



*Actions Are Needed to Control Risks With
International Transactions Reported on
Corporate Income Tax Returns*

May 30, 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.

Redaction Legend:

1 = Tax Return/Return Information



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 30, 2008

MEMORANDUM FOR COMMISSIONER, LARGE AND MID-SIZE BUSINESS DIVISION
COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Actions Are Needed to Control Risks With
International Transactions Reported on Corporate Income Tax Returns
(Audit # 200730IE028)

This report presents the results of our review of examination referrals to international specialists (specialists). The overall objective of this review was to assess the timeliness of requesting and delivering the assistance of specialists in corporate examinations that have international features. We conducted this review as part of our planned Fiscal Year 2008 audit coverage.

Impact on the Taxpayer

Promoting voluntary tax compliance fairly and equitably is of paramount importance to the IRS. However, some in the taxpaying public could perceive inequities in the processes used to select and examine corporate tax returns because smaller corporations reporting international transactions are far less likely to be scrutinized than larger ones, even when the same types of transactions and similar dollar amounts are involved.

Synopsis

The compliance risk associated with international transactions continues to grow and to present tax administration challenges as companies both small and large expand operations across international boundaries. The tax issues associated with the expansion involve significant potential tax revenues and involve complex arrangements between related companies operating in a multinational environment. Because of these and other challenges, the IRS has specifically trained specialists to evaluate the risks posed and, if necessary, examine the tax issues to ensure that companies operating in a multinational environment are reporting and paying the proper amount of taxes.



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Specialists generally do not have overall responsibility for the examination of a tax return. Therefore, examiners throughout the IRS have traditionally been required to manually request their assistance through the Specialist Referral System (SRS) when assigned to examine a tax return with international features. In Fiscal Years 2002 through 2006, IRS statistics show that specialists nationwide spent about 1.2 million hours on corporate examinations and recommended approximately \$8.7 billion in adjustments to the taxable incomes and credits reported on corporate income tax returns. This represents nearly one-third of the estimated \$27.5 billion in total recommended adjustments from these corporate examinations. The seemingly high return from the specialists' efforts did not come at the expense of increasing cycle time,¹ which indicates that their assistance is generally requested and delivered in a timely manner.

To ensure that specialists are involved in evaluating the risk with international transactions reported on corporate tax returns, the Large and Mid-Size Business (LMSB) Division uses an array of procedures and practices (management controls). For example, the Division enhanced its referral capabilities by linking its Workload Identification System² with the SRS, so that beginning in Fiscal Year 2005 many corporate tax returns with international tax transactions were automatically delivered to examiners and specialists electronically through the IRS Intranet. Despite this automated feature, the enhancement is leaving a gap between the number of referrals made to specialists and the number that should be made according to IRS procedures. Also, a majority of tax returns not referred involved examinations that were started in one tax year and expanded to other years when corporate tax returns were ordered by and forwarded to examiners.

In contrast to the control processes in the LMSB Division, those in the Small Business/Self-Employed (SB/SE) Division primarily rely on first-line managers to ensure that the examiners they supervise manually request the assistance of specialists through the SRS. These managers can also have broad spans of control and many other administrative demands on their time. As a result, a significant number of high-risk international tax issues that should be scrutinized for examination are missed. We reconciled to the SRS the corporate tax returns containing transfer-pricing transactions and/or foreign tax credits exceeding \$25,000 that were listed in the SB/SE Division closed examination files for the period October 2005 through December 2006. While the SB/SE Division closed just 157 corporate tax returns with these international features during the period, the assistance of a specialist was not requested in 143 of the tax returns (91 percent) as required.

On a larger scale, the limited number of corporate tax returns reporting foreign tax credits and/or transfer-pricing transactions found in the SB/SE Division closed examination files raises questions about how well the Division identifies and selects for examination corporate tax returns with international features. IRS statistics show that the SB/SE Division annually receives

¹ The IRS defines cycle time as the number of days that elapse between the dates tax returns are filed and examinations are completed.

² This application is primarily used by analysts to identify and send returns to first-line managers.



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almost twice as many corporate tax returns reporting international transactions as the LMSB Division. However, the corporate tax returns received by the SB/SE Division are far less likely to be examined, even when significant dollars are involved in the transactions. A high-ranking SB/SE Division official advised us that plans are underway to improve the way in which corporate returns with international features are identified and selected for examination. Until these changes have taken place, the IRS risks missing a significant number of high-risk international tax issues that should be examined.

Recommendations

We recommended that the Deputy Commissioner, International, LMSB Division,

1) re-emphasize to Examination function personnel the situations that require use of the SRS to manually request the involvement of a specialist and 2) initiate an evaluation to help identify and document the full range of challenges the LMSB Division faces with automating the specialist referral process. We also recommended that the Director, Examination, SB/SE Division, 1) develop and implement a process to provide better assurance that mandatory referrals are being made by examiners, 2) expand the Embedded Quality Review System and/or the National Quality Review System to include evaluating how well the requirements for requesting specialist assistance are met, 3) ensure that examiners are knowledgeable of and use the transfer-pricing compliance process, and 4) implement plans to use specialists in screening corporate tax returns with international features for examination.

Response

In their response to the report, IRS officials agreed with our recommendations and outlined numerous corrective actions to address them. The Deputy Commissioner, International, will provide all LMSB Division personnel with additional guidance that stresses the requirement of making international referrals early in the examination process and re-emphasizes the need to make a manual referral when prior or subsequent year returns are added to the examination process. The Deputy Commissioner, International, will also complete an evaluation of the automated referral process to identify and recommend solutions to ensure that international examiners are involved in examinations with international features.

