The Small Business/Self-Employed Division Is Beginning to Address Challenges That Affect Corporate Return Examination Coverage

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

August 22, 2005

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Small Business/Self-Employed Division Is Beginning to Address Challenges That Affect Corporate Return Examination Coverage (Audit # 200430030)

This report presents the results of our review of statistical information that reflects Examination function activities in the Small Business/Self Employed (SB/SE) Division. The overall objective of this review was to analyze statistical data on closed small corporation and S corporation[1] return examinations for Fiscal Years (FY) 2001 through 2004 in the SB/SE Division to identify and report trends.

Synopsis

The Internal Revenue Service (IRS) views the examination of income tax returns as an important tool to encourage voluntary compliance. One measure of the IRS' overall Examination program is the "examination coverage rate," commonly known as the "audit rate," which is computed by dividing the number of tax returns examined by the total number of tax returns filed in the previous calendar year.[2]

In summary, the number of small corporation and S corporation returns examined from FY 2001 to FY 2004 decreased, but recent Examination program initiatives may reverse this

[1] S corporations are corporations that elect to pass corporate income and losses to their shareholders for Federal tax purposes.
[2] *Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance* (Reference Number 2002-30-092, dated June 2002).

trend. Specifically, in Calendar Year 2003, small corporations filed approximately 2.3 million U.S. Corporation Income Tax Returns (Form 1120) and S corporations filed approximately 3.4 million U.S Income Tax Returns for an S Corporation (Form 1120S) with the IRS. The audit rate for small corporations was .32 percent and for S corporations was .19 percent in FY 2004.[3] The IRS Commissioner has commented on the decreased examination coverage in this area and that he expected audits to increase in 2005.

This audit focused on examinations of small corporations and S corporations with less than $10 million in assets closed by the SB/SE Division during FYs 2001 through 2004. Our analysis showed the number of small corporation and S corporation examinations significantly declined during this period, from 19,339 to 7,328 (approximately 62 percent). Moreover, acute declines in the number of examinations closed occurred from FY 2003 to FY 2004 when workload shifts caused a decreased emphasis on small corporation and S corporation examinations. The number of small corporation examinations decreased by 46 percent, while the number of S corporation examinations decreased by 57 percent. The decline in the number of FY 2004 small corporation examinations closed resulted in a 23 percent decrease in dollars recommended[4] from FY 2003 ($188 million) to FY 2004 ($145 million). Conversely, the average recommended assessment dollars per return for small corporations showed a positive trend, going from approximately $23,500 in FY 2003 to approximately $33,370 in FY 2004.

However, approximately 43 percent of small corporation returns examined had no change to the tax reported on their returns for FYs 2001 through 2004. The IRS segregates these "no-change" returns into those with adjustments and those without adjustments. For FYs 2001 through 2004, approximately 30 percent of the no-change returns had adjustments. During this same period, approximately 366 Direct Compliance Years[5] were charged to small corporation returns with no changes. For S corporations, 42 percent of the returns examined resulted in no changes; these examinations accounted for 286 Direct Compliance Years during FYs 2001 to 2004. During discussions with IRS management, the IRS commented on the value of return examinations closed with adjustments but no change to the tax reported. For small corporations, such examinations may include noncompliant taxpayers but due to offsets, such as net operating losses or credit carryovers, no additional tax is due in the year under examination. For S corporations, a no-change examination could result in an adjustment on other related returns, such as the shareholder's individual return.

Case selection systems, such as the Discriminant Index Function (DIF),[6] do not meet current Examination program needs. The DIF formulas used to score returns have not been updated

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[3] The audit rates from the FY 2004 IRS Data Book include both Forms 1120 and 1120S examined by the SB/SE and Large and Mid-Size Business Divisions. The audit rates include training returns and returns examined by correspondence.
[4] Dollars recommended represents the amount of additional tax proposed to be assessed against the taxpayer.
[5] Based on a Direct Compliance Year composed of 2,000 hours of Direct Examination Time.
[6] The DIF is a mathematical technique used to classify income tax returns as to Examination program potential.

since the 1980s and do not identify current IRS key compliance strategy cases such as abusive schemes, unreported income, and structured transactions. The focus for the FY 2004 Examination program was on key strategies the DIF could not address; therefore, examinations of small corporation and S corporation returns that were not a part of the strategies were not a priority. In FY 2004, the SB/SE Division selected 22 percent of small corporation returns using the DIF; the other 78 percent were selected from non-DIF sources.

The SB/SE Division recognizes the need to improve the selection of tax returns for examination and has initiatives underway, such as the Compliance Initiative Projects (CIP) that focus on identifying potential areas of noncompliance and developing strategies to improve compliance. Some CIP-identified returns entered the audit stream in October 2004, and examination results are pending. The SB/SE Division has also taken steps to address its longstanding human capital crisis by authorizing the hiring of 984 revenue agents in FY 2005. However, the full contribution of these new hires on helping reverse the decline in small corporation examinations will not be realized for several years. Also, the burden on existing staff in providing training and guidance to the new staff may further hamper productivity.

