



## Treasury Inspector General for Tax Administration Office of Audit

### THE RECOMMENDED ADJUSTMENTS FROM S CORPORATION AUDITS ARE SUBSTANTIAL, BUT THE NUMBER OF NO-CHANGE AUDITS IS A CONCERN

Issued on June 21, 2012

## Highlights

Highlights of Report Number: 2012-30-062 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

### IMPACT ON TAXPAYERS

IRS audits have led to a substantial number of recommended adjustments to items reported on S corporation returns. However, the number of audits closed with no recommended adjustments (no-change) is very high for returns selected by the Discriminant Index Function system. This system uses mathematical formulas to calculate and assign a score to returns based on their audit potential.

For example, Fiscal Year 2011 statistics for the IRS's Small Business/Self-Employed (SB/SE) Division showed that 62 percent of the S corporation returns audited after selection by the Discriminant Index Function system were closed as a no-change. According to the IRS, a high no-change percentage means compliant taxpayers are burdened by unnecessary audits.

### WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether SB/SE Division examiners are conducting audits of S corporation returns in accordance with IRS procedures and guidelines. The review was part of our Fiscal Year 2011 audit coverage and addresses the major management challenge of Tax Compliance Initiatives.

### WHAT TIGTA FOUND

TIGTA did not identify any significant quality problems that would suggest the manner in which items are selected and audited on S corporation returns substantially contributes to the no-change percentages. However, TIGTA believes that SB/SE Division researchers should explore using S corporation data files to determine if examiners are auditing the most productive returns. With skills in such specialized areas as statistics, operations research, economics, and computers, SB/SE Division researchers are uniquely qualified to suggest alternative audit selection methods and explore details such as assessing

the revenue impact from S corporation audits by determining the taxes assessed or refunded at the shareholder level. TIGTA also found that additional steps could be taken to strengthen controls over the return classification process to further minimize the risk of selecting returns for audit that have limited audit potential.

### WHAT TIGTA RECOMMENDED

TIGTA recommended that, as resources become available, the Director, Research, SB/SE Division, analyze S corporation data files to help identify additional productive returns for audit. In addition, the Director, Exam Policy, SB/SE Division, should revise classification guidelines to clarify that quality reviews need to be completed for each type of return classified.

In their response to the report, IRS officials agreed with our recommendations and plan to take corrective actions. Specifically, the IRS plans to analyze S corporation data files in order to better identify productive S corporation returns for audit and to revise guidance to reflect the need for a balanced review of various types of returns by all classifiers.

### READ THE FULL REPORT

To view the report, including the scope, methodology, and full IRS response, go to:

<http://www.treas.gov/tigta/auditreports/2012reports/201230062fr.pdf>.