

**Increased Attention Is Needed to Reduce
Taxpayer Burden and Ensure Fair and
Consistent Tax Treatment When Filing Small
Business Corporate Tax Returns**

September 2004

Reference Number 2004-30-172

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.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 23, 2004

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Gordon C. Milbourn III

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

SUBJECT: Final Audit Report - Increased Attention Is Needed to Reduce
Taxpayer Burden and Ensure Fair and Consistent Tax Treatment
When Filing Small Business Corporate Tax Returns
(Audit # 200430006)

This report presents the results of our review of the Internal Revenue Service's (IRS) actions to effectively address the burden and compliance issues related to unprocessable U.S. Income Tax Returns for an S Corporation (Form 1120S). In a previous report,¹ the Treasury Inspector General for Tax Administration recommended that the IRS seek alternatives to make it easier for first-time filers to be granted elections and file their Forms 1120S and that the IRS clarify procedures for handling unprocessable Forms 1120S. The overall objective of this review was to determine whether the IRS took the necessary actions to effectively address the burden and compliance issues related to unprocessable Forms 1120S.

In summary, more needs to be done to address the burden and compliance issues related to unprocessable Forms 1120S. In the prior review, we reported that the filing and processing of small business corporate returns needed to be simplified to better enable small businesses to successfully file their Forms 1120S. We estimated that each year, over 46,000 small businesses were unsuccessful in filing their Forms 1120S because the IRS did not have valid elections on file to allow their returns to be processed. In this review, we found the IRS took actions to address the need for legislative changes. However, the IRS needs to continue to pursue legislative changes and alternative measures to make the current election process less burdensome. We recommended the Director, Taxpayer Education and Communication, Small

¹ *The Internal Revenue Service Needs to Simplify Filing Requirements and Clarify Processing Procedures for Small Business Corporate Returns* (Reference Number 2002-30-186, dated September 2002).

Business/Self-Employed (SB/SE) Division, adopt interim measures, while the IRS pursues legislative changes, including increasing the frequency and availability of taxpayer and practitioner education regarding the requirements to file an election prior to filing the first Form 1120S, and the evidence needed to document that the IRS approved the election.

In the prior review, we also reported the IRS did not consistently process Forms 1120S and determine the correct taxes due from small business corporate taxpayers. We estimated that because returns were not processed correctly, there was the potential for the erroneous assessment of taxes on \$41 million of profits and the inability of taxpayers to claim \$100.3 million in losses.² In addition, because of unclear IRS procedures, we estimated that each year, approximately 3,700 taxpayers who file unprocessable Forms 1120S may have their rights violated because the IRS assesses taxes on profits of approximately \$6.7 million without providing taxpayers with a statutory notice of deficiency.³ In this review, we found the IRS has not taken sufficient actions to correct these conditions. Policies and procedures still need to be developed and adequate staffing needs to be committed to correct the compliance issues related to unprocessable Forms 1120S.

We recommended that the Director, Customer Account Services, SB/SE Division, develop clear and consistent guidelines for processing the Forms 1120S when either no elections or delinquent elections are received. Also, the Director, Compliance, SB/SE Division, should ensure that procedures are clarified to assign responsibility for determining and assessing the correct taxes and issuing statutory notices of deficiency for small business corporations and their shareholders when Forms 1120S are converted to regular corporate returns when there is no valid election on file. Additionally, we recommended that the Commissioner, SB/SE Division, commit the necessary resources to ensure unprocessable Forms 1120S and individual income tax returns for their related shareholders are fairly and consistently taxed.

Management's Response: The Commissioner, SB/SE Division, agreed with our recommendations and the need to continue expanding taxpayer education on requirements for filing small business corporation elections. The IRS is currently pursuing the options of legislative or regulatory change, while increasing communication with taxpayers. SB/SE Division management plans to add new language to the next edition of their Small Business Tax Workshop materials to explain the requirement to file an election prior to filing the first Form 1120S and describe the evidence needed to document that the IRS approved the election. An article on Form 1120S elections will be developed and distributed as a Taxpayer Education and Communication Headliner to payroll and practitioner associations; trade, business, and professional associations;

² We had reported the IRS did not process an estimated 9,000 returns as small business corporations, even after the taxpayers verified that their election requests were granted.

³ A statutory notice of deficiency is a notice that allows the taxpayer to respond to the proposed assessment before taxes are actually assessed.

government agencies; and educational organizations. Once distributed through the channels, the Headliner will be posted on the IRS website.

