



*The Telephone Excise Tax Refund Program
Was Successfully Implemented for
Businesses; However, a Large Amount of
Overcollected Tax Has Gone Unclaimed*

April 24, 2008

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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.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

April 24, 2008

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND
ENFORCEMENT

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – The Telephone Excise Tax Refund Program Was
Successfully Implemented for Businesses; However, a Large Amount
of Overcollected Tax Has Gone Unclaimed (Audit # 200730036)

This report presents the results of our review of the Telephone Excise Tax Refund (TETR) program for businesses. The overall objective was to determine whether the Internal Revenue Service (IRS) effectively implemented the TETR¹ program for business filers.² This audit was conducted due to a request from the Deputy Commissioner for Services and Enforcement.

Impact on the Taxpayer

The IRS estimated that between 13.9 million and 15.9 million business taxpayers would be eligible to claim the TETR. The IRS wanted to provide an easy process for taxpayers to make TETR claims, but at the same time it wanted to minimize the refunds in excess of taxes collected and discourage requests for overstated refunds. Based on the refund claims processed through

¹ On May 25, 2006, the Department of the Treasury announced its concession in the legal dispute over the Federal excise tax on long-distance and bundled telephone service. The IRS also announced its decision to stop collecting the tax and to issue refunds of tax paid on long-distance telephone service over the past 3 years. This announcement came after several court decisions held that the excise tax the IRS was collecting on long-distance and bundled telephone service was inappropriate. The IRS implemented a major program for taxpayers to receive refunds for the portion of their excise taxes paid on these services.

² Specifically, taxpayers filing U.S. Corporation Income Tax Return (Form 1120), U.S. Income Tax Return for an S Corporation (Form 1120S), U.S. Return of Partnership Income (Form 1065), and U.S. Income Tax Return for Estates and Trusts (Form 1041).



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

November 24, 2007, we believe a significant amount of the telephone excise tax collected could go unrefunded, and many taxpayers might still be eligible to file claims.

Synopsis

Overall, the IRS successfully planned and implemented the TETR program for businesses. Its efforts included modifying existing forms and developing strategies to educate taxpayers regarding the availability of the refunds. The IRS also developed methods and forms for taxpayers to claim either (1) an estimated amount of TETR without having to incur the required burden of obtaining substantial documentation from 41 months of telephone bills or (2) actual amounts as documented on their telephone bills. Despite these efforts, much of the overcollected tax might go unclaimed and unrefunded. As of November 24, 2007, only approximately 721,410 (5.6 percent) of the 12.8 million business taxpayers who had filed their returns had made TETR claims. The refunds associated with these claims totaled only \$876.6 million, or 17.5 percent of the \$5 billion collected.

Although we were unable to determine why the number of taxpayers claiming the credit and the total amount they claimed did not meet IRS estimations, we believe that the reasons might be attributed to the following conditions: (1) businesses believed the amount of work and associated fees outweighed the amount of the credit they would receive, (2) businesses were concerned that they would be unable to provide the necessary records needed to support the amount of the claim, and (3) businesses simply were not aware of the credit.

IRS efforts to create compliance screens for identifying overstated refund requests were ambitious. These screens used selection criteria that generally increased in proportion to an increase in the size of the business. However, the minimum selection criteria set for some businesses in comparison to others were inconsistent and led to some inconsistent results. The IRS employed two minimum selection criteria: one for relatively small businesses and another for all others. However, the smaller businesses received larger minimum criteria (50 percent larger) than the larger businesses. This resulted in large businesses being identified for examination and having refunds frozen for claim amounts that would have been under minimum criteria for much smaller businesses. Conversely, some claims made by smaller businesses that were not examined would have been examined if the claims were filed by a larger business.

In a prior review of TETR claims made by individuals,³ the Treasury Inspector General for Tax Administration found that many potentially erroneous claims went unchallenged by the IRS and resulted in excessive refunds. We believe the criteria used to identify potentially egregious individual claims were set too high. The IRS declined to adjust its criteria and declined to scrutinize many of these claims due to limited Examination function resources. At the same

³ *Although Strong Efforts Were Made, a Significant Amount of the Telephone Excise Tax Overcollected From Individual Taxpayers May Never Be Refunded* (Reference Number 2007-30-178, dated September 26, 2007).



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

time, other resources set aside to review questionable business claims were underused. Shifting resources from one operating division to another might have enabled the IRS to stop or recover much of the TETR that appears to have gone out erroneously.

Recommendations

We recommended that the Director, Electronic Tax Administration and Refundable Credits, survey tax preparers and business taxpayers who did not claim the TETR to determine why the refunds were not claimed. We also recommended that the Director, Campus Compliance Services, and the Director, Examination, make appropriate changes to the screening criteria for claims on amended returns and analyze screening criteria before implementing the criteria for future programs to ensure that they provide reasonable and consistent coverage. Lastly, we recommended that the Deputy Commissioner for Services and Enforcement give consideration to shifting resources from one operating division to another for future IRS projects or programs if doing so could help the IRS optimize its effectiveness and achieve its mission.

