated $12.6 Million in Interest Could Have Been Avoided

The IRS paid corporate taxpayers an estimated $22.8 million in interest on an estimated 3,300 late refunds (9 percent of the 36,400 refunds) issued based on Forms 1139 processed in CY 2002.[4] Interest was paid because the refunds were not issued within 45 days. We determined that by improving processes the IRS could have taken actions to avoid payment of an estimated $12.6 million of this interest on 87 percent of the estimated 3,300 late refunds. Due to unavailable documentation and other issues that may have contributed to the delays, we were unable to determine how much, if any, of the remaining $10.2 million of interest on 13 percent of the estimated 3,300 late refunds could have been avoided.

An estimated $2.5 million in interest payments could have been avoided by expediting refunds

Almost half of the late refunds were late because they were allowed to refund in the normal refund time, rather than being expedited.[5] These refunds were issued with an estimated $2.5 million in interest that would not have been paid had the refunds been expedited when the Forms 1139 were processed.

IRS procedures require that all refunds in excess of $1 million resulting from a tentative carryback adjustment be expedited. Refunds for amounts less than $1 million, but over the tolerance based on local procedures, should be expedited when the 45-day interest-free period is in jeopardy to avoid the payment of interest. These procedures, however, were not always followed.

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[4] This includes only interest paid due to the issuance of the refund in excess of 45 days. It does not include interest paid in error due to erroneous computations as discussed in a previous Treasury Inspector General for Tax Administration report, *Improvements Are Needed to Ensure Large Dollar Manual Refunds Are Issued Accurately and Timely* (Reference Number 2003-30-183, dated August 2003). See Appendices I and IV for more detailed information.

[5] Refunds are expedited by issuing the refund manually within 1 to 5 days.

<u>An estimated $10.1 million in avoidable interest was paid due to other factors</u>

Several other factors contributed to the delay in the issuance of refunds involving an estimated $10.1 million in avoidable interest. These other factors and the percentage of avoidable interest associated with each include the following:

- Forms 1139 were received in the Accounts Management Operation in sufficient time to issue timely refunds, but there was a delay in processing the forms (45.1 percent).
- Refunds were delayed because some adjustments containing errors were not promptly corrected, and some refunds were stopped for review purposes (26.0 percent).
- Delays were caused by shipping cases from other campuses and Area Offices (16.5 percent).
- Delays at the Cincinnati Campus, of as much as 51 days, occurred between the time forms were received at the Campus and the time they were received in the Accounts Management Operation where they are processed (7.9 percent).
- Forms 1139 were erroneously sent directly to the Examination function before the accounts were adjusted and refunds issued (2.5 percent).
- Forms 1139 were processed timely, but the refunds were sometimes held to offset a portion of the overpayment to a balance due on another account (1.7 percent). The refunds were not issued until some time after the forms were processed.
- Refunds were returned as undeliverable due to errors made by IRS personnel (.2 percent).[6]

In December 2001, the IRS consolidated the 10 campuses working these cases to 2,[7] requiring additional employees

[6] The sum of percentages does not equal 100 percent due to rounding.
[7] This does not include International cases, which were worked at the Philadelphia Campus.

with specialized training to handle the increased workload at these 2 campuses. In addition, the nationwide volume of these tentative carryback adjustments in CY 2002 increased 40 percent over the CY 2001 volume. Part of this increase was attributable to the Job Creation and Workers Assistance Act of 2002.[8]

The Act, which allowed taxpayers to carry losses back 5 years instead of 2 years, became effective after some taxpayers had already filed Forms 1139 and received refunds. Therefore, the taxpayers filed amended Forms 1139, requiring tax adjustments in earlier years and, in some cases, reassessment of the previous adjustments. Resulting overpayments in 1 year had to be offset to satisfy newly created balances in other years, complicating the issuance of refunds.

An additional estimated $10.2 million in interest was paid, some of which may have been avoidable

In 13 percent of the estimated 3,300 late refunds, we were unable to determine whether or not the payment of an estimated $10.2 million in interest could have been avoided.