SB/SE Division management updated Internal Revenue Manual procedures and issued a Program Enhancement to ensure clear and consistent guidelines for handling unprocessable Forms 1120S. The SB/SE Division will clarify the procedures to assign responsibility for determining and assessing the correct taxes and issuing statutory notices of deficiency for small business corporations and their shareholders when Forms 1120S are converted to Forms 1120 because there were no valid elections on file. Clarification was issued to campus operations and related procedural changes were implemented regarding the requirement to use Statutory Notice procedures on Form 1120S returns that were converted to Forms 1120. SB/SE Division management is also completing a comprehensive analysis and developing strategies for committing the necessary resources to ensure that unprocessable Forms 1120S and their related shareholders are fairly and consistently taxed. 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 Richard J. Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs) at (631) 654-6028.

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Background

Entities that request the Internal Revenue Service (IRS) to consider them a small business corporation so they may file a U.S. Income Tax Return for an S Corporation (Form 1120S) must first file an Election by a Small Business Corporation (Form 2553).¹ The major advantages of filing as a small business corporation are, generally, the small business pays no corporate tax, and profits or losses are passed through to the shareholders to be reported on their individual income tax returns. A regular corporation that files a U.S. Corporation Income Tax Return (Form 1120) pays corporate taxes on its profits, and its shareholders cannot claim corporate losses on their individual returns. According to the IRS, small business corporations currently represent more than one-half of all corporate entities filing tax returns.

In September 2002, we issued a report entitled, *The Internal Revenue Service Needs to Simplify Filing Requirements and Clarify Processing Procedures for Small Business Corporate Returns*.² Senator Christopher Bond, Ranking Member of the Senate Committee on Small Business and Entrepreneurship, stated in an October 15, 2002, letter to the IRS Commissioner and the Commissioner, Small Business/Self-Employed (SB/SE) Division, that this report, “sets out a number of recommendations for correcting the election-processing and return-filing problems facing S corporations and the IRS. I urge you and your staff to give these recommendations serious consideration.”

This audit was conducted during the period January through June 2004 at the Brookhaven IRS Campus³ covering work performed by the SB/SE Division’s Compliance and Customer Account Services functions. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

¹ Internal Revenue Code, 26 U.S.C. §§ 1362 (a) and (b) (1994).

² Reference Number 2002-30-186, dated September 2002.

³ The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayers’ accounts.

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**The Internal Revenue Service
Needs to Continue to Pursue
Legislative Changes and
Alternative Measures to Make the
Current Election Process Less
Burdensome**

In our prior report, we recommended the IRS simplify the process of filing election Forms 2553 and Forms 1120S for new filers by identifying and implementing alternatives to make it easier for first-time filers to be granted elections and to file their Forms 1120S. We also recommended the IRS seek modification of the legal requirements.

In response to our report, the IRS formed a task force⁴ to study and resolve the causes identified in the report. The overall scope of the team's efforts included the study of the Form 2553 election process, including delinquent elections, as well as the process for converting invalid Forms 1120S to Forms 1120. Part of the team's efforts resulted in a Revenue Procedure being issued in June 2003 that granted relief for failing to file elections timely if the request for relief is filed within 24 months of the due date of the election.⁵

Other actions considered or taken in this area include the following:

- The Taxpayer Advocate's Report to Congress in January 2003 specifically recommended Internal Revenue Code (I.R.C.) Section (§) 1362 (b)(1)(B) be amended to allow a small business corporation to elect to be treated as an S corporation when it files its first Form 1120S return.
- In January 2004, the Office of Taxpayer Burden Reduction proposed that a team be created to recommend legislative changes for S corporations. It proposed the creation of a team to evaluate the viability of amending I.R.C. § 1362 (b)(1)(B) to allow a small business corporation to elect to be treated as an S corporation when it files its first Form 1120S return. The team created by the Office of Taxpayer Burden Reduction also proposed, as an

⁴ Team members included analysts from the SB/SE Division's Headquarters Reporting Compliance function and the Business Master File Policies, Procedures, and Guidance Branch, as well as field employees from the submission processing sites.

⁵ Rev. Proc. 2003-43 granted relief by allowing additional time for taxpayers to obtain a timely election.

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alternative, amending the regulations regarding the manner of making elections to possibly eliminate the filing and processing of election forms.

- In April 20, 2004, testimony before the Committee on Government Reform, the IRS Commissioner indicated the IRS is evaluating the viability of amending portions of I.R.C. § 1362 to create a less burdensome process for a corporate taxpayer seeking to be taxed as an S corporation.
- The IRS also plans to revise letters to instruct taxpayers on the need to file timely elections and the availability of relief provisions.

While there has been some attention given to correcting the problem, legislation and procedures still need to be changed to further reduce taxpayer burden in this area.

