TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed

September 19, 2011

Reference Number: 2011-40-103

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

Redaction Legend:
1 = Tax return/Return Information
2(f) = Risk Circumvention of Agency Regulation or Statute

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HIGHLIGHTS

AFFORDABLE CARE ACT: EFFORTS TO IMPLEMENT THE SMALL BUSINESS HEALTH CARE TAX CREDIT WERE MOSTLY SUCCESSFUL, BUT SOME IMPROVEMENTS ARE NEEDED

Highlights

Final Report issued on September 19, 2011

Highlights of Reference Number: 2011-40-103 to the Internal Revenue Service Deputy Commissioner for Services and Enforcement.

IMPACT ON TAXPAYERS

The Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act were signed into law in March 2010. Among the credits contained in this legislation was the Small Business Health Care Tax Credit (Credit). In general, the Credit is available only to small employers who pay at least one-half the cost of health insurance coverage for their employees. The Credit was designed to encourage small employers to offer health care insurance. Internal Revenue Service (IRS) efforts to implement the Credit were mostly successful, but some improvements are needed.

WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether the IRS adequately implemented and accurately processed the Credit. The Congressional Budget Office estimated the Credit would cost $37 billion over 10 years and that taxpayers would claim up to $2 billion of Credit for Tax Year 2010.

WHAT TIGTA FOUND

The IRS timely completed actions to plan for and implement the Credit. The volume of claims for the Credit has been low despite IRS efforts to inform 4.4 million taxpayers who could potentially qualify for the Credit. According to the IRS, as of mid-May 2011, just more than 228,000 taxpayers had claimed the Credit for a total amount of more than $278 million. Among reasons given by industry groups and professional organizations for the low volume was the time and effort required to claim the Credit. The IRS plans to conduct focus groups to determine why the claim rate was so low.

The Credit is specifically targeted to small employers but certain taxpayers may claim the Credit even when they have not filed employment tax returns. This occurs because companies can enter into a contractual relationship with a Professional Employer Organization that manages human resources.
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The Credit for Small Employer Health Insurance Premiums (Form 8941) does not contain all of the data and calculations needed to verify each step of Credit eligibility and calculation. Based on the information that was available, TIGTA found that both taxpayers and tax practitioners were making mistakes when completing Form 8941. ***********2(f)***************
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WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS track Professional Employer Organization relationships; seek legislation to provide targeted math error authority ********2(f)********
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In their response to the report, IRS officials agreed with the recommendations and plan to take appropriate corrective actions.

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

September 19, 2011

MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed (Audit # 201040045)

This report presents the results of our review to determine whether the Internal Revenue Service adequately implemented and accurately processed the Small Business Health Care Tax Credit. This audit is included in our Fiscal Year 2011 Annual Audit Plan. It was initiated in response to the passage of the Patient Protection and Affordable Care Act[1] and addresses the major management challenge of Implementing Health Care and Other Tax Law Changes.

Management's complete response to the draft report is included in Appendix VI.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.

[1] Pub. L. No. 111-148, 124 Stat. 119 (2010).

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Abbreviations

FTE	Full-Time Equivalent
FY	Fiscal Year
HHS	Department of Health and Human Services
IRS	Internal Revenue Service
PEO	Professional Employer Organization
TIGTA	Treasury Inspector General for Tax Administration

Background

On March 23, 2010, the Patient Protection and Affordable Care Act[1] (Affordable Care Act) was signed into law. Along with amendments in the Health Care and Education Reconciliation Act of 2010,[2] which was signed on March 30, 2010, this legislation contains approximately $438 billion[3] worth of revenue provisions in the form of new taxes, fees, and penalties. It also contains credits providing incentives for medical research and for businesses to offer employee health insurance coverage. Additionally, new reporting requirements have been established for certain business transactions.

Among the credits contained in the new health care legislation was the Small Business Health Care Tax Credit (Credit).[4] Effective for tax years beginning after December 31, 2009, the Credit is a new business credit for employee health insurance expenses of small businesses and certain tax-exempt organizations. The Congressional Budget Office estimated the Credit would cost $37 billion over 10 years.

In general, the Credit is available only to small employers who pay at least one-half the cost of health insurance coverage for their employees. When claimed on individual or business returns, the Credit is nonrefundable (i.e., only available to offset actual tax liability). The Credit is refundable to tax-exempt organizations, but only to the extent it does not exceed the total amount of income tax and Medicare tax withholding from employees' wages and the employer share of Medicare tax. Employers will continue to be able to deduct the costs in excess of the Credit amount as an ordinary expense for employee compensation. A credit is normally preferred to a deduction because it reduces tax due dollar-for-dollar, as opposed to a deduction, which decreases taxable income.

The rules concerning which taxpayers qualify for the Credit and how to calculate the Credit amount are complex.

The legislation concerning which taxpayers qualify for the Credit and how to calculate the Credit amount is complex. To address this, the Internal Revenue Service (IRS) issued Notice 2010-44 and Notice 2010-82, which set forth detailed guidance on claiming the Credit.

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[1] Pub. L. No. 111-148, 124 Stat. 119 (2010).
[2] Pub. L. No. 111-152, 124 Stat. 1029.
[3] Joint Committee on Taxation estimated revenue effects, JCX-17-10, March 20, 2010.
[4] Pub. L. No. 111-148, 124 Stat. 119, Section 1421 (2010).