In some cases, we were unable to secure the necessary documents to determine the cause for the delay in issuing refunds paid with an estimated $6.3 million in interest.[9]

In the other cases, an additional $3.9 million was paid on late refunds, which may or may not have been avoidable. We estimate that for the cases where we could not make a determination:

- Interest was paid on refunds of taxpayers in litigation or due to insolvency issues (40.2 percent). The refunds, which must be approved before issuance, may not be approved until well after the Form 1139 has been processed. While the delay in

[8] Pub. L. No. 107-147, 116 Stat. 21 (2002).
[9] In 416 of the estimated 3,318 late refunds, we were unable to determine whether the interest could have been avoided. In 54.6 percent of the cases where we could not obtain the necessary documents to make a determination, an estimated $6.3 million of interest was paid. In the remaining 45.4 percent of these cases, an estimated $3.9 million of interest was paid.

obtaining approval could not be avoided in some cases, a case started too close to the 45-day limit would not allow sufficient time to obtain approval and issue the refund timely.

- Delays were attributed to waiting for documents, necessary for proper computations, from other areas or files (28.6 percent).
- Refunds were based on a Form 1139 that was originally disallowed or lost and based on certified receipts (16.9 percent).
- Delays were caused by necessary corrections to previous actions on the account before the refund could be issued (14.3 percent).

Significant improvements have been made in processing Form 1139 refunds

During 2002, the Ogden Campus processed almost three times the number of tentative carryback adjustments as they processed in the previous year. Ogden processed Forms 1139 for the small business taxpayers in the western part of the nation. They also processed the forms for the Large and Mid-Size Business Division taxpayers nationwide. The Cincinnati Campus, which also processed more than twice the volume of tentative carryback adjustments as in CY 2001, assisted with the Ogden workload. Since that time, the Ogden Campus has added more tax examiners to process these cases. The examiners are also more experienced and better trained to process "large dollar" cases.

While Forms 1139 are processed by employees in the Tentative Carryback Unit of the Taxpayer Relations Department at the Ogden Campus, Customer Service Representatives (CSR) in the Toll Free Department process most Forms 1139 at the Cincinnati Campus. The CSRs were aware that refunds were being issued late, with interest. However, they were performing a dual role: processing adjustments, and handling customer service phone calls. The phone calls took priority over processing Forms 1139.

Also, in CY 2002, Forms 1139 were distributed to any personnel with the appropriate training in the teams throughout the Accounts Management Operation at the Cincinnati Campus. Since CY 2002, distribution of Forms 1139 for processing at the Cincinnati Campus has been limited to only a few groups and control over these cases has greatly improved. A new system of sorting and identifying cases by age and amount enables any CSR to readily prioritize cases to be worked.

While the managers presently ensure that the CSRs have the necessary time for these cases, handling phone calls remains the priority. This could result in delays in processing Forms 1139 during periods of heavy receipts.

The causes of late refunds should be analyzed to reduce interest payments

Despite the improvements in procedures, an estimated $16 million in interest was paid on an estimated 3,000 late refunds based on Forms 1139 processed in CY 2003.[10]

In the past, an interest report was prepared for management by the tax examiner in each instance when interest was paid on an expedited refund issued based on a Form 1139. The case was reviewed, and the report recorded the progress of Form 1139 since receipt and the cause for the delay. These reports have been discontinued. A simpler report recording the cause of delays in processing any Form 1139 case where the refund will be issued in excess of the 45-day limit would alert management to any recurring problems requiring attention. By using interest reports to monitor interest, management can promptly address the causes and reduce the payment of avoidable interest.

The Net Tax Refunds Report, generated from the Interim Revenue Accounting Control System, captures interest from some of these refunds, but the total interest paid on tentative carryback refunds processed by the Accounts Management Operation is not separately identified.

[10] See Appendix I for more detailed information.

