# The Recommended Adjustments From S Corporation Audits Are Substantial, but the Number of No-Change Audits Is a Concern

**June 21, 2012**

**Reference Number: 2012-30-062**

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

Phone Number | 202-622-6500
E-mail Address | TIGTACommunications@tigta.treas.gov
Website | http://www.tigta.gov

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

# Highlights

**Final Report issued on June 21, 2012**

Highlights of Reference 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 the 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.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

June 21, 2012

**MEMORANDUM FOR** COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

**FROM:** Michael E. McKenney
Acting Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – The Recommended Adjustments From S Corporation Audits Are Substantial, but the Number of No-Change Audits Is a Concern (Audit # 201030041)

This report presents the results of our review to determine whether Small Business/ Self-Employed Division examiners are conducting audits of S corporation returns in accordance with Internal Revenue Service procedures and guidelines. The review was part of our Fiscal Year 2011 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Management's complete response to the draft report is included as Appendix V.

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 Frank J. Dunleavy, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations), at (213) 894-4470 (Ext.128).

# Table of Contents

# Abbreviations

| | |
|---|---|
| DIF | Discriminant Index Function |
| FY | Fiscal Year |
| IRM | Internal Revenue Manual |
| IRS | Internal Revenue Service |
| PY | Processing Year |
| PSP | Planning and Special Programs |
| SB/SE | Small Business/Self-Employed |
| TIGTA | Treasury Inspector General for Tax Administration |
| TY | Tax Year |

# Background

S corporations are required to annually file Form 1120S, *U.S. Income Tax Return for an S Corporation*, although they generally do not pay any Federal income taxes. Instead, an S corporation's income, deductions, and other items are divided among and passed on to its shareholders, who are required to report the items on their individual income tax returns. This distribution of the flow-through income, deductions, and other items are reported to the shareholder and the Internal Revenue Service (IRS) on Form 1120S Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc*.

S corporations provide shareholders a number of attractive benefits that contribute to making them one of the fastest growing types of business entities and the most common type of corporate entity filing returns with the IRS. Organizing a business as an S corporation allows shareholders to avoid double taxation on business profits. This treatment is unlike the traditional corporation that incurs a tax liability at the corporate level and again when distributing business profits to shareholders in the form of dividends. However, like a traditional corporation, an S corporation provides shareholders with limited liability protection. In addition, S corporations have the legal capacity to flow through business losses, within limitations, to their shareholders. Shareholders can use the losses to offset their taxable income from other sources, such as salaries and wages, reported on their individual returns.

To understand the impact the growth of S corporation returns could mean for tax compliance, the IRS initiated a National Research Program study in Fiscal Year[1] (FY) 2006 that documented the extent to which S corporations and their shareholders complied with the tax laws. Completed in FY 2008, the study involved the identification, selection, and examination of 4,877 S corporation returns processed by the IRS for Tax Years (TY) 2003 and 2004. The IRS used statistically valid sampling techniques to select the returns so the results from the examinations could reliably measure the level of compliance for all S corporation returns.

This study was important because there has been nearly a fivefold increase in the number of S corporation returns filed since the IRS last studied the reporting compliance of S corporations by auditing approximately 10,000 returns from TY 1984. Consequently, it is not too surprising that with the growth of S corporations and the length of time since the IRS last completed a compliance study, IRS estimates of the extent to which S corporations properly report the income, deductions, and credits on their returns and the corresponding tax consequences on shareholder returns have become less reliable. Researchers must have reliable data to refine estimates of the Tax Gap (*i.e.*, the amount of taxes owed but not voluntarily paid), suggest

[1] See Appendix IV for a glossary of terms.

needed tax policy and legislative changes, and assist the IRS in developing priorities for taxpayer education programs to help reduce noncompliance.

The IRS's Small Business/Self-Employed (SB/SE) Division serves the majority (more than 98 percent) of S corporations—those that have less than $10 million in assets. The SB/SE Division is responsible for helping approximately 57 million taxpayers, including about 41 million self-employed individuals, understand and meet their tax obligations. The IRS's Large Business and International Division serves larger S corporations, those with more than $10 million in assets.