Response

IRS management agreed with the recommendations presented in this report. Specifically, they do not have sufficient resources to survey tax preparers and business taxpayers who did not claim the TETR. However, because the TIGTA has limited Office of Management and Budget authority to perform such a survey, the IRS solicited our help in conducting this survey. The IRS is interested in any data regarding why presumably eligible businesses did not claim their TETR refund. The IRS also agreed to examine the screening criteria currently used to review and select for audit amended business returns with TETR requests. They are now in the process of reviewing the criteria. Finally, the IRS pointed out that shifting resources from one operating division to another is already part of the way in which the IRS conducts its strategic planning process. Management's complete response to the draft report is included as Appendix IV.

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 Margaret Begg, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-8510.



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

Table of Contents

Background	Page 1
Results of Review	Page 3
Overall, the Internal Revenue Service Successfully Planned and Implemented the Federal Telephone Excise Tax Refund Program for Businesses	Page 3
Like Individual Taxpayers, a Significant Amount of the Telephone Excise Tax Owed to Business Taxpayers May Never Be Refunded	Page 6
<u>Recommendation 1:</u>	Page 7
Efforts to Create Compliance Screens Were Ambitious, but Inconsistencies Exist	Page 8
<u>Recommendation 2:</u>	Page 9
Resources Could Have Been More Effectively Applied to Collect Erroneous Telephone Excise Tax Refund Claims	Page 9
<u>Recommendation 3:</u>	Page 10
Appendices	
Appendix I – Detailed Objective, Scope, and Methodology	Page 12
Appendix II – Major Contributors to This Report	Page 14
Appendix III – Report Distribution List	Page 15
Appendix IV – Management’s Response to the Draft Report	Page 16



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

Abbreviations

IRS	Internal Revenue Service
TETR	Telephone Excise Tax Refund
TIGTA	Treasury Inspector General for Tax Administration



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

Background

The telephone excise tax was first imposed in 1898 to fund the Spanish-American War. Originally, the tax applied to all telephone use. Later, it was revised to apply to long-distance calls on which call duration and distance were factored into the price. However, many telecommunications companies made changes to their billing models, factoring only call duration and not distance into their billing prices. As a result, these charges no longer met the requirements of the tax code and should not have been subject to tax.¹ Several businesses litigated the taxability of these portions of the telephone excise tax and, after five circuit court losses, the Department of the Treasury announced on May 25, 2006, that it was conceding the legal dispute over the tax and that the Department of Justice would no longer pursue litigation. The Internal Revenue Service (IRS) also announced its decision to stop collecting the tax. The IRS then implemented a major program for taxpayers to receive refunds for the portion of their telephone excise taxes paid on long-distance or bundled telephone service billed after February 28, 2003, and before August 1, 2006, that did not meet the statutory taxability requirements.

The Telephone Excise Tax Refund (TETR) was the most wide-reaching tax refund in the history of the IRS, estimated to affect between 145 million and 165 million individual taxpayers and between 13.9 million and 15.9 million business taxpayers.² The IRS developed a process to refund these monies in a timely manner and made the request process relatively easy for most taxpayers. At the same time, it wanted to minimize the number of refunds in excess of taxes collected and discourage requests for overstated refunds. The Treasury Inspector General for Tax Administration (TIGTA) recently reported on the IRS' efforts to administer the refund program for individual taxpayers.³ This report discusses the IRS' efforts to administer the refund program for business taxpayers.

To request the TETR, businesses are required to complete Credit for Federal Telephone Excise Tax Paid (Form 8913) and file it with their tax return. They can complete the form by using the actual amount of refundable long-distance telephone excise taxes that they paid between March 2003 and July 2006 (41 months), or they have an option to use an estimation method developed by the IRS.

¹ Five circuit court cases held that a telephonic communication for which there is a toll charge that varies with elapsed transmission time and not distance (time-only service) is not taxable toll telephone service as defined in Internal Revenue Code Section 4252(b)(1).

² This includes not only C-Corporations, S-Corporations, and Partnerships, but also non-profit filers, Government entities, and businesses no longer in operation. Estates and Trusts were not included in the estimate.

³ *Although Strong Efforts Were Made, a Significant Amount of the Telephone Excise Tax Overcollected From Individual Taxpayers May Never Be Refunded* (Reference Number 2007-30-178, dated September 26, 2007).



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

The estimation method was designed by the IRS to simplify the refund calculation and reduce the burden on taxpayers by helping them avoid having to recover their old telephone records. The estimation method requires businesses to compare only two telephone bills from Tax Year 2006 (April and September) to determine the percentage of their telephone expenses attributable to the excise tax on long distance. They must first figure the telephone tax as a percentage of their April 2006 bill, which included the excise tax for both local and long-distance telephone service, and their September 2006 telephone bill, which only included the tax on local telephone service. The difference between these 2 percentages should be multiplied by the total telephone expenses for the 41-month period. The refund is capped at 2 percent of telephone expenses for businesses with 250 or fewer employees and 1 percent for large businesses with more than 250 employees.

This review was performed at the IRS Campus⁴ in Ogden, Utah, during the period May through November 2007 and included a review of tax information from returns filed and processed nationwide, as well as an evaluation of information provided by the IRS TETR Working Group headed by the Director, Earned Income and Health Coverage Tax Credits, Wage and Investment Division. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

⁴ Campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

Results of Review

Overall, the Internal Revenue Service Successfully Planned and Implemented the Federal Telephone Excise Tax Refund Program for Businesses

Major business tax forms and instructions were timely and accurately updated to allow taxpayers to claim the TETR

The IRS added instructions and made appropriate changes to the business income tax forms that included a specific line on each tax form to claim the credit. Revisions were made to the forms and instructions for the U.S. Corporation Income Tax Return (Form 1120), the U.S. Income Tax Return for an S Corporation (Form 1120S), the U.S. Return of Partnership Income (Form 1065), and the U.S. Income Tax Return for Estates and Trusts (Form 1041).⁵ The IRS also created an entirely new form with instructions, Form 8913, that helped businesses compute their TETR refund using actual expenses or the estimation method.