Recommendation

The Director, Customer Account Services (CAS), Small Business/Self-Employed (SB/SE) Division, should ensure:

1. Interest reports are maintained to reflect the circumstances that delayed Tentative Carryback refunds beyond the 45-day interest-free period. These reports should be routed to a level of management with the authority to take corrective action when the volume of instances signifies that a problem exists.

   The Director should determine whether it is feasible for the information captured for Corporation Income in the "Net Tax Refunds Report" to be altered to separately identify tentative carryback adjustments and whether the report could be used as a tool to monitor the interest on the normal (generated) refunds.

<u>Management's Response</u>: The IRS generally agreed with our recommendation. The Accounts Management (AM) Operation within CAS, SB/SE Division will request an ad hoc report from the Net Tax Refunds Report to specifically identify Tentative Carryback Interest. The report will enable campuses to monitor refund and interest issued daily on Forms 1139. The AM Program Management/Process Assurance Staff and campuses will review data collected from the ad hoc reports through October 30, 2004, and provide recommendations, along with an assessment of the usefulness of the report to the Deputy Director, AM, SB/SE Division, by November 15, 2004.

IRS management agreed with the amount of avoidable interest paid for CY 2002 but believed the measurable benefit on tax administration of $48.3 million, projected over 5 years, should be reduced to reflect current performance. The IRS experienced a 30 percent reduction in receipts and anticipates this will continue.

<u>Office of Audit Comment</u>: The computation of the measurable benefit on tax administration recognizes that interest paid on late refunds in CY 2003 was about 30 percent less than the amount paid in CY 2002. Our review of actual cases was limited to those processed in CY 2002. To estimate the avoidable interest paid in

CY 2003, the CY 2002 ratio of avoidable interest to total interest paid on late refunds was applied to the total interest paid on late refunds in CY 2003. We used the lower CY 2003 estimate for each of 4 years in addition to the CY 2002 amount to arrive at our 5-year estimate of $48.3 million of interest that could have been avoided. The computations are included in Appendix IV.

Appendix I

Detailed Objective, Scope, and Methodology

The objective of this audit was to determine whether refunds from Corporation Application for Tentative Refund (Form 1139) were timely issued to avoid the payment of interest and to satisfy taxpayer rights.

To accomplish our objective, we:

I. Reviewed the U.S. Corporation Income Tax Return (Form 1120) accounts of the tax adjustments in our samples (details of samples to follow), and all of the tax adjustments for amounts in excess of $1 million. We determined whether interest-free refunds were issued within 45 days and whether any refunds were in excess of 90 days.

II. Reviewed Internal Revenue Manuals related to the processing of Forms 1139. We determined the correct dates to be reflected in the adjustments and reviewed instructions for issuing manual refunds.

III. Reviewed the adjustments where refunds were issued with interest and determined whether the correct Tentative Carryback dates were used.

IV. Determined, where possible, the cause of the refund delays and whether the refunds could have been issued timely.

To obtain our samples, we extracted all Transaction Codes (TC) 295, Abatement of Prior Tax With Interest Computation Date,[1] processed in Calendar Year (CY) 2002 to the Business Masterfile (BMF) for an amount greater than $10,000.[2] We eliminated any TC 295s processed to an account for U.S. Income Tax Return for Estates and Trusts (Form 1041) because these forms are not processed by the Small Business/Self-Employed Division, and the 161 TC 295s processed for Exempt Organization Business Income Tax Returns (Form 990T) and Farmers' Cooperative Association Income Tax Returns (Form 990C) due to the insignificant volume. We also eliminated any TC 295s that were not processed at the Cincinnati or Ogden Campus to the account of a Form 1120 because there were only 858 such transactions.[3]

We stratified the results for each site into 3 categories because the interest paid on refunds in excess of $1 million distorted the dollars projected to the universe. Also, processing differs somewhat in each of the categories.