This review was performed at the IRS's SB/SE Division Headquarters in New Carrollton, Maryland, and the SB/SE Division field offices in Los Angeles, California; Denver, Colorado; Boston, Massachusetts; Cincinnati, Ohio; and Tulsa, Oklahoma, during the period August 2010 through January 2012. 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 objective. 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.

# *Results of Review*

The IRS developed a variety of sources to select returns for audit. The IRS strives to select for audit those returns for which its examiners are likely to find areas of noncompliance and recommend changes to one or more items reported on the return. One audit source is the Discriminant Index Function (DIF) system, which the IRS has relied on over the years to help decide how to best allocate its audit resources. The system uses mathematical formulas to calculate and assign a score to returns based on their audit potential. The higher the score, the greater the chance an audit will result in recommended changes to the return.

While IRS audit sources have led to a substantial amount of recommended adjustments to items reported on S corporation returns, the number of audits closed with no recommended adjustments (no-change) is very high among DIF-selected returns. For example, SB/SE Division statistics show that the IRS closed with no changes 62 percent of the DIF-selected S corporation returns audited in FY 2011.[2] According to the IRS, a high no-change percentage means the IRS is spending a significant amount of resources on unproductive audits and burdening compliant taxpayers with unnecessary audits.

## *The Adjustments That Examiners Recommended to Address Suspected S Corporation Noncompliance Are Substantial*

IRS statistics show that in FYs 2007 through 2011, SB/SE Division examiners completed 53,544 audits of S corporation returns and recommended $5.7 billion in adjustments to items reported on those returns. This was a 54 percent increase over the number of S corporation returns the IRS audited in the previous five-year period (FYs 2002 through 2006). For each return audited in FYs 2007 through 2011, examiners generated about $105,534 in recommended adjustments to the net profits and losses reported by S corporations and passed on to shareholders.

Due to limitations with IRS databases, neither the Treasury Inspector General for Tax Administration (TIGTA) nor IRS officials know, with any degree of certainty, how much additional tax is assessed based on the adjustments examiners recommend to S corporation returns. However, the large number of recommended adjustments, combined with two other factors, will likely lead to an increase in the number of S corporation audits. The first factor that will drive the increase in S corporation audits is the IRS's efforts to maintain coverage over the

[2] For this report, we considered audits closed with Disposal Code 02 as no-changes. For a flow-through entity, this means that no adjustments were made to the reported income, loss, deductions, or credits of the entity.

growing number of S corporation returns, while the second involves addressing the compliance risk they pose.

## S corporations are a fast growing segment of business returns and are generating a considerable amount of economic activity

The IRS estimates that S corporations will file nearly 5.7 million returns in Processing Year (PY) 2015. This represents a 26 percent increase over the number of S corporation returns filed in PY 2011. The growth in the number of S corporation returns processed by the IRS from PYs 2006 through 2011 continued a trend that started in 1997, when they became the most common type of corporation return filed. In PY 2011, S corporations filed approximately 4.5 million returns (an 80 percent increase over the 2.5 million S corporation returns filed in PY 1997). This was also more than double the number of returns filed by traditional Subchapter C corporations.

As the number of S corporations has increased, so has their economic activity, as reflected in the growth of their assets and gross income. In TY 2008, IRS records show that S corporations reported owning property, equipment, and other assets totaling approximately $3.4 trillion and earning gross income of approximately $6.1 trillion. This growth was 89 percent over the $1.8 trillion in assets they owned in TY 2000 and a 69 percent increase over their $3.6 trillion in gross income for TY 2000. After deducting expenses from gross income, S corporations passed along net profits of approximately $1.8 trillion and losses of about $486 billion to their shareholders in TYs 2006 through 2010. Figure 1 shows the aggregate gross income, deductions, and net profits and losses for S corporations in TYs 2006 through 2010.