The IRS notices contain the following information:

To qualify for the Credit, an employer must have the following characteristics:

- Have fewer than 25 full-time equivalents (FTE)[5] for the taxable year.
- Have average annual wages for its employees for the year less than $50,000 per FTE.
- Maintain a "qualifying arrangement."[6]
- Not be an agency or instrumentality of Federal, State, local, or Indian Tribal Governments.
- If a tax-exempt organization, be described in Internal Revenue Code section 501(c) and be exempt from tax under section 501(a). Tax-exempt entities do not qualify if these sections do not apply.

In brief, an employer must follow these steps to determine eligibility for the Credit:

- Determine the employees who are taken into account for purposes of the Credit.
- Determine the number of hours of service performed by those employees.
- Calculate the number of the employer's FTEs.
- Determine the average annual wages paid per FTE.
- Determine the premiums paid by the employer that are taken into account for purposes of the Credit. The premiums must be paid by an employer under a qualifying arrangement and must be paid for health insurance that meets requirements related to the Credit.

There are multiple steps to calculate the Credit, and seven worksheets must be completed in association with claiming the Credit.[7] In general, the steps include:

- Calculate the maximum amount of the Credit.

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[5] FTEs, as defined by the legislation, mean a number of employees equal to the number determined by dividing the total number of hours of service for which wages were paid by the employer to employees during the taxable year by 2,080. Additional guidance on FTEs is also provided in the legislation and in IRS Notice 2010-44.
[6] An arrangement under which the employer pays premiums for each employee enrolled in health insurance coverage offered by the employer in an amount equal to a uniform percentage (not less than 50 percent) of the premium cost of the coverage.
[7] The worksheets are contained in the instructions for Credit for Small Employer Health Insurance Premiums (Form 8941).

- Reduce the maximum Credit in step 1 in accordance with the phase-out rule, if necessary.[8]
- For employers receiving a State credit or subsidy for health insurance, determine the employer's actual premium payment.

See Appendix IV for a copy of the Credit for Small Employer Health Insurance Premiums (Form 8941) showing the steps that must be reported. Appendix V contains a more detailed summary of factors that must be considered in determining eligibility for the Credit.

After eligibility is established and the Form 8941 is completed to determine the Credit amount, the amount is rolled up to another form or forms. In the case of most businesses and individuals, the Credit is reported as part of the General Business Credit (Form 3800) and then rolled up again (to the extent allowed) to the U.S. Corporation Income Tax Return (Form 1120) or U.S. Individual Income Tax Return (Form 1040). Partnerships and S corporations report the Credit as part of Schedule K on the U.S. Return of Partnership Income (Form 1065) or the U.S. Income Tax Return for an S Corporation (Form 1120S). Tax exempt organizations report the Credit on the Exempt Organization Business Income Tax Return (Form 990-T).

There is a risk of errors or irregularities occurring when the Credit is claimed or processed. The Credit is new, and both taxpayers and IRS employees will need to acquaint themselves with the rules. As described above, the rules themselves are complex, making it difficult for taxpayers to follow. The Credit is refundable to tax-exempt taxpayers, which is a high-risk factor for erroneous refunds. The IRS also had to complete new programming to accommodate the new Form 8941 and identify potential compliance risks.

This review was performed from the Treasury Inspector General for Tax Administration (TIGTA) offices in Fresno, California; Austin, Texas; and Ogden, Utah, and at the IRS Campuses[9] in Austin, Texas, and Ogden, Utah, during the period September 2010 through May 2011. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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[8] Employers with more than 10 but less than 25 FTEs or average wages of more than $25,000 but less than $50,000 will not be eligible for the full amount of the Credit but may qualify for a reduced amount.

[9] 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 taxpayer accounts.

Results of Review

Extensive Efforts Were Made to Implement the Credit

With some exceptions, the IRS timely completed actions to plan for and implement the Credit. This was complicated by the scope and complexity of the many provisions in the Affordable Care Act legislation, including some that were effective during the same calendar year the legislation was passed. Additional tax legislation passed later in the year also required additional IRS resources to implement.

The IRS completed extensive efforts related to implementing the Credit and other Affordable Care Act provisions. Shortly after the legislation was passed, the IRS began assessing what it would need to do to implement the Credit and tracked these efforts as they were completed. According to the IRS, it has completed more than 1,000 outreach and education actions, including communication efforts to inform taxpayers and tax professionals about the Credit. The IRS mailed approximately 4.4 million postcards with basic information on the Credit to businesses that could be affected. The IRS also used several means to inform tax professionals about the Credit. Figure 1 summarizes the planned and actual actions the IRS took to implement the Credit.

The IRS completed extensive efforts related to implementing the Credit and other Affordable Care Act provisions.

Figure 1: Planned and Actual Actions to Implement the Credit

Planned Actions	Actual Actions Taken
Define necessary programming.	Prepared programming requirements documents and implemented programming that allowed for accepting returns claiming the Credit.
Create or revise forms and instructions.	Created and revised key forms and instructions.
Provide guidance to IRS employees.	Developed internal procedures published in the Internal Revenue Manual and posted information on the Credit on an internal web site for employee reference.
Inform potentially affected taxpayers.	Developed a detailed communication plan to inform key groups about the Credit. Sent more than 4 million postcards (at a cost of approximately $990,000) directly to potentially affected taxpayers informing them about the Credit and where to get more information.