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[1] A TC 295 in the account of a Form 1120 signifies that the tax adjustment was based on a Form 1139.
[2] The BMF is the Internal Revenue Service (IRS) database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.
[3] The campuses are the data processing arms of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

Adjustments for amounts of $10 million or greater

We reviewed the account of each TC 295 with amounts of $10 million or greater (Cincinnati 47, Ogden 513) to determine whether the refund was issued timely and the amount of any interest paid. Refunds for $10 million and greater must be expedited.[4]

Adjustments for amounts of $1 million or greater, but less than $10 million

We also reviewed the account of each TC 295 for an amount of $1 million or greater, but less than $10 million (Cincinnati 251, Ogden 1,974). Refunds for less than $10 million (including interest) can be computer generated but are expedited for Forms 1139 if they are for $1 million or greater to ensure timely issuance.

Adjustments for amounts of $10,000 or greater, but less than $1 million

We reviewed the accounts of a statistically valid sample of 539 randomly selected cases out of 13,434 TC 295s processed at the Cincinnati Campus for amounts of $10,000 or greater, but less than $1 million. We also reviewed the accounts of a statistically valid sample of 428 randomly selected cases out of 21,658 TC 295s processed at the Ogden Campus for amounts of $10,000 or greater, but less than $1 million.

Samples were selected using a 95 percent confidence level and a confidence interval of 5. At the 95 percent confidence level, attribute sampling was used to project the number of cases where interest was paid on the refund, and variable sampling was used to project dollars of interest paid. For the CY 2002 Cincinnati sample, the standard error rate for the dollars of interest was .01277 and the precision was 2.504 percent. For the Ogden sample, the standard error rate for the dollars of interest was .01328 and the precision was 2.603 percent.

We also extracted a file of the TC 295s for amounts of $10,000 or greater processed to Form 1120 accounts in CY 2003. We stratified these results for each site as we did for CY 2002 cases. We reviewed the account of each TC 295 for an amount of $10 million or greater (Cincinnati 22, Ogden 481).

In addition, we reviewed the account of each TC 295 for an amount of $1 million or greater, but less than $10 million processed at the Cincinnati Campus in CY 2003 (63), but we reviewed the accounts for only a sample of the TC 295s in this range processed at the Ogden Campus. Specifically, we reviewed the accounts of a statistically valid sample of 339 randomly selected cases out of 1,691 TC 295s for amounts of $1 million or greater, but less than $10 million processed at the Ogden campus in CY 2003.

[4] Refunds are expedited by issuing the refund manually within 1 to 5 days.

We reviewed the accounts of a statistically valid sample of 381 randomly selected cases out of 12,557 TC 295s processed at the Cincinnati Campus in CY 2003 for amounts of $10,000 or greater, but less than $1 million. We also reviewed the accounts of a statistically valid sample of 383 randomly selected cases out of 21,837 TC 295s processed at the Ogden Campus for amounts of $10,000 or greater, but less than $1 million.

Samples were selected using a 95 percent confidence level and a confidence interval of 5. At the 95 percent confidence level, attribute sampling was used to project the number of cases where interest was paid on the refund, and variable sampling was used to project dollars of interest paid. For the CY 2003 Cincinnati sample of TC 295s for amounts of $10,000 or greater, but less than $1 million, the standard error rate for the dollars of interest was .01316 and the precision was 2.58 percent. For the Ogden sample of TC 295s for amounts of $10,000 or greater, but less than $1 million, the standard error rate for the dollars of interest was .01478 and the precision was 2.90 percent. For the Ogden sample of TC 295s of $1 million or greater, but less than $10 million, the standard error rate for the dollars of interest was .00640 and the precision was 1.26 percent.

Appendix II

Major Contributors to This Report

Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)
Richard J. Dagliolo, Director
Kyle R. Andersen, Acting Director
Robert K. Irish, Audit Manager
Dolores Castoro, Lead Auditor
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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Customer Account Services, Small Business/Self-Employed Division SE:S:CAS
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Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Funds put to better use – Potential; Estimated $48.3 million saved (see page 2).