**Figure 1: Aggregate Gross Income and Total Net Profits and Losses for S Corporation Returns for TYs 2006 Through 2010**

| | Tax Year | | | | | Totals 2006–2010 |
|---|---|---|---|---|---|---|
| | **2006** | **2007** | **2008** | **2009** | **2010(*)** | |
| **Gross Income (√)** | $5,691 | $5,939 | $5,819 | $5,229 | $5,487 | $28,165 |
| **Total Net Profits (√)** | $376 | $382 | $350 | $330 | $353 | $1,791 |
| **Total Net Losses (√)** | $75 | $95 | $118 | $111 | $87 | $486 |
| **Returns Processed** | 4,009,010 | 4,169,834 | 4,025,790 | 4,264,086 | 4,171,168 | 20,639,888 |
| **Returns With a Profit** | 2,358,896 | 2,413,304 | 2,240,631 | 2,359,510 | 2,417,624 | 11,789,965 |
| **Returns With a Loss** | 1,320,966 | 1,420,817 | 1,464,217 | 1,554,288 | 1,413,981 | 7,174,269 |

***(√) Money amounts are presented in billions. (*) TY 2010 returns do not include returns filed after September 30, 2011.***
*Source: TIGTA analysis of the IRS Business Master File data for TYs 2006 through 2010.*

***S corporations create compliance risks for the IRS because most are owned and controlled by only one or two individuals***

Continuing a trend that has existed for many years, the majority of S corporations are owned by one shareholder or a closely knit group of shareholders. These shareholders typically have a significant amount of control over managing and directing the day-to-day operations of the S corporation. This, in turn, presents a compliance risk because it provides shareholders with opportunities to structure transactions improperly to reduce the income taxes they would otherwise owe. For example, in Calendar Year 2000, the IRS published guidance on 10 transactions that would likely trigger an audit because they purportedly abuse the tax law, represent a significant loss of tax revenue, and undermine the public's confidence in the tax system. As of January 2012, the list of such abusive transactions has increased to 34, of which at least four involve S corporations.

## *The Number of Unproductive Audits Is Very High for S Corporations That Are Not Involved in Abusive Transactions*

One important measure of audit productivity that the IRS tracks is the percentage of audited returns that result in recommended adjustments to the return. The IRS associates a high percentage of audited returns that result in recommended adjustments with greater audit productivity, while audits that result in a no-change are considered to be unproductive. In FYs 2009 through 2011, the SB/SE Division no-changed 10,750 audits of S corporation returns out of the 32,546 returns it selected for audit from all sources. This indicates that the IRS closed as no-change roughly one out of every three (33 percent) returns audited. However, the no-change percentage was considerably higher for S corporation returns selected by the DIF.

As Figure 2 shows, the overall no-change percentage resulting from a DIF selection was approximately 43 percent for S corporation returns. This population includes audits of the original DIF-selected returns and any prior and subsequent year S corporation returns (DIF-related) selected because of the original audit. When looking solely at the original DIF-selected returns, SB/SE Division statistics show the no-change percentage to be about 60 percent in FYs 2009 through 2011. By comparison, the no-change percentage for S corporation returns selected for audit because of an abusive transaction was approximately 19 percent in FYs 2009 through 2011. The no-change percentage was also lower than the DIF for S corporation returns selected from other audit sources. These other sources include IRS projects and studies such as the ones designed to focus on specific suspected areas of noncompliance, other than known abusive transactions.

**Figure 2: SB/SE Division's S Corporation Audit Closures in FYs 2009 Through 2011 by Audit Source**

| Selected S Corporation Statistical Categories | Abusive Transactions | | | DIF and DIF-Related | | | All Other Audit Sources | | |
|---|---|---|---|---|---|---|---|---|---|
| | FY 2009 | FY 2010 | FY 2011 | FY 2009 | FY 2010 | FY 2011 | FY 2009 | FY 2010 | FY 2011 |
| **Total Returns Audited (a)** | 2,670 | 2,483 | 2,282 | 4,907 | 5,110 | 5,160 | 3,354 | 3,172 | 3,408 |
| **Audits With Adjustments (b)** | 2,153 | 2,035 | 1,831 | 2,748 | 3,016 | 2,848 | 2,456 | 2,322 | 2,387 |
| **No-Change Audits (a) – (b)** | 517 | 448 | 451 | 2,159 | 2,094 | 2,312 | 898 | 850 | 1,021 |
| **No-Change Percentage** | 19% | 18% | 20% | 44% | 41% | 45% | 27% | 27% | 30% |

