



Small Problems in 2007 Tax Filing Could Be Huge in 2008

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According to a recently released report from the Treasury Inspector General for Tax Administration (TIGTA), 2007 was a relatively low-pain year for tax compliance at the Internal Revenue Service.¹ However, the report highlighted several big problems last year that were caused by Congress's delay in enacting end-of-year tax changes. In a similar way, this could be a gigantic problem this coming spring unless something is done soon about the Alternative Minimum Tax (AMT).

The Lesson of Last Year's Debacle Over the Sales Tax Deduction

To get an idea of how bad this problem might be, we can look back at the problems taxpayers and the IRS had in the spring of 2007 with the sales tax deduction and the tuition and fees deduction. Last year, Congress waited on renewing these two exemptions until December when it passed the Tax Relief and Health Care Act of 2006. The IRS couldn't wait that long and had already printed the forms and instructions without including the instructions and lines for these two deductions. These erroneous forms greatly complicated the task of claiming the deductions and likely accounted for the decrease in claims that was seen in 2007 for both of these deductions.

Normally taxpayers get used to a new tax provision after a few years, and compliance improves. However, for the third year in a row, millions of eligible taxpayers failed to claim the deduction for sales taxes paid, which according to TIGTA can be laid at the feet of a late-acting Congress. In 2004, 1.1 million eligible taxpayers failed to claim the deduction, increasing to 1.4 million in 2005, and 2.1 million in 2006. In total, these 4.6 million taxpayers are entitled to an estimated \$1.66 billion in refunds, which can still be claimed by filing amended returns for the years in question. Anyone who itemized deductions and did not claim an income tax deduction is eligible for the sales tax deduction. The seven states that do not have an income tax are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming, so it is the taxpayers in these states who are most likely to benefit from the deduction for sales taxes paid.

Retroactive Amendments to an AMT Return?

Unfortunately, this problem has a real possibility of repeating itself this coming tax year in the area of the Alternative Minimum Tax. The AMT exemptions are set to drop back down to their previous levels for tax year 2007.

For example, a married couple could claim an AMT exemption of \$62,550 in 2006, but that was a temporary provision (called a "patch"), and it expired at the end of the year, so for the 2007 tax year the exemption is scheduled to fall back to \$45,000. Congress is likely to pass another patch, extending or increasing the exemptions retroactively, but with the year winding down there is precious little time left for the IRS to revise its forms to include these changes. Otherwise, the already complicated process of determining AMT liability will become even more confusing this spring.

Unfortunately, some have even suggested that it may take Congress until 2008 to fix 2007's tax rules. If so, some taxpayers will be filing tax returns based upon the current law (no patch), significantly overpaying, and then filing an amended return later for a large refund.

For example, a married couple with two children earning \$100,000 in wages and salary income but no itemized deductions would not know how to properly fill out their return. The accompanying table shows two possible scenarios for the calculation.

Tax Item	No AMT Patch (Current Law)		AMT Patch	
	Regular Tax Liability	AMT Liability	Regular Tax Liability	AMT Liability
Adjusted Gross Income	\$100,000	\$100,000	\$100,000	\$100,000
Standard Deduction	\$10,700	\$0	\$10,700	\$0
Exemption	\$13,600	\$45,000	\$13,600	\$62,550
Taxable Income	\$75,700	\$55,000	\$75,700	\$37,450
Tax	\$11,772.50	\$14,300	\$11,772.50	\$9,737
Alternative Minimum Tax		\$2,527.50		\$0
Income Tax Before Credits		\$14,300		\$11,772.50
Child Tax Credit		\$2,000		\$2,000
Income Tax After Credits		\$12,300		\$9,772.50

Note: This assumes that the patch Congress eventually passes for 2007 is the same amount that it passed for 2006.

If Congress waits until 2008 or even too long into 2007, many in this scenario would file their tax returns under the current law (no patch) and pay \$12,300 when their true liability will end up being

about \$2,500 less than that (\$9,772.50). And depending on their employers' withholding schedule and how quickly the amended return is filed and processed, the taxpayer will end up loaning a large amount to the government for many months.

Other Tax Enforcement Problems for 2007

There were several other areas in which issues of tax complexity caused headaches for the IRS and tax filers this past spring. The TIGTA report highlighted a few areas in which taxpayers failed to minimize their tax liabilities or incorrectly filled out their tax forms due to the complexity in the law and enforcement. These include the Telephone Excise Tax Refund, the Katrina evacuee exemption provision, rules on retirement accounts, and further complexity surrounding education tax incentives.

The Telephone Excise Tax Refund

The Telephone Excise Tax Refund (TETR) was a one-time refund for federal excise taxes paid on long-distance calls made between February 28, 2003 and August 1, 2006. Anyone who paid for these services during that time was entitled to this refund in 2006, including those who were not required to file an income tax return. While the IRS estimated that between 145 million and 165 million individuals would be eligible to receive the TETR, for a total of \$8 billion in refunds, as of June 9 only 87.6 million people had claimed the refund, and the refunds issued totaled just \$3.8 billion. In fact, the IRS identified over 35 million eligible taxpayers who did not claim the refund.

In addition, some taxpayers were identified who were obviously incorrectly claiming the TETR or intentionally exploiting the refund. According to the TIGTA, for many of the most extreme cases, "the taxpayers' long-distance telephone bills would have to have amounted to more than 25 percent of the taxpayers' total annual incomes" to justify the refund amounts claimed. The IRS responded by establishing new compliance selection criteria and starting a weekly review process for incoming refund claims.

Katrina Exemption Foul-Up

As of June 1, the IRS had identified 4,062 taxpayers who had claimed an exemption for housing Hurricane Katrina victims two years in a row. The rules of the exemption state that a taxpayer can take the exemption only once for each displaced individual housed and apply it to either tax year 2005 or 2006. These improperly claimed exemptions led to an estimated \$457,275 in lost revenue.

Doubling Up on Education Credits

Finally, in addition to the problems that accompany the delayed extension of education tax incentives, confusion remains in the tax code concerning these incentives. Specifically, taxpayers continued to incorrectly claim a "dual benefit" by claiming both the tuition and fees deduction and the education credit, even though the two benefits cannot be claimed in the same year for the same person. This is the fifth year that this has been a problem even though efforts have been made to warn taxpayers not to claim both credits. For more on the complexity involved in the education credits and a proposed solution put forth in Congress, see "[Expand But Simplify? Education Credits Under Emanuel-Camp-Bayh](#)," *Tax Foundation Fiscal Fact* No. 100.

Notes

1. *The 2007 Tax Filing Season Was Generally Successful, and Most Returns Were Timely and Accurately Processed*, Treasury Inspector General for Tax Administration, September 21, 2007

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