

**Forms, Publications, and Computer
Programming Were Adequately Addressed
and Updated in Most Instances for the
2005 Filing Season**

June 2005

Reference Number: 2005-40-094

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

June 03, 2005

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Forms, Publications, and Computer
Programming Requests Were Adequately Addressed and
Updated in Most Instances for the 2005 Filing Season
(Audit # 200440047)

This report presents the results of our review of the adequacy of updates and revisions to tax forms, publications, and computer programming in preparation for the processing of individual income tax returns. The overall objective of this review was to determine whether the Internal Revenue Service (IRS) accurately initiated updates to tax products¹ and computer programming for new tax law provisions that affect the processing of individual income tax returns during the 2005 Filing Season.² This audit focused on updates to tax products and requests for computer programming³ changes needed to implement provisions of eight pieces of tax legislation, including the recently enacted Working Families Tax Relief Act of 2004⁴ and American Jobs Creation Act of 2004.⁵

In summary, the IRS successfully updated tax products and initiated computer programming requests to update return processing programs necessary to implement new tax law provisions. However, we identified two omissions that could affect taxpayers claiming the refundable portion of the Child Tax Credit (Additional Child Tax Credit). During our review of tax products, we found that two tax products, *Armed Forces' Tax Guide* (Publication 3) and *Child Tax Credit* (Publication 972), did not adequately address the new tax law requirement to include nontaxable combat pay in earned income for purposes of computing the Additional Child Tax Credit. This

¹ Defined as tax forms, instructions, and publications.

² The period from January through mid-April when most individual income tax returns are filed.

³ Requests for Information Services.

⁴ Pub. L. No. 108-311, 118 Stat. 1166.

⁵ Pub. L. No. 108-357, 118 Stat. 1418.

omission could cause some military families to claim less than the total credit amount to which they may be rightfully entitled.

We recommended the Commissioner, Wage and Investment (W&I) Division, revise Publications 3 and 972 to more thoroughly address the effect of nontaxable combat pay on the computation of Additional Child Tax Credit and inform military families of this through appropriate media outlets. Our recommendations provide a measurable benefit on tax administration by reducing taxpayer burden for taxpayers who have nontaxable combat pay and are eligible for the Additional Child Tax Credit and helping ensure these taxpayers receive complete information on this provision of the new tax legislation.

Management's Response: IRS management agreed with our recommendations. Management agreed that properly implementing new tax law is one of their greatest management challenges, particularly when the legislation is enacted late in the year, and acknowledged that the two tax products, Publications 3 and 972, were not updated to address a new requirement concerning nontaxable combat pay. IRS management will revise Publications 3 and 972 to address nontaxable combat pay in the Additional Child Tax Credit discussion and inform potentially affected military families through the IRS Stakeholder Partnerships, Education, and Communication organization. However, IRS management noted that they do not believe the omitted information could cause military personnel to claim less than the total Additional Child Tax Credit they are rightfully entitled to or that their corrective actions will have a measurable impact on tax administration. Management's complete response to the draft report is included as Appendix VII.

Office of Audit Comment: We are pleased the Commissioner, W&I Division, has agreed to implement our recommendations to revise the two publications by including information relating to nontaxable combat pay for purposes of computing the Additional Child Tax Credit and to immediately contact outside stakeholders to inform military families that may have been adversely affected. Although we are puzzled by IRS management's negative assessment of the potential outcome from the corrective actions, we believe the agreement to the recommendations reflects a sound executive decision that will have a positive effect on military families by reducing their tax burden and ensuring they receive the intended benefits of the Additional Child Tax Credit.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael R. Phillips, Assistant Inspector General for Audit (Wage and Investment Income Programs), at (202) 927-0597.

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Background

Many new and significant tax law provisions will affect taxpayers' Tax Year (TY) 2004 individual income tax returns during the 2005 Filing Season.¹ These provisions were created by 8 different pieces of legislation that have been enacted over the past 8 years. Most recently enacted were the Working Families Tax Relief Act of 2004 (WFTRA)² and the American Jobs Creation Act of 2004 (AJCA).³ Both of these laws were enacted in October 2004 and include 7 provisions that alone will provide Wage and Investment (W&I) Division taxpayers⁴ with tax benefits of up to \$5.8 billion.

Properly implementing new tax law is one of the Internal Revenue Service's (IRS) greatest management challenges. It is especially challenging when the legislation is enacted late in the year. Controlling the implementation of new tax legislation, such as the WFTRA and AJCA, is the responsibility of the IRS Legislative Analysis, Tracking, and Implementation Services (LATIS) function.

The LATIS function is responsible for managing the IRS-wide implementation planning and monitoring of legislation having a significant impact on the IRS. This process uses the Legislative Implementation Tracking System (LITS), an Intranet-based planning and monitoring system that provides real-time status updates and has management information capabilities. Two areas covered by LITS controls are:

- **The revision of various tax forms, instructions, and publications (i.e., tax products).** Annually, the IRS must revise or create new tax products to implement new legislation. The IRS function responsible for tax products is the Tax Forms and Publications Division. This Division originates and improves tax forms and publications, ensuring they are understandable and as

¹ The period from January through mid-April when most individual income tax returns are filed.