Overall, during this audit, there was insufficient evidence to evaluate whether recent management actions will be effective in reversing the decline in the number of examinations, but we will continue to monitor their implementation and resulting effects.

Response

We made no recommendations in this report. However, key IRS management officials reviewed it prior to issuance.

Copies of this report are also being sent to the IRS managers affected by the report findings. Please contact me at (202) 622-6510 if you have questions or Curtis Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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Background

The Internal Revenue Service (IRS) views the examination of income tax returns as an important tool to encourage voluntary compliance. One measure of the IRS' overall Examination program is the "examination coverage rate." Commonly known as the "audit rate," it is computed by dividing the number of tax returns examined by the total number of tax returns filed in the previous calendar year.[1]

An April 2004 article from *The Wall Street Journal*, "IRS Audits of Corporations Continued to Decline in 2003," reported, "IRS audits of corporations continue to drop, despite a recent turn around in enforcement against individual taxpayers, said a report by Transactional Records Access Clearinghouse, a government watchdog group. Overall, face-to-face audits of all corporations declined to 7% in 2003 from 15% in 1999."[2]

In Calendar Year 2003, small corporations filed approximately 2.3 million U.S. Corporation Income Tax Returns (Form 1120) and S corporations filed approximately 3.4 million U.S. Income Tax Returns for an S Corporation (Form 1120S)[3] with the IRS. The audit rate for small corporations was .32 percent in Fiscal Year (FY) 2004 compared to .60 percent in FY 2001. For S corporations, the audit rate was .19 percent in FY 2004 compared to .43 percent in FY 2001.[4] The IRS Commissioner has commented on the decreased examination coverage in this area and that he expected audits to increase in 2005.

The IRS Small Business/Self-Employed (SB/SE) Division serves about 7 million small businesses, including corporations, S corporations, and partnerships with less than $10 million in assets. This audit focused on examinations of small corporations and S corporations closed by the SB/SE Division during FYs 2001 through 2004.

Small business compliance is important to tax administration. Approximately 68 percent ($141 billion) of the estimated $207 billion tax gap in 1998 was attributed to SB/SE Division taxpayers. Sole proprietors accounted for about $132.5 billion of this gap, and corporate taxpayers were responsible for $8.3 billion. These tax gap estimates were updated in 2005 to

[1] *Management Advisory Report: The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance* (Reference Number 2002-30-092, dated June 2002).
[2] Mckinnon, John D. 2004. "IRS Audits of Corporations Continued to Decline in 2003." The Wall Street Journal. April 12.
[3] S corporations are corporations that elect to pass corporate income and losses to their shareholders for Federal tax purposes.
[4] The audit rates from the FY 2004 IRS Data Book include both Forms 1120 and 1120S examined by the Small Business/Self-Employed and Large and Mid-Size Business Divisions. The audit rates include training returns and returns examined by correspondence.

between $312 and $353 billion, and the FY 2004 - 2005 Compliance Risk Assessment[5] revealed that those areas of noncompliance associated with the tax gap (i.e., nonfiling, nonpayment, and underreporting) continue to widen.

This review was performed at the SB/SE Division Headquarters Office in New Carrollton, Maryland, in the Office of Examination Planning and Delivery during the period September 2004 through June 2005. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

[5] Compliance Risk Assessments are part of the IRS' overall strategic assessment; each operating division was required to prepare an analysis and assessment of the compliance risk for each taxpayer segment.

Results of Review

Small Corporation and S Corporation Return Examinations Have Declined Significantly Since Fiscal Year 2001

The mission of the IRS is to provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all. A December 2003 article on AccountingWEB.com stated, "While the nation's 1,300 largest corporations face constant IRS scrutiny, the 148,000 mid-size companies are audited only about once every 20 years." The IRS Commissioner replied, "That's atrocious."[6]

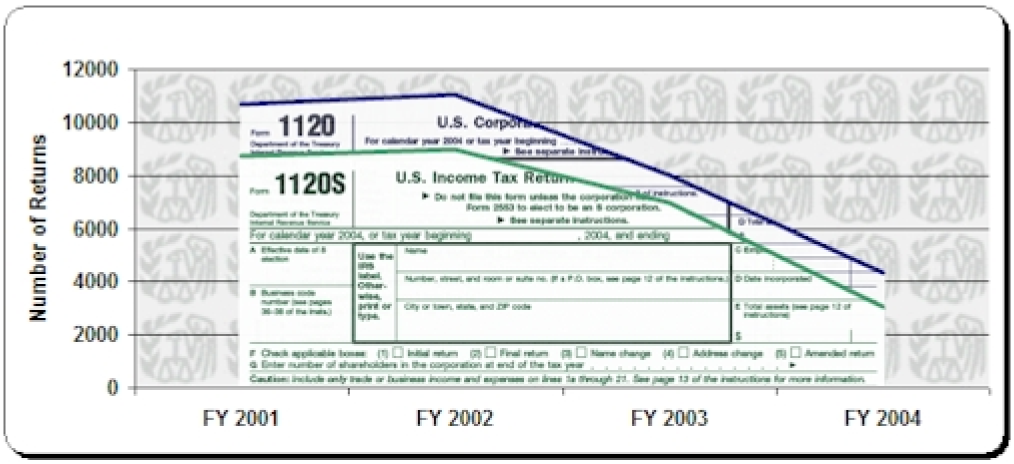
In May 2003 testimony to the Congress, the Government Accountability Office (GAO) stated, "Taxpayers' willingness to voluntarily comply with the tax laws depends in part on their confidence that their friends, neighbors, and business competitors are paying their fair share of taxes. The IRS's compliance programs, including audits and other efforts, are viewed by many as critical to maintaining the public's confidence in our tax system."[7]