*Source: TIGTA analysis of Audit Information Management System data for S corporation audits closed by the SB/SE Division in FYs 2009 through 2011.*

The difference between the DIF no-change percentage and the no-change percentage of returns audited because of an abusive transaction or as part of an IRS project can be attributed to how returns are selected for audit. For example, once the IRS identifies an abusive transaction and its participants, the participants' returns are assigned to examiners who simply disallow the abusive transaction and compute the additional taxes and penalties that may be owed at the shareholder level. In contrast, S corporation returns selected by DIF mathematical formulas do not identify the specific items to audit. Instead, examiners use their experience and judgment to screen the returns manually to identify the items that are questionable and should be included in the audit. Consequently, outdated compliance data in the formulas and unintentional errors that are inherent in any manual process are factors that contribute more to the higher no-change percentages in the DIF and the DIF-related S corporation audits than the quality and scope of the audits.

During our review of closed S corporation audits, we 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, we believe that SB/SE Division researchers should consider exploring using S corporation data files to determine if examiners are auditing the most productive returns. We 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.

## ***Examiners followed procedures in verifying the accuracy of the items they audited on S corporation returns***

We evaluated a judgmental sample[3] of 57 of the 3,542 S corporation returns audited in FY 2009 by the SB/SE Division where either the taxpayer agreed with the proposed assessment or the examiner made no changes to the return. We found that examiners documented the steps taken to plan the scope and depth of the audits. In addition, they used a variety of fact-finding techniques to determine the accuracy of items they audited on the S corporation returns and cited applicable sections of the tax law to support any recommended adjustments. Although we did not find any quality problems with the items audited on the S corporation returns or how they were audited, we found that, in 13 of the 57 audits, examiners did not properly consider audit issues between the S corporation and related returns.

While the related return issues would not have changed any recommended adjustments made to the S corporation return, they might have resulted in changes to one or more of the shareholders' returns. In this situation, the IRS may record the S corporation audit as a no-change closure even though changes were made to the shareholders' returns. This would indicate that the S corporation audits might be more productive than the statistics reflect.

For example, we found six cases where one or more shareholders' estimated personal living expenses exceeded the income they reported on their individual returns by more than $10,000. ************************************1**********************************. The considerable differences noted between expenditures and income raise serious questions about whether the S corporation audit should have been expanded to include the shareholders' individual returns to determine if there were additional sources of income that should have been reported on the returns.

We recently made recommendations in other reports to address the quality concerns with issues on related returns during audits.[4] The SB/SE Division responded with its plans to address the concerns, which included taking better advantage of the IRS's automated information systems and its performance management processes to ensure issues are properly considered and addressed during audits on related returns. Therefore, we are not making any additional recommendations for related return issues at this time.

---

[3] A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population.
[4] TIGTA, Ref. No. 2010-30-024, *Significant Tax Issues Are Often Not Addressed During Correspondence Audits of Sole Proprietors*, pp. 6–7 (Feb. 2010); TIGTA, Ref. No. 2011-30-084, *Additional Steps Are Needed to Better Ensure Audits Are Expanded to Prior and/or Subsequent Year Returns When Substantial Taxes May Be Owed*, p. 11 (Sept. 2011); TIGTA, Ref. No. 2011-30-113, *Steps Can Be Taken to Enhance the Quality of Audits Involving Small Corporate Returns*, p. 10 (Sept. 2011).

### SB/SE Division researchers should consider exploring how IRS data could be used to identify more productive returns for audit

The IRS completed a National Research Program study of S corporations in FY 2008 and subsequently developed a new DIF formula for selecting S corporation returns using new compliance data. However, National Research Program officials told us that they have not formulated plans to assess the effectiveness of the new DIF formula due to other workload priorities. Until such plans are developed and implemented, the IRS could pursue alternative selection techniques by using existing databases containing S corporation data to help identify additional productive returns for audit. For example, we used the IRS's Business Return Transaction File, which contains all the items transcribed from S corporation returns, and the Audit Information Management System, which contains S corporation audit results, to determine whether the characteristics of S corporations with audit adjustments might provide productive audit leads to other returns that were not selected for audit.