In the prior report, we estimated that, each year, over 46,000 small businesses are unsuccessful in filing their Forms 1120S because the IRS does not have valid elections on file to allow their returns to be processed. Although we were unable to quantify actual burden costs, we estimated taxpayers spend 3.2 million hours each year to prepare, copy, assemble, and send these returns to the IRS, which could not successfully process them. Also, it costs the IRS an estimated \$264,000⁶ annually to handle the Forms 1120S that could not be processed.⁷

Taxpayers and the IRS still need to perform too many steps before Forms 1120S can be successfully processed for first-time filers (see Appendix IV). These steps are time-consuming and burdensome for the IRS and for first-time filers who are not familiar with all of the necessary steps. If the IRS continues with its current policies for the filing and recording of elections, many first-time filers of Forms 1120S will continue to be unsuccessful in filing their returns.

⁶ This total does not include the cost of the IRS' attempts to resolve the unprocessable conditions.

⁷ Based on projected increases in the filings of Forms 1120S, there are indications that these figures may increase slightly.

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Recommendation

The Director, Taxpayer Education and Communication, SB/SE Division, should:

1. Adopt interim measures, while the IRS pursues legislative changes, to reduce taxpayer burden and the volume of unprocessable Forms 1120S. The Director should consider increasing the frequency and availability of taxpayer and practitioner education through publicity and online information regarding the requirements to file an election prior to filing the first Form 1120S, and the evidence needed to document that the IRS approved the election.

Management's Response: The Commissioner, SB/SE Division, agreed with our recommendation and the need to continue expanding taxpayer education on requirements for filing small business corporation elections. The IRS is currently pursuing the options of legislative or regulatory change, while increasing their communication with taxpayers. SB/SE Division management plans to add new language to the next edition of their Small Business Tax Workshop materials due to be published in late spring 2005.⁸ The additional information will explain the requirement to file an election prior to filing the first Form 1120S and describe the evidence needed to document that the IRS approved the election.

An article on Form 1120S elections will be developed and distributed as a Taxpayer Education and Communication Headliner through their stakeholder distribution channels to payroll and practitioner associations; trade, business, and professional associations; government agencies; and educational organizations. Once distributed through the channels, the Headliner will be posted on irs.gov/smallbiz.

⁸ *Small Business Tax Workshop: Student Workbook* (Publication 1066) and *Virtual Small Business Tax Workshop Digital Video Disc* (Publication 1066C).

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**The Internal Revenue Service Did
Not Take Sufficient Actions to
Promote Fair and Equitable
Compliance Practices for
Taxpayers Who Filed
Unprocessable Forms 1120S**

In the prior audit, we also reported the IRS did not consistently determine the correct and proper taxes due from small business corporate taxpayers. In the current review, we found that more needs to be done to ensure IRS compliance efforts are effective with regard to unprocessable Forms 1120S. The IRS did not take sufficient actions to promote fair and equitable compliance practices for small business corporate taxpayers in the following areas:

- Policies and procedures have still not been developed to calculate and assess the correct taxes for taxpayers who filed unprocessable Forms 1120S.
- The IRS did not provide the staffing needed to correct unprocessable Forms 1120S compliance issues.

Policies and procedures have still not been developed to calculate and assess the correct taxes for taxpayers who filed unprocessable Forms 1120S

IRS compliance policies and procedures for the conversion of unprocessable Forms 1120S to Forms 1120 have been unclear for at least the last 5 years⁹ and have led to inconsistent treatment of taxpayers. IRS policies and procedures have resulted in the conversion of Forms 1120S to Forms 1120 without the calculation and assessment of correct tax liabilities.

In the prior review, we also reported the IRS did not consistently process Forms 1120S and determine the correct taxes due from small business corporate taxpayers. We estimated that, because returns were not processed correctly, there was the potential for the erroneous assessment of taxes on \$41 million of profits and the inability of taxpayers to

⁹ An initial District Counsel opinion was requested on November 24, 1998. The Philadelphia IRS Campus sought advice from the Office of District Counsel regarding the following two questions:

1. May IRS campuses prepare proper income tax returns from the improper returns that taxpayers file with the IRS?
2. May the IRS assess tax liabilities based on the returns it prepares without following the statutory notice of deficiency procedures under I.R.C. §§ 6212 and 6213?

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claim \$100.3 million in losses.¹⁰ In addition, because of unclear IRS procedures, we estimated that each year, approximately 3,700 taxpayers who file unprocessable Forms 1120S may have their rights violated because the IRS assesses taxes on profits of approximately \$6.7 million without providing taxpayers with a statutory notice of deficiency.¹¹

In response to the prior report,¹² the IRS cited the following causes for the inconsistent handling of unprocessable Forms 1120S:

We have not developed clear and consistent guidelines for processing the Form 1120S when delinquent elections are received. Taxpayers are subject to inconsistent treatment when invalid 1120S returns are converted to Form 1120.

