United States General Accounting Office

GAO

Report to Congressional Committees

March 1989

TAX ADMINISTRATION

Interest on Tax Refunds Paid by IRS in 1988

GAO/GGD-89-42

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-223878

March 7, 1989

The Honorable Dan Rostenkowski
Chairman, Joint Committee
on Taxation

The Honorable Lloyd Bentsen
Vice Chairman, Joint Committee
on Taxation

The Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

In November 1988, we reported to you on the Internal Revenue Service's (IRS) implementation of the Tax Reform Act of 1986 and its success in processing tax returns during the 1988 filing season.[1] In that report, we said IRS had met its June 1 target date for issuing taxpayer refunds for returns received by April 15, thus avoiding the need to pay interest on those refunds. We have since learned that although IRS met its target date for issuing refunds, interest payments on timely filed returns amounted to about $12.6 million as of October 1, 1988—an increase of about 53 percent over 1987. Because the amount of interest is often looked to as an indicator of IRS' timeliness in processing refunds, we prepared this report to explain the apparent contradiction.

We obtained our information through discussions with IRS officials and a review of IRS' returns processing statistics; however, we did not verify this information. We did our work from October through December 1988 in accordance with generally accepted government auditing standards.

Background

Section 6611 of the Internal Revenue Code requires that IRS pay interest on any taxpayer refund it does not process within 45 days of the return's due date (normally April 15 for individual filers) or the date IRS received the return, whichever is later.[2] Interest, at a rate 2 percent above the short-term federal borrowing rate, is paid from the later of these dates until the date IRS issues the refund.

[1] Effective Implementation of the Tax Reform Act Led to Uneventful 1988 Filing Season (GAO/GGD-89-2, Nov. 14, 1988).

[2] Our report Options for Speeding Tax Refunds and Reducing IRS Interest Costs (GAO/GGD-86-72, July 28, 1986) discusses IRS' procedures for paying interest.

Between May 31, 1988, and October 1, 1988, IRS paid interest totalling $12.6 million on about 1.1 million refunds—an average of about $11.16 a refund. Those 1.1 million refunds accounted for about 1.3 percent of the total refunds issued by IRS during the first 9 months of 1988. During the comparable period in 1987, IRS paid interest of $8.3 million on about 800,000 refunds—an average of about $10.49 a refund. Those 800,000 refunds accounted for about .9 percent of all the refunds issued in 1987.

Reasons for Increased Interest Payments

IRS officials told us that two factors contributed to most of the $4.3 million increase in interest payments. First, interest rates increased from 8 percent in June to October 1987 to 9 percent during the same months in 1988. We estimate that about $1.4 million of the $4.3 million increase in interest payments was due to the increased interest rate. The second factor cited by IRS was an increase in the number of returns that were filed as nonrefund returns but were found during processing to contain errors that resulted in the taxpayer being owed a refund.

When IRS receives tax returns during the filing season, it separates those on which the taxpayer has determined that he or she is due a refund (called refund returns) from those that have a payment attached (called remittance returns). After depositing the payment, IRS generally sets the remittance return aside for later processing so that it can concentrate its resources on processing refund returns. IRS processes refund returns first so it can issue the refunds in a timely manner and thus avoid paying interest. In 1988, as stated in our report, IRS processed these refund returns and issued the refunds in a timely manner. Because it processes refund returns first, IRS generally does not begin processing remittance returns until June—after the 45-day interest-free period has expired. Accordingly, if a return that was originally identified as a remittance return is found, upon processing, to involve a refund, IRS will have to pay interest on the refund. This situation can occur when taxpayers, in preparing their returns, make errors that cause them to pay more tax than they should have. According to IRS' statistics, this occurred more often in 1988 than in 1987.

Through August 12, 1988 (the most recent date for which IRS had compiled such information), IRS had processed about 18.9 million remittance returns, about 2 million more than during the same period in 1987. During that period, IRS also issued about 1.1 million notices to advise taxpayers of errors they had made in preparing their remittance returns that had caused them to overpay, an increase of about 280,000 notices over 1987. According to our calculations, that increase caused IRS' interest payments in 1988 to grow by about $2.8 million.[3]

IRS' analysis of error notices issued in 1988 indicated that many related to sections of the tax return changed by the Tax Reform Act of 1986. One service center, for example, analyzed a small number of notices (62) and found that about 39 percent involved such taxpayer errors as miscalculating alternative minimum tax, failing to take the proper standard deduction, and miscomputing itemized deductions on Schedule A.

IRS officials said they plan to closely monitor interest payments during the 1989 tax filing season. As taxpayers become more familiar with tax law changes, IRS expects fewer errors on tax returns, with a corresponding decrease in interest payments. Officials also believe that the recently enacted Technical and Miscellaneous Revenue Act of 1988 clarified sections of the tax code, such as those dealing with alternative minimum tax, that may have confused taxpayers.

We are sending copies of this report to other congressional committees, the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. If you have any questions about the information in this report, please call me on 275-6407.

Jennie S. Stathis

Jennie Stathis
Director, Tax Policy
and Administration Issues

[3]We computed our estimate by multiplying 280,000 times the per refund interest of $11.16 in 1988. We then reduced the product by 1/9th to adjust for the increase in interest rates from 8 to 9 percent, which we had already accounted for separately.

Major Contributors to This Report

General Government Division, Washington, D.C.

Jennie S. Stathis, Director, Tax Policy and Administration Issues
(202) 275-6407
David J. Attianese, Assistant Director

Cincinnati Regional Office

Robert I. Lidman, Evaluator-in-Charge
Kenneth B. Bibb, Evaluator