Opportunities Exist to Improve Manual Interest Calculations on Estate Tax Returns

August 30, 2007

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Redaction Legend:

1 = Tax Return/Return Information

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DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

August 30, 2007

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Opportunities Exist to Improve Manual Interest Calculations on Estate Tax Returns (Audit # 200630029)

This report presents the results of our review of manual interest calculations on estate tax returns. The overall objective of this review was to determine whether interest is being calculated correctly on estate tax cases that have elected to pay the taxes due in installments or elected an extension to file or pay. This audit was conducted as part of our annual audit plan.

Impact on the Taxpayer

Because of the complexities involved in administering payment options on estate tax accounts involving Internal Revenue Code (I.R.C.) Section 6166 elections,[1] Internal Revenue Service (IRS) computers are not programmed to assess the interest associated with these accounts. The interest must be calculated manually and is subject to human error. If interest amounts owed by taxpayers are not calculated accurately, the IRS risks collecting too little or too much money from taxpayers whose account balances are calculated in error. Interest had been calculated inaccurately on 16 percent of the estate tax cases included in our review.

[1] A qualifying estate holding an interest in a closely held business with a value exceeding 35 percent of the value of the adjusted gross estate may elect under I.R.C. Section 6166 to pay in installments that portion of its Federal estate tax attributable to the business.

	Initiator	Proofreader	Reviewer	Reviewer	Reviewer	Reviewer	Reviewer	Reviewer
Office Symbols	IG:A		IG:A:SBP		IG:A			
Surname	Barneck		Madsen		Stephens			
Date	8/15/07		8/15/07		8/30/07			

Synopsis

In Calendar Years 2002 and 2003, the processing and administration of estate tax returns was consolidated from 10 IRS campuses[2] to the Cincinnati Campus in Covington, Kentucky. Along with the consolidation, the IRS implemented several changes that significantly improved the administration of these accounts. One such change enabled the IRS to systemically compute interest on all estate tax accounts except those involving I.R.C. Section 6166 elections.

We reviewed a statistically valid sample of 99 estate tax cases[3] involving I.R.C. Section 6166 elections for which interest had to be manually computed. Interest on 16 (16 percent) of these cases had been calculated in error. Ten estates were undercharged $81,677, and 6 estates were overcharged $3,161.

Of the 16 errors we identified, 9 were made by other IRS campuses prior to the cases being consolidated in the Cincinnati Campus. These errors were not identified because the Estate and Gift Operations function at the Cincinnati Campus updates interest for the yearly billing statements by computing interest from the previous billing, as outlined in Internal Revenue Manual section 4.25. Although computing interest only from the previous billing date is an easier process and requires less expertise, it does allow for prior year interest computation errors to remain undetected.

In addition, quality reviews of the yearly interest assessments on I.R.C. Section 6166 estate tax cases at the Cincinnati Campus are conducted by the employees' respective managers. These reviews are conducted on a sample basis and include all the employees' work, not just the yearly interest assessment cases. On average, the reviews consist of about two cases per month for each employee. Many of the managers reviewing the cases are not experts in calculating interest. Although the interest assessment cases are subject to some quality review, some interest errors go undetected because cases are not subject to their own separate review and the employees' managers may not be the most qualified to determine if an interest computation error has been made.

Based on the results of our sample, we estimate that as many as 360 of the 3,564 estate tax cases involving I.R.C. Section 6166 could be undercharged and 216 could be overcharged. Due to the high variability of our sample results, we are unable to accurately estimate the dollar amounts associated with these potential error cases.

[2] Campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
[3] See Appendix IV for details of our sample selection.

Recommendations

The Commissioner, Small Business/Self-Employed Division, should (1) implement a quality review process of yearly manual interest calculations on estate tax cases and ensure personnel assigned to perform these reviews have the skills and expertise to identify whether interest has been computed correctly and (2) implement a procedure involving periodic manual calculation of interest on each estate tax return from the due date of the return.