Planned Actions	Actual Actions Taken
Perform media outreach to taxpayers and tax professionals.	Established a telephone line for taxpayer and practitioner questions related to the Affordable Care Act, including questions about the Credit. Issued press releases that described the Credit and directed taxpayers to the IRS web site for more information. Sent electronic messages about the Credit to the small business and tax professional community subscribing to IRS alerts and news articles. Established an Internet page specifically to provide information on the Credit. The webpage contained a summary of Credit eligibility and calculation factors and links to sample scenarios, questions and answers, a video, press releases, formal guidance, and other Affordable Care Act provisions. Included Credit information in presentations made to tax professionals.
Issue official guidance.	Notice 2010-44 provided initial guidance to taxpayers on the Credit. Notice 2010-82 expanded on the guidance provided in Notice 2010-44 and provided guidance on additional issues relating to the Credit.
Develop a compliance strategy.	Developed a compliance plan with targeted approaches to identify noncompliance with Credit provisions by individual, business, and tax-exempt taxpayer groups.
Coordinate with the Department of Health and Human Services (HHS).	Revenue Ruling 2010-13, developed in conjunction with the HHS, set the average premium allowed, which acts as a cap to costs allowed to be claimed for the Credit.
Train IRS employees.	Offered online training as an option to employees reviewing individual and business returns. Provided in-person training for employees reviewing tax-exempt entity returns.

Source: Legislative Analysis Tracking and Implementation Services reports, Small Business/Self-Employed – Tax Exempt and Government Entities Communication Plan: Patient Protection and Affordable Care Act Section 1421 Small Business Tax Credit, and other internal IRS documents and documents available on the IRS's public web site, IRS.gov.

Guidance on applying State subsidy rules is currently being developed

While the IRS has issued guidance to taxpayers on how to account for State subsidies when calculating the Credit, little information was available from the IRS on which States offer such subsidies. The IRS also did not issue guidance to its revenue agents[10] on which States offer this benefit for consideration when auditing taxpayers. When we brought this to the IRS's attention, the IRS acknowledged that it should do more in these areas and plans to obtain tax practitioners'

[10] An employee in the Examination function who conducts face-to-face examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes (e.g., excise tax returns).

thoughts on how to improve. As of the date of our report, the IRS was in the process of developing a job aid for revenue agents to use during exams.

Funding has been sufficient so far, but future funding is uncertain

The IRS has received funding to implement various provisions of the Affordable Care Act through the HHS.[11] The IRS estimated that its costs to implement the Credit for Fiscal Year (FY) 2010 and FY 2011 would be approximately $29 million, with labor-related costs accounting for about $27 million of that total. The HHS is providing ongoing funding to the IRS on a quarterly basis, and IRS officials told us the funding should be sufficient through FY 2011 to implement all aspects of the Affordable Care Act assigned for implementation during that period. The IRS has estimated that specific Credit-related costs in FY 2012 will be about $24 million, with the majority of the requested funding being compliance related.[12] The IRS has had to incur significant costs, including hiring additional employees in many programs, to implement the various provisions related to the Affordable Care Act, including the Credit. However, funding for FY 2012 forward remains uncertain as of the date of our report.

Compliance Issues Exist for Companies That Do Not File Employment Tax Returns

Even though the Credit is specifically targeted to small employers, certain taxpayers may claim it even when they have not filed required employment tax returns. A lack of employment tax returns could indicate an erroneous claim and that the taxpayer is not even an employer.
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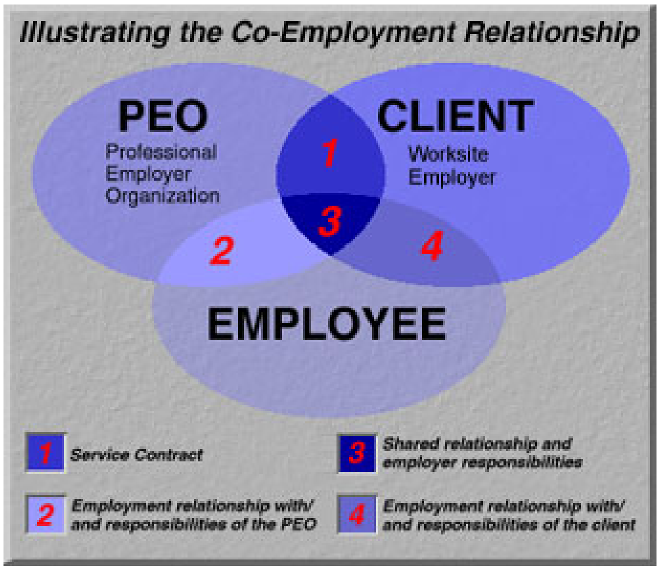
PEOs began operating in the early 1980s and assume some employment-related responsibilities

[11] The Health Care and Education Reconciliation Act provided the HHS with $1 billion in funding, in part to implement the Affordable Care Act legislation. The HHS may distribute the funding to other Federal agencies for this purpose.
[12] Internal Revenue Service FY 2012 Budget Request Congressional Budget Submission, February 14, 2011.

for client companies, including hiring some or all of the client companies' employees whose services are then leased back to the client companies (Figure 2 presents the graphical relationship). The PEOs pay wages and file employment tax returns on employees' wages that would otherwise be handled by their client companies. An industry organization, the National Association of Professional Employer Organizations, describes this relationship as "co-employment."

Figure 2: Relationship of the PEOs, Clients, and Employees



Source: © The National Association of Professional Employer Organizations, used with permission.

The PEO, acting as the employer of the leased employees, files employment tax returns under its own Employer Identification Number, and the client businesses where the employees work claim other employment-related expenses and the related deductions and credits (as long as these were paid by the client business) under their (different) Employer Identification Numbers.
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While some businesses, such as companies that only process payroll and file tax returns on behalf of other businesses, disclose similar arrangements to the IRS, this is generally not the case for the PEOs. Other arrangements, where one business acts as an agent for another business, are disclosed on the forms for Employer/Payer Appointment of Agent (Form 2678) and the Allocation Schedule for Aggregate Form 941 Filers (Schedule R (Form 941)). However, the PEO business model is premised on the PEO's view that it is a legal employer, not the agent of the client business. **************************2(f)*********************************

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The TIGTA identified the same issue related to tracking the relationships between the PEOs and client companies in a previous report.[13] In that report, the TIGTA recommended that the IRS work with the Department of the Treasury to explore all options, including use of the revised Form 2678, to establish accurate links between the PEOs and their clients. While the IRS did pursue legislative changes in response to the recommendation, the actions taken were not effective in addressing this problem.

