



*The National Research Program Study of  
S Corporations Has Been Effectively  
Implemented, but Unnecessary Information  
Was Requested From Taxpayers*

**January 30, 2007**

**Reference Number: 2007-30-027**

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.

**Redaction Legend:**

- 1 = Tax Return/Return Information
- 2(b) = Law Enforcement Guideline(s)
- 2(c) = Law Enforcement Tolerance(s)
- 3(d) = Identifying Information - Other Identifying Information of an Individual or Individuals

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TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

January 30, 2007

**MEMORANDUM FOR** COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION  
DIRECTOR, OFFICE OF RESEARCH, ANALYSIS, AND  
STATISTICS

*Michael R. Phillips*

**FROM:** Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – The National Research Program Study of  
S Corporations Has Been Effectively Implemented, but Unnecessary  
Information Was Requested From Taxpayers (Audit # 200630019)

This report presents the results of our review of the Internal Revenue Service's (IRS) National Research Program (NRP). The overall objective of this review was to determine whether the IRS is effectively implementing the NRP Study of Subchapter S Corporation<sup>1</sup> Taxpayers (hereafter referred to as the NRP study of S Corporations or the NRP study).

*Impact on the Taxpayer*

The NRP study is updating compliance statistics associated with S Corporation tax returns, which numbered just over 3.6 million in 2005 and were the most common corporate entity, accounting for almost 60 percent of all corporate tax returns filed during the year. While the IRS is actively involved in managing and monitoring the current NRP study, some areas need improvement. This is important because the NRP study results will assist the IRS in selecting and examining S Corporation tax returns that have a greater risk of noncompliance; reducing the number of examinations of taxpayers who had correctly reported income and deduction items; and, ultimately, reducing taxpayer burden.

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<sup>1</sup> Businesses in which the income generated is generally not taxable to the business but is passed on to the shareholders to report on their individual tax returns.



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## Synopsis

NRP studies are used to measure the amount of noncompliance by taxpayers filing various types of tax returns and to update the selection process used to identify tax returns for examination. The last study of S Corporations involved tax returns that were filed over 20 years ago, so it is outdated.

The current NRP study of S Corporations is in process and was effectively planned to include oversight and feedback to ensure the study provides valuable data when completed. The NRP study is on target, with just over 17 percent of the examinations closed as of November 3, 2006. Revenue agents conducting the examinations received appropriate and timely training. A multi-layered quality review process is in place, and feedback is provided when appropriate to resolve any problems identified.

While the IRS is actively involved in managing and monitoring the NRP study, we noted some areas where there can be further improvement. Some NRP study results may not be complete, accurate, or provide information sufficient to update existing return selection formulas.

- The NRP study instructions contained criteria for line items on tax returns that are mandatory to select for examination. Eleven of 61 tax returns<sup>2</sup> we reviewed contained these line items, but the items were not identified for examination.
- The NRP study process includes capturing demographic information about each business examined. This information was available in 9 of the 62 cases we reviewed (the data were not always available because we were reviewing in-process cases). In two of the nine cases, some of this information was inaccurate.
- The Examination function relies in part on selection formulas to identify tax returns that have greater potential for tax adjustment. An independent review of this NRP study's sampling methodology and sample size<sup>3</sup> expressed concern that the sample size may not be large enough to update the current selection formulas and recommended that other techniques be explored to analyze the results.

The three concerns we noted could reduce the reliability of the NRP study results. However, the IRS is taking or is planning actions that reduce these risks. Final decisions on how to address these concerns cannot be made until more of the examinations are completed. As a result, we are not recommending any additional actions the IRS should take at this time to address the completeness or accuracy of the NRP study results. We will monitor the adequacy of the IRS' decisions and actions to address the concerns in future reviews.

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<sup>2</sup> See Appendix I for an explanation of the scope of the review.

<sup>3</sup> *An Evaluation of The Sample Design for The National Research Program Study of Subchapter S Corporations* (Mathematica Policy Research Inc., dated May 12, 2005).