Response

The Commissioner, Small Business/Self-Employed Division, agreed with our first recommendation and partially agreed with our second recommendation. The Campus Compliance Services function will establish a quality review process and identify qualified staff to conduct regular reviews of a sampling of estate tax cases with manual interest computations. Results of reviews will be evaluated, and strategies will be developed to improve overall quality. The Commissioner also agreed to review the interest computations on I.R.C. Section 6166 installment cases every 3 years to 5 years. The initial review will check the calculations from the due date of the estate tax return. Subsequent reviews, however, will review computations made since the previous review rather than involving recomputation of the initial calculation from the due date of the estate tax return. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment

Although IRS management did not fully agree with our recommendation to implement a procedure requiring interest to be calculated from the due date of the return rather than from the previous billing date each time manual interest calculations are reviewed, we considered their alternative corrective action and found it to be satisfactory.

Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-5894.

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Abbreviations

I.R.C.	Internal Revenue Code
IRM	Internal Revenue Manual
IRS	Internal Revenue Service

Background

The Federal estate tax is imposed on the transfer of the property of a decedent at death. A United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706) must be filed when the value of the gross estate at the date of death and adjusted taxable gifts exceed the estate tax applicable exclusion amount in effect under Internal Revenue Code (I.R.C.) Section 2011. This exclusion amount varies depending on the year of death; it also acts as a threshold for filing an estate tax return and for estate tax liability. For Tax Years 2006 through 2008, the applicable exclusion amount is $2 million; for Tax Year 2009, it will be $3.5 million. Estates with property valued at less than the exclusion amount are not required to file an estate tax return and owe no estate tax. Accordingly, estate tax returns are required for only about 2 percent of all decedents, and even fewer estates are actually required to pay estate tax because of allowed deductions. Unless an extension of time to file is granted, Form 706 is due 9 months after the date of death and is filed and processed at the Internal Revenue Service (IRS) Cincinnati Campus[1] in Covington, Kentucky.

Form 706 is very complex; it is 40 pages long and includes 20 schedules. Although the Form has 20 schedules, each schedule does not necessarily need to be completed by each estate. The methods available to pay the tax due on a Form 706 from an estate with interest in a closely held business[2] add to the complexity of administering these tax accounts. A qualifying estate may elect under I.R.C. Section 6166[3] to pay in installments that portion of its Federal estate tax attributable to the business. Generally, the estate will pay annual installments of only the interest on the deferred tax for the first 4 years and then will pay interest and principal in 2 or more, but not to exceed 10, equal annual installments. The interest rate during the deferral period is less than the interest rate normally charged when the payment of tax is extended.

Because of the complexities involved in administering payment options on I.R.C. Section 6166 estate tax accounts, IRS computers are not programmed to assess the interest associated with these accounts. Specific codes are input to these accounts to restrict the computers from automatically computing interest. There were more than 3,500 such cases in inventory at the Cincinnati Campus as of September 30, 2006. Interest on these cases must be computed

[1] Campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
[2] Ownership of a trade or business carried on as a proprietorship, partner in a partnership carrying on a trade or business, or 20 percent or more in voting stock in a corporation carrying on a trade or business at the time of the decedent's death.
[3] A qualifying estate holding an interest in a closely held business with a value exceeding 35 percent of the value of the adjusted gross estate.

manually and assessed annually by an interest specialist.[4] These specialists, working in the Estate and Gift Tax Division, use a software program to notate and recalculate the interest assessment for each year.

This review included analysis of estate tax cases worked in the Estate and Gift Operations function of the Small Business/Self-Employed Division Campus Compliance Operations function in Covington, Kentucky. The review was performed during the period September 2006 through March 2007 and 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.

[4] An IRS employee that has had specialized interest computation training.

Results of Review

Notable Improvements to the Processing of Estate Tax Returns Have Been Made

In Calendar Years 2002 and 2003, the processing and administration of estate tax returns was consolidated from 10 IRS campuses to the Cincinnati Campus. Along with the consolidation, the IRS implemented several changes that have significantly improved the administration of these accounts.

The IRS developed computer programs to calculate and assess interest and penalties if the extension to file date and the extension to pay date are the same. IRS management believes development of this program reduced the number of estate tax cases that required manual or restricted interest computations by about 50 percent because the program allows for systemic calculation of interest owed on all estate tax accounts except those involving elections for annual installments under I.R.C. Section 6166. This is significant considering the fact that each restricted interest case requiring a manual computation could require these computations for as many as 14 years.

The IRS also automated the case inventory and the process for sending annual installment billing notices for estate tax cases by developing an electronic inventory and a simple interest calculation tool using Microsoft Access database software. This allowed employees to not only keep an electronic inventory of cases but also to be told by the computer what annual billings were coming due. The program also aids the interest specialists in calculating the annual interest installments and generating the annual billing notices.