The IRS has a high-priority compliance program aimed at identifying and auditing employers who have not paid employment taxes. Taxpayers using the PEOs may unnecessarily fall into this compliance program, resulting in a waste of IRS resources and an increased burden on the affected taxpayers.

To administer employment tax laws and to effectively use scarce compliance resources, the IRS needs to be able to identify businesses that begin using the services of a PEO, as well as when businesses terminate the use of those services. Without this ability, the IRS may not take appropriate actions against the businesses that do not pay employment taxes or improperly claim credits. Moreover, it may unnecessarily burden taxpayers who are paying through a PEO.

Recommendation

Recommendation 1: The Commissioner, Small Business/Self-Employed Division, should track PEO relationships by inputting cross-referenced Employer Identification Numbers on the client business tax accounts.

> ***Management's Response:*** IRS management agreed with this recommendation and will revise impacted form instructions to require reporting that will closely track relationships between businesses and PEOs and Professional Leasing Organizations filing payroll returns.

The Low Claim Rate and Errors and Omissions on Forms Indicate Continued Outreach and Improved Processes Are Needed

Taxpayers have been slow to claim the Credit, and both taxpayers and tax practitioners are making mistakes on Form 8941. In spite of the extensive outreach and education efforts made by the IRS to inform taxpayers and the tax preparer community about the Credit and how to claim it, more needs to be done to ensure that taxpayers are aware of the Credit and to improve accuracy in Credit claims.

[13] *Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations, but More Can Be Done* (Reference Number 2007-30-169, dated September 19, 2007).

The volume of Credit claims has been lower than expected

Despite IRS efforts to inform 4.4 million taxpayers who could potentially qualify for the Credit, the volume of claims for the Credit has been low. The Credit was designed to encourage small employers to offer health care insurance. However, as of mid-May 2011, the IRS reported that just more than 228,000 taxpayers had claimed the Credit for a total amount of more than $278 million. While some additional returns can be expected to continue to come in until the extension deadlines later this year, this is substantially lower than the Congressional Budget Office estimate that taxpayers would claim up to $2 billion of Credit for Tax Year 2010.

Although the IRS sent postcards to businesses that might potentially qualify for the Credit to make sure they were aware of it, the IRS did not have ready access to data that would allow it to determine which of these businesses actually offer health care insurance to their employees or otherwise qualify for the Credit. Many small businesses do not offer health insurance and would not qualify for the Credit. Other factors, such as family members working as employees or the business failing to offer the right kind of health care plan, might also cause businesses to be ineligible.

The IRS spoke with industry groups and professional organizations to try to determine why businesses were not claiming this Credit. Some reasons given were that small businesses may take a wait and see approach with the Credit, the Credit is not worth the time and effort to claim it, taxpayers are unclear on the specifics of the Credit and rely on tax professionals to claim it, and business-related information needed to claim the Credit is not readily available. The late start to the filing season may also have impacted the number of claims to date.[14]

The IRS plans to conduct focus groups with tax practitioners to identify knowledge gaps on the part of taxpayers and tax practitioners, determine barriers to taxpayers claiming the Credit, and determine better ways to communicate with stakeholders.

Taxpayer forms were inaccurate and incomplete

There was not sufficient information on the Form 8941 and other forms filed with taxpayer returns to identify all errors made when claiming the Credit; however, based on the information that was available, we concluded that some claims contained errors[15] or were incomplete.

We reviewed a judgmentally selected sample of different return types as they were being processed at the Austin, Texas, and Ogden, Utah, Campuses. We chose the returns based

[14] Because of the late passage of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (enacted December 17, 2010), individuals claiming certain deductions or itemizing on Schedule A had to wait until February 14, 2011, to file their individual tax returns. Consequently, filing was delayed for approximately 6.5 million returns.

[15] The Form 8941 does not contain all of the data and calculations needed to verify each step of Credit eligibility and calculation. It is necessary to complete worksheets in the Instructions for the Form 8941 in order to correctly claim the Credit, and the worksheets are not filed with the return.

primarily on how many forms of a particular type were available during our visit and whether we noticed any anomalies during our review. Our review included returns for individuals, businesses, and tax-exempt organizations. The results of the judgmental sample cannot be used to estimate the extent of actual errors. The purpose of the sample was to identify the types of errors that are occurring. Figure 3 describes the return types that we reviewed and the type of Credit that was claimed by taxpayers.

Figure 3: Return Types Reviewed From Site Visits

	How the Credit Was Claimed on Form 8941		
Form Type	**Business Only**	**Pass-Through[16] Only**	**Total**
1040	14	75	**89**
1120	46	**1**	****1****
1120S	34	**1**	****1****
1065	23	**1**	****1****
990-T	43	0	**43**
Other	5	12	**17**
Total	**165**	**92**	**257**

*Source: Results of TIGTA site visit case reviews. There were no sample cases in which taxpayers claimed the Credit for their own business and also claimed pass-through Credit, although this is possible. There were four taxpayers filing on Form 1040 that claimed the Credit on Form 3800 and***********1******************* *****************************1******************* and are not included in the totals.*

Additionally, we analyzed computerized data that were available prior to the end of the filing season for possible issues.