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In addition, in 35 of the 62 cases, the initial Information Document Requests (IDR)<sup>4</sup> included unnecessary items or did not state clearly what was needed from the taxpayers. In all 35 cases, the revenue agents used the IDRs to request information that was already available in the case files or that could have been obtained through use of research tools readily available to the agents. In addition, in 10 of the 35 cases, the revenue agents did not state clearly what was needed on the IDR or did not specify the time period when requesting bank records. Taxpayer burden is increased when revenue agents request unnecessary information or are unclear about the information needed. We identified similar concerns in our review of the NRP study of individual taxpayers.<sup>5</sup> The IRS agreed with our recommendation in that review and has completed the corrective action. We believe additional action is needed since this concern could exist on all examinations, not just NRP study examinations.

### *Recommendation*

We recommended the Director, Examination, Small Business/Self-Employed Division, issue a reminder to all examiners that the IDRs should be specific and tailored to each examination.

### *Response*

The IRS agreed with our recommendation and will issue a reminder in the Technical Digest that the IDRs should be specific and tailored to the examination. Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the IRS managers affected by the report recommendation. 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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<sup>4</sup> IDRs are used by revenue agents to request that taxpayers provide information needed during examinations (e.g., receipts and other items to support entries on tax returns). Multiple items can be requested on each IDR.

<sup>5</sup> *Additional Efforts Could Further Improve the Execution of the National Research Program* (Reference Number 2004-30-044, dated January 2004).



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## *Abbreviations*

IDR	Information Document Request
IRS	Internal Revenue Service
LMSB	Large and Mid-Size Business
NRP	National Research Program
SB/SE	Small Business/Self-Employed



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## *Background*

For years, the Internal Revenue Service (IRS) gathered taxpayer compliance data through Taxpayer Compliance Measurement Program<sup>1</sup> examinations. However, many external stakeholders including Congress and taxpayer representative associations believed this Program placed too much burden on taxpayers. The last Taxpayer Compliance Measurement Program was conducted for individual taxpayers in 1988. In 2000, the IRS established the National Research Program (NRP) to resume gathering the data it needs to effectively measure noncompliance and support its strategic planning process. In addition to estimating the level of noncompliance, the IRS uses the results of NRP studies to update the selection formulas used to identify tax returns for examination.

In November 2003, the IRS was authorized to conduct a pilot to determine its ability to measure the compliance level of flowthrough tax returns: U.S. Return of Partnership Income (Form 1065) and U.S. Income Tax Return for an S Corporation (Form 1120S). These are business returns on which the income reported is generally not taxable to the business but is passed on to the partners or shareholders, respectively, to report on their individual tax returns. As a result of the pilot, the IRS decided to concentrate on S Corporations for the first NRP of flowthrough tax returns. The NRP Study of Subchapter S Corporation Taxpayers (hereafter referred to as the NRP study of S Corporations or the NRP study) was officially approved in April 2005. S Corporations had not been studied since completion of a Taxpayer Compliance Measurement Program review of Forms 1120S for Tax Year 1984.

Since 1984, there has been great growth in the number of S Corporations. In 2005, just over 3.6 million S Corporation tax returns were filed, accounting for almost 60 percent of all corporate tax returns filed. The current NRP study of S Corporations includes Forms 1120S for Tax Years 2003 and 2004. Returns for Tax Years 2003 and 2004 were identified and sent to the field by the end of October 2005 and by early May 2006, respectively. The IRS planned to have all returns assigned by June or July 2006 and all examinations completed by September 2008.

This review was performed in the Small Business/Self-Employed (SB/SE) Division offices located in Chicago, Illinois; Cleveland, Ohio; and Denver, Colorado, during the period May through October 2006. The audit 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.

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<sup>1</sup> The Taxpayer Compliance Measurement Program was the method used by the IRS prior to the National Research Program to gather information about national compliance trends through examinations of tax returns.