After eliminating audits involving tax shelters, our analysis of Audit Information Management System and Business Return Transaction File data for FY 2011 showed that audits of S corporations owned by one shareholder who reported a loss of at least $25,000 in three or more consecutive years were highly productive in terms of the adjustments recommended. Of the 6,420 S corporations (8,568 returns)[5] audited by the SB/SE Division in FY 2011, we determined that 455 S corporations (7 percent) were in this category of single shareholders with consecutive $25,000 losses. The 579 returns audited for the 455 S corporations accounted for approximately $53.2 million in recommended adjustments and generated about $91,861 in adjustments for each return audited. In comparison, examiners generated about $46,924 per return for the remaining 7,989 S corporation returns audited. These results suggest that more productive audits may have occurred if resources had been directed to those S corporations that had one shareholder with consecutive losses of more than $25,000 in at least three consecutive years.

There are various limitations with our analysis. For example, we did not evaluate closed audit files to determine why the returns were selected for audit or the basis for the recommended adjustments to the returns. In addition, we did not attempt to assess the tax impact from the adjustments at the shareholder level. Because the tax impact at the shareholder level was not addressed, the productivity from the 7,989 audits that generated about $46,924 per return could be higher since significant adjustments might have been made to the shareholders' individual returns even though the audit of the S corporation returns resulted in a no-change.

Given its limitations, we do not expect the IRS to change how it selects S corporation returns based on our analysis. However, the analysis shows how IRS data files could be used to identify productive returns for audit and could be useful to SB/SE Division researchers who are responsible for providing information, guidance, and advice on methodologies and strategies for

[5] Audits often involve multiple tax years.

optimizing available resources to address noncompliance. 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.

## Controls over the return classification process could be strengthened

Before returns reach an audit group, experienced examiners on a temporary assignment screen (classify) the returns. These examiners (classifiers) have a critically important role in the audit selection process because they use their experience and judgment to determine which returns will be selected for audit consideration (selected) and which can be accepted as filed (accepted). If the classifier accepts a return, it is eliminated from the audit stream and returned to IRS storage. A classifier's ability to select returns for which an examiner is likely to recommend changes and to avoid selecting ones that pose little or no compliance risk will have a direct effect on no-change percentages and the amount of additional taxes that are ultimately recommended, regardless of how well the technical and procedural aspects of the audits are performed.

The primary technique used by the SB/SE Division to control and monitor the quality of the work performed by classifiers is the review of returns by managers in its Office of Planning and Special Programs (PSP). Among other things, the Internal Revenue Manual[6] (IRM) recommends PSP managers, or their designees, review a representative sample of returns selected and accepted as filed by each classifier. To supplement the IRM guidance, in Calendar Year 2007, the SB/SE Division developed and implemented a nationwide Classification Handbook[7] that provides detailed instructions and explanations of the administrative and business procedures required during the classification process. The IRM and the Handbook also outline expectations and responsibilities for both classifiers and managers. The manager's expectations and responsibilities include a requirement to document on Form 5126, *Classification Quality Review Record*, the results from reviewing a minimum of 10 percent of the returns classified by each classifier. The purpose for the reviews is to provide assurance that:

- Returns are selected or accepted in accordance with established guidelines.
- Classification checksheets are properly completed.
- The potential tax change is sufficient to warrant selection, especially on returns with a negative taxable income.
- Classifiers maintain a high level of technical proficiency, exercise good judgment while determining whether to accept returns as filed or select for audit, and utilize their time effectively.

[6] IRM 4.1.5.1.5 (Oct. 24, 2006).
[7] National Office Examination Classification Guidelines (revised May 31, 2007).