Analyses of IRS examination data[8] from FYs 2001 through 2004 showed a sharp decline in the number of small corporation and S corporation returns examined and closed by the SB/SE Division. The number of Form 1120 and 1120S examinations closed decreased from 19,339 to 7,328 (approximately 62 percent) from FYs 2001 to 2004. Specifically, Form 1120 examinations decreased from 10,686 to 4,353 (approximately 59 percent) and Form 1120S examinations decreased from 8,653 to 2,975 (approximately 66 percent). Moreover, acute declines in the numbers of examinations closed occurred from FY 2003 to FY 2004. The number of Form 1120 examinations closed dropped from 7,996 to 4,353 (approximately 46 percent), while the number of Form 1120S examinations closed dropped from 6,884 to 2,975 (approximately 57 percent).

Figure 1 shows the decline in Forms 1120 and 1120S examined from FYs 2001 through 2004 by the SB/SE Division.

[6] "IRS Simplifying Business Tax Audits." AccountingWEB.com. December 30, 2003.
[7] *Compliance and Collection: Challenges for IRS in Reversing Trends and Implementing New Initiatives* (GAO-03-732T, dated May 7, 2003).
[8] We analyzed data from the IRS Audit Information Management System (AIMS). The AIMS is a computer system used to control returns, input assessments/adjustments to the Master File, and provide management reports. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organization data.

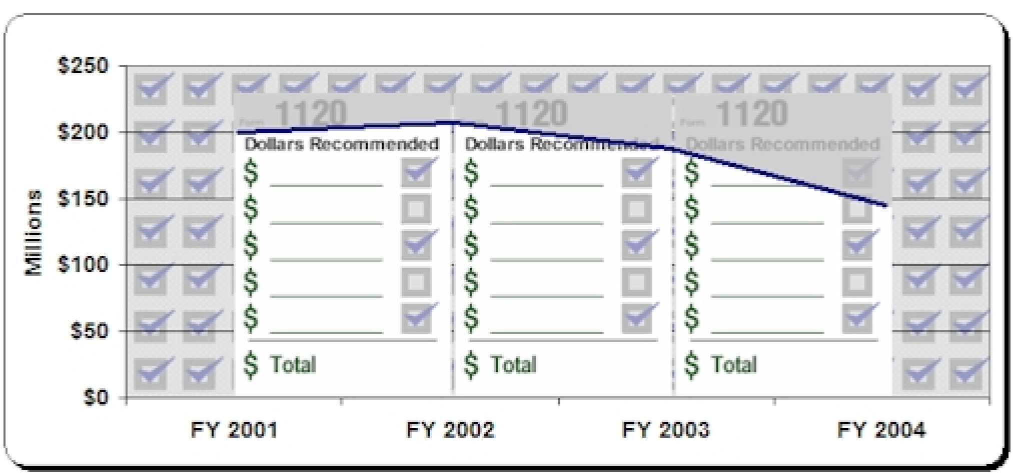
Figure 1: Forms 1120 and 1120S Examined – Assets Under $10 Million



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of AIMS data for FYs 2001 - 2004.

The decline in the number of returns examined resulted in a corresponding decrease in dollars recommended.[9] Figure 2 shows that the decline in the number of FY 2004 Form 1120 examinations closed resulted in a 23 percent decrease in dollars recommended from FY 2003 ($188 million) to FY 2004 ($145 million).

Figure 2: Dollars Recommended – Forms 1120



Source: TIGTA analysis of AIMS data for FYs 2001 - 2004.

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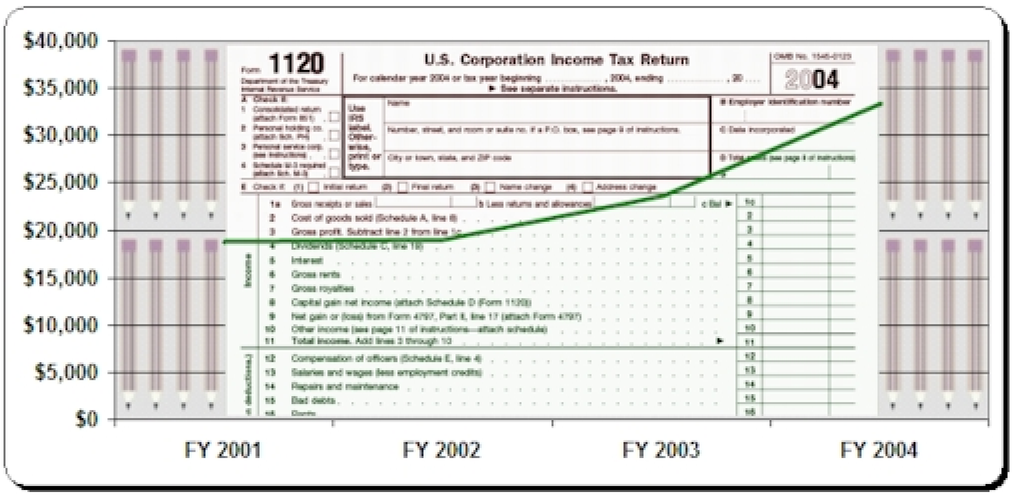
[9] Dollars recommended represents the amount of additional tax proposed to be assessed against the taxpayer.