We reviewed each of the new and revised forms and their related instructions and found that, overall, the forms were properly and clearly composed and the associated instructions were logically and accurately presented.

In preparation for processing these new and revised tax forms, the IRS also had to modify processing procedures, instructions, and/or computer programming involving (1) the acceptance of electronically filed returns with TETR claims, (2) data entry of TETR information from paper returns to IRS computers, (3) the resolution of errors on the returns, and (4) filters to identify and inform taxpayers of inappropriate claims. The IRS successfully accomplished these tasks.

The system for processing tax returns filed by partnerships was modified to allow the issuance of refunds

All partnerships must file an annual information return, Form 1065, to report the income, deductions, gains, losses, etc., from their operations, but they do not pay income tax. Instead, the partnerships “pass through” any profits or losses to their partners. Each partner includes his or her share of the partnership’s income or loss on his or her tax return. As a result, the IRS returns processing systems were not designed to issue TETR refunds directly to partnerships. However, to accommodate the TETR program, additional programming was designed and implemented

⁵ The IRS also made changes to the Exempt Organization Business Income Tax Return (Form 990-T) and its instructions, but they were not reviewed during this audit.



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

that enabled the processing system to recognize the Telephone Excise Tax credit and issue the proper amount of refund directly to the partnership.⁶

The IRS developed detailed strategies to educate taxpayers regarding the TETR provisions

The IRS developed an in-depth Telephone Excise Tax Communications Subgroup Summary Strategy that outlined overall communications objectives, audiences, and key messages. Out of this Strategy came an internal communications strategy, a comprehensive media strategy, and the IRS Refund of Telephone Excise Tax Outreach Plan. Each strategy/plan had refined objectives, messages, audiences, and steps to communicate those messages to the desired audience. These documents were all consistent with the Summary Strategy and its objectives.

The IRS worked with a large number of external partners to disseminate information about the TETR. Information regarding the TETR and how businesses can claim it is abundant on the Internet. The public IRS web site (IRS.gov) home page had TETR information prominently displayed with easy links that provide more information for businesses, tax-exempt entities, and individuals. Detailed questions and answers for each of these groups were very informative. In addition, our examination of various web sites found TETR references on newspaper web sites, tax practitioner sites, and tax and finance sites. One site listed 16 news releases issued by the IRS or the Department of the Treasury that were related to the TETR.

The estimation method developed by the IRS for businesses was reasonable and reduced taxpayer burden

To help taxpayers avoid searching through their old telephone records to determine their refund amount, the IRS developed a formula that most business organizations can use to compute their refund. As stated in the Background section of this report, the IRS developed an estimation method based on comparing the tax percentage of two different months--one in which the tax was inappropriately charged and the other in which only the correct amount was assessed. The difference between these 2 percentages was then multiplied by the total telephone expenses for the 41 months stipulated from March 2003 through July 2006. The resulting amount could be claimed for refund (after applying the appropriate cap if necessary). Prior to finalizing the formula, the IRS received public input and discussed the matter with business organizations, the Small Business Administration, and representatives from the tax-exempt community.

We were unable to determine the number of businesses that used the estimation method to figure their refund rather than taking actual expenses. That information was not compiled by the IRS and is not readily available through taxpayer files. However, we believe that the estimation method was an efficient way of providing taxpayers with an alternative to identifying and computing actual expenses and was effective in reducing taxpayer burden.

⁶ Changes enabling refunds to be issued to filers of other business tax forms had previously been made.



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

A processing problem existed but the IRS reacted quickly to mitigate its effects

The TIGTA developed computer programs to identify certain businesses claiming and receiving the TETR and provided the output of those programs to tax examiners in one of the IRS' Fraud Detection Centers. These tax examiners identified a problem in the processing of claims included on Forms 1065 resulting in erroneous refunds. The Fraud Detection Center informed the IRS' processing function, and the problem was immediately corrected. The IRS was able to recover over \$300,000 that had been erroneously refunded to taxpayers and avoided the further issuance of similar erroneous refunds.

The IRS developed and implemented a TETR compliance strategy and plan

The IRS Management Strategy for the TETR program identified three key overall objectives that included: (1) minimizing taxpayer and IRS burden associated with requesting, processing, and paying the refund; (2) minimizing refunds in excess of taxes collected; and (3) discouraging overstated refund requests. The IRS created and implemented a TETR compliance strategy and plan that was designed to deter such inappropriate refund claims. This included creating compliance screens that identify refund requests that appear to be statistically unlikely, then freezing those refunds until the return can be audited.⁷

The compliance screens were based on an existing model. The selection criteria were developed by the IRS and were based, in part, on historical telecommunication expenditures for long-distance telephone service provided to businesses.

