Improvements Are Needed for Processing Income Tax Returns of Controlled Corporate Groups

September 2004

Reference Number: 2004-30-170

INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 21, 2004

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Improvements Are Needed for Processing Income Tax Returns of Controlled Corporate Groups (Audit # 200330035)

This report presents the results of our review to evaluate the Internal Revenue Service's (IRS) effectiveness in processing the income tax returns of controlled corporate groups and to evaluate taxpayers' and tax preparers' understanding of the filing requirements for members of controlled corporate groups.

Corporations are classified as members of a controlled group if they are connected through certain stock ownership. All corporate members of a controlled group are treated as one single entity for tax purposes. However, each member of the group can file its own tax return rather than the group filing one consolidated return. The controlled group of corporations is subject to limitations on tax benefits to ensure the benefits of the group do not amount to more than those to which one single corporation would be entitled. A previous audit report[1] discussed how taxes on corporate tax returns for members of controlled corporate groups were not being correctly assessed because of inadequate processing controls and insufficient taxpayer information.

In summary, the IRS has developed a computer program to identify returns potentially liable for additional taxes and has established procedures for its employees to correspond with taxpayers for missing or insufficient information. These controls, if functioning properly, would improve the processing of tax returns for controlled corporate groups. However, additional improvements to processing controls and instructions to return preparers are needed.

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[1] *Review of the Service's Implementation of the Business Tax Provisions for the Omnibus Budget Reconciliation Act* (Reference Number 053612, dated March 1995).

From a statistical sample of tax returns filed for controlled corporate groups, we determined nearly 70 percent contained taxpayer or preparer errors, and 14 percent were processed incorrectly by IRS employees. We determined the IRS' criteria for identifying returns potentially liable for additional taxes was set too high. This allowed controlled corporate groups with individual taxable incomes below the level liable for additional taxes, but with combined taxable incomes above that level, to go undetected if they failed to pay the additional taxes. We also determined the IRS required some information from members of controlled corporate groups that was not necessary to process the tax returns or to determine the correct tax liabilities.

We recommended the Commissioners, Large and Mid-Size Business (LMSB) and Small Business/Self-Employed (SB/SE) Divisions, consider requiring a standard form for the apportionment plan[2] which will meet the needs of their compliance functions as well as the needs of their submission processing functions. The Director, Customer Account Services, SB/SE Division, should stress during training the importance of following existing processing instructions for tax returns of members of controlled corporate groups and should consider requesting revisions to computer programming to lower the threshold to systemically identify those returns warranting manual review and verification. Finally, the Division Counsels/Associate Chief Counsels (LMSB) and (Corporate) working with the Director, Tax Forms and Publications, Wage and Investment (W&I) Division, should evaluate the necessity for each item now required in the apportionment plan and determine whether items can be eliminated.

Management's Response: The Commissioner, SB/SE Division, agreed with our findings and is planning to implement several corrective actions and to complete an analysis of the feasibility of implementing the other recommendations. The Commissioner, SB/SE Division, stated that further review of our samples would be necessary before the IRS could comment on our estimate that the recommendations in this report will provide over $5.93 million annually in potential increased revenue and over $448,000 annually in taxpayer rights and entitlements.

Specifically, the LMSB Division will work with the Chief Counsel, the SB/SE Division Compliance function, and the W&I Division Tax Forms and Publications function to review Treasury Regulation 1.1561-3(b) and determine the feasibility of requiring a standard form to be filed annually for the apportionment plan. The Commissioner, SB/SE Division, noted that employee training material will be clearly stated and that analysts will participate in employee training to stress the importance of following the training instructions and manually verifying the tax when processing controlled corporate group returns. The Director, Customer Account Services, SB/SE Division, will conduct a study of controlled corporate groups to determine the feasibility of revising computer programming to systemically identify returns potentially liable for additional

[2] A controlled group of corporations filing separate returns is allowed only one set of graduated income tax brackets and respective tax rates. All members of the controlled corporate group must share the graduated tax bracket amounts equally unless all members elect otherwise. If the corporate members elect to apportion the graduated tax brackets unequally, all members must consent to an apportionment plan and attach a signed copy of the plan to their corporate tax returns.

tax. Results of the study will include a cost-benefit analysis to determine the feasibility of lowering the threshold. Finally, the Associate Chief Counsel (Corporate) will work with the LMSB Division, SB/SE Division Compliance function, and W&I Division Tax Forms and Publications function to determine information that is required with respect to controlled corporate group consents and apportionment plans in light of the apportionment information the IRS needs. Management's complete response to the draft report is included as Appendix V.