Although there was a significant decrease in the total dollars recommended from FY 2003 to FY 2004, the average dollars per return for Forms 1120 actually increased. Figure 3 shows the average dollars per return increased from $23,512 in FY 2003 to $33,377 in FY 2004.

Figure 3: Average Dollars Per Return – Forms 1120



Source: TIGTA analysis of AIMS data for FYs 2001 - 2004.

Most of the SB/SE Division examinations in FY 2004 were based on key strategies rather than on selection methods, such as the Discriminant Index Function (DIF)[10] or activity code.[11] According to the SB/SE Division, the compliance strategic initiatives, workload priorities, and major operational priorities for FY 2004 were:

- National Research Program.
- Offshore Schemes (Credit Card Project and Non-Credit Card Schemes).
- Abusive Tax Avoidance Transactions and Promoters.
- High-Income Taxpayers.
- High-Income Non-filers.
- Unreported Income.
- Anti-Money Laundering.

[10] The DIF is a mathematical technique used to classify income tax returns as to Examination program potential.
[11] An activity code is a three-digit numeric code that identifies the type and condition of a return selected for audit.

- Fraud.
- Other Priorities (Addressed in the Annual Compliance Program Letter).

The above initiatives exclude many small corporation and S corporation returns from the examination process. Focusing the majority of resources on the initiatives leaves an entire segment of taxpayers out of the IRS enforcement program. In a December 30, 2003, article from AccountingWEB.com,[12] IRS officials concede that their agency is simply not a factor for businesses in deciding whether to follow the Internal Revenue Code.

In a previously issued report,[13] we determined the number of examinations of small corporation returns in FY 2003 continued the decrease that started in FY 1997. The IRS attributed the decrease in part to a reallocation of resources. More recently, on January 5, 2005, the IRS Commissioner pointed to some increases in enforcement statistics but noted that one compliance area to keep an eye on might be small businesses, companies with less than $10 million in assets. Despite the overall gains in corporate return examination coverage, the audit rate for small businesses fell from .58 percent in 2003 to .32 percent (a 45 percent decrease) in 2004. The IRS Commissioner attributed the 2004 decrease to many factors, including diverting resources to enforcement of compliance of wealthy taxpayers and to investigations of abusive tax shelters.[14]

The SB/SE Division faced a number of challenges and changes during our audit period. Several factors resulted in a decline in the numbers of small corporation and S corporation returns examined and examinations closed, including major organizational realignments, budgetary constraints, and increased customer service and reengineering efforts. Additionally, workload shifts to examinations of abusive tax schemes, flow-through entities, off-shore trusts, and high-income taxpayers caused a decreased emphasis on corporations with less than $10 million in assets.

Examinations Recommending No Changes Remain Constant

The IRS examines income tax returns to determine whether corporations and other taxpayers have voluntarily complied with tax laws and reported the proper amount of tax. To use its resources efficiently, the SB/SE Division attempts to identify and examine returns with the greatest likelihood of noncompliance. Examinations that result in no change to the tax reported deplete limited resources and burden compliant taxpayers who voluntarily reported the correct amount of tax.

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[12] "IRS Simplifying Business Tax Audits." AccountingWEB.com. December 30, 2003.
[13] *Trends in Compliance Activities Through Fiscal Year 2003* (Reference Number 2004-30-083, dated April 2004).
[14] *Everson Evaluates State of IRS, Pledges Strong Agenda for 2005* (Tax Notes Statement, dated January 5, 2005).

IRS return selection processes have not been effective in decreasing the number of examinations that result in no change to the tax reported. During FYs 2001 through 2004, approximately 43 percent of small corporation returns examined resulted in no change to the tax reported. Returns examined and closed with no change to the tax reported are referred to as "no-change" returns.

The IRS further segregates no-change returns into two categories: (1) returns for which the IRS recommends an adjustment to the taxpayer's return but ultimately the tax reported does not change and (2) returns for which there were no adjustments to the return and the IRS accepts the return as originally filed by the taxpayer. Figure 4 shows that the overall percentage of no-change returns for Forms 1120 has slightly decreased from FYs 2001 through 2004 but still remains over 40 percent. The table also shows that of the total number of no-change returns examined (14,468), approximately 30 percent (4,279) resulted in adjustments to taxpayers' returns, but with no change in the tax reported.