² Pub. L. No. 108-311, 118 Stat. 1166.

³ Pub. L. No. 108-357, 118 Stat. 1418.

⁴ W&I Division taxpayers are individuals that report primarily wage and investment type income on Forms 1040, 1040A, or 1040EZ (these Forms are in the U.S. Individual Income Tax Return series).

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easy to use as possible and, as a result, enabling taxpayers to meet tax filing and payment obligations.

- **The reprogramming of computer systems that are used to process tax returns.** The process used for requesting computer programming changes is known as a Request for Information Services. The Requests are submitted to the IRS Modernization and Information Technology Services (MITS) organization by the function responsible for the computer process being changed. The computer programming requests needed for implementing new tax law provisions during the annual processing of individual income tax returns should normally be identified and submitted to the MITS organization by February 28th of the year preceding the filing season.

This review was performed in the W&I Division in Atlanta, Georgia; the Submission Processing offices in Lanham, Maryland; and the Austin Submission Processing Site⁵ in Austin, Texas, during the period August 2004 through February 2005. 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.

Updates to Tax Forms, Instructions, and Publications for Tax Year 2004 Were Generally Accurate

Overall, the IRS successfully updated the tax forms, instructions, and publications relating to the new tax law provisions that affect W&I Division taxpayers' TY 2004 individual income tax returns.

Our review initially examined 12 tax law provisions included in 6 pieces of tax legislation that became effective in TY 2004. However, in October 2004, 2 pieces of legislation were enacted that included 11 additional provisions that will affect W&I Division taxpayers for TY 2004. A brief summary of the provisions we reviewed for TY 2004 changes can be found in Appendix V.

To identify the tax forms, instructions, and publications (tax products) requiring updates as a result of the tax

⁵ Submission Processing sites are locations at which income tax returns are processed.

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provisions identified, we queried the LITS. Our query identified 31 tax products requiring updates for the initial 12 provisions we examined and 45 tax products for the subsequent 11 provisions. Some tax products were identified twice and subsequently reviewed twice because provisions of the October 2004 legislation extended or revised provisions previously scheduled to change for TY 2004. For example, the deduction for Educator Expenses was scheduled to expire for TY 2004 and the tax forms, instructions, and publications had been updated to reflect the changes. However, WFTRA Section 307 extended this deduction for TY 2004, and the tax products had to be subsequently revised.

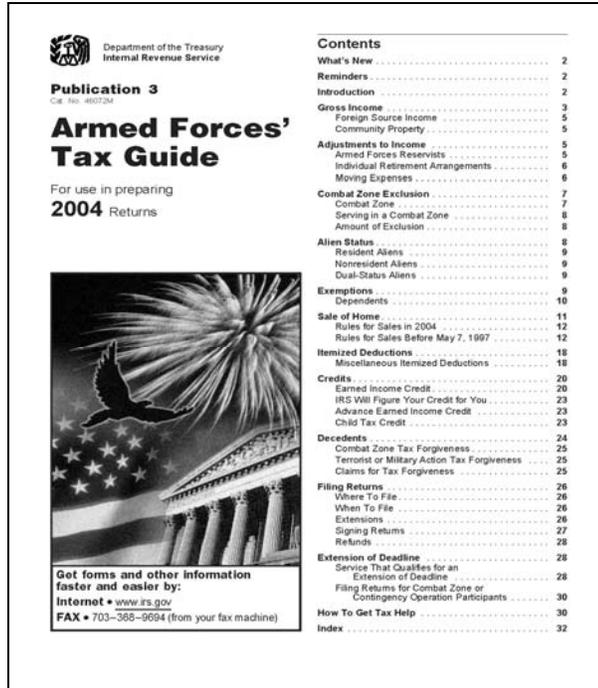
We reviewed a total of 49 tax products (24 forms, 11 instructions, and 14 publications) to determine whether they were consistent with the provisions enacted by the Congress. Comparison of each tax product with the related legislation determined that the tax products we reviewed were accurately updated, with two exceptions. A list of the 49 tax products we reviewed can be found in Appendix VI.

Nontaxable Combat Pay Was Not Adequately Addressed in Two Tax Publications

During our review of tax products, we found that two publications did not adequately address the new tax law requirement to include nontaxable combat pay in earned income for purposes of computing the refundable portion of the Child Tax Credit (Additional Child Tax Credit). These were the *Armed Forces' Tax Guide* (Publication 3) and *Child Tax Credit* (Publication 972).