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 Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (215) 516-2341.

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Background

Corporations are classified as members of a controlled group if they are connected through certain stock ownership. A parent-subsidiary controlled group consists of one or more chains of corporations connected through stock ownership with a common parent corporation.[1] A brother-sister controlled group exists if five or fewer persons commonly own two or more corporations.

All corporate members of a controlled group are treated as one single entity for tax purposes (i.e., only one set of graduated income tax brackets and respective tax rates applies to the group's total taxable income). However, each member of the group can file its own tax return rather than the group filing one consolidated return. The controlled group of corporations is subject to limitations on tax benefits[2] to ensure the benefits of the group do not amount to more than those to which one single corporation would be entitled.

This review was performed during the period May 2003 through February 2004 through analysis and review of tax return information processed at the Ogden and Cincinnati Internal Revenue Service (IRS) Submission Processing Sites.[3] The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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[1] Specifically, Internal Revenue Code § 1563 (a) (1) (1994 & Supp. IV 1998) defines a parent-subsidiary controlled corporate group as 1 or more chains of corporations connected through stock ownership with a common parent where:

- The common parent owns stock having at least 80 percent of the total combined voting power of all classes of stock entitled to vote, or at least 80 percent of the total value of shares of all classes of stock, of at least 1 other corporation in the chain.
- At least 80 percent of the stock (combined voting power or value) of each corporation in the chain (other than the parent) is owned by 1 or more of the other corporations in the chain.

[2] These benefits include graduated tax rates, accumulated earnings credits, alternative minimum tax exemptions, etc.

[3] IRS Submission Processing sites are responsible for processing tax returns and payments and issuing refunds.

The Internal Revenue Service Established Procedures to Improve the Processing of Tax Returns for Controlled Corporate Groups

A previous audit report[4] discussed how taxes on corporate tax returns for members of controlled corporate groups were not being correctly assessed because of inadequate processing controls and insufficient taxpayer information. As a result of that report, the IRS developed a computer program to identify returns with taxable income over a certain dollar threshold for verification of certain items such as the calculation of tax, the applicability of any additional tax, and the presence of necessary schedules. The IRS also established processing procedures for employees to correspond with taxpayers for missing or insufficient information on these returns.

These controls, if all functioning properly, would improve the processing of tax returns for controlled corporate groups. However, additional improvements to processing controls and instructions to taxpayers and preparers are needed.

The Internal Revenue Service Needs to Ensure Processing Procedures Are Followed and Taxpayer Filing Errors Are Identified to Correctly Assess Tax

Corporations are normally taxed at graduated rates that range from 15 percent to 35 percent. The tax brackets increase at taxable incomes over $50,000, $75,000, and $10 million. Any income exceeding $10 million is taxed at the maximum rate of 35 percent.

In addition, corporations with taxable incomes in excess of $100,000 and $15 million are subject to an additional 5 percent tax, not to exceed $11,750, and an additional 3 percent tax, not to exceed $100,000, respectively (see Table 1).

A controlled group of corporations filing separate returns is allowed only one set of graduated income tax brackets and respective tax rates that is applied to the group's total taxable income. All members of the controlled corporate group must share the graduated tax bracket amounts equally unless all members elect otherwise. All members are also treated as one corporation for purposes of determining whether the additional taxes are applicable.

[4] *Review of the Service's Implementation of the Business Tax Provisions for the Omnibus Budget Reconciliation Act* (Reference Number 053612, dated March 1995).

