IRS Oversight Board

November 26, 2007

The Honorable Max Baucus, Chairman
United States Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

The Honorable Charles Grassley, Ranking Member
United States Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Dear Chairman Baucus and Ranking Member Grassley:

The Internal Revenue Service (IRS) Oversight Board is gravely concerned about the serious risks to the 2008 filing season if legislation to change the Alternative Minimum Tax (AMT) is delayed. A delay threatens the IRS' ability to process returns and issue refunds in a timely manner and imposes significant burden on taxpayers. Moreover, the more time transpires before legislation is enacted, the more severe the risks become. The Board recommends that Congress act quickly to mitigate these risks.

The Board has reviewed the IRS' readiness for the 2008 tax filing season, which should begin on January 14, 2008. The IRS is prepared to begin this filing season in accordance with present tax law. Should Congress change the law on tax provisions that deal with the AMT, the IRS must re-program and thoroughly test its systems before it can process electronic and paper tax returns. The Oversight Board believes the Treasury Department and the IRS are both doing everything they can to mitigate the effects of possible AMT tax law changes. However, there is a limit to actions they can take.

Unfortunately, taxpayers will bear the burden of filing season delays. The attached white paper, based on historical data, shows in detail how a late filing season will likely impact taxpayers. The table below summarizes the effects of beginning the filing season later than the planned January 14, 2008 start for several possible delayed start dates. Longer delays would cause even more severe impacts.

Estimated Impact of Various Delays from Planned January 14th Filing Season Start

Date Filing Season Starts	Delayed Tax Returns	Refunds not Issued
Jan 28, 2008	6.7 million	$17 billion
Feb 4, 2008	15.5 million	$39 billion
Feb 18, 2008	37.7 million	$87 billion

Source: IRS Oversight Board analysis based on IRS data

The consequences of a large number of delayed tax returns could be especially troublesome if some taxpayers who have been filing electronically revert to paper filing. Although the IRS can shut down its systems for accepting electronic returns, it cannot prevent taxpayers from mailing paper returns, even if they cannot be processed by the IRS. In general, a larger than expected amount of paper filing would:

- drive up the IRS' costs of submission processing;
- increase the probability that the IRS could not issue refunds within the 45 day statutory limit;
- increase downstream costs and burdens of future error correction for both the taxpayer and the IRS due to the much higher error rate associated with manually-intensive paper processing; and
- expand demand for Refund Anticipation Loans (RALs) to former electronic filers who file on paper and increase the risks and fees associated with these loans.

In addition, telephone volumes on IRS toll-free customer service lines would also increase as more taxpayers feel the need to call the IRS to resolve any issues about the status of the filing season, the availability of updated tax forms, and related issues that might cause taxpayer confusion. The additional volumes are difficult to quantify, but the risks of customer service degradations due to higher call volumes are significant.

It is impossible to determine the impact of a difficult filing season on voluntary compliance. However, the Board believes the risks would inevitably be higher because confusion about tax obligations increases the risk of both deliberate and unintended non-compliance. This point can be illustrated with a situation that occurred during the 2007 filing season when the IRS implemented the one-year Telephone Excise Tax Refund (TETR) program. At the conclusion of the filing season, the Treasury Inspector General for Tax Administration reported that the IRS received a number of egregious claims related to TETR as some taxpayers tried to probe the limits of IRS enforcement for this special refund.

In conclusion, the Oversight Board urges Congress to take quick action so as to mitigate the risks of AMT changes on taxpayers. Although it is difficult to quantify the exact impact with certainty, the risks are high and the effect on taxpayers is potentially very burdensome.

Sincerely,

Paul Cherecwich
Chairman, IRS Oversight Board

Attachment

IRS Oversight Board
Issue Paper
Impact of Late AMT Legislative Changes on 2008 Filing Season

Background

Congress has recently proposed changes to the Alternative Minimum Tax (AMT) provisions to be effective for tax year 2007. Although a great deal of communication has taken place between the Administration and the Congress on the risks to the 2008 filing season that such changes would create, the Board has made its own independent assessment of the impact and risks that changes in AMT tax policy would likely create if enacted in December 2007 or later. This assessment was performed based on an operational analysis of business procedures used by the IRS to process electronic and paper tax returns and historic filing patterns.