Manual Interest Calculations on Some Estate Tax Cases Are Not Always Accurate

As discussed earlier, interest computations on estate tax cases involving I.R.C. Section 6166 elections are very complex and must be made and assessed annually by an interest specialist. We reviewed a statistically valid sample of 99 estate tax cases[5] involving I.R.C. Section 6166 elections for which interest had to be manually computed. Our sample was taken from the population of 3,564 of these cases in inventory as of September 30, 2006. From our analysis, we determined interest on 16 cases (16 percent) had been calculated in error.

Inherent in the IRS' mission to apply the tax law with integrity and fairness to all is the concept to collect the proper amount from each taxpayer. The Internal Revenue Manual (IRM) contains

[5] See Appendix IV for details of our sample selection.

information specific to interest computations for the IRS. IRM section 20.2.10.1.1 states that, if an extension has been granted to pay an estate tax deficiency, employees should compute interest on the entire balance due from the due date of the return to the date of payment. In contrast, IRM section 4.25.2.1.3 (5) (the section specific to estate and gift taxes) states interest should be updated from the previous annual installment billing to the date of the current installment billing. If employees computed interest each time from the due date of the return, most errors made in a previous billing would be corrected when interest is later computed for subsequent billings. Of the 16 errors we identified, 9 were made by other IRS campuses prior to the cases being consolidated in the Cincinnati Campus. These errors were not identified because the Estate and Gift Operations function at the Cincinnati Campus updates interest for the yearly billing statements by computing interest from the previous billing, as outlined in IRM section 4.25. Although computing interest only from the previous billing date is an easier process and requires less expertise, it does allow for prior year interest computation errors to remain undetected.

Each return with an election under I.R.C. Section 6166 is reviewed by an estate tax attorney upon receipt in the Cincinnati Campus. Quality reviews of the yearly interest assessments on a majority of the estate tax cases at the Cincinnati Campus are made by the employees' respective managers.[6] The managerial reviews are conducted on a sample basis and include all the employees' work, not just the yearly interest assessment cases. On average, the reviews consist of about two cases per month for each employee. Many of the managers reviewing the cases are not experts in calculating interest. Although the interest assessment cases are subject to some quality review, some interest errors go undetected because cases are not subject to their own separate review and the employees' managers may not be the most qualified to determine if an interest computation error has been made.

If interest amounts owed by taxpayers are not calculated accurately, the IRS risks collecting too little or too much money from taxpayers whose account balances are calculated in error. For 10 of the 16 error cases in our sample, the estates were undercharged interest totaling $81,677.[7] For the other 6 error cases, the estates were overcharged interest totaling $3,161. Based on this sample, we estimate that as many as 360 of the 3,564 cases could be undercharged and 216 could be overcharged. However, due to the high variability of our sample results, we are unable to accurately estimate the dollar amounts associated with these potential error cases.

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[6] We were also informed that specialized reviews are subsequently performed by estate tax attorneys on a very small number of cases.

[7] [redacted]

Recommendations

Recommendation 1: The Commissioner, Small Business/Self-Employed Division, should implement a quality review process of yearly manual interest calculations on estate tax cases and ensure personnel assigned to perform these reviews have the skills and expertise to identify whether interest has been computed correctly.

> ***Management's Response:*** IRS management agreed with this recommendation. The Campus Compliance Services function will establish a quality review process and identify qualified staff to conduct regular reviews of a sampling of estate tax cases with manual interest computations. Results of reviews will be evaluated, and strategies will be developed to improve overall quality.

Recommendation 2: The Commissioner, Small Business/Self-Employed Division, should implement a procedure requiring interest to be calculated from the due date of the return rather than from the previous billing date on each estate tax return. This could be done on a periodic basis every 3 years to 5 years, based on available resources, but should be done at least 3 times over the 14-year installment period to help ensure interest has been correctly assessed.