Because the IRS' authority to recover TETR overpayments is limited, the IRS' compliance efforts focused on pre-refund screening and examination. Once identified for examination, the IRS froze the refund, then sent the filer a notice requesting information to substantiate the TETR requested. The IRS also developed a compliance process whereby these newly identified cases could be worked effectively along with its normal work.

Our tests showed that the selection criteria implemented as part of the compliance screens effectively identified the intended cases. We also determined that the refunds were appropriately frozen on those cases until they could be audited. However, as discussed later in this report, the formula developed to administer these selection criteria resulted in some inconsistencies regarding which claims were scrutinized and which claims were processed without questions.

⁷ In addition, the IRS included a process for identifying and investigating TETR claims that appeared to be potentially fraudulent.



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

Like Individual Taxpayers, a Significant Amount of the Telephone Excise Tax Owed to Business Taxpayers May Never Be Refunded

The IRS estimated that between 13.9 million and 15.9 million business taxpayers would be eligible to claim the TETR and approximately \$5 billion were owed. As of November 24, 2007, approximately 721,410 of the 12.8 million business taxpayers who filed their returns made TETR claims. The telephone excise taxes associated with those claims totaled only \$876.6 million. This accounts for only 5.6 percent of the estimated number of businesses that could have claimed the credit and only 17.5 percent of what was collected.⁸

Just as we reported for individual taxpayers, we believe a significant amount of the telephone excise tax collected by the IRS from businesses might never be refunded. Because of the length of time it took to obtain permission from the Office of Management and Budget to contact and gather information from taxpayers, we were unable to determine why only a small portion of taxpayers claimed the credit.⁹

Although we do not know the specific reasons why business taxpayers did not claim the refund, we believe some general reasons were revealed in a survey of small businesses conducted by the Padgett Foundation.¹⁰ The survey found that small businesses believed the amount of work and associated fees outweighed the amount of the credit they would receive. It is likely that many businesses assumed that the costs spent on locating telephone expense records or the additional tax preparation involved in figuring the credit was not worth the gain received from claiming the refund. They might have falsely assumed that they would also have to file amended returns to reverse the expenses taken as deductions in prior years, resulting in additional tax preparation expense. The only additional action taxpayers must take once they claim the credit is to claim the TETR refund as income in the tax year received.

The survey also showed that taxpayers were concerned that they would not be able to provide the necessary records needed to support the credit claim. It was in response to this type of concern that the IRS developed the estimation formula. However, it is possible that taxpayers were not fully aware that the estimation method was available to them and might have even believed that using the estimation method was cost-prohibitive. In addition, the survey revealed that some taxpayers simply were not aware of the credit. We were contacted by one certified public accounting firm that admitted to overlooking the credit for many of its clients.

⁸ The TETR numbers presented in this paragraph do not include the numbers associated with approximately 2,000 taxpayers who filed claims for TETR refunds in anticipation of the IRS' reversal of their position. These cases were worked separately by the IRS and the numbers were not readily available.

⁹ Just after the scheduled completion date for fieldwork on our audit, we received Office of Management and Budget permission to contact taxpayers to determine why they did not claim the TETR.

¹⁰ Operated in conjunction with Padgett Business Services, a company with more than 400 locally owned and operated franchises across the United States and Canada specializing in small business advice and consultation.



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

Despite the IRS' significant efforts to advise business taxpayers of the TETR program, it seems that many businesses that would have qualified for the TETR failed to claim it. Many of these taxpayers might still be eligible to file claims.

As part of the TETR program, the IRS designed a comprehensive communications and outreach strategy that focused on building awareness, providing education, maximizing media reach, and minimizing taxpayer burden. Additionally, external stakeholders were engaged throughout the process.

This effort, combined with IRS' prior experience in communicating tax law changes and requirements to the taxpaying public, should have been an effective combination to communicate the TETR program to all business taxpayers. However, considering the significantly wide audience that the IRS was attempting to reach and the low number of taxpayers who actually claimed the credit, we believe the IRS should determine whether its communication and outreach strategies were effective or whether improvements should be made. For example, a survey of tax preparation firms, certified public accountants, or taxpayers might help the IRS determine whether the information was communicated effectively. By doing so, the IRS should be better able to determine whether the responsibility for not filing fell on the businesses and their preparers or whether the IRS needs to reevaluate its communication strategies in the future.

Recommendation

Recommendation 1: The Director, Electronic Tax Administration and Refundable Credits, should survey tax preparers and business taxpayers who did not claim the TETR to determine why the refunds were not claimed. Such a survey will help the IRS determine whether further actions are necessary to administer the refunds to businesses, assess the effectiveness of its communications strategies, and make appropriate changes for future outreach efforts. Because the TIGTA now has limited Office of Management and Budget authority to perform such a survey, we would be willing to work with the IRS to gather these data. If the results of the survey warrant, the TETR Working Group should identify demographics that had relatively low rates of claims and provide additional information to these business taxpayers on how they might still claim the TETR.

Management's Response: The Commissioner, Wage and Investment Division, agreed with this recommendation, but indicated that the IRS does not have sufficient resources to implement a study of this nature at this time. However, because the TIGTA has limited Office of Management and Budget authority to perform such a survey, the IRS solicited our help in conducting this survey. The IRS is interested in any data regarding why presumably eligible businesses did not claim their TETR refund. The IRS will analyze the data gathered from the survey to determine trends and common reasons why the TETR wasn't being claimed.