Figure 4: No-Change Returns for FYs 2001 – 2004

	FY 2001	FY 2002	FY 2003	FY 2004	TOTALS
Returns[15] Examined	10,686	11,005	7,996	4,353	34,040
No-change Code 01[16]	1,365	1,186	1,090	638	4,279
No-change Code 02[17]	3,302	3,443	2,266	1,178	10,189
% of No-change Code 01	12.77	10.78	13.63	14.66	12.57
% of No-change Code 02	30.90	31.29	28.34	27.06	29.93
%Total No-change Codes 01 & 02	**43.67**	**42.06**	**41.97**	**41.72**	**42.50**

Source: TIGTA analysis of AIMS data for FYs 2001 - 2004.

For Forms 1120S, approximately 42 percent of returns examined were no-change returns for FYs 2001 through 2004. Of the total number of Form 1120S returns examined and categorized as no-change returns (11,529), approximately 11 percent (1,317) were no-change returns with adjustments. During this same period, approximately 366[18] (36 percent) of the total Direct

[15] Our populations include all Forms 1120 for small corporations (those with assets of less than $10 million) examined by revenue agents in the SB/SE Division. Training returns are not included in the populations.
[16] Code 01 identifies returns with an adjustment but no change in tax reported.
[17] Code 02 identifies returns with no adjustments and no change in tax reported.
[18] The 366 includes no-change returns with adjustments (99) and no-change returns without adjustments (267).

Compliance Years[19] (1,018) applied to Form 1120 examinations were charged to no-change returns. Approximately 286[20] (38 percent) of the total Direct Compliance Years (759) applied to Form 1120S examinations were expended on no-change returns.

During discussions with IRS management concerning the issues in this report, the IRS commented that small corporation examinations closed as no-change with adjustments may include noncompliant taxpayers. However, offsets such as net operating losses or credit carryovers may result in no additional tax in the year under examination. In addition, IRS management also stated that no-change examinations of an S corporation return could result in an adjustment on other related returns, such as the shareholder's individual return, since the Form 1120S is a pass through return. Therefore, the no-change with adjustment examinations do differ from complete no-change examinations.

We agree that no-change with adjustment cases do have value. However, the number of no-change returns is one indicator the SB/SE Division examination workload identification and selection systems and processes are not adequately identifying tax returns with the greatest yield potential. One challenge of new workload identification and selection techniques is developing sufficient, up-to-date technical expertise.[21] Without improved identification and selection, the SB/SE Division runs the risk of expending excessive resources on less egregious noncompliant taxpayers and negatively affecting customer service with unnecessary taxpayer contacts.

Our review and analysis of a judgmental sample of 24 small corporation return examinations closed with no changes to the tax reported in FY 2004 determined that, overall, the 24 examination files contained sufficient documentation to explain the total cycle days[22] and examiner time. The 24 sampled examinations each had total cycle days exceeding 900 and examiner time below 50 hours. These examinations were reviewed to determine whether documentation existed to support the decision to close the examinations with no changes to the tax reported.

Initiatives Are Underway to Address Return Selection and Increase Resources for Examinations

The IRS is concerned about declines in the examination coverage of small corporations and S corporations and the productivity of tax returns selected for examination. The SB/SE Division has initiatives underway to improve return selection and increase resources to examine returns.

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19 Based on a Direct Compliance Year composed of 2,000 hours of Direct Examination Time.
20 The 286 includes no-change returns with adjustments (24) and no-change returns without adjustments (262).
21 *Small Business/Self-Employed Strategic Assessment Report for FY 2003 and 2004* (March 1, 2002, issued by the IRS).
22 Total cycle days are the number of days from when the return is filed until the examination process is completed.

The SB/SE Division uses Compliance Initiative Projects (CIP) to improve return selection

The SB/SE Division recognizes the need to improve the selection of returns for examination because case selection systems such as the DIF do not meet current needs. The DIF is based on assumptions developed after completion of the 1988 Taxpayer Compliance Measurement Program (TCMP)[23] and has not been updated. The DIF was not designed to score tax returns based on the IRS' current key enforcement strategies, such as abusive schemes, unreported income, and structured transactions. Since the focus of the FY 2004 Examination program was on key strategies the DIF could not address, examinations of small corporation and S corporation returns that were not a part of those strategies were not a priority.

In FY 2004, the SB/SE Division selected 22 percent of small corporation returns using the DIF; the other 78 percent were selected from non-DIF sources.[24] While the DIF-selected returns accounted for just 22 percent of the FY 2004 examinations, the DIF scoring system was reasonably effective. Recommended dollars from the DIF-scored examinations were comparable to those from non-DIF examinations. The DIF-selected returns contributed 32 percent of the recommended dollars. Additionally, DIF-selected returns resulted in a lower number of no-change returns.[25]

To assist in the return selection process, the IRS has implemented the use of CIPs to identify returns with better audit potential than those currently being selected using the DIF. The CIPs focus on identifying potential areas of noncompliance and developing strategies to improve compliance. Some CIP-identified returns entered the audit stream in October 2004, and examination results are pending.