Methodology Used to Measure the Reported Benefit:

A database of all tentative carryback adjustments, Transaction Codes (TC) 295,[1] processed to U.S. Corporation Income Tax Return (Form 1120) accounts in Calendar Year (CY) 2002 was extracted. From this database of 135,843 transactions, less 235 for the transactions that were split into 2 due to a partial reassessment, we extracted the 56,883 processed at the Cincinnati Campus[2] and the 76,173 processed at the Ogden Campus. For each Campus, we extracted a file of all transactions for amounts of $10,000 or greater, so that any interest paid would be significant. The resulting databases consisted of 13,732 transactions for the Cincinnati Campus and 24,145 for the Ogden Campus.

Each database was further stratified to amounts of $10,000 or greater, but less than $1 million; $1 million and greater, but less than $10 million; and $10 million or greater. The Cincinnati database under $1 million (over $10,000) consisted of 13,434 transactions and the Ogden database consisted of 21,658 transactions. It was from these 2 databases that we randomly extracted statistical samples using a 95 percent confidence level and a confidence interval of 5. The Cincinnati sample size for under $1 million tentative carryback adjustments was 539 and the Ogden sample size was 428. There were 298 transactions greater than $1 million at the Cincinnati Campus and 2,487 at the Ogden Campus.

Interest Paid on Late Refunds Processed in CY 2002

We reviewed the account of each TC295 in these files to determine if interest was paid on the refund due to issuance in excess of 45 days. We found that the Internal Revenue Service (IRS) paid an estimated $22.8 million in interest, determined as follows:

In the Cincinnati sample, total interest of $114,415.89 was paid on the late refunds in 55 of the 539 cases. Using attribute sampling, we projected the volume of 55 cases to the population of

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[1] A TC 295 in the account of a Form 1120 signifies that the tax abatement was based on a Form 1139.

[2] The campuses are the data processing arms of the Internal Revenue Service. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

13,434 and estimate that interest was paid on late refunds in 1,371 cases. Using variable sampling, we estimate that interest of $2,851,694 (+/- $1,688,290) was paid in the 1,371 cases.

In the Ogden sample, total interest of $80,917.54 was paid on the late refunds in 36 of the 428 cases. Using attribute sampling, we projected the volume of 36 cases to the population of 21,658 and estimate that interest was paid on late refunds in 1,822 cases. Using variable sampling, we estimate that interest of $4,094,654 (+/- $2,347,339) was paid in the 1,822 cases.

We also reviewed all of the tentative carryback adjustments for amounts of $1 million or more for Cincinnati and Ogden where interest was paid on a late refund. Interest of $7,832,751 was paid on late refunds in 52 of the 298 cases where the tentative carryback adjustment processed at the Cincinnati Campus was for an amount of $1 million or greater. Interest of $7,992,037 was paid on late refunds in 71 of the 2,487 cases where the tentative carryback adjustment processed at the Ogden campus was for an amount of $1 million or greater.

Avoidable Interest Paid on Late Refunds Processed in CY 2002

We reviewed the cases to determine why issuance of the refund was delayed and found the IRS could have taken actions to avoid the payment of an estimated $12.6 million in interest on late refunds, determined as follows:[3]

In the Cincinnati sample, total interest of $85,406 could have been avoided on the late refunds in 51 of the 539 cases. Using attribute sampling, we projected the volume of 51 cases to the population of 13,434 and estimate that interest could have been avoided on late refunds in 1,271 cases. Using variable sampling, we estimate that interest of $2,128,656 (+/- $1,150,020) could have been avoided in the 1,271 cases.

In the Ogden sample, total interest of $50,004 could have been avoided on the late refunds in 31 of the 428 cases. Using attribute sampling, we projected the volume of 31 cases to the population of 21,658 and estimate that interest could have been avoided on late refunds in 1,569 cases. Using variable sampling, we estimate that interest of $2,530,345 (+/- $1,745,972) could have been avoided in the 1,569 cases.

We also reviewed all of the tentative carryback adjustments for amounts of $1 million or more for Cincinnati and Ogden where interest was paid on a late refund. Interest of $3,631,206 could have been avoided on late refunds in 35 of the 298 cases where the tentative carryback adjustment processed at the Cincinnati Campus was for an amount of $1 million or greater. Interest of $4,296,436 could have been avoided on late refunds in 26 of the 2,487 cases where the tentative carryback adjustment processed at the Ogden Campus was for an amount of $1 million or greater.