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

Efforts to Create Compliance Screens Were Ambitious, but Inconsistencies Exist

As noted earlier in the report, the IRS Management Strategy for the TETR program identified three key overall objectives. To assist in accomplishing these objectives, the IRS developed compliance screens to identify potential TETR compliance issues for taxpayer claims that met its selection criteria.

The compliance screens were based on an existing IRS model, and the selection criteria were developed by the IRS using telecommunication industry data. The IRS identified the key variables that are predictors of telephone usage, then added the complexity of accounting for the size of the business relative to the refund claim amount. This enabled the IRS to set business selection criteria in relation to the size of the business, which is generally defined by the amount of gross receipts.¹¹

The resulting criteria were a system of mathematical equations applied to an indicator (i.e., “applicable amount”) that reflected the size of the business. In general, a larger business would be able to claim a greater amount of TETR without further scrutiny by the IRS. In addition, the selection criteria were set to optimize compliance resources.

Overall, the compliance screens appeared to provide an effective method of identifying questionable claims. However, we identified some inconsistencies in its application. IRS management did not recognize these inconsistencies. As mentioned earlier, one of the main tenets of the selection criteria is that they increase in proportion to an increase in the size of the business. This appears to be a logical approach. However, some inconsistencies existed with the criteria set by the IRS which appear counter to the tenet and caused inequities among businesses. For example, the refund of a large business claiming a small TETR amount would be frozen and examined, while a much smaller business could claim a larger TETR amount without the refund being frozen and examined.

The IRS employed two different selection criteria: one for relatively small businesses and another for all other businesses. However, under the established criteria, some large businesses were identified for examination and had their refunds frozen for claim amounts that would not have occurred for much smaller businesses.

We identified 367 TETR claims filed by large businesses meeting examination criteria¹² that would not have met the criteria had they been claimed by much smaller businesses. At the same time, we identified 124 TETR claims filed by relatively small businesses that were not examined but would have met the examination criteria had they been filed by larger businesses.

¹¹ When gross receipts equaled zero, total deductions defined the size of the business.

¹² As of November 26, 2007, we were informed the IRS examined 3,280 business returns claiming the TETR.



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

Recommendation

Recommendation 2: The Director, Campus Compliance Services, and the Director, Examination, should make appropriate changes to the screening criteria for claims on amended returns and should analyze screening criteria before implementing them for future programs to ensure that they provide reasonable and consistent coverage.

Management's Response: IRS management agreed with this recommendation. The Commissioner, Wage and Investment Division, agreed to examine the screening criteria currently used to review and select for audit amended business returns with TETR requests. The IRS is now in the process of reviewing the criteria. The IRS believes that because the selection criteria did not change during the entire 2007 and 2008 filing periods, similarly situated taxpayers received the same treatment, and the method of selecting egregious TETR requests for examination was both fair and appropriate. However, as noted, the IRS will reassess these criteria as they relate to amended business returns with TETR requests.

Office of Audit Comment: We do not dispute the fact that similarly situated taxpayers received the same treatment. Our issue is with the treatment of dissimilar businesses. Allowing a relatively large TETR request for a small business and yet freezing a TETR request for the same or even smaller amount claimed by a much larger business does not seem logical. We encourage the IRS to address this issue in its reassessment of the screening criteria for amended tax returns.

Resources Could Have Been More Effectively Applied to Collect Erroneous Telephone Excise Tax Refund Claims

During the prior TETR review, the TIGTA believed the selection criteria used to identify potentially egregious individual claims were set too high and found that highly suspicious claims made by individuals often went unchallenged by the IRS. The IRS declined to adjust its selection criteria and declined to scrutinize many of what appeared to be erroneous claims, due to limited Examination function resources. As a result, the TIGTA projected that more than 52,000 taxpayers claimed highly suspicious TETR claims amounting to almost \$47 million.¹³

At the same time, other resources set aside to review questionable business claims were underused. The IRS estimated and prepared to examine more than 8,700 business returns. As of November 26, 2007, the IRS had selected only 3,280 business returns (38 percent) for examination. Shifting resources from one operating division to another might have enabled the

¹³ Calculated as follows: 52,360 taxpayers included in our analysis of questionable cases not examined by the IRS multiplied by the maximum standard amount of \$60 = \$3,141,600 (which most likely should have been claimed). These taxpayers actually claimed \$49,896,486. Thus, \$49,896,486 - \$3,141,600 = \$46,754,886.



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

IRS to stop or recoup much of the TETR that appears to have gone out erroneously to individual taxpayers.

During the IRS reorganization, operating divisions were created to serve customers with similar needs, which resulted in four primary operating divisions (Wage and Investment Division, Large and Mid-Size Business Division, Small Business/Self-Employed Division, and Tax Exempt and Government Entities Division). We recognize that shifting resources from one division to another might rarely be done. However, in this circumstance (i.e., the claims are somewhat generic because both individuals and businesses file for the TETR using Form 8913 and skilled examiners were underused), we believe the IRS could have considered transferring resources and services across division boundaries to optimize its compliance resources. Redirection of resources would have been helpful because the TETR issue became very high profile, and the IRS made a great deal of effort to prevent the claiming and subsequent refunding of inappropriate credit amounts, including vocalized and written warnings.