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## *Results of Review*

### **Overall, the National Research Program Study of S Corporations Was Managed and Monitored Effectively**

The NRP study of S Corporations was effectively planned to include oversight and feedback to ensure the study provides valuable data when completed. More specifically:

- The IRS applied lessons learned from the initial NRP study of U.S. Individual Income Tax Returns (Form 1040) and improved the process. Many team members responsible for the NRP study of S Corporations also worked on the NRP study of individuals. They built on that experience in planning and implementing the current NRP study. The managers we contacted believe the current NRP study is running more smoothly than the NRP study of individuals. The IRS received similar feedback during its focus group sessions with group managers and revenue agents.
- The NRP study appears to be on target at this point. As of November 3, 2006, most of the examinations have been started (about 99 percent) and just over 17 percent had been closed. See Appendix V for details about the number of S Corporations under examination and their status as of November 3, 2006. IRS personnel are closely monitoring the status of the examinations.
- Training records show that revenue agents assigned to the 62 cases (60 SB/SE Division and 2 Large and Mid-Size Business (LMSB) Division) in our review had appropriate training and/or experience prior to starting the examinations. All but two of the revenue agents had completed the NRP study training prior to starting the examinations. The two revenue agents completed the training shortly after starting the examinations. In addition, all 62 revenue agents examining the returns had experience examining corporate tax returns in the year prior to initiation of the NRP study of S Corporations.
- Once cases are assigned, the revenue agents are timely contacting the taxpayers and are monitoring dates established for taxpayer meetings and dates established for the taxpayers to provide needed information.
- A multilayered quality review process is in place. This includes reviews of in-process cases by the group managers and Area Office<sup>2</sup> review teams. Headquarters personnel conducted visitation reviews of each Area Office and reviewed a sample of closed cases

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<sup>2</sup> Area Offices are located throughout the United States; they serve as the coordination point for and assist the public with tax issues.





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during those reviews. In addition, group managers and the Area Office NRP study coordinators are responsible for reviewing cases as they are being closed. NRP study cases may also be included in the routine Examination function quality review process. The IRS has identified concerns with unnecessary information being requested on Information Document Requests (IDR),<sup>3</sup> insufficient depth in income probes, and inaccurate data capture during the in-process and Headquarters reviews. Feedback has been provided where needed, and corrective actions are being planned or taken on the problems identified.

While the IRS is actively involved in managing and monitoring the NRP study, we noted some areas where there is still room for improvement. Details on these areas are included below.

***Some Study Results May Not Be Complete, Accurate, or Provide Information Sufficient to Update Existing Return Selection Formulas***

Some line items on the tax returns that are considered mandatory examination issues may not be examined because they were not identified during classification,<sup>4</sup> and the database containing demographic information about the taxpayers may contain incorrect information. In addition, it is not yet known if the sample size will be sufficient to allow updating of the Examination function's return selection formulas.

Not examining the required examination issues and inaccurate data capture have the potential to reduce the reliability of the NRP study results. Incomplete and inaccurate results could also affect the data used to update return selection formulas. The inability to update return selection formulas could increase the chances of the IRS examining tax returns that do not exhibit a high degree of noncompliance. However, as we will explain in the following sections, there are factors that reduce the risk in each of the areas, including actions the IRS is taking or has planned.

***Mandatory examination issues were not always selected during classification***

Classifiers for the NRP study of S Corporation tax returns received special instructions for classification, including the selection of some return line items that were mandatory for examination. Some instructions stated to select the items if there was an entry on the line; others contained additional criteria that, if met, would require selection of the line item. In addition, the mandatory items were noted on the classification sheet to remind revenue agents to consider the criteria for those items.

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<sup>3</sup> IDRs are used by revenue agents to request that taxpayers provide information needed during examinations (e.g., receipts and other items to support entries on tax returns). Multiple items can be requested on each IDR.

<sup>4</sup> Classification is the process of reviewing tax returns for examination potential and determining which issues should be examined. Experienced examiners, referred to as classifiers, conduct classification of tax returns.