[3] This includes only interest paid due to the issuance of the refund in excess of 45 days. It does not include interest paid in error due to erroneous computations as discussed in a previous Treasury Inspector General for Tax Administration report, *Improvements Are Needed to Ensure Large Dollar Manual Refunds Are Issued Accurately and Timely* (Reference Number 2003-30-183, dated August 2003). We also excluded late refunds paid with interest of less than $100.

Interest Paid on Late Refunds Processed in CY 2003

We also extracted a database of all TC 295s processed to Form 1120 accounts in CY 2003. From this database of 147,967 transactions, less 87 for the transactions that were split into 2 due to a partial reassessment, we extracted the 63,731 processed at the Cincinnati Campus and the 79,389 processed at the Ogden Campus. For each Campus, we extracted files of transactions for amounts of $10,000 or greater, so that any interest paid would be significant. The resulting databases were stratified to amounts of $10,000 or greater, but less than $1 million; $1 million and greater, but less than $10 million; and $10 million or greater. The databases included 12,642 transactions for the Cincinnati Campus and 24,009 for the Ogden Campus.

The Cincinnati database for amounts under $1 million (over $10,000) consisted of 12,557 transactions and the Ogden database consisted of 21,837 transactions. It was from these 2 databases that we randomly extracted statistical samples using a 95 percent confidence level and a confidence interval of 5. The Cincinnati sample size of tentative carryback adjustments for amounts under $1 million was 381 and the Ogden sample size was 383. There were 63 transactions for amounts of $1 million or greater, but less than $10 million, in the database from the Cincinnati Campus, but 1,691 for the Ogden Campus, so we randomly selected a statistical sample of 339 cases from the Ogden database. We again used a 95 percent confidence level and a confidence interval of 5. There were 22 transactions for amounts of $10 million or greater processed by the Cincinnati Campus, and 481 processed by the Ogden Campus.

We reviewed the account of each TC 295 in these files to determine if interest was paid on the refund due to issuance in excess of 45 days. We found that the IRS paid an estimated $16.2 million in interest on late tentative carryback refunds processed in CY 2003, determined as follows:

In the Cincinnati sample of TC 295s for amounts less than $1 million, total interest of $46,043 was paid on the late refunds in 28 of the 381 cases. Using attribute sampling, we projected the volume of 28 cases to the population of 12,557 and estimate that interest was paid on late refunds in 923 cases. Using variable sampling, we estimate that interest of $1,517,496 (+/- $1,229,902) was paid in the 923 cases.

In the Ogden sample of TC 295s for amounts less than $1 million, total interest of $28,948 was paid on the late refunds in 36 of the 383 cases. Using attribute sampling, we projected the volume of 36 cases to the population of 21,837 and estimate that interest was paid on late refunds in 2,053 cases. Using variable sampling, we estimate that interest of $1,650,466 (+/- $840,920) was paid in the 2,053 cases.

Interest of $1,528,122 was paid on late refunds in 17 of the 63 cases where the tentative carryback adjustment processed at the Cincinnati Campus was for an amount of $1 million or greater, but less than $10 million.

In the Ogden sample of TC 295s for amounts of $1 million or greater, but less than $10 million, total interest of $564,455 was paid on the late refunds in 6 of the 339 cases. Using attribute sampling, we projected the volume of 6 cases to the population of 1,691 and estimate that interest was paid on late refunds in 30 cases. Using variable sampling, we estimate that interest of $2,815,613 (+/- $2,725,703) was paid in the 30 cases.

Interest of $4,021,282 was paid on late refunds in 3 of the 22 cases where the tentative carryback adjustment processed at the Cincinnati Campus was for an amount of $10 million or greater, and interest of $4,628,107 was paid on late refunds in 14 of the 481 cases for this amount processed at the Ogden Campus.