In the SB/SE Division, the Director, Examination will ensure, among other things, that the Embedded Quality Review System Job Aids are updated to provide additional guidance on requesting the assistance of a specialist. The Director will also publish materials and provide training to enhance awareness of international issues. Finally, the Director will develop and implement procedures to include international specialists in the SB/SE Division's process for screening corporate tax returns for examination. Management's complete response to the draft report is included as Appendix V.



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



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Abbreviations

IRS	Internal Revenue Service
LIN	Large and Mid-Size Business Image Network
LMSB	Large and Mid-Size Business
LWIS	Large and Mid-Size Business Workload Identification System
SB/SE	Small Business/Self-Employed
SRS	Specialist Referral System



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Background

The compliance risk associated with international tax transactions continues to grow and to present tax administration challenges as both small and large companies expand operations across international boundaries and engage in cross-border transactions. As described in a 2006 Internal Revenue Service (IRS) announcement,¹ reproduced in part below, the related international tax issues² associated with the expansion involve significant potential tax revenues and involve complex arrangements between related companies operating in a multinational environment.

The Internal Revenue Service announced today that it has successfully resolved a transfer pricing dispute with Glaxo SmithKline (Americas) Inc. & Subsidiaries (GSK). This case, which is pending in the United States Tax Court, represents the largest tax dispute in the history of the Internal Revenue Service. Under the settlement agreement, GSK will pay the Internal Revenue Service approximately \$3.4 billion, and will abandon its claim seeking a refund of \$1.8 billion in overpaid income taxes, as part of an agreement to resolve the parties[sic] long-running transfer pricing dispute for the tax years 1989 through 2005.

The agreement between GSK and the IRS brings to a conclusion a dispute dating back to the 1980s and involves adjustments to GSK's tax years from 1989 through 2000. The Tax Court case concerns "transfer pricing," an accounting method requiring that related parties engage in transactions at arm's length to ensure the proper reporting of taxable income. GSK and the IRS have also reached agreement for tax years 2001 through 2005 with respect to the transfer pricing issues arising in those years.

The Tax Court dispute for years 1989-2000 involves intercompany transactions between GSK and certain of its foreign affiliates relating to various GSK "heritage" pharmaceutical products. Specifically at issue is the level of U.S. [United States] profits reported by GSK after making intercompany payments that took into account product intangibles developed by and trademarks owned by its U.K. [United Kingdom] parent, and other activities outside the U.S., and the value of GSK's marketing and other contributions in the U.S. Under the settlement agreement, GSK has conceded over 60% of the total amount put in issue by the two parties for the years pending in Tax Court.

To address the challenges posed by international taxation, the IRS uses a variety of approaches to identify and resolve tax issues as early as possible. Companies, for example, can work with the IRS in processes designed to resolve potential areas of disagreement before filing their tax

¹ IR-2006-142, September 11, 2006.

² Tax issues are potential areas of controversy because, from the IRS' perspective, they could represent noncompliance.



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returns. One such process that we have previously reported³ on is the Pre-Filing Agreement program. Unlike a regular examination, during which issues are often resolved long after the tax return has been filed, the objective of the Pre-Filing Agreement program is to resolve a potentially contentious tax issue before the tax return is filed. The Advanced Pricing Agreement program is another process that can be used in the pre-filing environment to avoid multimillion dollar transfer-pricing disputes, such as the one initially discussed in this report. Under the Advanced Pricing Agreement program, the IRS and participating companies agree on the methods to determine the prices that related businesses charge each other when transferring goods and services. To monitor compliance with the terms of the agreement, participating companies submit annual reports to the IRS.

In the post-filing environment, where a significant number of high-risk international tax issues are identified during the examination process, international specialists (specialists) are responsible for evaluating the risk posed by the issues and, if necessary, examining them to help ensure that companies operating in a multinational environment are reporting and paying the proper amounts of taxes. Specialists are generally selected from the ranks of experienced IRS examiners and specifically trained to take on the complexities of the international tax laws. Organizationally, the approximately 417 specialists are assigned to the Large and Mid-Size Business (LMSB) Division, even though the majority of corporate tax returns with international features are filed with the Small Business/Self-Employed (SB/SE) Division.⁴

Specialists generally do not have overall responsibility for the examination of a tax return. Therefore, examiners throughout the IRS are required to request their assistance when assigned to examine a tax return with international features. To make requests for assistance faster and less cumbersome, the IRS replaced a paper process with the Specialist Referral System (SRS) in 2002. The SRS allows examiners to request a specialist's assistance online. It also provides management with a tool for easily monitoring the timeliness of service requests.

This review was performed in the LMSB and SB/SE Divisions, respectively headquartered in Washington, D.C., and New Carrollton, Maryland, during the period March through August 2007. 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 objectives. We believe that the evidence obtained provides a reasonable basis for our finding 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.

³ *The Pre-Filing Agreement Program for Large Businesses Has Yielded Modest Results* (Reference Number 2005-30-151, dated September 2005).

⁴ The LMSB Division serves corporations with \$10 million or more in assets, and the SB/SE Division serves all other corporations.



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Results of Review

The contributions that specialists make to the IRS’ compliance efforts are substantial and expected to increase. In Fiscal Years 2002 through 2006, IRS statistics show that specialists nationwide spent about 1.2 million hours on corporate examinations and recommended approximately \$8.7 billion in adjustments to the taxable incomes and credits reported on corporate income tax returns. This represents about 32 percent of the estimated \$27.5 billion in total recommended adjustments from corporate examinations during these years. It also indicates that for each hour spent on a corporate examination, a specialist recommended about \$7,275 in adjustments. Comparatively, examiners in both the LMSB and SB/SE Divisions recommended about \$5,233 for each hour spent on a corporate examination during this 5-year period.