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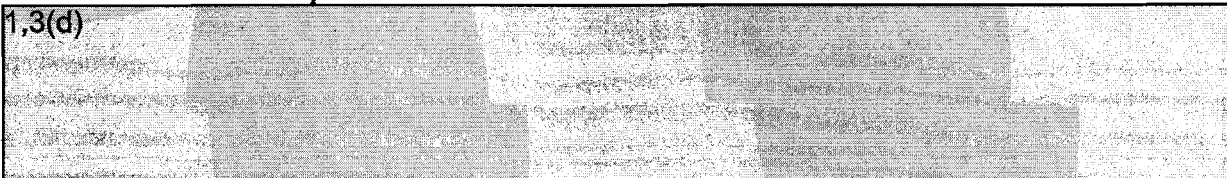
Eleven of the 61 tax returns<sup>5</sup> reviewed had 12 line items that were mandatory for examination, but the line items were not selected during classification. Five of the 11 returns were included in the classification quality review process, but the line items still were not identified for examination. However, in 3 of the 11 returns, the line items not selected were closely related to other line items that had been selected for examination. Since the examinations were still open at the time of our review, it was too early for us to determine whether the line items would be included in the examination of the other related line items. Including examination of these line items with the related line items would minimize any negative impact on the NRP study.

While the NRP study process and training included appropriate controls for the classification process, there is still the potential for human error. The chance for human error is increased when dealing with the volume of line items that were being classified on each of the NRP study S Corporation tax returns.

***Questionnaires were not always accurately completed***

When examinations are closed, information such as adjustments to tax are entered into Examination function automated systems. During the NRP study examination process, additional demographic information is being gathered about the taxpayer, such as information about the business and information for other types of tax returns the business is required to file. These data are being gathered through a questionnaire that is to be completed by the revenue agent before closing the examination.

Since our review included in-process (open) cases, the questionnaire had been completed in only 9 of the 62 cases. The questionnaires contained inaccurate information in two of the nine cases.



During the focus group sessions, some revenue agents commented they believed the questionnaires should have been discussed during the NRP study training. They were not sure how to interpret some of the questions.

NRP study procedures require that group managers review the questionnaires as they are reviewing the cases for closing. These reviews had not been completed on the two cases discussed above, so it is possible the data were or would be corrected after our review of the cases. This review process should minimize any negative impact on the NRP study.

<sup>5</sup> See Appendix I for an explanation of the scope of the review.



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***Program results may not provide sufficient information to update existing  
Examination function tax return selection formulas***

One underlying principle of the overall NRP study process design is to gather data to update the scoring system (formulas) used to identify and select tax returns for examination. These formulas are applied to tax returns to calculate a score based on the attributes of the tax returns. The theory is, 2(b),2(c)

Since the last study of S Corporations was conducted on Tax Year 1984 returns, the existing scoring formulas are outdated and may not be effective. As noted in a recent Treasury Inspector General for Tax Administration report,<sup>6</sup> the number of S Corporation examinations that result in no adjustments remains a concern. Conducting examinations on tax returns of taxpayers that are in compliance is not an effective use of IRS resources and creates undue burden on the taxpayers.

Prior to implementation of the NRP study of S Corporations, the IRS contracted for an independent review of the study's sampling methodology and sample size.<sup>7</sup> The contractor concluded, "In view of the constraints imposed by the combination of labor-intensive examinations and the limited resources available, on the one hand, and the limited information on the variability of the two key measures of compliance, on the other, we find that the proposed design addresses the study's needs about as well as possible." However, the contractor expressed concern that the sample size may not be large enough to update the current scoring formulas and recommended that other techniques be explored to analyze the results. The independent review noted a certain number of instances of noncompliance are necessary to be able to update existing formulas. It is too early in the NRP study to know the extent of noncompliance that will be identified by the study's examinations.

As the contractor noted, resource constraints were a major factor in the decision about the number of S Corporations that would be included in the NRP study. The IRS has a limited amount of revenue agent resources with recent training for conducting examinations of S Corporation tax returns. In addition, while the NRP study is ongoing, the IRS still has a need to dedicate revenue agent resources to maintain balanced coverage for examinations of other types of tax returns.