Facts, Constraints, and Assumptions

The Oversight Board based its analysis on a number of realistic facts, constraints, and assumptions. Among the most important are the following:

- The IRS does not have the capability to develop dual baselines for certain systems associated with the submission processing of tax returns. These systems can only accommodate one programming option without introducing excessive risk to the filing season. Above all else, the IRS must ensure that its systems can process tax returns under current law. The IRS believes that implementing program changes into these systems that do not reflect current law could jeopardize this responsibility. The Board concurs.

- Tax return preparation and filing patterns for individual taxpayers are very predictable. Figure 1 shows the timing of individual tax returns for the last three filing seasons, and indicates that the receipt of these returns during the last three filing periods is virtually identical on a week-by-week basis. Thus, the Board believes it can predict with a high degree of certainty the number of returns that will be received and refunds issued under normal circumstances.

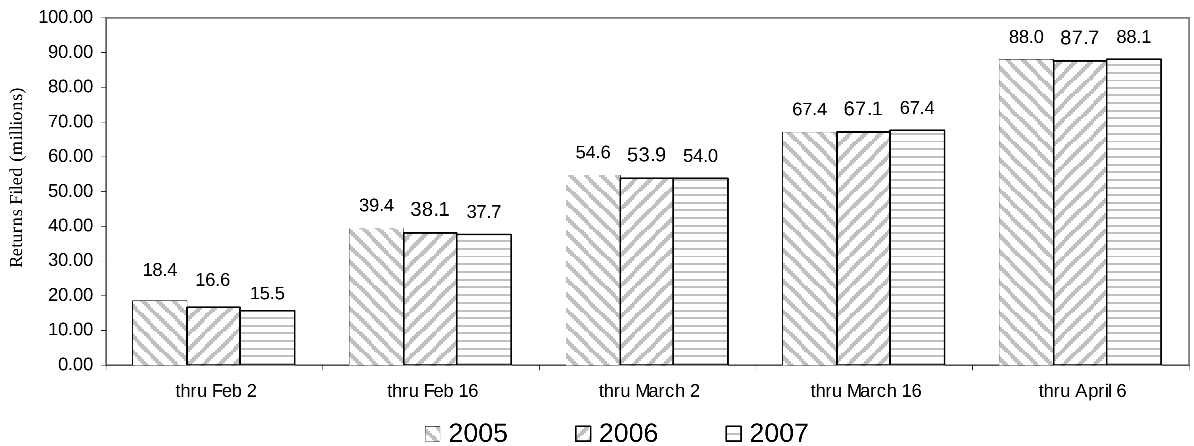
- The IRS is committed to taking every action possible to mitigate the impact of tax law changes that affect the AMT. It normally takes 10 weeks to complete programming after enactment. Since receiving a letter from the Tax Writing Committees signaling their commitment to enact an AMT patch, the IRS has done everything possible to position itself to implement an AMT patch as quickly as possible. At some point, however, these actions will be completed and only programming and subsequent testing activity will remain uncompleted. If an AMT patch is not enacted at that point, the IRS will not be able to proceed further and still retain its readiness to process tax returns under current law. The IRS' best estimate is that it will reach that date in early to mid-December. As a result of action already taken to prepare for the patch, the IRS now estimates that it could begin processing returns within seven weeks of enactment

- Until IRS systems have been completely re-programmed and tested, the IRS may not be able to open the filing season and process tax returns. Although not all tax returns are affected by possible changes to AMT, the IRS currently does not have procedures to distinguish tax returns that are affected by AMT changes and those that are not. The IRS continues to evaluate whether it can accept and process tax returns prior to the completion of programming and testing, but the worst case is that the IRS will not be able to accept returns until this activity is completed. In such a worst case situation, the IRS would not accept electronically filed returns and would not process paper returns it receives.