Current IRM¹³ procedures do not clearly explain how these cases should be processed.

Thus far, the IRS has not developed formal procedures to calculate and assess the correct taxes for unprocessable Forms 1120S. Although the IRS had procedures in place for a local project in one campus, they were used only for a relatively small number of tax returns worked in the Correspondence Examination function and not for all incoming unprocessable Forms 1120S.

The IRS has the authority and responsibility for providing procedures and consistently applying them to determine the correct taxes due by corporate taxpayers. In addition, the Government Accountability Office¹⁴ *Standards for Internal*

¹⁰ We had reported the IRS did not process an estimated 9,000 returns as small business corporations, even after the taxpayers verified that their election requests were granted.

¹¹ A statutory notice of deficiency is a notice that allows the taxpayer to respond to the proposed assessment before taxes are actually assessed.

¹² The report was issued in September 2002; the implementation date for the corrective action was January 1, 2004. The IRS agreed to work with the Office of Chief Counsel to determine the proper way to assess taxes on small business corporate returns that could not be processed and update the appropriate Internal Revenue Manual procedures.

¹³ Internal Revenue Manual.

¹⁴ Formerly the General Accounting Office.

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Controls in the Federal Government indicate internal controls should provide reasonable assurance that the effectiveness and efficiency of operations are achieved.

Because these procedures have not been revised or clarified, taxpayers who file unprocessable Forms 1120S will continue to be subjected to inconsistent handling of the profits and losses from Forms 1120S that were converted to Forms 1120. The following list demonstrates the adverse effects and the need for developing and revising current policies and procedures:

- ***Unprocessable Forms 1120S are being converted to Forms 1120 without calculation of the correct taxes.*** IRS instructions provide for putting a blank copy of a Form 1120 over an unprocessable Form 1120S, renumbering the blank Form 1120 to appear as though a Form 1120 was filed, and recording a zero dollar tax assessment for that return, regardless of whether there is a gain, so IRS records indicate a corporate return was filed. There is a legal requirement¹⁵ that there must be sufficient data with which to calculate the tax liability on a Form 1120S to convert the Form 1120S to a Form 1120. However, the IRS is not using this data to calculate the correct tax liabilities.

¹⁵ Memorandum for District Counsel, Pennsylvania District, from Assistant Chief Counsel (Field Services) CC:DOM:FS, dated May 20, 1999; Subject: Significant Service Center Advice. Page 2 of this memorandum, under Law and Analysis, provides the criteria regarding “The Incorrect Forms That Provide Sufficient Data to Calculate Tax Liability Constitute Returns.” Generally, the legal requirements that must be met for an unprocessable Form 1120S to be converted to a Form 1120 are, “First, there must be sufficient data to calculate a tax liability; second, the document must purport to be a return; third, there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and fourth, the taxpayer must execute the return under the penalties of perjury.”

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- ***Taxpayers' rights are potentially being violated because required statutory notices of deficiency¹⁶ are not always being issued.*** Our review showed that 12.7 percent (24 of 189)¹⁷ of the applicable taxpayers in our sample had taxes assessed of approximately \$927,000 on \$2.7 million in gains without statutory notices being issued.
- ***Gains and losses on unprocessable Forms 1120S are not being properly addressed.*** Taxes on approximately \$935,000 in gains for 36.5 percent (69 of 189) of the applicable taxpayers in our sample were not assessed. Further, unallowable losses of approximately \$1.7 million from 43.4 percent (82 of 189) of the unprocessable Forms 1120S may not have been disallowed to the shareholders.¹⁸
- ***Most Forms 1120 converted from unprocessable Forms 1120S were either not evaluated for their examination potential or evaluated but not examined.*** The evaluation of examination potential was curtailed in Calendar Year 2003, apparently to reduce the number of converted Forms 1120S from automatically being sent for evaluation. However, current IRS procedures still require that these converted returns be automatically sent to the Examination function for evaluation of their examination potential. Required procedures are not

¹⁶ The advice provided by the Office of District Counsel on May 20, 1999, indicated incorrect returns that provide sufficient data with which to calculate tax liabilities constitute returns and the IRS must follow deficiency procedures to make the related tax assessments. A statutory notice of deficiency is a notice that allows the taxpayer to respond to the proposed assessment before taxes are actually assessed.

¹⁷ Our total sample was 215 cases. For the purposes of this calculation, we used 189 cases because the remaining 26 cases either had no return/assessment posted (7 cases) or were processed as Forms 1120S (19 cases).

¹⁸ We concluded that losses from unprocessable Forms 1120S may not have been disallowed because we were informed shareholder returns were not being worked in one campus due to inadequate resources and the fact that only a small volume of invalid election returns were being examined. The scope of this audit did not include a review of the shareholders' individual income tax returns with losses.