If the IRS determines that sufficient noncompliance exists to warrant updating the formulas, it is considering the following options:

<sup>6</sup> *Filing Characteristics and Examination Results for Partnerships and S Corporations* (Reference Number 2006-30-114, dated August 28, 2006).

<sup>7</sup> *An Evaluation of The Sample Design for The National Research Program Study of Subchapter S Corporations* (Mathematica Policy Research Inc., dated May 12, 2005).



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- Use the NRP study data to update the existing formulas.<sup>8</sup> This can occur only if a sufficient number of instances of noncompliance are identified in each of the existing S Corporation categories. As previously noted, this will not be known until later in the NRP study.
- Combine the existing formulas into one formula for all S Corporation tax returns. If the IRS combines all instances of noncompliance identified into one category rather than dividing them into multiple categories, it is more likely the number of instances of noncompliance will be sufficient to develop the new formula.
- Supplement the NRP study information with data from other routine examinations of S Corporation tax returns to update the existing formulas or develop a new formula. The IRS currently uses this method for updating formulas for tax returns of individuals.

However, even if the formulas are not updated because of the concerns discussed, the IRS believes the information developed during the current NRP study still can be used to improve the selection of S Corporation tax returns for examination. The IRS is considering the following options that could indicate noncompliance:

- Using the noncompliance information as the basis for queries of automated systems such as the Midwest Automated Compliance System<sup>9</sup> to identify tax returns with similar characteristics.
- Using the noncompliance information during the classification process to improve the identification of noncompliance on the part of S Corporations.

While some results from the NRP study of S Corporation may not be complete, accurate, or provide information sufficient to update existing return selection formulas, the IRS is taking or is planning actions to reduce the risks. Final decisions about how to address these concerns cannot be made until more of the examinations are completed. As a result, we are not recommending any additional actions the IRS should take at this time to address the completeness or accuracy of the NRP study results. We will monitor the adequacy of the IRS' decisions and actions to address these concerns in future reviews.

***Some Information Document Requests Included Unnecessary Items  
or Were Vague***

Examiners use IDRs to advise taxpayers of the items needed to complete the examination. While most items included on the IDRs were needed in the examination, some items listed on the initial

2(c)

<sup>9</sup> The Midwest Automated Compliance System is a computer system developed by the Examination function that contains tax return information.



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IDRs included information that was not necessary or did not state clearly what was needed from the taxpayers. Clear and concise information requests are critical to minimizing taxpayer burden and confusion and ensuring timely completion of the examinations.

We noted similar concerns with the IDRs during our review of the NRP study of individual taxpayers.<sup>10</sup> The IRS agreed with our recommendation in the prior report and incorporated information on the completion of the IDRs in the NRP study of S Corporations training. The training cautioned that revenue agents should be cognizant of the burden each IDR places on the taxpayer and/or representative. In addition, the Internal Revenue Manual requires that revenue agents customize the initial IDR to the case using information gathered from the taxpayer during the initial contact (e.g., the type of accounting system used and the types of records that are kept).

Even with the additional training for preparing the IDRs for the NRP study, in 35 of the 62 cases we reviewed, revenue agents requested unnecessary items from the taxpayer on the initial IDR.<sup>11</sup>

- In 29 cases, the revenue agents requested employment tax data that could have been researched via the Integrated Data Retrieval System.<sup>12</sup> The Integrated Data Retrieval System shows whether the taxpayer has filed each return and the total dollar amount for wages reported during the year. This can be used to determine if the taxpayer filed the required tax returns and verify the salary expense being claimed on the tax return under examination.
- In nine cases, the revenue agent requested a copy of the shareholder or S Corporation tax return from the taxpayer when the original return was in the case file. NRP study procedures provide for obtaining the original S Corporation return under examination and shareholder returns under certain circumstances as part of the case building process that is performed by the support function.