The types of erroneous claims we identified through either the case review or data analysis included:

<u>Arithmetic or Calculation Errors:</u>

- Errors in calculating FTEs (FTEs exceeded the number of employees (seven occurrences; case review).
- Incorrect application of percentage allowance (nine occurrences; case review).

[16] Partnerships and S corporations are sometimes called flow-through or pass-through entities because income and expenses “pass through” these business entities and are reported on the income tax returns of the partners or owners.

- Incorrect calculations of phase-out rules (five occurrences; case review).
- Claims that exceeded the maximum allowed based on the State average and all employees with family coverage (22 of 12,486 total Form 1120 claims made through mid-April; data analysis of all claims filed at the time the analysis was performed).

Other Errors:

- Taxpayer reported no employees were covered under qualifying agreements (i.e., the health care plan offered did not meet the specifications in the law (six occurrences; case review).
- Missing Employer Identification Numbers on the Form 3800 when the taxpayer claimed the Credit from a pass-through entity (10 occurrences; case review).
- Missing the Form 3800 when the taxpayer claimed the Credit from a pass-through entity (14 occurrences; case review).
- Claims made when no employment tax returns were filed (6 of 10 cases reviewed from a preselected group of 535 Form 1120 taxpayers who had apparently not filed employment tax returns but had claimed the Credit; data analysis of all claims filed at the time the analysis was performed).

Several of the errors we identified during our review could be addressed by allowing the IRS to exercise math error authority for this Credit when appropriate. Math error authority would allow the IRS to improve compliance and avoid burdensome audits by correcting errors or contacting the taxpayer during processing, but prior to allowing the Credit or paying refunds on potentially erroneous returns.

The lack of targeted math error authority hampers IRS compliance efforts

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****************2(f)****************. Additional math error authority can be provided by statute, but in the case of the Credit it was not included in the law.

Math error authority allows the IRS to correct certain errors during processing, including calculation errors and entries that are inconsistent or exceed statutory limits, without having to issue the taxpayer a statutory notice of deficiency. This is especially important with respect to refundable credits because such credits are targets for fraud. The TIGTA has recommended in a prior report that the IRS seek math error authority for all refundable credits when no supporting

documentation is attached.[17] ******************2(f)*******************************
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Some errors could be addressed with existing authority

Some errors that taxpayers have made when completing the Form 8941 could be addressed during processing because they are straightforward arithmetic errors. ***********2(f)******
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One IRS objective is to resolve taxpayer issues in a timely manner, which enhances the taxpayer experience with the IRS and makes it easier for people to voluntarily comply with the law. The IRS's compliance plan related to the Credit, ****************2(f)****************
*************2(f)******************************speeds processing but actually may be more burdensome on taxpayers than a more timely intervention. Determining eligibility and making Credit calculations is a complex task and it is relatively easy to make inadvertent mistakes. Making corrections to mathematically incorrect returns as they are processed is one way to save both the IRS and the taxpayer time. The potential burden of an audit is also averted for the taxpayer.

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*****************2(f)*****************. Fortunately for impacted taxpayers, the amount of Credit is limited (either to the extent of taxable income or to the extent of certain payroll-related taxes in the case of tax-exempt taxpayers), so these errors have not resulted in excessively large amounts of credits or refunds in cases we reviewed.

[17] *Recovery Act: Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits* (Reference Number 2011-41-035, dated March 31, 2011).

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The IRS has been tasked with implementing many programming changes related to recent legislation and also would like to limit database size to conserve resources. However we believe that taxpayers and the IRS would be better served by preemptively dealing with claims that have obvious arithmetic errors on them and limiting the need for formal post-processing audits.

Recommendations

The Commissioner, Small Business/Self-Employed Division, should:

Recommendation 2: Work with the Department of the Treasury, Office of Tax Policy, to seek legislation to provide targeted math error authority that would allow the IRS to disallow the Small Business Health Care Tax Credit when employment tax returns have not been filed or when other supporting documents have not been provided.

> **Management's Response:** IRS management agreed that math error authority is an important compliance tool in many cases. In determining the appropriate administration of the Credit, the IRS will explore with its colleagues at the Department of the Treasury, Office of Tax Policy, whether math error authority is appropriate.

Recommendation 3: Until math error processes are established,**************2(f)****** ***********************************2(f)*********************************** **************************2(f)***********************************

> **Management's Response:** ********************2(f)****************** *******************************2(f)********************************** *******************************2(f)***************** The IRS agreed that it is beneficial to address potential compliance issues as early in the process as possible and has developed procedures to examine questionable returns prior to the issuance of a refund.
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Recommendation 4: ********************2(f)****************** **********************************2(f)************************************* **********************************2(f)*********************************** **********************************2(f)************************************** ****************************2(f)*********************

> **Management's Response:** ********************2(f)********************* **********************************2(f)******************************** **********************************2(f)**************** *********** **********************************2(f)***************.

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the IRS adequately implemented and accurately processed the Small Business Health Care Tax Credit (Credit). We evaluated outreach (identification of qualifying businesses), forms and publications, computer programs, training, processing, and compliance. To accomplish this objective, we:

I. Determined how the IRS helped ensure that all potential taxpayers were identified and given sufficient information on the Credit.

   A. Interviewed IRS staff and obtained relevant documents regarding the steps the IRS took to perform outreach to potentially eligible taxpayers and inform them about the Credit. We considered taxpayers filing returns as individuals, businesses, and tax-exempt entities.

      1. Analyzed the methodology the IRS used to identify the population of potentially eligible employers for outreach efforts such as the postcard mailing. The estimates included number and type of taxpayer and dollar amounts of Credit claimed.