Table 1: Corporate Tax Rate Schedule

Taxable Income	Tax Rate	Amount Subject to This Rate
$0 - $50,000	15%	$50,000
$50,001 - $75,000	25%	$25,000
$75,001 - $10,000,000	34%	$9,925,000
Over $10,000,000	35%	Unlimited
Additional Tax		
$100,001 - $335,000	5%	$235,000
$15,000,001 - $18,333,333	3%	$3,333,333

Source: Summarized from Instructions for U.S. Corporation Income Tax Returns (Forms 1120 and 1120-A).

Taxpayers indicate they are members of a controlled corporate group by marking a box on the tax computation schedule of the income tax return. If the corporate members elect to apportion the graduated tax brackets and/or additional tax amounts unequally, all members must consent to an apportionment plan and attach a signed copy of the plan to their corporate tax returns. The apportionment plan must be signed by an authorized person and include the name, address, Taxpayer Identification Number, tax year, amount apportioned, and IRS Submission Processing site at which the original apportionment plan is to be filed.[5]

IRS employees are responsible for placing the proper codes (controlled corporate group codes) on the returns and accurately entering them and any taxpayer amounts into the computer system when taxpayers have marked the box. The IRS uses the information indicated by the taxpayer to calculate and assess income tax.

Taxpayers do not always properly file income tax returns for all corporate members of the group

Using a computer program, we identified 36,354 Forms 1120 filed in Calendar Year 2002 with net

[5] Treas. Reg. § 1.1561-3(b) (revised as of April 1, 2003).

taxable income greater than $6,666[6] for which IRS records indicated the taxpayers filed as a member of a controlled corporate group. We reviewed a statistically valid sample of 73 of these returns and found nearly 70 percent had some taxpayer or preparer errors.

- Fifteen (20 percent) did not have an apportionment plan when it was required.
- Thirty-six (49 percent) contained inaccuracies because of errors in completing or apportioning the graduated tax bracket amounts, failing to determine the additional tax applicable to the controlled corporate group, or failing to provide all the information related to the apportionment plan.

A significant part of the IRS' mission is to help taxpayers understand and meet their tax responsibilities. The instructions provided by the IRS for filing tax returns for controlled corporate groups were unclear and may have contributed to taxpayers' errors. The instructions did not provide taxpayers with a clear explanation of a controlled corporate group or apportionment plan requirements but instead provided references to sections of the Internal Revenue Code. In addition, the IRS did not provide or require a standard tax form or schedule to document either a controlled corporate group's tax computation[7] or the apportionment of the graduated tax brackets among all members of a controlled corporate group.

Because of this, taxpayers did not prepare apportionment plans or used a wide variety of methods to document their tax calculations or apportionments. Their documentation often had incomplete information and contained errors. The taxpayers often failed to consider taxable income levels for all members of the group and overlooked the applicability of the additional taxes. Further, IRS regulations are

[6] Returns with this net taxable income have potential income taxes of $1,000 or more at a 15 percent tax rate.
[7] The IRS does provide a tax computation worksheet, but the worksheet is not attached to the tax return and may not be completed by the taxpayer.

ambiguous regarding whether a copy of the apportionment plan should be attached with the tax return each year.[8]

Without properly prepared tax apportionment schedules, the IRS cannot correctly identify all members of a controlled corporate group or their respective taxable income levels and apportioned tax bracket amounts and cannot verify each member's computed tax and additional tax. Processing of inaccurately prepared or incomplete returns can be delayed while IRS employees attempt to correct inaccuracies or obtain more information. If these returns are not corrected, the taxes paid by the corporations will not be correct. Eleven of the tax returns in our sample contained incorrect tax amounts. Based on the results of our sample, we estimate that controlled corporate groups inaccurately filed approximately 5,400 Tax Year 2002 tax returns, resulting in underpaid taxes of over $5.93 million and overpaid taxes of over $448,000.

IRS employees did not always properly process controlled corporate group income tax returns

Of the 73 tax returns included in our sample, 10 (14 percent) were incorrectly processed by the IRS.[9]

The IRS has established controls to systemically identify controlled corporate group returns that are potentially liable for additional tax amounts. The controls include the computerized identification of any return from a controlled corporate group with taxable income over a certain dollar threshold for manual verification of tax computations by IRS employees and the requirement for any controlled corporate group with unequal apportionment of the tax brackets to include an apportionment plan with its return.