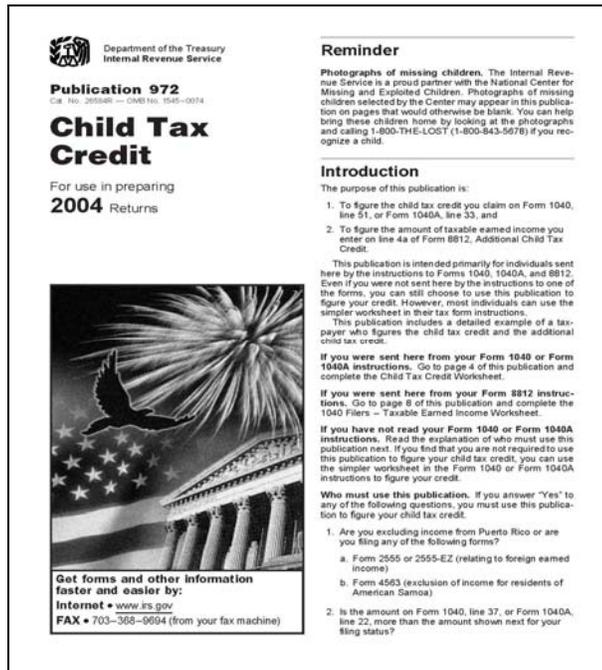
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Figure 1: Armed Forces' Tax Guide (Publication 3)



Source: IRS Internet web site.

Figure 2: Child Tax Credit (Publication 972)



Source: IRS Internet web site.

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The new legislation, WFTRA Section 104, provides that combat pay (which is normally not taxable) be included in computing taxable (earned) income for purposes of calculating the Additional Child Tax Credit. The Congress enacted this provision to provide additional tax benefits for military families. By the end of TY 2004, 193,000 Reservists and National Guard troops had been mobilized for service. Approximately 165,000 troops were in the combat zones of Iraq and Afghanistan, and many of these troops have families at home. When nontaxable combat pay is included in the computation of earned income, the refundable amount of the Child Tax Credit increases.

Military families who rely on Publications 3 and 972 for guidance will not be informed about this new tax benefit and could risk losing the benefit of the new law. The Additional Child Tax Credit (Form 8812), in its instructions section, is the only tax product that adequately addresses the combat pay issue relative to the Credit.

We discussed this issue with the IRS Tax Forms and Publications Division and were informed that, due to the large number of late changes created by the October 2004 legislation, these two Publications were not updated to include additional information on this new provision.

Recommendations

To provide military families with complete information on treatment of nontaxable combat pay regarding the Additional Child Tax Credit, the Commissioner, W&I Division, should:

1. Revise Publications 3 and 972 to more thoroughly address the effect of nontaxable combat pay on the computation of the Additional Child Tax Credit.

Management's Response: The IRS will revise the 2005 Publications 3 and 972 to address nontaxable combat pay in the Additional Child Tax Credit discussion.

Office of Audit Comment: We are pleased the Commissioner, W&I Division, has agreed to implement our recommendation to revise the above publications by

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including information relating to nontaxable combat pay for purposes of computing the Additional Child Tax Credit and to immediately contact outside stakeholders to inform military families that may have been adversely affected (see Recommendation 2). Although we are puzzled by IRS management's negative assessment of the potential outcome from the corrective actions, we believe the agreement with the recommendations reflects a sound executive decision that will have a positive effect on military families by reducing their tax burden and ensuring they receive the intended benefits of the Additional Child Tax Credit.

2. Consider immediately informing potentially affected military families in various Armed Forces publications or other appropriate media through the IRS Stakeholder Partnerships, Education, and Communication (SPEC) organization.

Management's Response: The IRS included information on treatment of nontaxable combat pay regarding the Additional Child Tax Credit in the Military Volunteer Income Tax Assistance (VITA) training materials, and Military VITA volunteers were trained on the treatment of nontaxable combat pay prior to preparing tax returns for military taxpayers. The IRS will inform the Executive Director of the Armed Forces Tax Council of the requirements and request that a communiqué on the treatment of nontaxable combat pay regarding the Additional Child Tax Credit be sent immediately to all military bases. Finally, the IRS will coordinate through the SPEC organization the issuance of a press release for distribution to military news media regarding the treatment of nontaxable combat pay regarding the Additional Child Tax Credit.

Requests for Computer Programming Changes Were Generally Accurate

Overall, the IRS accurately initiated computer programming requests to update return processing programs for new tax law provisions that affect W&I Division taxpayers' TY 2004 individual income tax returns.

Many of the new tax law provisions for TY 2004 include changes that require the IRS to update its return processing computer programs to ensure taxpayers receive the correct credit or deduction and comply with eligibility requirements. For example, Medicare Prescription Drug

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Improvement and Modernization Act of 2003⁶ Section 1201 created the deduction for Health Savings Accounts (HSA), which provides a tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. Several factors are used in determining the computation of the deduction. These include:

- The amount contributed by the taxpayer to the HSA.
- The amount contributed by the taxpayer's employer to the HSA.
- The taxpayer's age.
- The deductible for the taxpayer's High-Deductible Health Plan.