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being followed and fewer of the cases converted to Forms 1120 are evaluated and examined. If unprocessable Forms 1120S converted to Forms 1120 are not evaluated and examined, the correct taxes due will not be calculated and assessed on unprocessable Forms 1120S.

The IRS did not provide the staffing needed to correct unprocessable Form 1120S compliance issues

While the IRS has recognized the need to work unprocessable Form 1120S cases, more needs to be done to commit sufficient resources to ensure fair and equitable compliance practices.

As a result of our September 2002 report, the IRS stated,

Correspondence Examination (Corr. Exam) has agreed to begin working these cases in FY 04 [Fiscal Year 2004]. The number of cases that will be worked has yet to be determined. The invalid election issues, both IMF¹⁹ and BMF,²⁰ will be worked by tax examiners who will have assistance from other technical employees as needed.

The IRS also indicated it needed additional time to review the process in place since the issuance of policy and procedural changes²¹ in June 2003. Consequently, it has delayed implementation of the corrective actions from January 1, 2004, to January 15, 2005.

The IRS policy and procedural changes issued in June 2003 granted relief for failing to file elections timely if the request for relief is filed within 24 months of the due date of the election. However, this change may not necessarily reduce the volume of unprocessable Forms 1120S or affect the staffing needed to process these returns.

¹⁹ The IMF is the Individual Master File, which is the IRS database that maintains transactions or records of individual tax accounts.

²⁰ The BMF is the Business Master File, which is the IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

²¹ Rev. Proc. 2003-43.

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We were informed that, as of March 2004, the Cincinnati Submission Processing Site was still not working unprocessable Form 1120S conversion cases and related investors' returns due to inadequate staffing and the requirement to use statutory deficiency procedures. A year before, in March 2003, S Corporation task force minutes also indicated that the Cincinnati Submission Processing Site, one of the two sites responsible for processing Forms 1120S, did not work the investor side of the Form 1120S conversion issue because of inadequate staffing. In March 2003, the Ogden Submission Processing Site also requested permission not to work approximately 6,500 converted S corporation returns for the same reason.

The SB/SE Division Inventory Delivery Report for FY 2004 showed the IRS was going to work only 300 unprocessable Form 1120S cases. We have not been provided with any evidence that additional funding or staffing was requested for this purpose.

In FY 2003, an S Corporation Project was conducted in only one (Ogden) of the two sites processing Forms 1120S, and its accomplishments were significant. This project was 7th highest (of approximately 140 projects) in recommended dollar assessments. Recommended dollars totaled over \$4 million for approximately 3,600 returns, for which the IRS spent 1.4 hours per return.²²

Unless sufficient resources are devoted to working these cases, compliance efforts for this taxpayer segment will not be sufficient or fairly administered. Although the volume of unprocessable Forms 1120S has continued to increase over the last 6 years,²³ fewer cases are planned or expected to be worked. Working so few cases reduces recommended dollar assessments and hampers the IRS' ability to foster taxpayer compliance.

²² This information is based on Audit Information Management System Table SC 38 for FY 2003.

²³ The overall volume of unprocessable Forms 1120/1120S has significantly increased over the last 6 calendar years, from 88,888 in 1998 to 131,411 in 2003.

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Recommendations

The Director, Customer Account Services, SB/SE Division, should:

2. Develop clear and consistent guidelines for handling unprocessable Forms 1120S. The Internal Revenue Manual (IRM) procedures should clearly explain how these cases should be processed.

Management's Response: SB/SE Division management updated IRM procedures and issued a Program Enhancement to ensure clear and consistent guidelines for handling unprocessable Forms 1120S.

The Director, Compliance, SB/SE Division, should:

3. Clarify the IRM procedures to assign responsibility for determining and assessing the correct taxes and issuing statutory notices of deficiency for small business corporations and their shareholders when Forms 1120S are converted to Forms 1120 because there were no valid elections on file.

Management's Response: SB/SE Division management will clarify the IRM procedures.

4. Clarify the role of the Examination function with regard to unprocessable Forms 1120S that were converted to Forms 1120. The clarification of these procedures needs to take into account that the Assistant Chief Counsel's opinion indicated statutory notices of deficiency are needed in these conversion cases before taxes are assessed.

Management's Response: SB/SE Division management issued clarification to campus operations regarding the requirement to use Statutory Notice procedures on Form 1120S returns that were converted to Forms 1120. Accompanying IRM changes were also implemented.

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The Commissioner, SB/SE Division, should:

5. Commit the necessary resources to ensure unprocessable Forms 1120S and their related shareholders, who filed these returns without valid elections on file, are fairly and consistently taxed.