All 10 of the returns processed incorrectly had taxable income of more than the threshold and were subject to verification by IRS employees. However, IRS employees

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[8] IRS regulations in one section tell taxpayers that an apportionment plan has a continuing effect and need not be renewed annually. However, in other sections, the regulations state that each component member of the group should attach a copy of its consent to its income tax return.
[9] Nine of these 10 returns were included in those with taxpayer errors discussed earlier.

did not take the appropriate action to process these 10 returns. In these instances, taxpayers made errors or did not include all required information on their tax computation schedules or apportionment plans; however, IRS employees did not correct the errors or contact the taxpayers for the missing information or plans.

Possible causes for the IRS employee errors include:

- Employees encounter tax returns from members of controlled corporate groups much less often than other tax returns and may not be as familiar with the processing procedures.
- Employees can easily bypass the processing controls requiring validation of information on returns meeting the threshold criteria by taking no action and simply placing the return back into the processing stream.

The threshold for manual verification of controlled corporate group returns allows errors to go undetected

The IRS' computer program to automatically identify a tax return that may be liable for additional taxes is set at the specific threshold at which the entire controlled corporate group becomes liable for the additional taxes.

Since information to tie all the members of a controlled corporate group together is not entered into IRS computers, the only way to determine whether the group is liable for the additional tax or has properly filed all schedules is through manual review of the tax computation and apportionment plan for the group. The additional tax applies when the total taxable income of all the corporations in the controlled corporate group together reaches the threshold amount. Therefore, setting the criteria for manual verification of tax computations at that specific level allows controlled corporate groups whose individual members have taxable income of less than the threshold amount, but the total group taxable income is more than that amount, to omit paying the additional tax without their errors being detected by the IRS.

For our population of 36,354 tax returns for controlled corporate groups, we determined that over 60 percent would not be identified by themselves (without adding the taxable income of other members) as potentially liable for additional tax amounts and, therefore, would not be systemically identified during processing.

In our sample of 73 returns, 6 (8 percent) had taxable income below the threshold amount that, when combined with the taxable income of other members of the group, exceeded the threshold. In two of these six cases, the controlled corporate group did not pay the additional tax.

Recommendations

1. The Commissioner, Large and Mid-Size Business (LMSB) Division, and the Commissioner, Small Business/Self-Employed (SB/SE) Division, should consider requiring a standard form for the apportionment plan which will meet the needs of their compliance functions as well as the needs of their submission processing functions. The Commissioners should coordinate with the Director, Tax Forms and Publications, Wage and Investment (W&I) Division, regarding the requirements of the form. In addition, they should consider changing instructions to require a copy of the apportionment plan form to be attached to the return each year. This form should include information required to process the return, including taxable income amounts and apportionment of additional 5 percent or 3 percent tax amounts for all members of the group.

Management's Response: The LMSB Division will work with the Chief Counsel, SB/SE Division Compliance function, and the W&I Division Tax Forms and Publications function to review Treasury Regulation 1.1561-3(b) and determine the feasibility of requiring a standard form to be filed annually for the apportionment plan, which will meet the needs of the IRS' compliance functions as well as the needs of its submission processing functions. Additionally, the Commissioners, LMSB and SB/SE Divisions, will coordinate the requirements of the proposed form and necessary revisions to Form 1120 instructions with the Chief Counsel and the Director, Tax Forms and Publications, W&I Division.

2. The Director, Customer Account Services, SB/SE Division, should stress during training the importance of following existing processing instructions for smaller volume business return programs. This training should emphasize processing procedures and instructions for controlled corporate group returns such as manual verification of tax (and corresponding with taxpayers when necessary) and the impact these actions have on the processing of returns.

Management's Response: Customer Account Services function analysts will coordinate with the course developers to ensure the relevant section in the training material is clearly stated prior to distribution to the field. In addition, the analysts will participate in employee training to stress the importance of following the training instructions and manually verifying the tax when processing controlled corporate groups. Internal Revenue Manual instructions will also be revised to simplify the steps in the manual verification process.