In 10 of the 35 cases, the revenue agents also could have been more specific in the initial IDRs to help the taxpayers understand what was being requested. In eight cases, the revenue agents requested bank statements but did not specify the time periods to be covered. In three cases, the revenue agents requested such things as “all bills” or “details” for the examination issues.<sup>13</sup> Taxpayers may not understand what is required of them when the IDRs are vague.

Some revenue agents routinely use various pro forma IDRs when working cases. These agents may not always take the time to ensure the IDRs are completely customized to the specific cases.

<sup>10</sup> *Additional Efforts Could Further Improve the Execution of the National Research Program* (Reference Number 2004-30-044, dated January 2004).

<sup>11</sup> Three cases contained both issues mentioned below.

<sup>12</sup> The Integrated Data Retrieval System is an IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

<sup>13</sup> [REDACTED]



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As previously noted, the NRP study reviewers also have been identifying problems with the IDRs during their in-process reviews and Headquarters visitations. They have used various methods to communicate the problems being noted to the NRP study staffs. However, we believe additional action is needed because this situation could exist on all examinations, not just NRP study examinations.

### ***Recommendation***

**Recommendation 1:** The Director, Examination, SB/SE Division, should issue a reminder to all examiners, not just NRP study examiners, that IDRs should be specific and tailored to each examination and that examiners need to consider taxpayer burden in preparing the IDRs.

**Management's Response:** The IRS agreed with the recommendation. The Director, Examination, SB/SE Division, will issue a reminder in the Technical Digest to all examiners that IDRs should be specific and tailored to the examination and that examiners need to consider taxpayer burden in preparing IDRs.



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**Appendix I**

***Detailed Objective, Scope, and Methodology***

The overall objective of this review was to determine whether the IRS is effectively implementing the NRP Study of Subchapter S Corporation<sup>1</sup> Taxpayers (hereafter referred to as the NRP study of S Corporations or the NRP study). This NRP study should provide updated information about tax compliance of S Corporations, and the data should be used to improve the selection of those tax returns for examination.

Our case review consisted of 60 SB/SE Division cases from the Central, Midwest, and Western Area Offices<sup>2</sup> and 2 LMSB Division cases assigned to groups in the   metropolitan area that had been identified through judgmental selection by IRS operations personnel. We reviewed the same cases being quality reviewed by IRS operations personnel in the Area Offices we visited. We agreed to use the same cases to minimize the number of in-process cases that had to be taken offline. IRS operations personnel had selected the cases based on the amount of time applied to the cases to identify cases that would have had significant examination work completed. In addition, they selected a wide dispersion of cases throughout the geographical area. However, the information to complete our reviews was not always available in every case file. The scope for the case review tests was 62 unless otherwise noted. To accomplish our objective, we:

- I. Determined whether the resources of the selected field offices were effectively organized to meet the goals of the NRP study of S Corporations.
  - A. Reviewed Audit Information Management System<sup>3</sup> monitoring reports to determine whether NRP study examinations were being timely assigned.
  - B. Evaluated NRP study inventory allocation among offices and available staffing.
  - C. Interviewed responsible managers to determine whether NRP study goals were attainable.
  - D. Analyzed the type of case assignments made prior to the NRP study for revenue agents assigned to the 62 cases included in our review to determine their existing skill

<sup>1</sup> Business returns in which the income generated is generally not taxable to the business but is passed on to the shareholders to report on their individual tax returns.

<sup>2</sup> Area Offices are located throughout the United States; they serve as the coordination point for and assist the public with tax issues.

<sup>3</sup> The Audit Information Management System is a computer system designed to give the Examination function information about tax returns in inventory and closed.