Management's Response: SB/SE Division management completed preliminary analysis and will compile additional data from a statistically valid sample of audits involving invalid Form 1120S elections and/or their corresponding shareholders. Once the comprehensive analysis is completed, appropriate strategies will be developed.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective was to determine whether the Internal Revenue Service (IRS) took the necessary actions to effectively address the burden and compliance issues related to unprocessable U.S. Income Tax Returns for an S Corporation (Form 1120S). To accomplish this objective, we:

- I. Determined the status of any actions taken or planned to address the compliance issues related to converting unprocessable Forms 1120S to U.S. Corporate Income Tax Returns (Form 1120).
 - A. Met with national and local management officials to obtain information regarding the status of the corrective actions to address our recommendation regarding clarifying the procedures and assigning responsibility for determining and assessing the correct taxes on converted Forms 1120 resulting from unprocessable small business corporate returns.
 - B. Determined whether any problems and solutions were identified by reviews conducted by the Government Accountability Office¹ and the Taxpayer Advocate Office relating to assessing and completely processing converted Forms 1120.
 - C. Determined whether the IRS had received or justified the need for additional funding or staffing to work the converted corporation returns and related shareholders' individual income tax returns.
- II. Determined whether policies and procedures were established to ensure taxes were properly assessed on Forms 1120S that could not be processed.
 - A. Reviewed the Internal Revenue Manual (IRM) and other written instructions to determine the procedures established to convert unprocessable Forms 1120S to Forms 1120.
 - B. Reviewed procedures established to evaluate the examination potential of Forms 1120 converted from unprocessable Forms 1120S.
 - C. Held discussions with national and local management officials (including the Office of Chief Counsel) to obtain information regarding:
 1. The proper method of assessing taxes on small business corporate returns that could not be processed.

¹ Formerly the General Accounting Office.

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2. Any specific IRM or Law Enforcement Manual procedural changes that affect the examination screening and conversion processes.
- III. Determined whether IRS processing procedures and examination screening adequately ensured taxes were accurately assessed and compliance goals were achieved for Forms 1120S that could not be processed.
- A. Selected and reviewed a statistical sample of 215 taxpayer accounts. We used attribute sampling at a 95 percent confidence level and an expected error rate not over 10 percent with a precision level of +/- 4 percent. We used a computer extract to determine the volume (71,931) of unprocessable small business corporate returns (Unpostable Code 310 with Reason Codes 2, 4, 5, and 6, which relate primarily to Forms 1120S) that were resolved with an Unpostable Resolution Code (URC)² 8 for Calendar Year 2002. We then identified the 49,999 returns for Tax Year 2001 that were worked by the Cincinnati and Ogden Submission Processing Sites.³ We used the 49,999 return population to select the statistically valid sample of 215 cases.
 - B. Reviewed the sample of 215 accounts by analyzing various IRS records and the related tax returns to determine whether elections were present in accounts, Forms 1120S were successfully processed, there was evidence that the converted Forms 1120s were sent for examination screening, tax returns were transshipped to other IRS sites for examination screening, and Statutory Notices of Deficiency⁴ were used before taxes were assessed on converted Forms 1120.
 - C. Matched the 215 cases against the IRS Schedule K-1 matching files⁵ to potentially quantify income and losses from the corporations.
 - D. Analyzed information gathered to determine whether there were any trends or patterns to indicate the IRS' traditional screening practices and processing procedures relating to unprocessable Forms 1120S needed to be more vigorously addressed and revised.

² Unpostable Code 310 is generated when the filing requirements of the Forms 1120 or 1120S do not match the information in the IRS' computerized files. URC 8 removes the record from the Submission Processing Unpostable Master File of taxpayer accounts.

³ Because the Cincinnati and Ogden IRS Campuses now process all of the business tax returns, we selected our sample from those two Campuses. The campuses are the data processing arms of the IRS. They process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayers' accounts.

⁴ A notice that allows the taxpayer to respond to the proposed assessment before taxes are actually assessed.

⁵ The IRS uses the Schedule K-1 to determine whether the shareholders of the S Corporation are reporting their distributive share of profits and losses on their individual income tax returns.