3. The Director, Customer Account Services, SB/SE Division, should consider requesting revisions to computer programming to lower the threshold to systemically identify returns potentially liable for additional taxes and to identify returns without properly filed apportionment plans.

Management's Response: The Director, Customer Account Services, SB/SE Division, will conduct a study of controlled corporate groups to determine the feasibility of revising computer programming to systemically identify returns potentially liable for additional tax. The study will thoroughly analyze a valid sample of returns with a controlled corporate group 1 edited on returns and filed during Tax Year 2005. Results of the study will include a cost-benefit analysis to determine the feasibility of lowering the threshold.

Taxpayer Burden Could Be Reduced by Requiring Less Information on Apportionment Plans

As discussed earlier, the apportionment plan for a controlled corporate group must be signed by an authorized person and include the name, address, Taxpayer Identification Number, tax year, amount apportioned, and IRS Submission Processing site at which the original apportionment plan is to be filed. Much of this information is available elsewhere on the tax return or is not needed to process the tax return.

It is important that tax returns contain all information necessary to complete proper processing. However, requiring unnecessary information results in additional taxpayer burden. The IRS Office of Taxpayer Burden Reduction has focused its efforts on reducing unnecessary taxpayer burden, including current requirements that taxpayers provide the same information more than one time, that taxpayers provide information not used by the IRS, or that taxpayers provide information which gives only minimal assistance in determining the accuracy of a return.

When determining what should be required on the apportionment plan, the IRS did not take into consideration the availability of the information already included with the return or limit the requested information to that which is needed to process the return or determine the correct tax liability.

Taxpayer burden is increased when taxpayers must provide information that is already available to the IRS elsewhere or that is not required for return processing.

Recommendation

4. The Division Counsel/Associate Chief Counsel (LMSB) and Associate Chief Counsel (Corporate), working with the Director, Tax Forms and Publications, W&I Division, should evaluate the necessity for each item now required in the apportionment plan and determine whether items can be eliminated. They should also provide input to the Commissioners, LMSB and SB/SE Divisions, regarding the recommendation to require a copy of the apportionment plan to be attached to the tax return of each member of the controlled corporate group each year.

Management's Response: The Associate Chief Counsel (Corporate) will work with the Director, Strategy, Research, and Program Planning, LMSB Division; the SB/SE Division Compliance function; and the W&I Division Tax Forms and Publications function to determine information that is required with respect to controlled corporate group member consents, and apportionment plans, in light of the apportionment information the IRS needs.

Appendix I

Detailed Objectives, Scope, and Methodology

Our overall objectives were to evaluate the Internal Revenue Service's (IRS) effectiveness in processing the income tax returns of controlled corporate groups[1] and to evaluate taxpayers' and tax preparers' understanding of the filing requirements for members of controlled corporate groups. To accomplish our objectives, we:

I. Determined whether the IRS had an effective process in place to identify, control, and correct processing problems related to income tax returns for controlled corporate groups.

   A. Identified and evaluated controls in place within the Processing Division of the IRS campuses.[2]

      1. Obtained and reviewed the Internal Revenue Manual (IRM) and local procedures used for identifying and processing controlled corporate group returns.

      2. Obtained and reviewed applicable letters, notices, error resolution error codes and explanations, and math error taxpayer notice codes related to issues for controlled corporate group returns.

      3. Determined whether explanations and wording in letters and notices clearly and accurately explained the error or issue to the taxpayer.

      4. Discussed with local employees, managers, and analysts within the various processing functions any concerns or problems they are experiencing with processing controlled corporate group returns.

      5. Evaluated IRM procedures, local procedures, and concerns or problems identified to determine whether they are effective to accurately identify and process controlled corporate group returns.

   B. Identified and evaluated controls in place nationally to identify, control, and correct processing-related issues and problems related to controlled corporate groups.

      1. Determined whether there were any national procedures, instructions, etc. (other than the IRM) used by the operating divisions to identify and process controlled corporate group returns.

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[1] Corporations are classified as members of a controlled group if they are connected through certain stock ownership. All corporate members of a controlled group are treated as one single entity for tax purposes. However, each member of the group can file its own tax return rather than the group filing one consolidated return.
[2] The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

2. Reviewed applicable web sites and other IRS documentation to identify issues or problems that related to controlled corporate group returns.