As reflected in Figure 1, the seemingly high return from the specialists’ efforts did not come at the expense of increasing cycle time,⁵ providing evidence that their assistance is generally requested and delivered in a timely manner. This is important because IRS executives, as well as other stakeholders, have focused considerable attention on the need to reduce the time, costs, and burdens associated with lengthy cycle times.

Figure 1: Cycle Time of Corporate Examinations in Fiscal Years 2002 Through 2006

Average elapsed days from the date the corporate tax return was filed until the examination was completed					
Specialist assistance requested and delivered	Fiscal Year 2002	Fiscal Year 2003	Fiscal Year 2004	Fiscal Year 2005	Fiscal Year 2006
No	1,235	1,431	1,281	1,269	1,031
Yes	1,211	1,336	1,148	1,027	934
Difference	24	95	133	242	97

Source: Our analysis of the IRS Audit Information Management System data.⁶

According to the new Service-wide Approach to International Tax Administration, specialists are expected to play an even bigger compliance role in the coming years, as the IRS has determined that businesses of all types and sizes are increasingly engaging in cross-border transactions as participants in the expanding global economy. To meet the challenges associated with the tax issues and business structures that are evolving with globalization, the IRS expects that the specialists will be a critically important component in its plans for expanding international

⁵ The IRS defines cycle time as the number of days that elapse between the dates tax returns are filed and examinations are completed.

⁶ The Audit Information Management System is used to monitor and report on tax returns in the examination stream.



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expertise organizationally, improving examination coverage, increasing specialization, and reducing the tax gap attributable to international transactions.

Despite the important contributions that specialists are making to tax administration, the IRS is missing opportunities to take greater advantage of their expertise in determining the scope and depth of corporate examinations with international features. The missed opportunities in the SB/SE Division are a particular concern because this Division serves the majority of corporations that report international transactions.

Additional Steps Are Needed to Ensure That Specialists Are Involved in Determining the Scope and Depth of Corporate Examinations With International Features

The Government Accountability Office *Standards for Internal Control in the Federal Government* provides an overall framework for control processes that, in short, require establishing procedures and practices that ensure actions are taken to curtail risks. We used these standards in assessing the degree to which LMSB Division and SB/SE Division procedures and practices provide reasonable assurances that international specialists have the opportunity to evaluate the international transactions reported on tax returns in the examination stream.

Specifically, we reconciled to the SRS the 1,987 corporate tax returns that reported transfer-pricing transactions and/or foreign tax credits exceeding a certain amount and were listed in LMSB Division closed examination files for the period October 2005 through December 2006. Although all the tax returns had been assigned to LMSB Division examiners and each required a referral to a specialist, our reconciliation showed that referrals were not made in 1,069 (54 percent) of the 1,987 tax returns.

To determine if a referral problem might exist in the SB/SE Division, we similarly reconciled to the SRS the corporate tax returns containing the same characteristics that were listed in its closed examination files for the same 15-month period. Our results showed that an even higher percentage of required referrals were not made to international specialists. While the SB/SE Division closed just 157 corporate tax returns with these international features during the period, 143 of these returns (91 percent) were not referred as required.

To provide assurances of the accuracy of the SRS, we reviewed the case files associated with a judgmental sample of 32 tax returns that were included in our analysis. In three instances, the SRS showed that a referral was not made, but documentation in the case file showed that the examiner included the issue in the scope of the examination after a telephone conversation with a specialist. Because none of the case files showed that the specialist actually reviewed the tax return and/or the corporate records as required by IRS guidelines, we concluded that the SRS accurately reflected that a referral was not made in these instances. We did not identify any cases for which a referral was reflected in the SRS but was not in the case files reviewed.



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Of course, absent an examination by a specialist, we have no way of determining whether any of the corporations that filed tax returns that were not referred avoided taxes that might have otherwise been owed. Overall, the 1,212 tax returns that were not referred to an international specialist (out of the 2,144 returns listed in the closed examination files for the period October 2005 through December 2006) reflected foreign tax credits and transfer-pricing transactions totaling more than \$72 billion. In addition, the LMSB Division control processes provide a greater level of assurance that specialists will have an opportunity to evaluate the compliance risk associated with international transactions reported on tax returns than those in the SB/SE Division.

An array of procedures and practices in the LMSB Division emphasize the importance of specialist involvement in corporate examinations with international features

Since the LMSB Division began operation in 2000, its control processes have emphasized the importance of specialist involvement in corporate examinations with international features. These controls include the Internal Revenue Manual,⁷ management directives, and the LMSB Division quality measurement standards. One management directive issued in 2003, for example, was part of a comprehensive transfer-pricing strategy coordinated with the Department of the Treasury Office of Tax Policy that instructed examiners to request the transfer-pricing practices from companies and to promptly refer the information to a specialist for evaluation of the risk associated with the practices. The importance of obtaining and evaluating the transfer-pricing practices from companies during examinations was subsequently expanded, elaborated on, and incorporated in the Internal Revenue Manual.

The LMSB Division Quality Measurement System staff evaluate several hundred examination cases each year and assess the degree to which examiners are complying with procedures for involving specialists in examinations with international features. A primary purpose of the evaluations review is to identify problem areas in the examination process so they can be elevated to management for corrective action. In recent years, the LMSB Division has moved away from a traditional, broad-based examination process to one that is focused on specific high-risk tax issues. To support its limited issue-focused examination process, the LMSB Division is using evolving technologies to develop and introduce new compliance tools, such as the LMSB Image Network (LIN) system.

Introduced in Fiscal Year 2004, the LIN system is designed to take advantage of the efficiencies offered by electronic filing by imaging paper returns filed with the LMSB Division and delivering them to examiners electronically through an IRS Intranet site hosted by the Statistics

⁷ The Internal Revenue Manual is an official compilation of procedures, instructions, and guidelines that govern the operational features of the IRS; it includes guidance that examiners are required to follow for requesting the assistance of specialists in examinations with international features.