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Appendix II

Major Contributors to This Report

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Michael D. Luongo, Lead 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, Small Business/Self-Employed Division SE:S
Director, Compliance, Small Business/Self-Employed Division SE:S:C
Director, Customer Account Services, Small Business/Self-Employed Division SE:S:CAS
Director, Taxpayer Education and Communication, Small Business/Self-Employed Division
SE:S:T
Assistant Director, Customer Account Services, Small Business/Self-Employed Division
SE:S:CAS
Director, Internal/External Stakeholders, Small Business/Self-Employed Division SE:S:C:CP:I
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 Management Controls OS:CFO:AR:M
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S

**Increased Attention Is Needed to Reduce Taxpayer Burden and Ensure
Fair and Consistent Tax Treatment When Filing Small Business
Corporate Tax Returns**

Appendix IV

**How Small Business Corporate Taxpayers File,
and the Internal Revenue Service Processes,
Small Business Corporate Elections and Tax Returns**

The process generally includes the following steps:

- Taxpayers file an Election by a Small Business Corporation (Form 2553) before filing their initial U.S. Income Tax Return for an S Corporation (Form 1120S).
- The election is processed separately from the initial Form 1120S by the Internal Revenue Service (IRS), given a unique Document Locator Number (DLN),¹ and assigned a unique transaction code. The transaction code is recorded in a separate section of the IRS' computerized record of tax accounts from the section in which the tax return is recorded.
- The IRS sends notices to taxpayers to inform them that their elections have been accepted or rejected. If a Form 2553 is incomplete or information is incorrect, the IRS corresponds with the taxpayer to obtain the necessary information and suspends the Form 2553 from further processing while awaiting the taxpayer's response.
- If a taxpayer files a Form 1120S and the IRS has no record of the election on file, the Form 1120S cannot be processed; it becomes what the IRS calls "unpostable." This Form 1120S is transferred from a processing unit to the unpostable unit for research and resolution.
- After preliminary research, if the IRS cannot determine that a valid election is on file, the IRS sends the taxpayer a letter instructing the taxpayer to submit verification that an election was granted (e.g., a copy of the IRS acceptance notice or evidence of approved election) or to file a completed U.S. Corporation Income Tax Return (Form 1120).
- The taxpayer has to respond within 30 days with the requested information. If the IRS does not receive a response to the letter, the IRS generally renumbers the Form 1120S to a Form 1120.
- The IRS is required to send the tax return to the Compliance Services/Classification function for screening.
- The IRS would then have to determine the correct and proper tax due by the corporate taxpayer.

¹ A unique number assigned to every tax return/document to assist in controlling, identifying, and locating documents.

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Appendix V

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

RECEIVED
SEP 21 2004

SEP 13 2004

MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION

FROM: Kevin M. Brown *KMB*
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report - Increased Attention Is Needed to Reduce
Taxpayer Burden and Ensure Fair and Consistent Tax Treatment
When Filing Small Business Corporate Tax Returns
(Audit # 200430006)

I have reviewed your draft report and agree with your recommendations and the need to continue expanding taxpayer education on requirements for filing small business corporation elections. We are currently pursuing our options of legislative or regulatory change, while increasing our communication with taxpayers.

The Internal Revenue Code, as currently written, requires that a corporation file an election to convert to an S-Corporation. If an election is not timely filed, the Service cannot remedy the matter efficiently. Adjustments made on a U.S. Income Tax Return for an S Corporation (Form 1120S) due to the lack of a timely filed Election by a Small Business Corporation (Form 2553) are often reversed due to the allowance of a late election. While a legislative change is the most practical solution, we will continue to improve our efforts in taxpayer education and review our compliance options.

Many improvements have already been made as the result of Treasury Inspector General for Tax Administration (TIGTA) Audit 200130037, "The Internal Revenue Service Needs to Simplify Filing Requirements and Clarify Processing Procedures for Small Business Corporate Returns". Revenue Procedure 2003-43 was created to allow the Service more time to allow a late election. This eliminated the burden on many taxpayers of having to file a Private Letter Ruling to get a late election approved. Because we created a new set of action codes to track the election status of Form 1120S, the Service can now identify Form 1120S returns converted due to the lack of an election and those allowed after a late election. In addition, many letters have been changed to provide taxpayers more specific information about filing elections and obtaining late elections.

Increased Attention Is Needed to Reduce Taxpayer Burden and Ensure Fair and Consistent Tax Treatment When Filing Small Business Corporate Tax Returns

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Our comments on the recommendations in this report are as follows:

RECOMMENDATION 1

The Director, Taxpayer Education and Communication, Small Business/Self-Employed (SB/SE) Division should adopt interim measures, while the Service pursues legislative changes, to reduce taxpayer burden and the volume of unprocessable Forms 1120S. The Director should consider increasing the frequency and availability of taxpayer and practitioner education through publicity and online information regarding the requirements to file an election prior to filing the first Form 1120S, and the evidence needed to document that the Service approved the election.

CORRECTIVE ACTION

We are adding new language to the next edition of our Small Business Tax Workshop materials due to be published in late spring 2005: Publication 1066, "Small Business Tax Workshop: Student Workbook" and Publication 1066C, "Virtual Small Business Tax Workshop Digital Video Disc." The additional information will explain the requirement to file an election prior to filing the first Form 1120S and describe the evidence needed to document that the Service approved the election.