At the direction of the IRS Deputy Commissioners, the IRS established a TETR Compliance Review Council designed in part to maintain real-time monitoring and enable weekly adjustments to the TETR examination plan. The Council included a representative from each operating division, and its objective was to ensure that the preliminary plan was effective and the best cases were being worked. The IRS had this control in place to respond to emerging examination issues and make changes to the initial strategies. We believe that this Council should have recognized a needed change in strategy and considered additional options including the transfer of resources.

Recommendation

Recommendation 3: The Deputy Commissioner for Services and Enforcement should consider shifting resources from one operating division to another for future IRS projects or programs if it could help the IRS optimize its effectiveness and achieve its mission.

Management's Response: IRS management agreed with this recommendation. The Commissioner, Wage and Investment Division, pointed out that shifting resources from one operating division to another is already part of the way in which the IRS conducts its strategic planning process and will consider this for future projects or programs. The IRS considered a number of factors in constructing the TETR examination plan and concluded that the allocation of audit resources was appropriate and should not be modified to shift efforts away from other productive work to the TETR. Throughout the filing season, the IRS monitored the workload of examiners handling TETR cases and, when deciding how to apportion work, took into consideration a balanced coverage approach and the business unit's overall work plan for the fiscal year. The IRS decided to continue examining business returns with multiple issues rather than moving business examination resources to examine single-issue TETR requests from individuals.



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

Office of Audit Comment: We recognize that the IRS decided to continue examining business returns rather than moving business examination resources to examine single-issue TETR requests for individuals. We disagree with that decision, particularly because the number of business TETR claims meeting examination selection criteria were well below those planned for, and the TIGTA had made the IRS aware of significant noncompliance with regard to individual TETR claims. However, because the IRS has agreed to give consideration to shifting resources from one operating division to another in the future and is even now considering this during its strategic planning process, we do not disagree with the IRS' stated corrective action.



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

Appendix I

Detailed Objective, Scope, and Methodology

Our overall audit objective was to determine whether the IRS effectively implemented the TETR program for business filers, specifically taxpayers filing U.S. Corporation Income Tax Return (Form 1120), U.S. Income Tax Return for an S Corporation (Form 1120S), U.S. Return of Partnership Income (Form 1065), and U.S. Income Tax Return for Estates and Trusts (Form 1041). To accomplish this objective, we:

- I. Determined the adequacy of the internal controls in place to administer the TETR program for businesses by completing a risk matrix and designing audit tests to address the control weaknesses identified.
- II. Determined whether the IRS had properly modified computer programs as they related to the telephone excise tax refund on business returns.
 - A. Determined how the credit was treated on the various tax forms (primarily determined whether the IRS provided a separate line for taking the credit or whether it was allocated to a miscellaneous refundable credit line), reviewed changes made to the forms and the related instructions, and analyzed the estimation method for basis and reasonableness.
 - B. Selected a statistically valid sample of 150 (from a population of 436,332) business tax returns claiming the telephone excise tax credit and ensured that the credits were properly posting to the Master File,¹ and ensured that claimed amounts were properly supported. The data were extracted from the TIGTA Data Center Warehouse,² and we selected the sample using a 95 percent confidence level, 10 percent expected error rate, and 5 percent precision.³
- III. Determined whether the TETR program statistics compiled by the IRS were accurate.
 - A. Obtained IRS estimates of the number of businesses projected to claim the TETR and the IRS' anticipated amount of refund dollars claimed.

¹ The Master File is the IRS database that stores various types of taxpayer account information. This database contains individual, business, and employee plans and exempt organization data.

² The Data Center Warehouse is a collection of IRS databases containing various types of taxpayer account information that is maintained by the TIGTA for the purpose of analyzing data for ongoing audits.

³ The returns were visually reviewed electronically using IRS databases. No actual returns were pulled for review. The return data extracted were verified by matching it to the return information maintained on IRS databases.



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

- B. Obtained IRS data showing the actual number of taxpayers claiming the credit and also the amount of credits claimed (excise taxes and interest amounts). We also determined the accuracy of the IRS data by comparing statistics to the data available on the TIGTA Data Center Warehouse and resolved substantial differences.
 - C. Compared IRS estimates to the actual number and amount of TETR claims. We obtained explanations of the differences from the IRS and determined whether it has any plans to study and address the issue of substantially fewer taxpayers claiming the credit than expected.
- IV. Determined the efforts made by the Compliance function to deter and prevent excessive TETR claims.
- A. Obtained examination selection criteria and determined whether they were reasonable.
 - B. Judgmentally sampled⁴ and reviewed 282 business tax returns claiming the telephone excise tax credit and determined whether the examination criteria were appropriately applied. The sample data were extracted from the TIGTA Data Center Warehouse.⁵
 - C. Determined the reasons taxpayers claimed excessive amounts of the TETR by interviewing revenue agents and their managers that were involved with the Examination of TETR cases.
- V. Determined the efforts made by the Criminal Investigation Division to prevent fraudulent TETR claims.
- A. Obtained the Criminal Investigation Division's criteria for identifying taxpayers/preparers to investigate.
 - B. Obtained the number of taxpayers/preparers under investigation by the Criminal Investigation Division.
 - C. Analyzed databases of taxpayers to determine whether suspicious claims exist, focusing on large dollar claims, common preparers, etc.

⁴ Judgmental samples were selected because they provided the most efficient method of testing examination criteria and because the test results would not be projected.