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- sets and reviewed class rosters to determine whether the revenue agents had completed the NRP study training.
- II. Determined whether field-level controls were effective to ensure the NRP study for S Corporations examinations were timely completed and yielded reliable data.
- A. Reviewed minutes from focus group sessions with group managers and revenue agents to identify field-level concerns regarding the NRP study process.
  - B. Reviewed the report prepared by the independent reviewer<sup>4</sup> of the sampling process and discussed resolution of the concerns or problems identified with NRP study management.
  - C. Reviewed training modules and instructions provided to NRP study revenue agents.
  - D. Reviewed documentation of the classification quality reviews.
  - E. Reviewed a sample of 62 open NRP study cases in the selected geographical areas to determine whether:
    - a. All necessary case-building materials were included in the examination case file (61 cases).
    - b. Revenue agents were addressing all classified items (61 cases).
    - c. Internal sources of information were used wherever possible to minimize information requests to taxpayers.
    - d. Related returns were secured as needed.
    - e. There were indications of reviews being conducted by group managers or other management officials.
    - f. Taxpayer contacts were initiated within 30 calendar days of assignment (60 cases).
    - g. Taxpayers were timely providing data requested and revenue agents were timely monitoring action dates.
- III. Evaluated the extent of all levels of IRS managerial supervision and involvement in the NRP study of S Corporations examination process.
- A. Reviewed the analysis of the flowthrough NRP study pilot to determine how concerns or problems identified were resolved for the full-scale study.

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<sup>4</sup> *An Evaluation of The Sample Design for The National Research Program Study of Subchapter S Corporations* (Mathematica Policy Research Inc., dated May 12, 2005).





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- B. Interviewed program and operational managers to determine the types of cooperation that existed within the IRS for coordinating the process and commitment to timely completion of the NRP study.
- C. Reviewed the procedures and outcomes of the various in-process and closed case reviews and visitations to determine the level of quality assurance being provided. This included reviewing how the results were shared with operating staff and the adequacy of corrective actions.
- D. Observed press coverage of the NRP study of S Corporations to determine whether there was negative reaction from external stakeholders.



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## **Appendix II**

### *Major Contributors to This Report*

Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs)  
Parker F. Pearson, Director  
Amy L. Coleman, Audit Manager  
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Janis Zuika, Senior Auditor  
Phyllis E. Heald, Auditor  
Chanda L. Stratton, Auditor



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## **Appendix III**

### *Report Distribution List*

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Services and Enforcement SE  
Commissioner, Large and Mid-Size Business Division SE:LM  
Deputy Commissioner, Large and Mid-Size Business Division SE:LM  
Deputy Commissioner, Small Business/Self-Employed Division SE:S  
Project Director, National Research Program RAS:NRP  
Director, Examination, Small Business/Self-Employed Division SE:S:E  
Director, Examination Planning and Delivery, Small Business/Self-Employed Division  
SE:S:E:EPD  
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 Liaisons:  
    Commissioner, Large and Mid-Size Business Division SE:LM  
    Commissioner, Small Business/Self-Employed Division SE:S



***The National Research Program Study of S Corporations Has  
Been Effectively Implemented, but Unnecessary Information Was  
Requested From Taxpayers***

**Appendix IV**

***Outcome Measure***

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

***Type and Value of Outcome Measure:***

- Taxpayer Burden – Potential; 35 taxpayers on whose initial IDRs<sup>1</sup> the revenue agents requested unnecessary information or used vague language (see page 6).

***Methodology Used to Measure the Reported Benefit:***

We reviewed 62 in-process cases being worked as part of the NRP Study of Subchapter S Corporation<sup>2</sup> Taxpayers. The cases had been selected by the IRS for its quality review process. The IRS selected a judgmental sample of in-process cases, including those assigned to a wide range of Examination function groups and revenue agents. The IRS was conducting these reviews for the entire country. However, we reviewed only the 60 SB/SE Division cases from the Central, Midwest, and Western Area Offices<sup>3</sup> and the 2 LMSB Division cases assigned to groups in the [redacted] metropolitan area.

<sup>1</sup> IDRs are used by revenue agents to request that taxpayers provide information needed during examinations (e.g., receipts and other items to support entries on tax returns). Multiple items can be requested on each IDR.

<sup>2</sup> Business returns in which the income generated is generally not taxable to the business but is passed on to the shareholders to report on their individual tax returns.