Analysis

The IRS publishes statistics on the weekly volumes of individual income tax returns received and processed during the filing season. Historical IRS data indicates that the weekly filing pattern for individual returns is quite similar from year to year, as shown in Figure 1. Data for the past three years are presented in the figure for five selected periods—approximately early February, mid-February, early March, mid-March, and early April. While there are some relatively small differences for the very early weeks, e.g., a little over 18 million returns received through early February 2005 compared to about 15.5 million by early February 2007, these slight differences soon become indistinguishable by early March.

Figure 1. Cumulative Number of Individual Returns Filed through Selected Weeks of 2005-2007 Filing Seasons



Note: Week ending dates reflect 2007; those for 2005 and 2006 slightly different.

Because filing season patterns have historically been so predictable, the Board is using 2007 filing season data to estimate the impact of delays to the 2008 filing season.

Table 1 presents selected weekly IRS data from the 2007 filing season (tax year 2006 returns). These data reflect cumulative volume counts and include the number of returns received (on paper, electronically, and in total), and processed, the number of refunds issued, and the total dollar amount of those refunds. The IRS receives and processes individual tax returns throughout the entire year; however, the late January through late April period covered in Table 1, known as the “filing season”, comprises the time frame in which the vast majority of individual income tax returns are filed. The filing season presents special challenges to the IRS because it is during this period when the IRS must meet its most fundamental commitment to taxpayers—the receipt and acceptance of their returns and the refunding of any overpayment of taxes.

Importantly, there is considerable return processing that occurs early in the filing season. For example, by Feb 16, 2007, the IRS received nearly 38 million tax returns, about 80 percent of which were electronically filed. The vast majority of these returns processed by that point, almost 32 million, claimed refunds, and the IRS issued approximately $87 billion in refunds, an average of about $2,733 per return.

The impact is more pronounced if the filing season is delayed even longer. For example, through March 9, 2007, the IRS received 61 million tax returns, of which 46 million were electronically filed, and issued $129 billion in refunds, or $2,548 per return.

The detailed IRS data available for the 2007 filing season combined with the fact that taxpayer filing patterns are very consistent from year to year also makes it possible to highlight a few of the probable impacts from any delay in the filing season. These additional observations are summarized in Table 2. These estimated impacts are only approximations, based on the 2007 information readily available to the Board, and are not as refined as those the IRS could provide, in time, using more precise assumptions and projected 2008 volumes. However, the impact figures highlighted in Table 2 are reasonably indicative of the impacts likely to ensue should IRS have to hold off accepting and processing returns until later in the 2008 filing season.

Impact of Delayed Filing Season on Taxpayers

If the IRS must postpone accepting returns in the early part of the filing season in 2008, it would delay the processing of returns and the issuance of the associated refunds. Depending upon the length of the delay, a substantial backlog of unprocessed paper returns could also develop. To quantify the potential impact on returns filed and refunds issued, three scenarios were considered: alternative start dates for the 2008 filing season of January 28th, February 4th, and February 18th.

<u>Scenario One: Filing Season Starts January 28</u>

If the start of the 2008 filing season is delayed to January 28th, the IRS would not process approximately the number of returns that it received through the week ending January 26, 2007. As shown in Table 2, this would indicate a delay in receiving around 6.7 million returns. It would also entail a delay in issuing about 5.6 million refunds totaling just over $17 billion.

<u>Scenario Two: Filing Season Starts February 4</u>

If the start of the 2008 filing season is delayed to February 4th, the IRS would not process approximately the number of returns that it received through the week ending February 2, 2007. This would indicate a delay in receiving around 15.5 million returns. It would further entail a delay in issuing about 13.3 million refunds totaling just over $39 billion.

<u>Scenario Three: Filing Season Starts February 18</u>

If the start of the 2008 filing season is delayed to February 18th, the IRS would not process the returns typically filed through February 16. This would indicate a delay in receiving nearly 38 million returns. It would also delay the issuing of nearly 32 million refunds totaling approximately $87 billion.