3. Determined whether tax forms, publications, and applicable instructions given to taxpayers filing controlled corporate group returns were accurate and provided sufficient information to allow taxpayers to accurately file income tax returns.

4. Reviewed the business Functional Specification Package for all applicable U.S. Corporation Income Tax Returns (Form 1120) processing to determine whether programming to process controlled corporate group returns is accurate.

II. Determined whether corporation returns for members of controlled corporate groups were properly processed and accurately filed.

A. Determined whether the IRS was properly processing and assessing the correct amount of tax on corporation returns for members of controlled corporate groups.

1. Identified from the IRS Business Returns Transaction File (BRTF)[3] 45,729 returns processed during Calendar Year 2002 with a control group code 1, indicating they are a member of a controlled corporate group. We verified that all return information was accurate by comparing the data on 10 returns against information from the IRS' records.

2. Stratified the population of 45,729 returns into 36,354 returns with net taxable income greater than $6,666 (a potential income tax effect of at least $1,000 with a tax rate of 15 percent). We reviewed a statistical sample of 73 of these returns to determine whether the IRS computed the correct income tax using the correct tax rate, taxable income and tax computations were considered for all members of the controlled corporate group, and the IRS accurately identified and corrected return errors. Our sample size was determined based on a 95 percent confidence level, an expected error rate of 25 percent, and a precision of +/- 10 percent. A statistical sample was taken because we wanted to estimate the number of returns the IRS inaccurately processed.

B. Determined whether taxpayers were properly filing returns and paying the correct amount of income tax.

[3] The BRTF contains information from business tax returns filed for the current and 2 previous years.

1. Reviewed a statistical sample of 73 of the 36,354 returns to determine whether taxpayers used the correct income tax rate and computed the correct tax, problems existed in the allocation of income tax brackets among all members of the controlled corporate group, and taxable income and tax computations were considered for all members of the controlled corporate group. Our sample size was determined based on a 95 percent confidence level, an expected error rate of 25 percent, and a precision of +/- 10 percent. A statistical sample was taken because we wanted to estimate the number of returns with taxpayer filing errors.

Appendix II

Major Contributors to This Report

Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)
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Appendix III

Report Distribution List

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Appendix IV

Outcome Measures

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

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $5,934,666 annually ($29.67 million over 5 years) in additional taxes for 3,984 taxpayers (see page 2).

Methodology Used to Measure the Reported Benefit:

Selection of Sample -

We identified from the Internal Revenue Service (IRS) Business Returns Transaction File (BRTF)[1] 45,729 returns processed during Calendar Year 2002 with a control group code 1, indicating they are a member of a controlled corporate group.[2] We then stratified our population of returns identified into 36,354 returns with net taxable income greater than $6,666 (a potential income tax effect of at least $1,000 with a tax rate of 15 percent). We selected a statistically valid sample of 73 of these returns at a 95 percent confidence level, an expected error rate of 25 percent, and a precision of +/- 10 percent. We obtained tax returns and reviewed them to determine whether the IRS correctly processed the returns and computed the correct income tax using the correct tax rate and whether taxpayers correctly filed the returns and computed taxes at the correct rate.

Sample Results –

We determined taxpayers incorrectly filed 8 of the 73 returns and underpaid income taxes by $11,917. The remaining returns were correctly filed, had no determinable tax effect, or had an overpayment of income taxes.

Projection of Sample Results –

$5,934,666 - Additional taxes to be assessed by the IRS annually. In our sample of 73 cases, we found that income taxes were underpaid by $11,917. Using the average dollar error of the sample, we estimate there was a total of $5,934,666[3] in underpaid income tax in our population of returns ($11,917 divided by 73, multiplied by the population of 36,354).

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[1] The BRTF contains information from business tax returns filed for the current and 2 previous years.
[2] Corporations are classified as members of a controlled group if they are connected through certain stock ownership. All corporate members of a controlled group are treated as one single entity for tax purposes. However, each member of the group can file its own tax return rather than the group filing one consolidated return.
[3] This point estimate is based on a 95 percent confidence level and a precision of +/- $4,585,987.