<sup>3</sup> Area Offices are located throughout the United States; they serve as the coordination point for and assist the public with tax issues.



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Appendix V

**Current Status of S Corporation Tax Returns  
Included in the National Research Program**

	Cases Not Started	Cases Started	Cases Being Closed	Cases Closed	Totals
1st Year 2003	2	400	269	527	1,198
1st Year 2004	70	2,920	415	333	3,738
<b>Total</b>	<b>72</b>	<b>3,320</b>	<b>684</b>	<b>860</b>	<b>4,936</b>
<b>SPIF Areas</b>					
North Atlantic	1				702
Central					755
South Atlantic					904
Midwest					834
Great Plains					563
Mountain					490
California					408
<b>SPIF Total</b>	<b>59</b>	<b>3,110</b>	<b>658</b>	<b>829</b>	<b>4,656</b>
<b>EMAF Total</b>	<b>13</b>	<b>210</b>	<b>26</b>	<b>31</b>	<b>280</b>
<b>Total</b>	<b>72</b>	<b>3,320</b>	<b>684</b>	<b>860</b>	<b>4,936</b>

Source: Treasury Inspector General for Tax Administration analysis of the NRP study Audit Information Management System<sup>1</sup> Status Reports as of November 3, 2006.

**Legend:**

- Cases Not Started – Cases in a status code<sup>2</sup> below 12.
- Cases Started – Cases in Status Code 12.
- Cases Being Closed – Cases in a status code above 12 and below 90.
- Cases Closed – Cases in Status Code 90.

<sup>1</sup> The Audit Information Management System is a computer system designed to give the Examination function information about tax returns in inventory and closed.

<sup>2</sup> A code used in Examination function databases indicating the status of an examination.



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**Appendix VI**

*Management's Response to the Draft Report*




COMMISSIONER  
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

RECEIVED  
JAN 12 2007

JAN 11 2007

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: The National Research Study of S Corporations Has Been  
Effectively Implemented, but Unnecessary Information Was  
Requested from Taxpayers (Audit #200630019)

We have reviewed your draft report on the implementation of the National Research Program (NRP) Study of S Corporations and agree with your audit recommendation. We appreciate your acknowledgement that the NRP study was effectively planned to include oversight and feedback ensuring it will provide valuable data when completed.

We incorporated lessons learned from the NRP Individual Reporting Compliance Study in the planning and implementation of the NRP Study of S Corporations. For example, experienced revenue agents received specialized training and we established a multi-layered quality review process.

Although Information Document Requests (IDRs) are used to request receipts and other documentation to support transactions required to be reported on a tax return, we will remind all examiners that IDRs should be specific and tailored to each examination. We will issue a reminder in an edition of the Technical Digest which is delivered to SB/SE Examination and Collection compliance personnel.

We also accept the non-monetary outcome measures cited in your report as part of your findings and agree the potential for taxpayer burden exists whenever information is requested from the taxpayer to verify, confirm, or reconcile information during an audit.

Our comments on your recommendation are attached. If you have questions or concerns, please contact SB/SE Examination Director, Steve Burgess at (904) 665-0503.

Attachment



*The National Research Program Study of S Corporations Has  
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2

Attachment

**Recommendation 1:**

The Director, Examination, SB/SE Division, should issue a reminder to all examiners, not just NRP study examiners, that IDRs should be specific and tailored to each examination and that examiners need to consider taxpayer burden in preparing IDRs.

**Corrective Action:**

We agree with this recommendation. The Director, Examination, Small Business/Self-Employed Division will issue a reminder in the Technical Digest to all examiners that IDRs should be specific and tailored to the examination and that examiners need to consider taxpayer burden in preparing IDRs.

**Implementation Date:**

July 15, 2007

**Responsible Official:**

Director, Examination, Small Business/Self-Employed Division

**Corrective Action Monitoring Plan:**

The Director, Examination, will advise the Commissioner, Small Business/Self-Employed Division of any delays.