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of Income Division.⁸ The LIN system provides an electronic image that is made available for assignment to LMSB Division examiners via the LMSB Workload Identification System (LWIS).⁹ In 2005, the LMSB Division enhanced its referral capabilities by linking the LWIS with the SRS, so that requests for assistance from specialists are automatically generated. Importantly, the enhancement is also intended to better ensure that specialists have the opportunity to be involved in determining the scope and depth of examinations with international features.

Despite the automated feature, the enhancement is leaving a large gap between the number of referrals made to specialists and the number that should be made according to IRS procedures. As summarized in Figure 2, we found that 257 (73 percent) of the 350 corporate tax returns in the population analyzed were not referred as required after the link between the LWIS system and the SRS was established.

Figure 2: Corporate Tax Returns With Transfer-Pricing Transactions and/or Foreign Tax Credits Exceeding \$25,000 in the LMSB Division October 2005 Through December 2006 Closed Examination Files

<i>Referrals in the population analyzed</i>	<i>Number</i>	<i>Percentage</i>
Returns assigned to examiners that required a referral to a specialist.	1,987	100%
Returns assigned to examiners and referred to a specialist as required.	918	46%
<i>Referrals before linking the LWIS system with the SRS</i>		
Returns assigned to examiners that required a referral to a specialist.	1,637	100%
Returns assigned to examiners and referred to a specialist as required.	825	50%
<i>Referrals after linking the LWIS system with the SRS</i>		
Returns assigned to examiners that required a referral to a specialist.	350	100%
Returns assigned to examiners and referred to a specialist as required.	93	27%
Returns assigned to examiners and <i>not</i> referred to a specialist as required.	257	73%

Source: Our analysis of the IRS Audit Information Management System, the LWIS system, and the SRS.

Our analysis showed that a substantial majority (179 of 257) of the tax returns that were not referred to a specialist involved examinations that were started in one tax year and expanded to other years when corporate tax returns were ordered by and forwarded to examiners. [REDACTED]

⁸ This Division is responsible for collecting, analyzing, and disseminating information on Federal taxation for the Department of the Treasury Office of Tax Analysis, Congressional Committees, the IRS in its administration of tax laws, other organizations engaged in economic and financial analysis, and the general public.

⁹ The LWIS application is primarily used by analysts to identify and send returns to first-line managers.



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To its credit, the LMSB Division recognized these and other shortcomings with the automated feature and has issued guidance to examiners. The guidance, among other things, instructs examiners to access the SRS online and to manually request the assistance of a specialist in certain situations, such as when expanding examinations with international features to other tax years.

Despite the guidance to examiners, there are other problems with the 257 tax returns that were not referred in the population we analyzed. Specifically, we found a code missing in IRS computer records that is used to identify tax returns with international features. This might have caused 26 of the 257 tax returns to not be referred as required. Finally, we were unable to determine why 50 other tax returns were not referred, even though they collectively reported transfer-pricing transactions and foreign tax credits totaling \$1 billion.

While these other problems might indicate deficiencies in the LWIS system, the SRS, or the link between the two systems, the work needed to make that determination was beyond the scope of our review. We believe, however, that it would be useful for the LMSB Division to incorporate our observations in an evaluation of the issue with the personnel who were involved in planning and implementing the automated feature. This kind of internal evaluation would be in line with the Government Performance and Results Act of 1993¹⁰ in terms of identifying improvement options and might help lay a stronger foundation to take full advantage of the efficiencies offered by electronic filing.

Corporations served by the SB/SE Division that are engaging in International transactions are far less likely to be examined than those served by the LMSB Division

In contrast to the control processes in the LMSB Division, those in the SB/SE Division provide less assurance that specialists will have an opportunity to evaluate the risk posed by international transactions reported on corporate tax returns. As a result, significant international tax issues that should be examined can be missed, and implementation of the Service-wide Approach to International Tax Administration could be undermined.

We found that neither the SB/SE Division Embedded Quality Review System¹¹ nor its National Quality Review System¹² specifically evaluate and report on the extent to which its examiners comply with requirements for involving specialists. In addition, examiners have not received written instructions on carrying out the transfer-pricing compliance process. The SB/SE

¹⁰ Pub. L. No. 103-62, 107 Stat. 285 (codified as amended in scattered sections of 5 U.S.C., 31 U.S.C., and 39 U.S.C.).

¹¹ The Embedded Quality Review System allows field managers to provide timely feedback to individual employees through performance case reviews.

¹² The National Quality Review System conducts closed case reviews and provides quality measurement results for the SB/SE Division.



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Division instead primarily relies on first-line managers to ensure that the examiners they supervise follow the requirements for involving specialists in examinations with international features. These managers can also have broad spans of control and many other administrative demands on their time.

Although the first-line managers we surveyed were aware of the requirement to request the assistance of a specialist, some did not always follow the requirement because they saw no potential issues worth examining. Other first-line managers stated that they did not want to involve an “outside” specialist due to concerns that the process could be time consuming and thereby delay closing the examination. Our analysis of IRS examination closed case data, however, indicates that there is little justification for this concern. As discussed earlier, corporate examinations with a specialist involved less cycle time than those without a specialist. In addition, examinations with the involvement of a specialist resulted in significantly greater recommended additional assessments than those with no specialist involvement.

In discussions about control processes, SB/SE Division officials noted that both the Embedded Quality Review System and the National Quality Review System capture information on the degree to which examiners are complying with procedures for involving all types of IRS specialists in examinations. They explained that, besides international specialists, there are situations in which examiners are required to request the assistance of other IRS examination specialists. These other specialists include, among others, economists, engineers, and computer audit specialists. The officials also noted that SB/SE Division controls include requiring examiners to complete an Administrative Lead Sheet¹³ to include in examination case files. The Administrative Lead Sheet is a checklist designed to solicit answers to important procedural and process questions, such as whether specialists were involved in examinations when required.