3,984 - Taxpayers filing incorrect returns. In our sample of 73 cases, we found that there were 8 returns incorrectly filed by taxpayers with underpayment of taxes. Using the same percentage of occurrence for our sample and population, we estimate that, in our population, there were 3,984 returns on which the taxpayers may be filing with an underpayment of taxes (8 divided by 73, multiplied by the population of 36,354).

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential; $448,200 annually ($2.24 million over 5 years) in overpayment of taxes for 1,494 taxpayers (see page 2).

Methodology Used to Measure the Reported Benefit:

Selection of Sample -

See *Selection of Sample* on previous page.

Sample Results –

We determined taxpayers incorrectly filed 3 of the 73 returns and overpaid income taxes by $900. The remaining returns were correctly filed, had no determinable tax effect, or had an underpayment of income taxes.

Projection of Sample Results –

$448,200 - Overpayment of taxes by taxpayers annually. In our sample of 73 cases, we found that income taxes were overpaid by $900. Using the average dollar error of the sample, we estimate there was a total of $448,200[4] in overpaid income tax in our population of returns ($900 divided by 73, multiplied by the population of 36,354).

1,494 - Taxpayers filing incorrect returns. In our sample of 73 cases, we found that there were 3 returns incorrectly filed by taxpayers with overpayment of taxes. Using the same percentage of occurrence for our sample and population, we estimate that, in our population, there were 1,494 returns on which the taxpayers may be filing with an overpayment of taxes (3 divided by 73, multiplied by the population of 36,354).

[4] This point estimate is based on a 95 percent confidence level and a precision of +/- $606,129.

Appendix V

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

August 30, 2004

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: K E Stiff for
Kevin M. Brown
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Improvements Are Needed for Processing Income Tax Returns of Controlled Corporate Groups (Audit # 2003-30-035)

Thank you for your draft audit report on the Internal Revenue Service's effectiveness in processing the income tax returns of controlled corporate groups (audit number 2003-30-035). As a result of the recommendations in your March 1995 report (Reference Number 053612), we implemented all of the agreed corrective actions. For example, we enhanced our computer programming to identify returns that may be potentially liable for additional taxes and implemented procedures to instruct employees on the appropriateness of corresponding with taxpayers.

Within the next few months, we plan to begin implementing several of the corrective actions recommended in the current report and will also focus on completing our analysis of the feasibility of the other recommendations. Our specific comments in response to the audit recommendations and outcome measures are attached.

RECOMMENDATION 1

The Commissioner, Large and Mid-Size Business Division, and the Commissioner, Small Business/Self-Employed Division, should consider requiring a standard form for the apportionment plan, which will meet the needs of their compliance functions as well as the needs of their submission processing functions. The Commissioners should coordinate with the Director, Tax Forms and Publications, Wage and Investment (W&I) Division, regarding the requirements of the form. In addition, they should consider changing instructions to require a copy of the apportionment plan form to be attached to the return each year. This form should include information required to process the return, including taxable income amounts and apportionment of additional 5 percent or 3 percent tax amounts for all members of the group.

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CORRECTIVE ACTION

LMSB will work with Chief Counsel, SB/SE Compliance, and W&I Tax Forms and Publications to review Treasury Regulation 1.1561-3(b) and determine the feasibility of requiring a standard form to be filed annually for the apportionment plan, which will meet the needs of our compliance functions as well as the needs of our submission processing functions.

If we decide to develop a standard form, the form would be designed to allow taxpayers and the submission processing functions to correctly apportion and apply the single set of tax brackets to the entire group of controlled corporations. Additionally, the Commissioners, LMSB and SB/SE would coordinate the requirements of the proposed form and necessary revisions to Form 1120 instructions with Chief Counsel and the Director, Tax Forms and Publications (W&I Division).

IMPLEMENTATION DATE

A decision on whether the IRS will implement the audit recommendation will be reached no later than March 15, 2005.