The current communications plan includes development of an article on Form 1120S elections. We will distribute this article as a Taxpayer Education and Communication (TEC) Headliner through our stakeholder distribution channels to payroll and practitioner associations; trade, business and professional associations; government agencies and educational organizations. Once distributed through the channels, we post all Headliners on irs.gov/smallbiz.

IMPLEMENTATION DATE

June 1, 2005

RESPONSIBLE OFFICIAL(S)

The Director, Taxpayer Education and Communication, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN

The Program Manager, Taxpayer Education Communication will advise the Director, Taxpayer Education Communication of any corrective action delays.

RECOMMENDATION 2

Director, Customer Account Services, SB/SE Division should develop clear and consistent guidelines for handling unprocessable Forms 1120S. The IRM procedures should clearly explain how these cases should be processed.

Increased Attention Is Needed to Reduce Taxpayer Burden and Ensure Fair and Consistent Tax Treatment When Filing Small Business Corporate Tax Returns

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CORRECTIVE ACTION

Internal Revenue Manual (IRM) 3.13.222.72 was updated to ensure clear and consistent guidelines for handling unprocessable Forms 1120S. Changes made include the following:

- Input Transaction Code (TC) 971 Action Code (AC) 375 to identify when a Form 1120S has failed to post to the Master Filer (MF)
- Input TC 971 AC 376 to freeze all refunds to the taxpayer.
- Input TC 971 AC 377 to identify the conversion of a Form 1120 back to Form 1120S.

Program Enhancement (PE) #SBSE IA-2002-35 was issued January 14, 2004. The PE included several instructions:

- We are requesting the taxpayer provide us with documentation that they have a valid Form 2553 election on file (this will qualify them as a Form 1120S filer) and have instructed field personnel to input TC 971, AC 375.
- If the taxpayer does not respond, then we convert their return to a Form 1120 and have instructed field personnel to input TC 971, AC 376. This input freezes all refunds to the taxpayer.
- If the taxpayer responds after the 30 days that we allow and provides proof that they filed Form 2553, then we convert their return back to a Form 1120S and have instructed field personnel to input TC 971, AC 377.
- If the taxpayer's Employer Identification Number (EIN) is incorrect (whether this is due to taxpayer error or field personnel error), we have instructed field personnel to input TC 972 to reverse the TC 971.

IMPLEMENTATION DATE

Completed

RESPONSIBLE OFFICIAL(S)

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 3

Clarify the IRM procedures to assign responsibility for determining and assessing the correct taxes and issuing statutory notices of deficiency for small business corporations and their shareholders when Forms 1120S are converted to Forms 1120 because there were no valid elections on file.

CORRECTIVE ACTION

IRM procedures will be clarified.

**Increased Attention Is Needed to Reduce Taxpayer Burden and Ensure
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IMPLEMENTATION DATE

January 1, 2005

RESPONSIBLE OFFICIAL(S)

Director, Filing and Campus Compliance, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN

The Program Manager, Compliance Services will advise the Director, Campus and Filing Compliance of any corrective action delays.

RECOMMENDATION 4

Clarify the role of the Examination function with regard to unprocessable Forms 1120S that were converted to Forms 1120. The clarification of these procedures needs to take into account that the Assistant Chief Counsel's opinion indicated statutory notices of deficiency are needed in these conversion cases before taxes are assessed.

CORRECTIVE ACTION

Clarification issued to campus operations regarding the requirement to use Statutory Notice procedures on Form 1120S returns that were converted to Forms 1120. Accompanying IRM changes were also implemented.

IMPLEMENTATION DATE

Completed.

RESPONSIBLE OFFICIAL(S)

N/A

CORRECTIVE ACTION MONITORING PLAN

N/A

RECOMMENDATION 5

Commit the necessary resources to ensure unprocessable Forms 1120S and their related shareholders, who filed these returns without valid elections on file, are fairly and consistently taxed.

CORRECTIVE ACTION

While preliminary analysis has been completed, additional data will be compiled from a statically valid sample of audits involving invalid Form 1120S elections and/or their corresponding shareholders. Once the comprehensive analysis is completed, appropriate strategies will be developed.

IMPLEMENTATION DATE

March 1, 2005

**Increased Attention Is Needed to Reduce Taxpayer Burden and Ensure
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RESPONSIBLE OFFICIAL(S)

The Director, Filing and Campus Compliance, SB/SE Division

CORRECTIVE ACTION MONITORING PLAN

The Program Manager, Compliance Services will advise the Director, Campus and Filing Compliance of any corrective action delays.

If you have any questions, please call me at (202) 622-0600 or Robert L. Hunt, Acting Deputy Director, Compliance Policy, Small Business/Self-Employed, at (202) 283-2200.