      2. Identified if there were significant omissions compared to the TIGTA estimate.

      3. Evaluated the IRS methodology in terms of how many taxpayers of each group (individuals, businesses, and tax-exempt entities) the IRS (a) identified and (b) attempted to contact. We assessed the adequacy of the methods of contact (e.g., postcards, industry events, new employer workshops).

      4. Assessed the information provided to taxpayers and determined if it was timely, accurate, and adequate (e.g., described the Credit and told taxpayers how to get more information).

   B. If there were obstacles or delays in outreach, identified causes and any compensatory actions the IRS took to get out information on the Credit.

II. Determined if the IRS took the appropriate action to update forms, instructions, and publications.

   A. Interviewed IRS staff regarding the steps the IRS took to update relevant forms, schedules, instructions, and publications.

   B. Identified forms, publications, etc., the IRS updated and determined if any additional documents should have been updated.

1. Reviewed copies of the forms, publications, etc., as they were updated.
2. Reviewed other forms, publications, etc., that were relevant to determine if they should have also been updated.

C. Assessed if the updates were timely, complete, accurate, and clear and adequately assisted taxpayers in determining if they qualified for the Credit and how to claim it.

III. Determined if the IRS took the appropriate action to update IRS data systems to accept Credit information and for use in compliance programs related to the Small Business/Self-Employed Division and the Tax Exempt and Government Entities Division.

A. Interviewed business unit staff regarding the steps taken to update IRS data systems to accept Credit information and for use in compliance programs.

B. Reviewed Programming Requirements Package and/or Functional Specifications Package logic and assessed computer programming

C. Interviewed business unit staff regarding programming progress and issues.

D. Evaluated the IRS plans to validate Credit claims prior to accepting the return as filed.

E. Followed up on any delays or issues with the Modernization and Information Technology Services organization.

F. As forms were being processed at the campuses,[1] we took a judgmental sample of 166 business returns at the Ogden, Utah, Campus and 96 individual returns at the Austin, Texas, Campus. Our sample included 44 Exempt Organization Business Income Tax Returns (Form 990-T), 48 U.S. Corporation Income Tax Returns (Form 1120), 35 U.S. Income Tax Return for an S Corporation (Form 1120S), 25 U.S. Return of Partnership Income (Form 1065), 10 U.S. Income Tax Return for Estates and Trusts (Form 1041), 4 other business form types, 93 U.S. Individual Income Tax Returns (Form 1040), and 3 U.S. Nonresident Alien Income Tax Returns (Form 1040NR). We chose the returns based primarily on how many forms of a particular type were available during our visit and whether we noticed any anomalies during a cursory review. We reviewed input and results on the Integrated Data Retrieval System[2] to verify data entry accuracy. To the extent it was possible, we validated Credit amounts calculated by taxpayers.

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[1] 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 taxpayer accounts.
[2] IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

G. Interviewed Examinations function staff in the business unit to determine what information they would need to identify returns of interest.

H. Assessed compliance plans from the business unit to determine what post-filing procedures would be used to identify cases of interest.

I. Performed various analyses based on data in the TIGTA Data Center Warehouse[3] database related to business taxpayers.

- We matched taxpayers who filed Form 1120 and had claimed the Credit against the database of taxpayers who had paid employment taxes in March 2010 or later. We reviewed 10 Form 1120 cases meeting the specified criteria to determine if the taxpayer accounts showed a possible exception to the requirement to file employment tax returns. We identified 6 out of the 10 Form 1120 cases in which the taxpayer account did not show any reason why the taxpayer did not file employment tax returns. We researched the exception cases on the Integrated Data Retrieval System to validate that the data were accurate.

- We selected taxpayer accounts for analysis in which taxpayers had apparently claimed Credit amounts in excess of the allowed amount. Because these amounts ranged from just over $50,000 to more than $1 million and the maximum allowed for any one business is less than $50,000, it is unlikely that a taxpayer could have legitimately claimed these large amounts; however, due to the lack of complete information, we could not definitively identify the source of the errors. We identified 22 taxpayers who filed Forms 1120 on which the Credit claimed exceeded the allowed amount. We researched five of these on the Integrated Data Retrieval System to validate that the data were accurate.

IV. Determined if the IRS is taking the appropriate action to provide training to Submission Processing and Examination functions staff.

A. Interviewed IRS staff regarding the steps the IRS has taken to provide training to Submission Processing and Examination functions staff.

B. Reviewed guidance used by IRS staff during customer interactions, such as the Internal Revenue Manual for Code and Edit and Transcription, training materials, etc.

C. Reviewed training plans for processing and compliance groups, including when and where the different groups would be trained.

[3] The Data Center Warehouse is a collection of IRS Databases containing various types of taxpayer account information that is maintained by the TIGTA for the purpose of analyzing data for ongoing audits.

V. Determined if the implementation of the Credit progressed on schedule.

A. Interviewed IRS staff and determined the reasons for any delays or omissions in implementing the Credit.

B. Verified and validated any corrective actions to any delays or omissions, along with the time periods for completion.

VI. Interviewed IRS staff to determine if the IRS had the necessary budget to properly implement the Credit.

A. Interviewed IRS staff regarding budgetary needs for implementing the Credit properly.

B. If budgetary needs were not met, verified actions taken by the IRS to obtain the necessary funding.

<u>Internal controls methodology</u>

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the IRS processes for informing taxpayers about the Credit, ensuring taxpayers who claimed the Credit were eligible and correctly calculated the amount of Credit, and ensuring that incorrect claims were prevented or detected.

Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)
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Mary L. Jankowski, Lead Auditor
Jack W. Laney, Jr., Audit Evaluator
Nelva A. Usher, Auditor

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Commissioner, Wage and Investment Division SE:W
Commissioner, Small Business/Self-Employed Division SE:S
Commissioner, Tax Exempt and Government Entities Division SE:T
Deputy Commissioner, Wage and Investment Division SE:W
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Tax Exempt and Government Entities Division SE:T
Director, Strategy and Finance, Wage and Investment Division SE:W:S
Director, Compliance, Wage and Investment Division SE:W:CP
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM
Director, Reporting Compliance, Wage and Investment Division SE:W:CP:RC
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:

Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PEI

Program Manager, Policy and Strategic Planning, Communications, Liaison, and Disclosure, Small Business/Self-Employed Division SE:S:CLD:PSP

Appendix IV

Form Used to Claim the Credit

Form **8941**

Department of the Treasury
Internal Revenue Service

Credit for Small Employer Health Insurance Premiums

► See separate instructions.
► Attach to your tax return.

OMB No. 1545-2198
2010
Attachment Sequence No. 63

Name(s) shown on return | **Identifying number**

1	Enter the number of individuals you employed during the tax year who are considered employees for purposes of this credit (see instructions)	1	
2	Enter the number of full-time equivalent employees you had for the tax year (see instructions). If you entered 25 or more, skip lines 3 through 11 and enter -0- on line 12	2	
3	Average annual wages you paid for the tax year (see instructions). If you entered $50,000 or more, skip lines 4 through 11 and enter -0- on line 12	3	
4	Premiums you paid during the tax year for employees included on line 1 for health insurance coverage under a qualifying arrangement (see instructions)	4	
5	Premiums you would have entered on line 4 if the total premium for each employee equaled the average premium for the small group market in which you offered health insurance coverage (see instructions)	5	
6	Enter the **smaller** of line 4 or line 5	6	
7	Multiply line 6 by the applicable percentage: • Tax-exempt small employers, multiply line 6 by 25% (.25) • All other small employers, multiply line 6 by 35% (.35)	7	
8	If line 2 is 10 or less, enter the amount from line 7. Otherwise, see instructions	8	
9	If line 3 is $25,000 or less, enter the amount from line 8. Otherwise, see instructions	9	
10	Enter the total amount of any state premium subsidies paid and any state tax credits available to you for premiums included on line 4 (see instructions)	10	
11	Subtract line 10 from line 4. If zero or less, enter -0-	11	
12	Enter the **smaller** of line 9 or line 11	12	
13	If line 12 is zero, skip lines 13 and 14 and go to line 15. Otherwise, enter the number of employees included on line 1 for whom you paid premiums during the tax year for health insurance coverage under a qualifying arrangement (see instructions)	13	
14	Enter the number of full-time equivalent employees you would have entered on line 2 if you only included employees included on line 13	14	
15	Credit for small employer health insurance premiums from partnerships, S corporations, cooperatives, estates, and trusts (see instructions)	15	
16	Add lines 12 and 15. Partnerships and S corporations, stop here and report this amount on Schedule K; all others, go to line 17	16	
17	Credit for small employer health insurance premiums included on line 16 from passive activities (see instructions)	17	
18	Subtract line 17 from line 16	18	
19	Credit for small employer health insurance premiums allowed for 2010 from a passive activity (see instructions)	19	
20	Carryback of the credit for small employer health insurance premiums from 2011	20	
21	Add lines 18 through 20. Cooperatives, estates, and trusts, go to line 22. Tax-exempt small employers, skip lines 22 and 23 and go to line 24. All others, stop here and report this amount on Form 3800, line 29h	21	
22	Amount allocated to patrons of the cooperative or beneficiaries of the estate or trust (see instructions)	22	
23	Cooperatives, estates, and trusts, subtract line 22 from line 21. Stop here and report this amount on Form 3800, line 29h	23	
24	Enter the amount you paid in 2010 for taxes considered payroll taxes for purposes of this credit (see instructions)	24	
25	Tax-exempt small employers, enter the **smaller** of line 21 or line 24 here and on Form 990-T, line 44f	25	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37757S Form **8941** (2010)

Source: IRS web site.

Appendix V

Summary of Considerations in Determining Eligibility

IRS Notice 2010-44 describes the following factors in determining eligibility for the Small Business Health Care Tax Credit (Credit):

- Determine the employees who are taken into account for purposes of the Credit.
  - Exclude any wages and premiums paid related to partners, most owners,[1] or family members of these partners or owners.
  - Seasonal workers are disregarded in determining FTEs and average annual wages unless the seasonal worker works for the employer on more than 120 days during the taxable year, although premiums paid on their behalf may be counted in determining the amount of the Credit.
  - Employers who are part of a controlled group or affiliated service group[2] are treated as a single employer.
- Determine the number of hours of service. Consider hours for which employees were paid or entitled to payment (including vacations, holidays, illness) and use any of three methods for calculations (actual, days-worked equivalency based on 8 hours of service per day, or weeks-worked equivalency based on 40 hours of service per week).
- Determine the number of an employer's FTEs.
  - Divide (1) the total hours of service (but not more than 2,080 for any employee) by (2) 2,080. The result, if not a whole number, is then rounded to the next lowest whole number. In some circumstances, an employer with 25 or more employees may qualify for the Credit if some of its employees work part-time.
- Determine the average annual wages paid. Divide (1) the total wages paid for employees taken into account by (2) the number of the employer's FTEs for the year. The result is then rounded down to the nearest $1,000. Only wages that are paid for hours of service as determined under Credit-related rules are taken into account.