⁵ The returns were reviewed electronically using IRS databases. No actual returns were pulled for review. The return data extracted were verified by matching it to the return information maintained on IRS databases.



*The Telephone Excise Tax Refund Program Was Successfully
Implemented for Businesses; However, a Large Amount of
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Appendix II

Major Contributors to This Report

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*The Telephone Excise Tax Refund Program Was Successfully
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Appendix III

Report Distribution List

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Commissioner, Wage and Investment Division SE:W
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SE:S:CLD
Director, Compliance, Wage and Investment Division SE:W:CP
Director, Customer Assistance, Relationships, and Education, Wage and Investment Division
SE:W:CAR
Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division
SE:W:ETARC
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 Commissioner, Wage and Investment Division SE:W



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

Appendix IV

Management's Response to the Draft Report


COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

MAR 25 2008

RECEIVED
MAR 25 2008

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *for* Richard Byrd, Jr. *Pamela S. Watson*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report - The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed (Audit # 200730036)

I reviewed the subject draft report and thank you for your positive assessment of the IRS' efforts to successfully plan and manage the Telephone Excise Tax Refund (TETR) initiative for businesses. We appreciate the opportunity to respond to your report on the effort.

As of February 24, 2008, taxpayers have requested \$5.48 billion for 97.8 million TETR requests including 97.2 million individual taxpayer returns (\$4.2 billion in TETR requests) and .77 million business returns (\$1.28 billion in TETR requests). The number of business requests for TETR refunds were lower than expected. Your report highlights several reasons we believe may have contributed to the low number of requests. You note that, according to the Padgett Survey, small businesses believed the amount of work and associated fees outweighed the amount of the TETR credit they would receive. The IRS heard the same concern voiced by a number of business organizations. In addition, we agree that businesses may have felt they could not produce the necessary records to substantiate their request. It is also possible that businesses did not know about the refund availability. However, you also note that the IRS conducted a significant marketing and communications effort aimed at educating 15 million businesses and tax-exempt organizations of the availability of the refund.

Implementing the TETR posed several challenges for IRS. First, the TETR was a refund of tax that was collected and paid by a party other than the party entitled to the refund. Therefore, the IRS did not have deficiency authority as there is no tax to assess against the party entitled to the refund. This means that IRS could not use regular collection activities to recover refunds if they were issued erroneously. For this reason, the IRS decided to screen every refund prior to issuing it to the taxpayer. In addition, phone companies that collected and paid the tax to the IRS did not have complete records of



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

2

the amounts paid by taxpayers. Nor did they keep billing records readily available beyond a certain period of time or maintain records on how much tax each customer paid.

To address these challenges, the IRS developed objectives for managing and implementing TETR. First, the IRS minimized the burden of requesting the refund by providing two ways for businesses to request their refund through the traditional IRS income tax processing channels. Second, the IRS minimized TETR refunds in excess of taxes collected by instituting a strong compliance program aimed at the most egregious requests. Third, the IRS generated awareness of the availability of the refund and discouraged overstated requests through a broad communications and outreach campaign. Finally, the IRS put processes in place to monitor the TETR implementation, including regular communication, issues and risk management, and performance measures reporting.

Business Estimation Formula

To reduce the burden of requesting the refund, the IRS developed an alternative method (the estimation formula) for business taxpayers and tax-exempt organizations to request the refund in addition to allowing taxpayers to request a refund of the actual tax amount paid. Extensive feedback was solicited from taxpayers, tax preparers, advocacy groups and the telecommunications industry to develop a fair and reasonable method of refunding the monies collected. The estimation formula relieved taxpayers of having to produce telephone bills for the 41-month refund period, and replaced it with a formula that allowed taxpayers to request an estimate of the actual amount of tax paid based on only two monthly bills from 2006.

The 2006 tax forms were updated to include a line for the TETR, and a new Form 8913 (Credit for Federal Telephone Excise Tax Paid) helped taxpayers determine and request their refund using either the estimation formula or an actual amount. Utilizing the existing income tax filing system encouraged compliance and reduced burden on taxpayers and the IRS.

Communications and Outreach

As you mention in your report, the IRS developed detailed strategies to educate taxpayers about TETR. We implemented a communications and outreach strategy focused on awareness, education, maximizing media reach, and publicizing compliance issues.

IRS' outreach strategy included working closely with organizations like the National Chamber of Commerce, the Small Business Administration, the Tax Executives Institute, and numerous other business industry groups. We listened to these groups



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

3

and made a significant effort to understand the best ways to reach them and their constituents.

Before and during the filing season, the IRS issued twenty-two news releases and eight "Tax Tips." The TETR message was included in over four thousand articles and interviews in magazines and newspapers throughout the country, and the estimated media reach of magazines alone was more than eighty-eight million. In addition, the number of people reached by advertising that the IRS placed in newspapers and other media exceeded fourteen million.

The IRS also launched a comprehensive TETR web page, which has been viewed by more than four and a half million taxpayers, tax practitioners, and other stakeholders. The TETR site included an extensive list of frequently asked questions (FAQs) for businesses, including detailed examples of how to use the Business Estimation Method. Over 217 thousand people viewed the TETR business FAQs and over one million TETR forms were downloaded from the site. Additionally, the IRS provided information to tax preparers and representative organizations through newsletters, national phone forums, teleconferences, and multiple tailored briefings, reaching over one hundred thousand tax professionals.