We agreed to re-examine the SB/SE Division quality review systems and to review the documentation on the Administrative Lead Sheet in our sample examination case files. As SB/SE Division officials indicated, we found that both the Embedded Quality Review System and the National Quality Review System have the capability to report on whether procedures for involving IRS specialists in general are followed in the examination process. However, neither System reports on the extent to which examiners comply with the specific requirement for involving international specialists. As a result, problems with involving international specialists in examinations could go undetected if the procedures for involving other specialists are followed. Further, the decision to evaluate whether examiners are following the procedures for involving international specialists in examinations is left to the discretion of the first-line manager performing the review under the Embedded Quality Review System.

¹³ See Appendix IV for a reproduction of the Administrative Lead Sheet that was available to examiners on the IRS Intranet in March 2008.



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The Lead Sheet solicited answers about whether requests for various specialists were made as required and contained references to specific Internal Revenue Manual sections where examiners could locate additional guidance for involving specialists in examinations.

Moreover, the Lead Sheet has yet to be updated with the current Internal Revenue Manual section¹⁴ on involving international specialists in examinations, which was changed in 2002, and does not require first-line managers to sign the Lead Sheet certifying that the actions were properly completed. As we have previously reported,¹⁵ manager certifications can be an important control component to hold personnel accountable for ensuring that required procedures are completed properly.

On a larger scale, the limited number of corporate tax returns reporting foreign tax credits and/or transfer-pricing transactions found in the SB/SE Division's closed examination files raises questions about how well the Division identifies and selects for examination corporate tax returns with international features. IRS statistics show that the SB/SE Division annually receives almost twice as many corporate tax returns reporting international transactions as the LMSB Division. However, as shown in Figure 3, the corporate tax returns received by the SB/SE Division are far less likely to be examined, even when significant dollars are involved in the transactions.

Figure 3: Examination Coverage for Corporations Reporting Transfer-Pricing Transactions on Tax Returns Filed in Processing Years 2003 Through 2004

Division	Transfer-Pricing Transactions of Less Than \$1 million		Transfer-Pricing Transactions of \$1 million or More	
	Returns received	Returns examined (√)	Returns received	Returns examined (√)
SB/SE	21,254	126 (1%)	10,233	106 (1%)
LMSB	3,306	436 (13%)	12,641	2,188 (17%)

(√) – These figures include examinations of corporate tax returns that were completed or in process as of November 30, 2007.

Source: Our analysis of the Business Returns Transaction File¹⁶ and the Audit Information Management System.

¹⁴ The section referenced on the Lead Sheet should be revised from an Internal Revenue Manual pertaining to classification of international feature returns to referral criteria and procedures.

¹⁵ *The Strategy to Re-emphasize Penalties in Corporate Examinations Could Be Enhanced* (Reference Number 2005-30-123, dated August 2005).

¹⁶ The Business Returns Transaction File contains information transcribed from tax returns filed by corporations, partnerships, and other business entities.



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Due to time constraints, we did not expand our work to include determining the various factors that might be contributing to the low number of examinations the SB/SE Division is conducting of corporate returns with international features. However, we did discuss the issue with a high-ranking SB/SE Division official who told us that plans are underway to improve the way in which corporate returns with international features are identified and selected for examination. The plans include using special audit codes to identify returns with specific international features and having specialists routinely participate in evaluating the compliance risk on the returns identified by the special audit codes before examinations are initiated. These plans, coupled with actions to strengthen the control processes, should increase the involvement of specialists in the examination process. However, until these plans are in place and the actions are completed, the IRS is at risk of missing significant international tax issues that should be examined.

Recommendations

Recommendation 1: The Deputy Commissioner, International, should re-emphasize to LMSB Division examination personnel the situations that require using the SRS to manually request the involvement of a specialist.

Management's Response: IRS management agreed with this recommendation. The Deputy Commissioner, International, will issue a memorandum to all LMSB Division personnel reminding them of the requirement to make an international referral early in the examination process. The memorandum will also remind examiners that a manual referral is necessary when prior or subsequent year returns that meet the mandatory referral criteria are added to the examination process.

Recommendation 2: The Deputy Commissioner, International, should initiate an evaluation to help identify and document the full range of challenges the LMSB Division faces with automating the specialist referral process. The evaluation should include the observations identified in this report and provide solutions to better ensure that specialists are involved in determining the scope and depth of examinations with international features.

Management's Response: IRS management agreed with this recommendation. The Deputy Commissioner, International, will complete an evaluation of the automated referral process to identify and recommend solutions to ensure that international examiners are involved in examinations with international features.

Recommendation 3: The Director, Examination, SB/SE Division, should develop and implement a process to provide better assurance that examiners are requesting the assistance of specialists. This could be accomplished by ensuring that the Administrative Lead Sheet refers examination personnel to the correct Internal Revenue Manual sections for guidance and requires first-line managers to certify that procedures were properly followed.

Management's Response: IRS management agreed with this recommendation. The Director, Examination, SB/SE Division, will ensure that the Administrative Lead Sheets



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reflect the appropriate Internal Revenue Manual sections for guidance and that first-line managers review the Lead Sheets for international procedures during their scheduled reviews of cases.

Recommendation 4: The Director, Examination, SB/SE Division, should coordinate with other decision makers in expanding the Embedded Quality Review System and/or the National Quality Review System to include evaluating how well the requirements for requesting specialist assistance are followed, so that problems can be identified, evaluated, and addressed.