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[1] Specifically, sole proprietors, partners in a partnership, shareholders owning more than 2 percent of an S corporation, and any owners of more than 5 percent of other businesses are not taken into account as employees for purposes of the Credit. For purposes of the Credit, a very comprehensive list of potential relatives and dependent members of their households are excluded from eligibility.

[2] Groups covered under section 414(b), (c), (m), or (o).

- Determine the premiums paid by the employer that are taken into account for purposes of the Credit. Only the portion paid by the employer is taken into account.
  - Determine the premiums related to qualifying arrangements. Qualifying arrangements may cover a wide range of medical expenses (e.g., hospital or medical policies, certificates, or service plans; dental or vision; long-term care). However, certain specific types of plans do not qualify.[3] Different types of plans are not aggregated for purposes of meeting the qualifying arrangement requirement. So if an employer pays for a health insurance plan and a separate vision plan, determinations must be made for each plan with respect to whether it is a qualifying arrangement.
  - The amount of an employer's premium payments that are taken into account is limited to the premium payments the employer would have made under the same arrangement if the average premium for the small group market in the State (or an area within the State) in which the employer offers coverage were substituted for the actual premium. For example, if an eligible small employer pays 80 percent of the premiums for coverage provided to employees, the premiums taken into account for purposes of the Credit are the lesser of the 80 percent of the total actual premiums paid or 80 percent of the premiums that would have been paid for the coverage if the average premium for the small group market were substituted for the actual premium.

[3] Section 9832(c)(1).

Appendix VI

Management's Response to the Draft Report

RECEIVED
AUG 22 2011
DAR

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

AUG 22 2011

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Faris R. Fink Faris R. Fink
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed (Audit # 201040045)

Thank you for the opportunity to review your draft report titled: "Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed."

We appreciate your acknowledgement of the efforts we have already taken in implementing this provision. We made every effort to timely implement this credit, including: systems programming, creation of new forms and revisions to others, as well as internal and external education and outreach. We issued guidance, developed a compliance strategy, and arranged training for IRS personnel. As a result, we were prepared for the challenges of the initial filing year for this credit.

Shortly after the legislation was passed, we assessed what we would need to do to implement the credit and tracked these efforts as they were completed. We have held or participated in more than 1,000 outreach and education events, in addition to conducting a multi-tiered communications effort to practitioners and small employers directly. In addition to press releases and other general publications, the IRS featured this credit in its E-News for small businesses, which has over 200,000 subscribers and provided content to small business and tax practitioner industry groups for use in their communications. We also established an Internet web page specifically to provide information on the credit.

Attached is a detailed response outlining our corrective actions. If you have any questions, please contact me, or with respect to the compliance issues outlined in your report a member of your staff may contact Shenita Hicks, Director, Examination, Small Business/Self-Employed Division at (859) 669-5526.

Attachment

Attachment

RECOMMENDATION 1:
The Commissioner, Small Business/Self-Employed Division, should track PEO relationships by inputting cross-referenced Employer Identification Numbers on the client business tax accounts.

CORRECTIVE ACTION:
We concur with this recommendation and will revise impacted form instructions to require reporting that will closely track relationships between businesses and Professional Employer Organizations and Professional Leasing Organizations filing payroll returns.

IMPLEMENTATION DATE:
January 15, 2012

RESPONSIBLE OFFICIAL(S):
Director, Abusive Transaction and Technical Issues, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:
We will monitor this action as part of our internal management control process.

RECOMMENDATION 2:
The Commissioner, Small Business/Self-Employed Division should work with the Department of the Treasury, Office of Tax Policy, to seek legislation to provide targeted math error authority that would allow the IRS to disallow the Small Business Health Care Tax Credit when employment tax returns have not been filed or when other supporting documents have not been provided.

CORRECTIVE ACTION:
We agree that math error authority is an important compliance tool in many cases. In determining the appropriate administration of the credit, the IRS will explore with its colleagues at the Department of the Treasury, Office of Tax Policy whether math error authority is appropriate.

IMPLEMENTATION DATE:
January 15, 2012

RESPONSIBLE OFFICIAL(S):
Director, Abusive Transaction and Technical Issues, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:
We will monitor this action as part of our internal management control process.

RECOMMENDATION 3:

The Commissioner, Small Business/Self-Employed Division should, ******2(f)************************************
*******************************2(f)**
*******************************2(f)**
*******************************2(f)*****************************.

CORRECTIVE ACTION:
****************************2(f)***2(f)*****************
2(f)************************. We agree that it is beneficial to address potential compliance issues as early in the process as possible, and have developed procedures to examine questionable returns prior to the issuance of a refund.

**********************************2(f)**2(f)**********
2(f)*
************2(f)***2(f)*********************************
***************************************2(f)***2(f)*****
2(f)**********************************.

***********************************2(f)**2(f)********************
****

IMPLEMENTATION DATE:
Ongoing

RESPONSIBLE OFFICIAL(S):
Director, Abusive Transaction and Technical Issues, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:
We will monitor this action as part of our internal management control process.

RECOMMENDATION 4:
The Commissioner, Small Business/Self-Employed Division, should *******2(f)*********************************
********************************2(f)***
*******************************2(f)**
*******************************2(f)**2(f)*************
****

CORRECTIVE ACTION:
We concur with this recommendation. ******************2(f)**
*******************************2(f)**2(f)*****************
2(f)*******************

IMPLEMENTATION DATE:
January 15, 2012

RESPONSIBLE OFFICIAL(S):
Director, Abusive Transaction and Technical Issues, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:
We will monitor this action as part of our internal management control process.