Other eligibility requirements apply but do not affect the computation of the deduction. These include that the individual may not be entitled to Medicare benefits; have no other health insurance coverage, except what is permitted; and must not be claimed as a dependent on another individual's tax return.

It is essential that computer programs for new tax provisions are updated accurately. According to the Joint Committee on Taxation, the tax effect for this provision alone in Fiscal Year 2005 will be \$474 million.

We identified four requests that were initiated for computer programming changes needed to implement the new tax provisions that affect individual income tax return processing during the 2005 Filing Season. In addition, we identified six amendments for subsequent changes made to these computer programming requests. Analysis of these computer programming requests determined that the requested updates submitted by the W&I Division Submission Processing function to the MITS organization were generally accurate. In addition, analysis of computer programming documentation for return processing programs determined that the programs were accurately updated for the new tax law provisions.

⁶ Pub. L. No. 108-173, 117 Stat. 2066.

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While accurate updates to computer programming documentation are a good indication that the actual computer programs were correctly updated, we cannot determine whether they are truly accurate until processing of tax returns begins. We will test the actual accuracy of computer programming updates for these new tax law provisions as a part of our 2005 Filing Season review.⁷

⁷ 2005 Filing Season Implementation (Audit # 200540018).

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) accurately initiated updates to tax products¹ and computer programming for new tax law provisions that affect the processing of individual income tax returns during the 2005 Filing Season.² The audit focused on updates to tax products and computer programming required by provisions of the eight pieces of tax legislation listed in Appendix V. To accomplish our objective, we:

- I. Determined whether the IRS initiated changes to the tax products and the Requests for Information Services (RIS) needed to implement new tax law provisions that affect the processing of Wage and Investment (W&I) Division taxpayers' returns.³
 - A. Identified 12 new tax legislation provisions that will have a significant effect on returns filed by W&I Division taxpayers during the 2005 Filing Season.
 - B. Identified 31 tax products that will require updating as a result of tax law changes affecting Tax Year (TY) 2004 returns and reviewed 27 tax products⁴ to determine whether these instruments were accurately updated.
 - C. Reviewed the RISs controlled by the IRS and determined whether RISs exist to address the new tax law provisions identified.
- II. Determined whether the RISs initiated for tax law changes that potentially affect large numbers of W&I Division taxpayers or tax dollars completely and accurately reflect the new provisions of the tax law.
 - A. Reviewed the new tax law provisions identified and determined the specific elements and criteria based on the tax law that should be included in the RISs.
 - B. Evaluated the RIS documentation and determined whether the necessary elements and criteria were included and clearly communicated.
 - C. Reviewed the Functional Specification Packages (FSP)⁵ that required updating as a result of the RISs identified and determined whether the necessary elements and criteria were accurately included in return processing program documentation.

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² The period from January through mid-April when most individual income tax returns are filed.

³ W&I Division taxpayers are individuals that report primarily wage and investment type income on Forms 1040, 1040A, or 1040EZ (these Forms are in the U.S. Individual Income Tax Return series).

⁴ Four tax products were not reviewed because they had not been finalized by the conclusion of our work.

⁵ FSPs provide text descriptions of the computer programs used by the IRS to process tax returns.

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- III. Determined whether the IRS correctly initiated changes to the tax products, RISs, and FSPs needed to implement provisions of the recently enacted Working Families Tax Relief Act of 2004 (WFTRA)⁶ and American Jobs Creation Act of 2004 (AJCA)⁷ that will affect the processing of W&I Division taxpayers' TY 2004 returns.
- A. Reviewed the WFTRA and AJCA and identified the 11 provisions that will affect the processing of individual income tax returns during the 2005 Filing Season.
 - B. Identified the 45 tax products that will require revision as a result of the WFTRA and AJCA provisions identified and reviewed 39 tax products⁸ to determine whether the tax products were accurately updated.
 - C. Identified the one RIS initiated to implement the changes necessary to update return processing programs as a result of the WFTRA and AJCA provisions identified and determined whether it correctly reflected the requirements of the legislation.
 - D. Reviewed the FSPs that required changes as a result of the RIS identified and determined whether changes to the elements and criteria requested in the RIS were accurately updated.

⁶ Pub. L. No. 108-311, 118 Stat. 1166.

⁷ Pub. L. No. 108-357, 118 Stat. 1418.

⁸ Six tax products were not reviewed because they had not been finalized by the conclusion of our work.

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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Wage and Investment Division SE:W
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Acting Director, Strategy and Finance, Wage and Investment Division SE:W:S
Acting Chief, Performance Improvement, Wage and Investment Division SE:W:S:PI
Director, Stakeholder Partnerships, Education, and Communication, Wage and Investment
Division SE:W:CAR:SPEC
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaison: Acting Senior Operations Advisor, Wage and Investment Division SE:W:S

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:

- Taxpayer Burden – Actual; two publications did not adequately address the new requirement to include nontaxable combat pay in earned income for purposes of computing the Additional Child Tax Credit (see page 3).