Projection of estimated avoidable interest for 5 years:

While CY 2002 was an exceptional year due to the consolidation from 10 campuses to 2 campuses processing Forms 1139 and increased volume of Forms 1139 due to the Job Creation and Workers Assistance Act of 2002, the payment of interest on tentative carryback refunds continued in CY 2003. We estimated the volume of avoidable interest paid in CY 2003 based on the ratio in CY 2002 of avoidable interest to interest paid, and used the CY 2003 estimated amount to project avoidable interest for an additional 3 years.

Total estimated avoidable interest for CY 2002: $12,586,644 ($2,128,656 + $2,530,345 + $3,631,206 + $4,296,437).

Estimated interest paid on late refunds in CY 2002: $22,771,136 ($2,851,694 + $4,094,654 + $7,832,751 + $7,992,037)

Estimated interest paid on Late Refunds in CY 2003: $16,161,086 ($1,517,496 + $1,650,466 + $1,528,122 + $2,815,613 + $4,021,282 + $4,628,107)

$12,586,644 / $22,771,137 = .5527

.5527 X $16,161,086 = $8,932,232

$8,932,232 X 4 years = $35,728,928 (2003 through 2006)

$12,586,644 (2002)

Estimated avoidable interest: $48,315,572

Appendix V

Management's Response to the Draft Report

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

RECEIVED
AUG 27 2004

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

AUG 25 2004

MEMORANDUM FOR ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kevin M. Brown
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Avoidable Interest Was Paid on Tentative Carryback Refunds Requested by Corporate Taxpayers (Audit #200330039)

Thank you for your report concerning carryback refunds requested by corporate taxpayers. While we have made measurable progress in recent years, we agree that this remains an area that merits close attention. The Ogden and Cincinnati Campuses have established the necessary controls and procedures to process tentative carrybacks in a more efficient and timely manner. Ogden has two experienced processing teams and Cincinnati has put into place special procedures to handle work through their Adjustment Program. Primary consideration is given to interest processing dates and dollar amounts for each case. This ensures every claim is appropriately prioritized and controls are monitored.

The stated measurable benefit on tax administration of $48.3 million reflected in your report is based on a ratio of calendar year (CY) 2002 volumes and avoidable interest paid with a straight-line projection for out years. While we concur in the amount of avoidable interest paid for CY02, we believe that your projections for the out years should be reduced to reflect current performance. We have experienced a 30 percent reduction in receipts in this program over the last year and anticipate this will continue, which would result in a reduction in your estimate. As a result of the two sites strengthening their controls and processes, we are confident there will be revenue protection.

<u>**Recommendation 1**</u>
Interest reports are maintained to reflect circumstances that delayed Tentative Carryback refunds beyond the 45-day interest-free period. These reports should be routed to a management level with authority to take corrective actions when the volume of instances signifies that a problem exists.

2

The Director should determine whether it is feasible for information captured for Corporation Income in the "Net Tax Refunds Report" to be altered to separately identify tentative carryback adjustments and whether the report could be used as a tool to monitor interest on normal (generated) refunds.

Corrective Action
SB/SE CAS, Accounts Management (AM) will request that the Submission Processing, Accounting Team provide an ad hoc report from the Net Tax Refunds Report (NTRR). This report will specifically identify interest on line 66 (Tentative Carryback Interest), the reference number and refund information on all MCC, IDRS, and manual refunds, enabling campuses to monitor refund and interest issued daily on Forms 1139.

The SB/SE CAS AM Program Management/Process Assurance Staff and campus sites will review data collected from ad hoc reports through October 30, 2004. Recommendations, along with the usefulness of the report, will be provided to the SB/SE Deputy Director, Accounts Management, by November 15, 2004.

Implementation Date
December 3, 2004

Responsible Official
SB/SE Deputy Director, Accounts Management

Corrective Action Monitoring Plan
NA

If you have questions or concerns about this matter, please call me or have a member of your staff contact John Crawford, Director, Customer Account Services, Small Business/Self-Employed Division, at (972) 308-7010.