> ***Management's Response:*** IRS management partially agreed with this recommendation. The Commissioner, Small Business/Self-Employed Division, agreed to review the interest computations on I.R.C. Section 6166 installment cases every 3 years to 5 years. The initial review will check the calculations from the due date of the estate tax return. Subsequent reviews, however, will check computations made since the previous review rather than involving recomputation of the initial calculation from the due date of the estate tax return.
>
> ***Office of Audit Comment:*** Although IRS management did not fully agree with our recommendation to implement a procedure requiring interest to be calculated from the due date of the return rather than from the previous billing date each time manual interest calculations are reviewed, we considered their alternative corrective action and found it to be satisfactory.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether interest is being calculated correctly on estate tax cases that have elected to pay the taxes due in installments or elected an extension to file or pay. To accomplish our objective, we:

I. Had the Treasury Inspector General for Tax Administration Information Technology unit develop a computer program to select estate tax accounts currently on the Master File[1] that had a restricted interest assessment[2] during Fiscal Year 2006. From the population, we determined the number of accounts with restricted interest assessments and the amount of restricted interest assessed.

   A. Established the reliability of the data by reviewing a random sample of 36 cases obtained from the Master File extract and verifying the data received against data on the Integrated Data Retrieval System.[3]

   B. From the computer extract, determined the number of accounts with a manual interest assessment/reversal and the dollar amount of manual interest assessed.

II. Determined if manually assessed interest amounts on estate tax cases in deferred payment or filing status are being computed correctly.

   A. From the computer extract in Step I., selected a statistical random sample of 100 accounts in deferred payment status. We selected a statistical random sample so the error rate and amounts could be projected to the population of 3,564 modules that had a restricted interest amount assessed in Fiscal Year 2006. Our sample size was based on a confidence level of 95 percent, an expected error rate of 20 percent, and a precision factor of $\pm$8 percent. Because of difficulties obtaining pertinent data for 1 of the cases in our sample, we reviewed only 99 cases.[4]

   B. Reviewed the software program, Inter-Est, the IRS uses to calculate interest. We analyzed the program to determine its effectiveness and the accuracy of its rates and provisions.

[1] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[2] An assessment of interest to a tax account that can not be systemically computed and must be manually computed and posted.
[3] IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.
[4] Our sample of 99 cases was still statistically valid for this population.

C. Reviewed the sample cases and recalculated the interest to determine if the interest was properly computed on the accounts.

III. Performed a risk assessment to identify any internal control weaknesses that needed to be included in our audit tests. We determined quality controls and IRM instructions needed to be strengthened and developed those issues during our audit.

Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs)
Kyle R. Andersen, Director
Larry Madsen, Audit Manager
Douglas C. Barneck, Lead Auditor
Bill R. Russell, Auditor
James E. Adkisson, Information Technology Specialist

Appendix III

Report Distribution List

Acting Commissioner C
Office of the Commissioner – Attn: Acting Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Campus Compliance Services SE:E:CCS
Director, Specialty Programs SE:S:SP
Director, Campus Compliance Operations, Cincinnati SE:S:CCS:CCO:CIN
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 Internal Control OS:CFO:CPIC:IC
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S

Appendix IV

Outcome Measures

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

Type and Value of Outcome Measure:

Increased Revenue/Revenue Protection – Actual; $81,677 in undercharged interest on 10 taxpayer accounts (see page 3).

Methodology Used to Measure the Reported Benefit:

The Treasury Inspector General for Tax Administration Information Technology unit provided a database containing all 3,564 estate tax accounts that were in installment status (Master File[1] Status 14) and had had a restricted interest amount (Transaction Code 340) or a restricted interest reversal (Transaction Code 341) posted to the account during Fiscal Year 2006. We selected a statistically valid random sample from this population. Our target sample size was 94 cases. We selected 100 cases to ensure we had enough cases to review and completed review of 99 cases. Our sample size was based on a confidence level of 95 percent, an expected error rate of 20 percent, and a precision factor of ±8 percent. The sample was chosen based on random selection. Upon selecting our sample, we obtained the source documentation for each of the estate tax cases and reviewed the information to determine if the interest had been assessed accurately from the time the case was established on the Master File.

We determined 10[2] (10.10 percent) of the 99 cases reviewed had errors that caused the interest to be undercharged by a total of $81,677.

[1] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[2] There were 2 additional error cases on which interest was undercharged, but the interest difference was less than $25 and considered to be de minimis for our purposes.

Type and Value of Outcome Measure:

Taxpayer Rights and Entitlements – Actual; $3,161 in overcharged interest on 6 taxpayer accounts (see page 3).