Methodology Used to Measure the Reported Benefit:

We reviewed a total of 49 tax products (24 forms, 11 instructions, and 14 publications) to determine whether they were consistent with the new provisions enacted by the Congress. We compared each tax product to the related legislation to determine whether each tax product was accurately updated.

Section 104 of the Working Families Tax Relief Act of 2004¹ provides that combat pay (which is normally not taxable) be included in computing taxable (earned) income for purposes of calculating the refundable portion of the Child Tax Credit (Additional Child Tax Credit). The Congress intended this provision to provide assistance to military families in combat zones by increasing the refundable portion of the Child Tax Credit.

Military families who rely on the *Armed Forces' Tax Guide* (Publication 3) and *Child Tax Credit* (Publication 972) for guidance will not be informed about this issue and could risk losing the benefits of the new law. These publications do not provide any narrative explanation of this new requirement. The Additional Child Tax Credit (Form 8812), in its instructions section, is the only tax product that adequately addresses the combat pay issue relative to the Credit.

¹ Pub. L. No. 108-311, 118 Stat. 1166.

Overview of Tax Law Provisions Examined During the Review

The following information describes various tax law provisions that affect tax products¹ for and processing of individual income tax returns during the 2005 Filing Season.²

Taxpayer Relief Act of 1997 (TRA)³

The TRA contained the following provision:

- 1) **Section 301 - Restoration of IRA [Individual Retirement Arrangement] Deduction for Certain Taxpayers.** Provides for taxpayers covered by a retirement plan at work. The deduction for contributions to a traditional IRA will be reduced if the modified adjusted gross income (MAGI) exceeds the phase-out limitations. For Tax Year (TY) 2004, these phase-out limitations have been increased. The deduction for traditional IRA contributions will be reduced when a taxpayer's MAGI is more than \$65,000 but less than \$75,000 for a married couple filing a joint return or a qualified widow(er) (or is more than \$45,000 but less than \$55,000 for single individuals or taxpayers filing as head of household).

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)⁴

The EGTRRA contained the following three provisions:

- 1) **Section 402 - Modifications to Qualified Tuition Programs (QTP).** Provides that for TY 2004 a distribution from a QTP established and maintained by an eligible educational institution (generally private colleges and universities) can be excluded from income if the amount distributed is not more than qualified education expenses.
- 2) **Section 431 - Deduction for Higher Education Expenses.** Provides for an above-the-line deduction for qualified education expenses. For TY 2004, the amount of qualified education expenses that can be taken into account when figuring the tuition and fees deduction increases from \$3,000 to \$4,000 if the MAGI is not more than \$65,000 (\$130,000 if married filing jointly). If the MAGI is more than \$65,000 (\$130,000 if married filing jointly), but not more than \$80,000 (\$160,000 if married filing jointly), the maximum tuition and fees deduction will be \$2,000. No tuition and fees deduction will be allowed if the MAGI is more than \$80,000 (\$160,000 if married filing jointly).
- 3) **Section 631 - Change in Catch-Up Contributions for Individuals Age 50 and Over.** Provides that participants in 403(b), 401(k), and other applicable employer plans that are age 50 or

¹ Defined as tax forms, instructions, and publications.

² The period from January through mid-April when most individual income tax returns are filed.

³ Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).

⁴ Pub. L. No. 107-16, 115 Stat. 38.

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over at the end of the year generally can make catch-up contributions to the plan. For TY 2004, the maximum catch-up contribution increases to \$3,000.

Job Creation and Worker Assistance Act of 2002 (JCWAA)⁵

The JCWAA contained the following five provisions. These provisions were subsequently superseded by the Working Families Tax Relief Act of 2004.⁶

- 1) Section 406 - Adjusted Gross Income Determined by Taking Into Account Certain Expenses of Elementary and Secondary School Teachers (Educator Expenses). Provides an above-the-line deduction for up to \$250 annually of expenses paid or incurred by an eligible educator for books, supplies, computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom. To be eligible for this deduction, the expenses must be otherwise deductible under Internal Revenue Code Section 162 as a trade or business expense. This provision was available for TYs 2002 and 2003, but Section 307 of the Working Families Tax Relief Act of 2004 (see below) extended the Educator Expenses through TY 2005.
- 2) Section 601 - Allowance of Nonrefundable Personal Credits Against Regular and Minimum Tax Liability. Provides for an individual to offset the entire regular tax liability and alternative minimum tax liability by the personal nonrefundable credits in TYs 2002 and 2003. For TY 2004, the allowance is no longer available.
- 3) Section 602 - Credit for Qualified Electric Vehicles. Provides for a deferral of the phase-out of the credit for 2 years. Taxpayers may claim the full amount of the credit for qualified purchases made in TYs 2002 and 2003; however, in TY 2004, the phase-out of the credit value commences and it is reduced by 25 percent.
- 4) Section 606 - Deduction for Clean-Fuel Vehicles and Certain Refueling Property. Provides for a deferral of the phase-out of the deduction for clean-fuel vehicle property by 2 years. Taxpayers may claim the full amount of the deduction for qualified vehicles placed in service in TYs 2002 and 2003; however in TY 2004, the phase-out of the deduction for clean-fuel vehicles commences and it is reduced by 25 percent.
- 5) Section 612 - Availability of Medical Savings Accounts (MSA). Provides for an extension of the Archer MSA program through December 31, 2003, after which participation is limited to active participants before January 1, 2004, or those covered by a High-Deductible Health Plan of an Archer MSA-participating employer.