Other Consequences

Delays in processing of tax returns could have another dysfunctional consequence. IRS submission processing staff work as quickly as their resources permit to process through their "pipeline" system the tax returns filed, so as to get the tax return data recorded on the IRS' data bases, certify the information, and issue refunds or balance due notices, as appropriate. However, returns filed electronically require little IRS intervention to move these return data through the pipeline processing.

Due to the large increase in electronic filing in recent years, the IRS has reduced the number of submission processing sites for handling paper returns. Its current capacity for handling paper tax returns for individuals is five submission processing sites. Assuming these five sites have a capacity to handle 4 million paper returns a week, 38 million delayed returns, of which 20 percent or 7.6 million were paper, would represent about a two week processing backlog. If the percentage of electronic returns fell to 50 percent, resulting in 19 million delayed paper returns, at least a five week backlog would result, which would be exacerbated by the additional returns that would be received during the time the IRS was working off the backlog. Further reductions in the percentage of electronic returns would have even more severe impacts. In general, a larger than expected amount of paper filing would:

- drive up the IRS' costs of submission processing;
- increase the probability that the IRS could not issue refunds within the 45 day statutory limit, thus incurring unexpected interest costs;
- increase downstream costs and burdens of future error correction for both the taxpayer and the IRS due to the much higher error rate associated with manually-intensive paper processing; and
- expand demand for Refund Anticipation Loans (RALs) to former electronic filers who file on paper. Because the IRS does not provide a Debt Indicator for paper filers, these RALs would be more risky and thus carry higher fees and interest, placing even more burden on low-income taxpayers who are the most likely taxpayers to use RALs.

Attachment

Table 1. Cumulative Individual Income Tax Return Receipts and Processed by Week During 2007 Tax Filing Season (in millions)

2007 Filing Season Start	Jan 15													
2007 Week End date	Jan 19	Jan 26	Feb 2	Feb 9	Feb 16	Feb 23	Mar 2	Mar 9	Mar 16	Mar 23	Mar 30	Apr 6	Apr 13	Apr 20
Paper Returns	0.5	1.0	2.2	4.5	7.3	9.9	12.8	15.4	18.0	20.7	23.5	26.8	32.1	48.2
Electronic Filing	2.1	5.7	13.3	23.4	30.4	36.2	41.2	45.5	49.4	53.1	56.9	61.3	67.2	76.1
Total Individual Returns Received	2.6	6.7	15.5	27.9	37.7	46.1	54.0	60.9	67.4	73.8	80.4	88.1	99.3	124.2
Total Individual Returns Processed	2.4	6.3	14.4	25.5	34.2	41.9	49.7	57.0	63.8	70.5	77.2	84.2	92.9	105.2
Total Number of Refunds Issued	2.0	5.6	13.3	23.8	31.8	38.6	45.4	50.5	55.2	63.0	68.3	73.6	79.8	88.2
Total Dollar Amount Refunded ($ in billions)	$6.8	$17.3	$39.3	$67.6	$86.9	$102.6	$117.1	$128.7	$139.3	$152.8	$163.4	$174.2	$186.6	$203.0

Source: IRS Tax Stats

Table 2. Impact of Delays in Starting the 2008 Filing Season for Selected Scenarios

Scenario One: Filing Season Starts January 28, 2008*	
Number of Return Filings Delayed	6.7 million
Number of Refunds Not Issued	5.6 million
Dollar Amount of Refunds Not Issued	$17.3 billion
Scenario Two: Filing Season Starts February 4, 2008*	
Number of Return Filings Delayed	15.5 million
Number of Refunds Not Issued	13.3 million
Dollar Amount of Refunds Not Issued	$39.3 billion
Scenario Three: Filing Season Starts February 18, 2008*	
Number of Return Filings Delayed	37.7 million
Number of Refunds Not Issued	31.8 million
Dollar Amount of Refunds Not Issued	$86.9 billion

Source: Analysis by IRS Oversight Board; actual data from 2007 filing season from IRS reports.
* Only an approximation as data reflects 2007 volumes.