Compliance

As noted in your report, the IRS developed a comprehensive strategy to address the most egregious TETR claims. At the time business returns began to be filed, staff from the Small Business/Self Employed Division regularly monitored TETR requests, identified emerging issues, adjusted the weekly work plan, planned appropriate compliance activities, and communicated with the TETR Compliance Review Council members. Early in the filing season, the IRS set its audit selection criteria based on available resources, examination time required and the estimated dollars protected per case (compared to other examination cases).

The IRS also considered examination priorities in developing a balanced compliance program. The IRS utilized all available resources to examine virtually every return that met the audit selection criteria. To date, we have selected over 5,000 business returns for egregious TETR issues. It is important to keep in mind that additional examinations would have only been possible at the expense of other scheduled examination work.

Taxpayers have up to three years from the date their 2006 return was filed to request the TETR by filing an amended return. As a result, we intend to assess the screening criteria currently used to review and select amended BMF returns with TETR requests for audit.



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

4

Attached are our specific comments to your recommendations. Again, we thank you for the opportunity to respond to this report. If you have any questions, please call me at (404) 338-7060, or members of your staff may contact David R. Williams, Director, Electronic Tax Administration and Refundable Credits at (202) 622-7990.

Attachment



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

Attachment

RECOMMENDATION 1

The Director, Electronic Tax Administration and Refundable Credits, should survey tax preparers and business taxpayers who did not claim the TETR to determine why the refunds were not claimed. Such a survey will help the IRS determine whether further actions are necessary to administer the refunds to businesses, assess the effectiveness of its communications strategies, and make appropriate changes for future outreach efforts. Because the TIGTA now has limited Office of Management and Budget authority to perform such a survey, we would be willing to work with the IRS to gather these data. If the results of the survey warrant, the TETR Working Group should identify demographics that had relatively low rates of claims and provide additional information to these business taxpayers on how they might still claim the TETR.

CORRECTIVE ACTION

The IRS agrees that we could learn a great deal from a survey of businesses and tax professionals regarding why they did not request a refund of TETR. We do not have sufficient resources to implement a study of this nature at this time; however, we would greatly appreciate any help TIGTA could provide in conducting such a study. The IRS would be interested in any data regarding why presumably eligible businesses did not claim their TETR refund. We would be able to analyze any data TIGTA could produce to determine trends and common reasons.

IMPLEMENTATION DATE

September 15, 2008; dependent on TIGTA staff's availability to assist.

RESPONSIBLE OFFICIAL

Director, Electronic Tax Administration and Refundable Credits, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

By June 1, 2008 determine TIGTA staff availability. If resources are available, work with TIGTA staff to identify survey participants, administer survey and analyze results by September 15, 2008.

RECOMMENDATION 2

The Director, Campus Compliance Services, and the Director, Examination, should make appropriate changes to the screening criteria for claims on amended returns and should analyze screening criteria before implementing them for future programs to ensure they provide reasonable and consistent coverage.

CORRECTIVE ACTION

The IRS agrees to look at the screening criteria currently used to review and select for audit, amended BMF returns with TETR requests. We are now in the process of



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

reviewing the criteria. However, we would like to point out that the IRS analyzed data from the telecommunications industry and spoke to numerous telecommunications industry organizations and business groups before finalizing the Business Estimation Formula and the TETR selection engine. IRS' audit selection engine was designed to identify the most egregious questionable TETR refund requests. Because the selection criteria have not changed during the entire 2007 and 2008 filing periods, similarly situated taxpayers have received the same treatment. The IRS believes that the method of selecting egregious TETR requests for examination was both fair and appropriate. However, as noted above, we will reassess these criteria as it relates to amended BMF returns with TETR requests.

IMPLEMENTATION DATE

August 15, 2008

RESPONSIBLE OFFICIALS

Director Exam Planning and Delivery, Exam, Small Business/Self-Employed Division
Director, Reporting Compliance, Campus Compliance Services, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN

By August 15, 2008 a determination will be made as to whether changes are appropriate to the screening criteria for review and audit selection of amended BMF returns with TETR requests. If changes are warranted, application of the new criteria will be studied by a review of cases.

RECOMMENDATION 3

The Deputy Commissioner for Services and Enforcement should give consideration to shifting resources from one operating division to another for future IRS projects or programs if it could help the IRS optimize its effectiveness and achieve its mission.

CORRECTIVE ACTION

We agree with this recommendation. In fact, it is already part of the way in which the IRS conducts its strategic planning process. Our goal is to deploy our resources to optimize their effectiveness in enabling the Service to achieve its mission and objectives. This was certainly the case with our approach to TETR. We considered a number of factors in constructing the TETR examination plan and concluded the allocation of audit resources was appropriate and should not be modified to shift efforts away from other productive work to TETR.

Throughout the filing season, the IRS monitored the workload of examiners handling TETR cases and, when deciding how to apportion work, took into consideration a balanced coverage approach and the business unit's overall work plan for the fiscal year. IRS decided to continue examining business returns with multiple issues rather than moving business examination resources to examine single-issue TETR requests from individuals.



The Telephone Excise Tax Refund Program Was Successfully Implemented for Businesses; However, a Large Amount of Overcollected Tax Has Gone Unclaimed

IMPLEMENTATION DATE

N/A

RESPONSIBLE OFFICIALS

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A