⁵ Pub. L. No. 107-147, 116 Stat. 21 (codified as amended in scattered sections of 26 U.S.C., 29 U.S.C., and 42 U.S.C.).

⁶ Pub. L. No. 108-311, 118 Stat. 1166.

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Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)⁷

The JGTRRA contained the following provision:

- 1) Section 301 - Reduction in Capital Gains Rates for Individuals; Repeal of 5-Year Holding Period Requirement. Provides that, for sales and dispositions of property after May 5, 2003, the maximum tax rates for net capital gains were reduced from 20 percent to 15 percent and from 10 percent to 5 percent. For TY 2004, the post-May 5, 2003, capital gain distributions language and calculations no longer apply. All sales and dispositions for the year are covered by the new rates.

Military Family Tax Relief Act of 2003 (MFTRA)⁸

The MFTRA contained the following provision:

- 1) Section 109 - Above-the-Line Deduction for Overnight Travel Expenses of National Guard and Reserve Members. Creates an above-the-line deduction for travel expenses of National Guard troops and Reservists. Travel must take the National Guard soldier or Reservist more than 100 miles away from home and require an overnight stay. The amount of deductible expenses cannot exceed the general Federal Government per diem rate applicable to the locality. The deduction was available in TY 2003, but it had to be written in on the face of the return. For TY 2004, the deduction is being given a specific line on the return.

Medicare Prescription Drug Improvement and Modernization Act of 2003 (MPDIMA)⁹

The MPDIMA contained the following provision:

- 1) Section 1201 - Health Savings Accounts (HSA). Creates HSAs, which provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. Within limits, contributions to an HSA are deductible if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Distributions from HSAs for qualified medical expenses are not includible in gross income. Distributions that are not for qualified medical expenses are includible in gross income and subject to an additional 10 percent tax. The additional 10 percent tax does not apply after death or disability or when the individual attains the age of Medicare program eligibility.

Working Families Tax Relief Act of 2004 (WFTRA)

The WFTRA contained the following seven¹⁰ provisions:

- 1) Section 102 - Acceleration of Increase in Refundability of the Child Tax Credit. Provides for an acceleration of the refundable portion the Child Tax Credit. Beginning in

⁷ Pub. L. No. 108-27, 117 Stat. 752.

⁸ Pub. L. No. 108-121, 117 Stat. 1335.

⁹ Pub. L. No. 108-173, 117 Stat. 2066.

¹⁰ Three additional WFTRA provisions were reviewed. These included Sections 401, 402, and 403, which relate to technical corrections for the MPDIMA, JGTRRA, and EGTRRA.

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TY 2004, the Child Tax Credit is refundable to the extent of 15 percent of the taxpayer's taxable earned income in excess of \$10,750. Previously, the increase from 10 percent to 15 percent was to occur in TY 2005.

- 2) Section 104 - Earned Income Includes Combat Pay. Provides that combat pay, which is otherwise excluded from gross income, is treated as earned income for purposes of calculating the refundable portion of the Child Tax Credit beginning in TY 2004. Also beginning in TY 2004, combat pay, if the taxpayer elects, can be included as earned income for purposes of calculating the Earned Income Tax Credit.
- 3) Section 307 - Deduction for Certain Expenses of School Teachers (Educator Expenses). Provides a 2-year extension of the up to \$250 deduction for classroom expenses paid or incurred by an eligible educator. This deduction was scheduled to expire in TY 2003 but has been extended through TY 2005.
- 4) Section 312 - Allowance of Nonrefundable Personal Credits Against Regular and Minimum Tax Liability. Provides a 1-year extension for an individual to offset the entire regular tax liability and alternative minimum tax liability by the personal nonrefundable credits. The allowance was scheduled to expire in TY 2003 but has been extended through TY 2005.
- 5) Section 318 - Elimination of Phase-Out of Credit for Qualified Electric Vehicles for [Tax Years] 2004 and 2005. Provides for a deferral of the phase-out of the credit for qualified electric vehicles for 2 years. Taxpayers may claim the full amount of the credit for qualified purchases made in TYs 2004 and 2005.
- 6) Section 319 - Elimination of Phase-Out for Deduction for Clean-Fuel Vehicle Property for [Tax Years] 2004 and 2005. Provides for a deferral of the phase-out of the deduction for clean-fuel vehicles for 2 years. Taxpayers may claim the full amount of the deduction for qualified vehicles placed in service in TYs 2004 and 2005.
- 7) Section 322 - Availability of Medical Savings Accounts. Provides for an extension of the Archer MSA program through December 31, 2005.