Management's Response: IRS management agreed with this recommendation. The Director, Examination, SB/SE Division, will ensure that the Embedded Quality Review System Job Aids are updated to include additional guidance to determine if the appropriate steps were taken to request a specialist in cases selected for review.

Recommendation 5: The Director, Examination, SB/SE Division, should ensure that examiners are knowledgeable of and use the transfer-pricing compliance process.

Management's Response: IRS management agreed with this recommendation. The Director, Examination, SB/SE Division, will ensure that examiners' awareness of international issues is enhanced by 1) publishing an article concerning international referral criteria and procedures in the Technical Digest and 2) including a mandatory topic in the Fiscal Year 2009 Revenue Agents' Continuing Professional Education.

Recommendation 6: The Director, Examination, SB/SE Division, should follow through and implement plans to use specialists in the tax return screening process to increase the number of corporate tax returns with international features that are identified and selected for examination.

Management's Response: IRS management agreed with this recommendation. The Director, Examination, SB/SE Division, will coordinate with the Director, International Compliance, Strategy, and Policy, LMSB Division, to develop and implement procedures designed to include LMSB Division international specialists in the SB/SE Division corporate tax return classification process.



Actions Are Needed to Control Risks With International Transactions Reported on Corporate Income Tax Returns

Appendix I

Detailed Objective, Scope, and Methodology

Our objective was to assess the timeliness of requesting and delivering the assistance of international specialists (specialists) in corporate examinations that have international features. During the review, we relied on IRS databases. Although we did not conduct audit tests to determine the accuracy and completeness of the information in any of the databases, we checked the reliability of the information against source documents. Our checks are described below and did not identify any material errors in the information used from the databases. To meet our objective, we:

- I. Used the Government Accountability Office *Standards for Internal Control in the Federal Government* to assess the policies, procedures, and practices the IRS had established for ensuring that the assistance of specialists is requested and delivered in a timely manner.
- II. Used the IRS Audit Information Management System, Business Returns Transaction File, and Foreign Information System¹ in conjunction with the SRS² to evaluate statistics from corporate tax returns reporting transfer-pricing transactions and/or foreign tax credits.
- III. Reviewed a judgmental sample³ of 32 of the 2,144 corporate cases (1,987 LMSB Division returns and 157 SB/SE Division returns) containing transfer-pricing transactions and/or foreign tax credits that were closed by examiners between October 1, 2005, and December 31, 2006, to evaluate whether required procedures were followed and the information in IRS databases was reliable enough to meet our objective.
- IV. Identified challenges to ensuring that tax returns with international features selected for examination are screened for potential international tax issues by interviewing a judgmental sample of 47 of the 185 first-line managers who supervised examiners that had closed 1 or more corporate tax returns from the examination stream with transfer-pricing transactions and/or foreign tax credits greater than a certain amount.

¹ The Audit Information Management System is used to monitor and report on tax returns in the examination stream. The Business Returns Transaction File contains information transcribed from tax returns filed by corporations, partnerships, and other business entities. The Foreign Information System contains information transcribed from the Information Return of U.S. Persons With Respect to Certain Foreign Corporations (Form 5471) and Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Form 5472).

² The SRS allows examiners to request a specialist's assistance online. It also provides management with a tool for easily monitoring the timeliness of service requests.

³ Judgmental sampling techniques were used for all samples to conserve time and resources.



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Appendix II

Major Contributors to This Report

Margaret E. Begg, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)
Philip Shropshire, Director
Frank Dunleavy, Director
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Timothy Greiner, Lead Auditor
Earl Burney, Senior Auditor
Stanley Pinkston, Senior Auditor
Debra Mason, Auditor
Ali Vaezazizi, 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
Deputy Commissioner, Large and Mid-Size Business Division SE:LM
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, International SE:LM:IN
Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS
Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, Field Specialists SE:LM:FS
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



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Appendix IV

Examiner's Administrative Lead Sheet

Administrative Lead Sheet				
Overview of the Lead Sheet Workpaper System	Yes	No	N/A	Reference
Pre-Audit				
If applicable, follow TEFRA procedures (IRM 4.31.1.3)				
Is collectibility an issue? (IRM 4.10.2.4.3 & 4.20.2)				
Use "Revenue Agent Plan to Close" Check Sheet				110
Power of Attorney (POA) (IRM 21.3.7.2) – ATTACH COPY OF POA TO RETURN				
Determine if valid POA exists (CC CFINK)				
Enter required information on POA and date stamp				
Route or Fax POA to CAF Unit within 5 days				
Initial Taxpayer Contact (IRM 4.10.2.7 & IRM 4.10.2.8)				
Use Initial Taxpayer Contact Check Sheet				120
RRA 'Separate Notice Requirements (IRM 4.10.1.6.8)				
Unlocatable Taxpayer (IRM 4.10.2.7.2 & 4.10.2.8.6)				
Initial Appointment				
Use Initial Appointment Agenda				125-1
Issue Initial Appointment Agreement (Optional)				
Abusive Tax Avoidance Transactions (ATAT) (IRM 4.32)				
Probe for participation in Domestic and Offshore Abusive Tax Schemes and Listed Transactions				
Referrals (IRM 4.10.2.6.7) Use Specialist Referral System				
Employment Tax , Employee Plans (IRM 4.10.5.9(1))				
Engineers (IRM 4.3.16, Section 1.5), International (IRM 4.60.5)				
Excise Tax (IRM 4.10.5.8(3)), Economist (IRM 4.49.1)				
Computer Assisted Audit (IRM 4.47)				
Estate and Gift				
TEGE (IRM 4.32.2)				
Statute of Limitations (IRM 4.10.2.2.1)				
Statute Extension (IRM 25.6.22)				
Provide and discuss Publication 1035				