Methodology Used to Measure the Reported Benefit:

Using the sample of 99 cases referred to above, we determined 6[3] (6.06 percent) of the 99 cases reviewed had errors that caused the interest to be overcharged by a total of $3,161.

[3] There were 2 additional error cases for which interest was overcharged, but the interest difference was less than $25 and considered to be de minimis for our purposes.

Appendix V

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

RECEIVED
AUG 15 2007

August 13, 2007

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kathy K. Petronchak Kathy K. Petronchak
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Opportunities Exist to Improve Manual Interest Calculations on Estate Tax Returns (Audit #200630029)

We have reviewed your report "Opportunities Exist to Improve Manual Interest Calculations on Estate Tax Returns" and substantially agree with your recommendations to improve the accuracy of manual interest calculations on estate tax returns involving closely held businesses. Of the 99 cases reviewed, interest computation errors were found in 16. As stated in the draft report, Estate & Gift Tax processing was consolidated in the Cincinnati Campus in 2002. Nine of the errors found were from cases that had been worked by other campuses prior to the consolidation.

Although the consolidation and subsequent systemic changes have improved the accuracy of interest computations, we agree that more can be done to improve our accuracy rate. The Estate & Gift Tax Campus Compliance Operation will institute a quality review process on estate tax interest computations involving Internal Revenue Code Section 6166 installment payment cases. Results of the reviews will be monitored and corrective actions will be taken, as needed, to improve our accuracy rate. We agree with the calculations and manner of presentation of the outcome measures outlined in Appendix IV.

Attached is a detailed response to your recommendations. If you have any questions, please contact me at (202) 622-0600 or call Brenda Dial, Director, Campus Compliance Services, Small Business/Self-Employed Division, at (202) 283-2518.

Attachment

Attachment

RECOMMENDATION 1:
The Commissioner, Small Business/Self-Employed Division, should implement a quality review process of yearly manual interest calculations on estate tax cases and ensure personnel assigned to perform these reviews have the skills and expertise to identify whether interest has been computed correctly.

CORRECTIVE ACTIONS:
We agree with this recommendation. Campus Compliance Services will establish a quality review process and identify qualified staff to conduct regular reviews of a sampling of estate tax cases with manual interest computations. Results of reviews will be evaluated and strategies will be developed to improve overall quality.

IMPLEMENTATION DATE:
December 15, 2007

RESPONSIBLE OFFICIAL:
The Director, Campus Compliance Services, Small Business/Self-Employed Division

CORRECTIVE ACTION(S) MONITORING PLAN:
The Director, Campus Compliance Services, will notify the Commissioner, Small Business/Self-Employed Division, of any delays in implementation of the corrective action.

RECOMMENDATION 2:
The Commissioner, Small Business/Self-Employed Division, should implement a procedure requiring interest to be calculated from the due date of the return rather than from the previous billing date on each estate tax return. This could be done on a periodic basis every 3 years to 5 years, based on available resources, but should be done at least 3 times over the 14-year installment period to help ensure interest has been correctly assessed.

CORRECTIVE ACTIONS:
We partially agree with the recommendation to review the interest computations on the Internal Revenue Code (IRC) Section 6166 installment cases every 3 to 5 years. The reviews will be noted in the case files. The initial review will check the calculations from the due date of the estate tax return. Subsequent reviews, however, will review computations made since the previous review, rather than re-review the initial calculation from the due date of the estate tax return.

Our processes currently result in interest being calculated from the due date of the return in all estate tax cases. In the IRC Section 6166 installment cases, however, the initial calculation of interest from the due date is followed by annual computations from the last billing date. While we do not see a need for changing current procedures, we will review our Internal Revenue Manual guidance and clarify, where necessary, the requirements for computing interest on estate tax cases.

We recognize the importance of the accuracy of the initial calculation (from the due date of the return) on the IRC Section 6166 installment cases given the impact on future computations. The review process will allow for a check of the calculations from the due date of the return.

IMPLEMENTATION DATE:
December 15, 2007

RESPONSIBLE OFFICIAL:
The Director, Campus Compliance Services, Small Business/Self-Employed Division

CORRECTIVE ACTION(S) MONITORING PLAN:
The Director, Campus Compliance Services, will notify the Commissioner, Small Business/Self-Employed Division, of any delays in implementation of the corrective action.