American Jobs Creation Act of 2004 (AJCA)¹¹

The ACJA contained the following provision:

- 1) Section 501 - Deduction of State and Local General Sales Taxes in Lieu of State and Local Income Taxes. Permits taxpayers to elect, in lieu of the itemized deduction now provided for state and local income taxes, an itemized deduction for their state and local general sales taxes. Taxpayers who elect could deduct either their actual sales taxes paid, as evidenced by their accumulated receipts showing those amounts, or the amount shown for their income bracket in tables issued by the Secretary of the Treasury. The state-by-state tables are to be based on average consumption by taxpayers in each state taking into account filing status,

¹¹ Pub. L. No. 108-357, 118 Stat. 1418.

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number of dependents, adjusted gross income, and rates of state and local general sales taxation. Taxpayers who use the tables may, in addition to the table amounts, deduct eligible general sales taxes paid with respect to the purchase of motor vehicles, boats, and other items specified by the Secretary of the Treasury. The provision is effective for TY 2004.

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Appendix VI

List of Tax Products Examined

Tax Forms

Tax Product	Title
1. Form 1040	U.S. Individual Income Tax Return
2. Form 1040, Schedule A	Schedule A-Itemized Deductions
3. Form 1040, Schedule D	Capital Gains and Losses
4. Form 1040, Schedule R	Credit for the Elderly or the Disabled
5. Form 1040A	U.S. Individual Income Tax Return
6. Form 1040A, Schedule 2	Child and Dependent Care Expenses for Form 1040A Filers
7. Form 1040A, Schedule 3	Credit for the Elderly or the Disabled for Form 1040A Filers
8. Form 1040EZ	Income Tax Return for Single and Joint Filers With No Dependents
9. Form 1040NR	U.S. Nonresident Alien Income Tax Return
10. Form 2106-EZ	Unreimbursed Employee Business Expenses
11. Form 2441	Child and Dependent Care Expenses
12. Form 5329	Additional Taxes on Qualified Plans (Including IRAs ¹) and Other Tax-Favored Accounts
13. Form 5498-ESA	Coverdell ESA ² Contribution Information
14. Form 8396	Mortgage Interest Credit
15. Form 8801	Credit for Prior Year Minimum Tax - Individuals, Estates, and Trusts
16. Form 8812	Additional Child Tax Credit
17. Form 8834	Qualified Electric Vehicle Credit
18. Form 8839	Qualified Adoption Expenses

¹ Individual Retirement Arrangement.

² Educational Savings Account.

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19. Form 8851	Summary of Archer MSAs ³
20. Form 8853	Archer MSAs and Long-Term Care Insurance Contracts
21. Form 8863	Education Credits (Hope and Lifetime Learning Credits)
22. Form 8880	Credit for Qualified Retirement Savings Contributions
23. Form 8885	Health Coverage Tax Credit
24. Form 8889	Health Savings Accounts (HSAs)

Tax Form Instructions

Tax Product	Title
1. Form 1040	2004 1040 Instructions
2. Form 1040, Schedule D	2004 Instructions for Schedule D, Capital Gains and Losses
3. Form 1040A	2004 1040A Instructions
4. Form 1040A, Schedule 2	2004 Instructions for Schedule 2 (Form 1040A), Child and Dependent Care Expenses for Form 1040A Filers
5. Form 1040C	Instructions for Form 1040-C, U.S. Departing Alien Income Tax Return
6. Form 1040EZ	2004 1040EZ Instructions
7. Form 1040NR	Instructions for Form 1040NR, U.S. Nonresident Alien Income Tax Return
8. Form 2106	Instructions for Form 2106, Employee Business Expenses
9. Form 2441	Instructions for Form 2441, Child and Dependent Care Expenses
10. Form 8853	Instructions for Form 8853, Archer MSAs and Long-Term Care Insurance Contracts
11. Form 8889	Instructions for Form 8889, Health Savings Accounts (HSAs)

Tax Products

Tax Product	Title
1. Publication 3	<i>Armed Forces' Tax Guide</i>
2. Publication 17	<i>Your Federal Income Tax For Individuals</i>

³ Medical Savings Account.