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Administrative Lead Sheet				
Overview of the Lead Sheet Workpaper System	Yes	No	N/A	Reference
Date stamp original and duplicate copy of extension forms				
Forward extension forms and case file to group manager				
Attach original extension form to tax return and return signed copy of consent to taxpayer with Letter-929				
Issue Resolution (IRM 4.10.7.5)				
Consider partial agreement for unagreed cases				
Corrected Reports (IRM 4.10.8.12)				
Special Reports and Forms (IRM 4.10.8.13)				
Researching Tax Law (IRM 4.10.7.2)				
Offer Fast Track Mediation for unagreed issues Pub 3605				
Offer Manager's Conference				
Provide to taxpayer/representative Pub 3498 with initial RAR or 30-Day letter (send to each spouse individually)				
Previously issued RAR's, UNSIGNED (IRM 4.10.8.11)				105-1.3
Payment (IRM 4.20.3 & 4.23.10)				
Solicit Payment (Full, Partial, Installment Agreement)				
Coordinate with Collection if applicable				
Additional Procedural Items				
Information Report (Form 5346; IRM 4.10.8.13)				
IRC 6404(g), Suspension of Interest				
Innocent Spouse Provisions (IRM 4.10.1.6.4)				
Third Party Contacts (IRM 4.10.1.6.12)				
Summons (IRM 25.5, Summons Handbook)				
Claims for Refund (IRM 4.10.8.8)				
Nonfilers (IRM 4.10.6.8.3 & 4.10.5.2.5)				
Whipsaw Issues (IRM 4.10.7.4.9)				
No-Change Report (IRM 4.10.8.2)				
Unagreed Reports, T-Letter, etc. (IRM 4.10.8.10)				
Rules of Practice Before the IRS (Circular 230)				
Referral to the Office of Professional Responsibility (IRM 20.1.6.2.1 & Form 8484, Report of Suspected Practitioner Misconduct)				
SBSE Lead Development Center – referral of Promoters and Preparers of Abusive Schemes (Requires manually prepared referral form IRM 4.32.2)				
Inadequate Records Notice (IRM 4.10.8.16)				



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Administrative Lead Sheet				
Overview of the Lead Sheet Workpaper System	Yes	No	N/A	Reference
Was return prepared for compensation? (If yes, complete remaining items)				
Identification penalties required?				
Did preparer negotiate refund?				
Did taxpayer receive a copy of return?				
LMSB/Office Tax Shelter Administration (IRM 4.32.2)				
Case File Assembly (IRM 4.10.9.6)				
Form 3198 (IRM 4.10.3.16.5)				
Form 5344 (IRM 4.10.8.16.1)				
Complete EOAD Data				
Move case to Fileserver				

*IRM = Internal Revenue Manual.
Source: IRS Intranet, March 2008.*



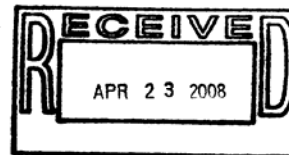
Actions Are Needed to Control Risks With International Transactions Reported on Corporate Income Tax Returns

Appendix V

Management's Response to the Draft Report



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



April 21, 2008

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Frank Y. Ng *Cheryl P. Clayton for*
Commissioner, Large and Mid-Size Business Division

SUBJECT: Draft Audit Report – Actions Are Needed to Control Risks with International Transactions Reported on Corporate Income Tax Returns (Audit # 2007301E028)

Thank you for sharing your draft report on the review of the timeliness of requesting international referrals for corporate returns with international features and delivering international specialists' assistance in evaluating the risk associated with these types of returns. I am pleased that your report findings show that specialists' assistance is generally requested and delivered timely during the examination process. I agree with all of your audit recommendations and plan to continue to improve the way in which we control the risks associated with international transactions reported on corporate returns. Our detailed action plan to address the audit recommendations is attached.

TIGTA conducted this review to assess the timeliness of requesting and delivering the assistance of international specialists in corporate examinations that have international features. With the new *Servicewide Approach to International Tax Administration*, the IRS is expected to improve international tax administration to deal more effectively with the increase of globalization of individual and business taxpayers. The Large and Mid-Size Business (LMSB) Division will accomplish this through cross-functional coordination with organizations such as the Small Business/Self-Employed (SB/SE) Division, the Criminal Investigation Division, and Chief Counsel (International) to address emerging international issues. Our priority is to improve voluntary compliance with international tax requirements and reduce the tax gap associated with international transactions. The new *Servicewide Approach to International Tax Administration* includes, among other components, plans to enhance enforcement of the tax laws. To properly identify, address, and pursue such emerging issues, we will strengthen reporting requirements; enhance IRS access to international data; ensure adherence to professional standards by tax professionals; and increase industry and global issue focus by aligning resources to examination cases and issues with the highest compliance risk.

As your report indicates, the IRS uses a variety of pre-filing and post-filing approaches to resolve tax issues posed by international taxation. In the post-filing environment,



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when tax returns with international features are identified and selected for evaluation and examination, we have trained international specialists who evaluate returns with international features to ensure that companies operating in a multinational environment are reporting and paying the proper amount of taxes. Usually, international feature returns involve significant tax revenues and complex business arrangements between related companies. Therefore, the contributions that the international specialists make to our international compliance efforts are significant, and their involvement in the examination process will continue to increase based on our focus on international tax administration.

If you have any questions on the attached detailed response outlining the corrective actions that the LMSB and SB/SE divisions will take to address the audit recommendations, please contact Barry Shott, Deputy Commissioner, International, at (202) 435-5001.

Attachment



Actions Are Needed to Control Risks With International Transactions Reported on Corporate Income Tax Returns

Attachment

RECOMMENDATION 1:

The Deputy Commissioner, International, should reemphasize to LMSB Division examination personnel the situations that require using the Specialist Referral System (SRS) to manually request the involvement of a specialist.