RESPONSIBLE OFFICIALS

Director, Strategy, Research and Program Planning (LMSB)
Director, Tax Forms and Publications (W&I)
Director, Compliance (SB/SE)
Associate Chief Counsel, Corporate

CORRECTIVE ACTION MONITORING PLAN

The Director, Strategy, Research, and Program Planning (LMSB Division) will arrange for the necessary meetings to coordinate the feasibility study for Recommendation 1 with the Director, Compliance (SBSE Division), Director, Tax Forms & Publications (W&I Division), and Chief Counsel. The pertinent directors and Chief Counsel officials will designate representatives for the study group, track the progress of group discussions, and review the final recommendations to reach a decision on whether to implement any proposed corrective actions and report to the Office of Management Controls by February 15, 2005. New corrective actions would be submitted to TIGTA depending on the outcome of the feasibility study.

RECOMMENDATION 2

The Director, Customer Account Services, SB/SE Division, should stress during training the importance of following existing processing instructions for smaller volume business return programs. This training should emphasize processing procedures and instructions for controlled corporate group returns such as manual verification of tax (and corresponding with taxpayers when necessary) and the impact these actions have on the processing of returns.

CORRECTIVE ACTION

Customer Account Services analysts will coordinate with the course developers to ensure that the relevant section in the training material is clearly stated prior to distribution to the field. In addition, the analysts will participate in employee training to stress the importance of following the training instructions and manually verifying the tax when processing controlled corporate groups. Internal Revenue Manual (IRM) instructions will also be revised to simplify the steps in the manual verification process.

IMPLEMENTATION DATE

March 15, 2005.

RESPONSIBLE OFFICIAL

Director, Customer Account Services (SB/SE)

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 3

The Director, Customer Account Services, SB/SE Division, should consider requesting revisions to computer programming to lower the threshold to systemically identify returns potentially liable for additional taxes and to identify returns without properly filed apportionment plans.

CORRECTIVE ACTION

The Director, Customer Account Services, SB/SE Division, will conduct a study of controlled corporate groups to determine the feasibility of revising computer programming to systemically identify returns potentially liable for additional tax. The study will thoroughly analyze a valid sample of returns with a controlled group "1" edited on returns filed during the 2005 tax year. Results of the study will include a cost-benefit analysis to determine the feasibility of lowering the threshold.

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IMPLEMENTATION DATE

The determination whether to adopt this recommendation will be made by August 15, 2005.

RESPONSIBLE OFFICIAL

Director, Customer Account Services (SB/SE)

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 4

The Division Counsels/ Associate Chief Counsels (LMSB) and (Corporate) working with the Director, Tax Forms and Publications, W & I Division, should evaluate the necessity for each item now required in the apportionment plan and determine whether items can be eliminated. They should also provide input to the Commissioner, LMSB Division, and the Commissioner, SB/SE Division, regarding the recommendation to require a copy of the apportionment plan to be attached to the tax return of each member of the controlled corporate group each year.

CORRECTIVE ACTION

The Associate Chief Counsel (Corporate) will work with LMSB (Director, SRPP), SB/SE Compliance, and W&I Tax Forms and Publications to determine information that is required with respect to controlled group member consents, and apportionment plans, in light of the apportionment information the Service needs. At a minimum, all members of the apportioning groups should be required to include the names and TINS group members with their returns each year so that proper apportionment can be verified. The Associate Chief Counsel (Corporate) will make any conforming changes to Treasury Regulation 1.1561-3.

IMPLEMENTATION DATE

A decision on whether the IRS will implement the audit recommendation will be reached by February 15, 2005.

RESPONSIBLE OFFICIALS

Director, Strategy, Research and Program Planning (LMSB)
Director, Tax Forms and Publications (W&I)

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Director, Compliance (SB/SE)
Associate Chief Counsel, Corporate

CORRECTIVE ACTION MONITORING PLAN

N/A

OUTCOME MEASURES

The LMSB and SB/SE Compliance Division will not be able to comment at this time on TIGTA's outcome measures with respect to the estimated size of the error rate or projected monetary benefits. We need to further review TIGTA's sample and calculations to determine the accuracy of the statistics provided.

If you have any questions, please call me at (202) 622-0600, or have a member of your staff contact John Crawford, Director, Customer Account Services, Small Business/Self-Employed Division at (972) 308-7010.