Increased Examination program staffing should eventually help to increase the examination coverage of small corporation and S corporation returns

The SB/SE Division, as well as the rest of the IRS, continues to face a human capital resource crisis. From FYs 2001 through 2004, 853 SB/SE Division employees transferred to the Large and Mid-Size Business (LMSB) Division. Furthermore, 25 percent of the SB/SE Division revenue agents will be eligible for retirement by the end of FY 2005; 36 percent of the SB/SE Division workforce will be eligible for retirement by the end of FY 2006.

[23] The TCMP used lengthy and detailed examinations to comprehensively measure taxpayer compliance and identify potential tax law changes.
[24] See Appendix IV, Figure 1.
[25] See Appendix IV, Figure 2.

The following represents revenue agents that transferred from the SB/SE Division to the LMSB Division according to IRS personnel data:

- FY 2001 – 379.
- FY 2002 – 81.
- FY 2003 – 119.
- FY 2004 – 274.

To reverse the decline in compliance resources, the SB/SE Division was authorized to hire 984 revenue agents in FY 2005 as part of its Curb Egregious Noncompliance initiative. This initiative is one of the SB/SE Division's major FY 2005 goals. Through this initiative, the SB/SE Division seeks to reverse the continuing decline in compliance resources and to maintain the public's faith in the fairness of our nation's tax system.

Although the IRS appears committed to increasing SB/SE Division compliance resources, it will likely take several years to see the effect on increasing the number of small corporation and S corporation return examinations. It is uncertain whether increased resources will guarantee a solution to the declining examination coverage. Also, the burden on existing staff to provide training[26] and guidance to the new staff may further hamper productivity.

The IRS' efforts are encouraging, but it is too soon to determine the impact on small corporation and S corporation examinations

While we are encouraged by the IRS' efforts to develop better return selection methods through the CIPs and to increase enforcement staffing, it is unclear how effective management's actions will be in reversing the declining examination coverage trend and reducing the number of examinations resulting in no changes to tax reported, especially in the near future. In our opinion, the voluntary compliance of small corporations and S corporations may be negatively affected with the continuing decline in the number of examinations.

Continued efforts to increase the examination coverage are important to the effectiveness of the voluntary compliance system. During this audit, there was insufficient evidence to evaluate whether recent management actions will be effective in reversing the decline in the number of examinations. We plan to monitor their implementation and resulting effects in future TIGTA audits. We have no specific recommendations to offer at this time.

[26] See Appendix IV, Figures 3 and 4.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to analyze statistical data on closed small corporation and S corporation[1] return examinations for Fiscal Years (FY) 2001 through 2004 in the Small Business/Self-Employed (SB/SE) Division to identify and report trends. To meet our objective, we relied on the Internal Revenue Service's (IRS) internal management reports and databases. We did only limited testing to establish the reliability of these data because extensive data validation tests were outside the scope of the audit and would have required a significant amount of time. To accomplish our objective, we:

I. Reviewed the mission statements, centralized workload plans, and strategic planning initiatives of the SB/SE Division with respect to enforcement and examination coverage for the corporate Examination program.

   A. Determined the focus for the corporate Examination program and whether return closure is the program's emphasis.

   B. Determined whether the SB/SE Division has a sufficient number of trained examiners to meet program goals and objectives.

II. Analyzed data on the closed Audit Information Management System (AIMS)[2] database to identify the numbers and types of small corporation and S corporation return examinations conducted for FYs 2001 through 2004. Analyses included determining the number of closed examinations for each period, average dollars per return, average hours per return, and average assessments by disposal code. We also analyzed the number of returns selected by source and activity code.[3] Based on the analyses conducted in this test, we attempted to identify trends in the corporate Examination program.

   A. Determined what disposal codes count as a return closure.

   B. Evaluated the return closure disposal codes that resulted in no change to the tax reported. We determined the time open and the time charged to disposal codes that resulted in no change to the tax reported for examinations that were not completed.

[1] S corporations are corporations that elect to pass corporate income and losses to their shareholders for Federal tax purposes. Small corporations file U.S. Corporation Income Tax Returns (Form 1120); S corporations file U.S Income Tax Returns for an S Corporation (Form 1120S).
[2] The AIMS is a computer system used to control returns, input assessments/adjustments to the Master File, and provide management reports. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organization data.
[3] An activity code is a three-digit numeric code that identifies the type and condition of a return selected for audit.

1. Selected a judgmental sample of 30[4] cases for which total cycle days[5] exceeded 900 days and examiner time charges were below 50 hours. A judgmental sample was used due to time constraints. We reviewed the closed examination files to determine whether documentation existed to support no change to the tax reported. We selected this sample from a population of 4,353 small corporation returns examined and closed by the SB/SE Division in FY 2004 on the AIMS database. Of the 4,353 closed returns, there were 1,816 closed with no change to the tax reported.

III. Based on identified trends, discussed plans to have the SB/SE Division corporate Discriminant Index Function (DIF)[6] Examination program provide more balanced examination coverage.