CORRECTIVE ACTIONS:

The Deputy Commissioner, International, will issue a memorandum to all LMSB personnel reminding them of the requirement to make an international referral early in the examination process. The guidelines published in IRM 4.60.6, International Referral Criteria and Procedures, will be stressed. The memorandum will also provide a reminder to examiners that a manual referral is necessary when prior or subsequent year returns that meet the mandatory referral criteria are added to the examination process.

IMPLEMENTATION DATE:

September 30, 2008

RESPONSIBLE OFFICIAL:

Deputy Commissioner, International (LMSB Division)

CORRECTIVE ACTION(S) MONITORING PLAN:

We will monitor both the number of international referrals on the SRS and the quality results issued by the LMSB Quality Measurement System to determine the effectiveness of this memorandum and whether further emphasis or education is needed.

RECOMMENDATION 2:

The Deputy Commissioner, International, should initiate an evaluation to help identify and document the full range of challenges the LMSB Division faces with automating the specialist referral process. The evaluation should include the observations identified in this report and provide solutions to better ensure that specialists are involved in determining the scope and depth of examinations with international features.

CORRECTIVE ACTIONS:



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The Deputy Commissioner, International, and the Director, Field Specialists, will complete an evaluation of the automated referral process to identify and recommend solutions to ensure international examiners are involved in determining the scope and depth of examinations with international features within the LMSB Division.

IMPLEMENTATION DATE:

June 30, 2009

RESPONSIBLE OFFICIAL:

Deputy Commissioner, International (LMSB Division)

CORRECTIVE ACTION(S) MONITORING PLAN:

Once we determine the full extent of the challenges with automating the specialist referral process, we will determine the corrective actions that are needed. Depending on what actions are needed, we will use our current management information systems such as the SRS and Issue Based Management Information System (IBMIS) to monitor the effectiveness of the corrective actions.

RECOMMENDATION 3:

The Director, Examination (SB/SE Division), should develop and implement a process to provide better assurance that examiners are requesting the assistance of specialists. This could be accomplished by ensuring that the Administrative Lead Sheet references examination personnel to the correct Internal Revenue Manual (IRM) sections for guidance and requires first-line managers to certify that procedures were properly followed.

CORRECTIVE ACTIONS:

The Director, Examination (SB/SE Division), will ensure the Administrative Lead Sheets reflect the appropriate IRM sections for guidance and that first-line managers include, as appropriate, a review of the Administrative Lead Sheets for international procedures during their scheduled review of cases.

IMPLEMENTATION DATE:

December 15, 2008

RESPONSIBLE OFFICIAL:

Director, Examination (SB/SE Division)

CORRECTIVE ACTION(S) MONITORING PLAN:



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The Director, Exam Policy and Technical Services (SB/SE Division), will monitor the status of this corrective action and advise the Director, Examination (SB/SE Division), of any delays in implementing the corrective actions.

RECOMMENDATION 4:

The Director, Examination (SB/SE Division), should coordinate with other decision makers in expanding the Embedded Quality Review System (EQRS) and/or the National Quality Review System (NQRS) to include evaluating how well the requirements for requesting specialist assistance are followed, so that problems can be identified, evaluated, and addressed.

CORRECTIVE ACTIONS:

The Director, Examination (SB/SE Division), will ensure the EQRS Job Aids are updated to include additional guidance to determine if the appropriate steps were taken to request a specialist in cases selected for review. We estimate there will be very few cases that will be selected for review within the NQRS. Based on the very limited number of sample cases, we do not believe that the job aids need to be updated to include additional guidance. Should the situation arise, we will address the specific situation to ensure the sample review contains the most updated guidance.

IMPLEMENTATION DATE:

December 15, 2008

RESPONSIBLE OFFICIAL:

Director, Examination (SB/SE Division)

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Exam Policy and Technical Services (SB/SE Division), will monitor the status and advise the Director, Examination (SB/SE Division), of any delays in implementing the corrective actions.

RECOMMENDATION 5:

The Director, Examination (SB/SE Division), should ensure that examiners are knowledgeable of and use the transfer-pricing compliance process.

CORRECTIVE ACTIONS:

The Director, Examination (SB/SE Division), will ensure that examiners' awareness of international issues is enhanced by publishing an article in the Technical Digest



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concerning international referral criteria and procedures and by including a mandatory topic in the fiscal year 2009 Revenue Agents' Continuing Professional Education (CPE).

SB/SE managers and examiners will receive additional training to recognize international and domestic transfer-pricing issues and make referrals to international specialists when appropriate.

IMPLEMENTATION DATE:

September 15, 2009

RESPONSIBLE OFFICIAL:

Director, Examination (SB/SE Division)

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Exam Policy and Technical Services (SB/SE Division), will monitor the status of the corrective actions and advise the Director, Examination (SB/SE Division), of any delays in implementing them.

RECOMMENDATION 6:

The Director, Examination (SB/SE Division), should follow through and implement plans to use specialists in the tax return screening process to increase the number of corporate tax returns with international features that are identified and selected for examination.

CORRECTIVE ACTIONS:

The Director, Exam Planning and Delivery (SB/SE Division), in coordination with the Director, International Compliance, Strategy, and Policy (LMSB Division), will develop and implement procedures designed to include LMSB international specialists in the SB/SE corporate tax return classification process. This will assist in ensuring that SB/SE corporations containing international features are appropriately identified and selected for examination.

IMPLEMENTATION DATE:

October 15, 2010

RESPONSIBLE OFFICIAL:

Director, Examination (SB/SE Division)

CORRECTIVE ACTION(S) MONITORING PLAN:



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The Director, Exam Planning and Delivery (SB/SE Division), will monitor the status and advise the Director, Examination (SB/SE Division), of any delays in implementing the corrective actions.