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|---------------------|---|
| 3. Publication 502 | <i>Medical and Dental Expenses (Including the Health Coverage Tax Credit)</i> |
| 4. Publication 503 | <i>Child and Dependent Care Expenses</i> |
| 5. Publication 504 | <i>Divorced or Separated Individuals</i> |
| 6. Publication 524 | <i>Credit for the Elderly or the Disabled</i> |
| 7. Publication 529 | <i>Miscellaneous Deductions</i> |
| 8. Publication 590 | <i>Individual Retirement Arrangements (IRAs)</i> |
| 9. Publication 596 | <i>Earned Income Credit (EIC)</i> |
| 10. Publication 600 | <i>Optional State Sales Tax Tables</i> |
| 11. Publication 968 | <i>Tax Benefits for Adoption</i> |
| 12. Publication 969 | <i>Health Savings Accounts and Other Tax-Favored Health Plans</i> |
| 13. Publication 970 | <i>Tax Benefits for Education</i> |
| 14. Publication 972 | <i>Child Tax Credit</i> |

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Appendix VII

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

RECEIVED
MAY 04 2005

APR 29 2005

MEMORANDUM FOR PAMELA J. GARDINER
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Henry O. Lamar, Jr. *Henry O. Lamar, Jr.*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report - Forms, Publications, and Computer Programming Requests Were Adequately Addressed and Updated in Most Instances for the 2005 Filing Season (Audit # 200440047)

We are pleased you acknowledged that overall we successfully updated the tax products and computer programming necessary to implement the new tax law provisions for the 2005 Filing Season.

We agree that properly implementing new tax law is one of our greatest management challenges, particularly when legislation is enacted late in the year. Specifically, the Working Families Tax Relief Act of 2004, which requires nontaxable combat pay to be included in earned income for purposes of computing the Additional Child Tax Credit, was not enacted until October 2004. We recognize two tax products, *Armed Forces Tax Guide* (Publication 3) and *Child Tax Credit* (Publication 972), were not updated to address this new requirement and agree with your recommendations. However, we do not agree this omission could cause some military families to claim less than the total credit amount to which they may be rightfully entitled.

The starting point for all taxpayers claiming the Child Tax Credit is the worksheets found in the Form 1040 or Form 1040A instructions. While most taxpayers can use these simpler worksheets to figure the credit, taxpayers meeting certain criteria are directed to Publication 972. Taxpayers eligible for the Additional Child Tax Credit are subsequently directed by the worksheets in the forms' instructions and in Publication 972 to Form 8812, Additional Child Tax Credit, to compute the credit. The instructions for Form 8812 thoroughly explain that nontaxable combat pay counts as earned income when figuring the credit limit.

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Finally, we do not agree your recommendation will have a measurable impact on tax administration by reducing taxpayer burden for taxpayers who have nontaxable combat pay and are eligible for the Additional Child Tax Credit. Since all taxpayers must use the worksheets and Form 8812 to figure the credit, military families will not lose the benefit of the new law nor will they claim less than the total credit to which they are entitled.

We appreciate your continued support of our efforts to ensure timely and accurate inclusion of new tax law provisions in tax products. Our corrective actions are detailed in the attachment. If you have any questions, please call me at (404) 388-7060, or members of your staff may contact Bernard Zycherman, Acting Director, Tax Forms and Publications, Media and Publications, at (202) 622-5200.

Attachment

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Attachment

To provide military families with complete information on treatment of nontaxable combat pay regarding the Additional Child Tax Credit, the Commissioner, W&I Division, should:

RECOMMENDATION 1

The Commissioner, W&I Division should revise Publications 3 and 972 to more thoroughly address the effect of nontaxable combat pay on the Additional Child Tax Credit.

CORRECTIVE ACTION

We will revise the 2005 Publications 3 and 972 to address nontaxable combat pay in the Additional Child Tax Credit discussion.

IMPLEMENTATION DATE

January 15, 2006

RESPONSIBLE OFFICIAL

Director, Media and Publications, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

The Director, Tax Forms and Publications, established milestones on the Oracle database for tax products development and will monitor to ensure the revisions are completed timely.

RECOMMENDATION 2

Consider immediately informing potentially affected military families in various Armed Forces publications or other appropriate media through the IRS Stakeholder Partnerships, Education and Communication (SPEC) organization.

CORRECTIVE ACTION

- a) We included information on treatment of nontaxable combat pay regarding the Additional Child Tax Credit in our Military Volunteer Income Tax Assistance (VITA) training materials. Military VITA volunteers were trained prior to January 31, 2005, on the treatment of nontaxable combat pay regarding the Additional Child Tax Credit in IRS-SPEC led training classes prior to preparing tax returns for military taxpayers.
- b) We will inform the Executive Director of the Armed Forces Tax Council of the requirements and request that a communiqué be sent immediately to all military bases on the treatment of nontaxable combat pay regarding the Additional Child Tax Credit.
- c) We will coordinate with SPEC Communications and Liaison to immediately craft a single press release for distribution to military news media regarding

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the treatment of nontaxable combat pay regarding the Additional Child Tax Credit.

IMPLEMENTATION DATE

- a) Completed
- b) Completed
- c) May 15, 2005

RESPONSIBLE OFFICIAL

Director, Stakeholder Partnerships, Education and Communication, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

Not applicable