A. Interviewed management to determine plans for increasing examination coverage in the SB/SE Division corporate Examination program.

B. Secured and reviewed plans, meeting minutes, and other documents that pertain to the future of the SB/SE Division corporate Examination program.

C. Reviewed documents pertaining to the staffing changes and staff years specific to the SB/SE Division corporate Examination program for FYs 2001 through 2004.

D. Assessed the resources allocated to the corporate Examination program.

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[4] The sample size was adjusted to 24 because 6 returns were considered Large and Mid-Size Business Division returns.
[5] Total cycle days are the number of days from when the return is filed until the examination process is completed.
[6] The DIF is a mathematical technique used to classify income tax returns as to Examination program potential.

Appendix II

Major Contributors to This Report

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Appendix III

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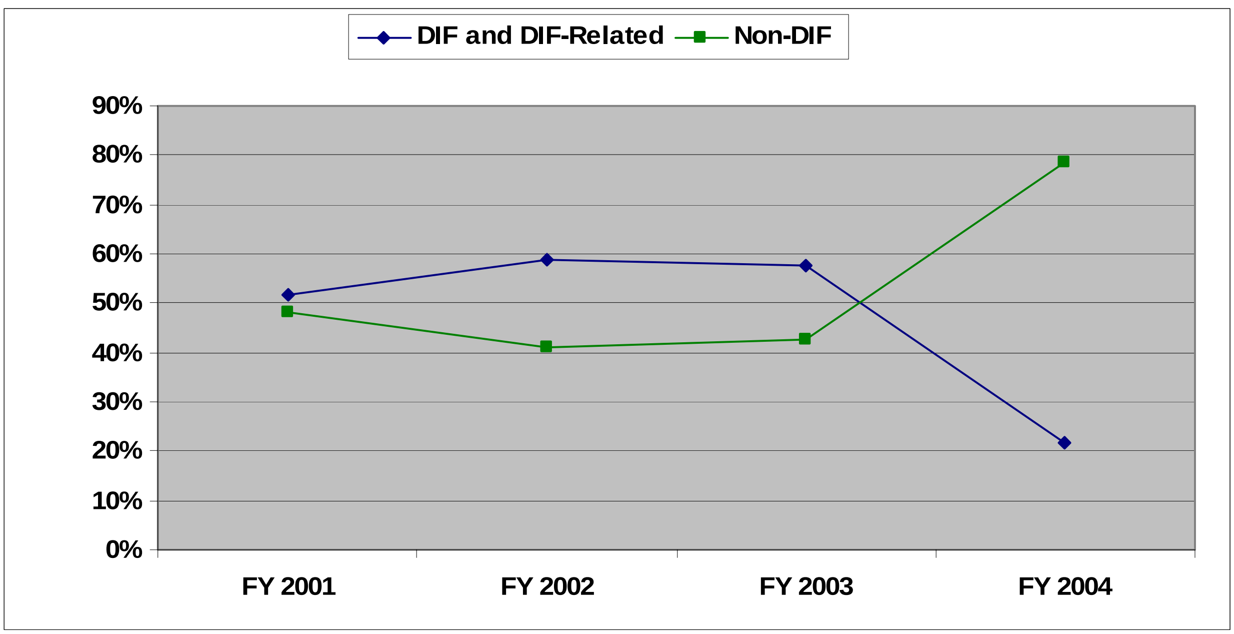
Appendix IV

Detailed Charts of Statistical Information

As shown in Figure 1, the sources of U.S. Corporation Income Tax Returns (Form 1120) selected for examination have changed dramatically since Fiscal Year (FY) 2001, with fewer returns selected from the Discriminant Index Function (DIF)[1] scoring system being examined in recent years.

Figure 1: Sources of Small Corporation Returns Examined for FYs 2001 - 2004



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of Audit Information Management System (AIMS)[2] data.

[1] The DIF is a mathematical technique used to classify income tax returns as to Examination program potential.
[2] The AIMS is a computer system used to control returns, input assessments/adjustments to the Master File, and provide management reports. The Master File is the IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organization data.

As shown in Figure 2, overall, DIF-selected returns had fewer returns closed with no changes.

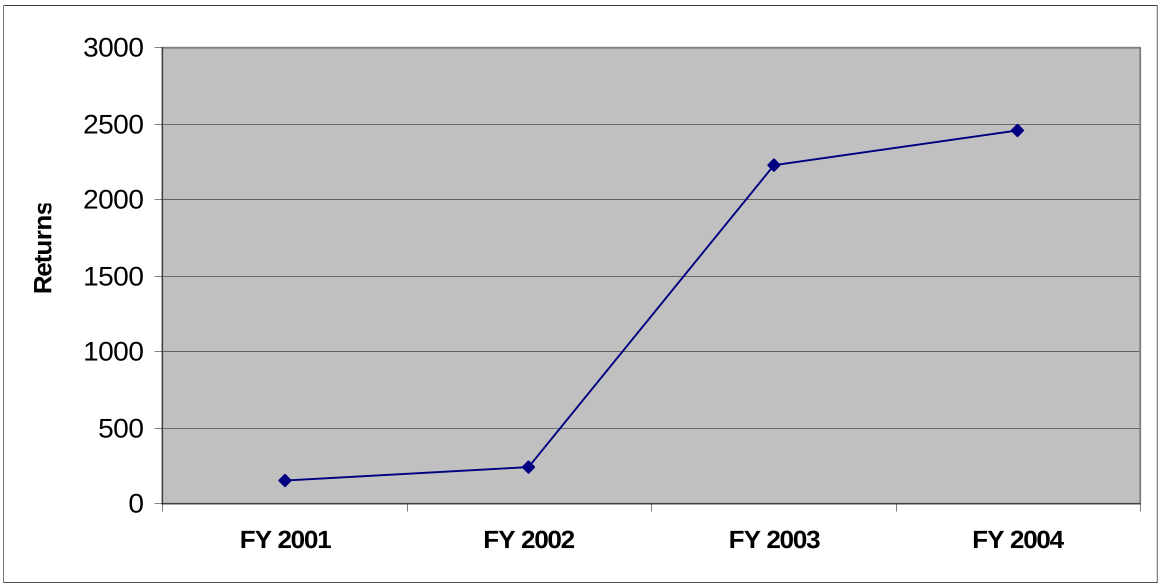
Figure 2: Percentage of Returns Examined With No Change to Tax Reported, Based on Source of Selection

	FY 2001	FY 2002	FY 2003	FY 2004
DIF and DIF-Related Returns:				
No changes, adjustment	7.03%	6.67%	8.65%	12.11%
No changes, no adjustment	31.94%	31.82%	28.39%	13.71%
Total	**38.97%**	**38.49%**	**37.04%**	**25.82%**
Non-DIF Returns:				
No changes, adjustment	18.96%	16.67%	20.38%	15.36%
No changes, no adjustment	29.77%	30.53%	28.28%	30.74%
Total	**48.73%**	**47.20%**	**48.66%**	**46.10%**

Source: TIGTA analysis of AIMS data for Forms 1120.

As shown in Figure 3, the numbers of training returns examined (Forms 1120 and U.S. Income Tax Returns for an S Corporation [Form1120S]) increased from 151 in FY 2001 to 2,459 in FY 2004.

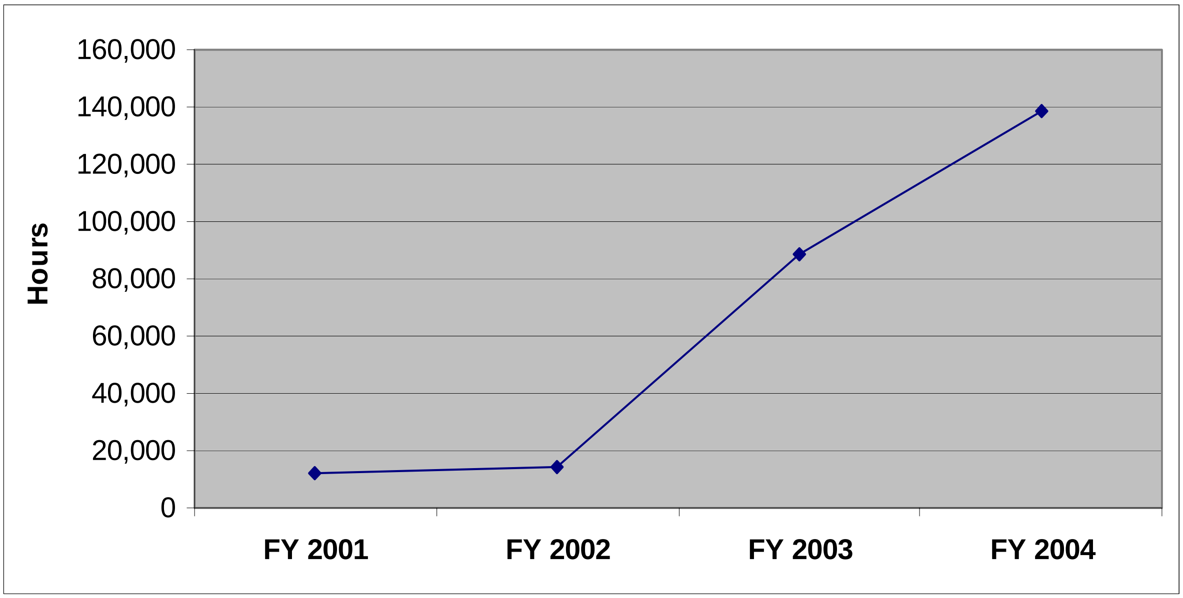
Figure 3: Changes in the Number of Training Return Examinations by Fiscal Year



Source: TIGTA analysis of AIMS data.

As shown in Figure 4, the numbers of examiner hours expended on training returns (Forms 1120 and 1120S) have increased sharply since FY 2001, as new revenue agents have been hired.

Figure 4: Examination Program Resources Dedicated to Training Returns



Source: TIGTA analysis of AIMS data.