We reviewed available documentation for nine classification assignments[8] involving 42 classifiers in four PSP offices during Calendar Year 2011. We determined that reviewers properly documented Forms 5126 for 37 (88 percent) of 42 classifiers to indicate they had reviewed and discussed with classifiers the required minimum 10 percent sample of classified returns. However, we found that no reviews were conducted on any of the 255 S corporation returns classified by five of the classifiers in two PSP offices. The reviewers did look at the required 10 percent of individual and corporate returns classified by these five classifiers.

In a fifth PSP office evaluated, we found no reviews of the work completed by 15 classifiers who screened 1,474 S corporation returns in FY 2011. IRS officials told us that all the classifiers in this office were subject matter experts and the IRM[9] does not require any supervisory review over their classification work. However, SB/SE Division's personnel directories did not list these classifiers as contact points or subject matter experts, nor did the IRM specify the qualifications needed to be a subject matter expert. Moreover, the absence of supervisory review over these classifiers is contrary to the *Standards for Internal Control in the Federal Government*,[10] which specifies providing continual supervision to effectively carry out important activities, such as the return classification process.

## Recommendations

***Recommendation 1:*** As resources become available, the Director, Research, SB/SE Division, should analyze S corporation data files to develop audit leads to help select additional productive returns for audit.

> ***Management's Response:*** IRS management agreed with this recommendation. The Director, Research, SB/SE Division, will work in collaboration with the Director, Examination, SB/SE Division, to analyze S corporation data files in order to better identify productive S corporation returns for audit.

***Recommendation 2:*** The Director, Exam Planning and Delivery, SB/SE Division, should revise classification guidelines to clarify that quality reviews are needed for each type of return classified, including those classified by designated subject matter experts.

***Management's Response:*** IRS management agreed with this recommendation and will revise their guidance to reflect the need for a balanced review of various types of returns by all classifiers.

---

[8] One or two week assignments set up periodically (*e.g.*, quarterly) by PSP offices to bring together a group of classifiers to review DIF-selected returns for audit potential.
[9] IRM 4.1.5.1.5.2 (Oct. 24, 2006).
[10] Government Accountability Office (formerly known as the General Accounting Office), GAO/AIMD-00-21.3.1, *Internal Control: Standards for Internal Control in the Federal Government*, p. 15 (Nov. 1999).

**Appendix I**

## Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether SB/SE Division examiners are conducting audits of S corporation returns in accordance with IRS procedures and guidelines. To accomplish this objective, we:

I. Reviewed documentation to identify the policies and procedures for conducting S corporation audits in the SB/SE Division. This included documenting the applicable Internal Revenue Code sections, Treasury Regulations, Internal Revenue Manual (policy and procedural) sections, management directives, and examiner training materials.

II. Determined how closely examiners are following IRS procedures and guidelines during S corporation audits.

   A. Reviewed examination management information reports and the Audit Information Management System[1] database for FYs 2005 through 2009 and determined case volumes, no-change percentages, and adjustment dollars by type of case to identify the population of S corporation returns for selecting our sample.

   B. Reviewed a judgmental sample[2] of 57 of 3,542 S corporation returns audited during FY 2009 with the following characteristics: DIF-selected returns, tax-shelter returns, and tax-shelter-related returns closed as no-change, no-change with adjustment, or agreed. We used a judgmental sample due to time and resource constraints. We confirmed the reliability of the data by comparing the Audit Information Management System data we extracted with examination management information reports.

   C. Reviewed the S corporation returns, examination work papers, and related Forms 1040, *U.S. Individual Income Tax Return*, to determine if the examiners:

      1. Identified whether related returns (shareholders' income tax returns, employment tax returns, and information returns) were required and accurately filed.

      2. Addressed the accuracy of the shareholder's stock and debt basis and identified any issues affected by the shareholder's stock and debt basis.

      3. Identified and addressed any other significant issues on the returns that warranted audit consideration.

[1] See Appendix IV for a glossary of terms.

[2] A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population.

D. Discussed our results with IRS officials and obtained agreement to the facts for the exception cases.

E. Analyzed statistics for S corporation filings and examinations to determine trends.

   1. To review the growth in S corporation filing and examination statistics, we reviewed SB/SE Examination function management information reports for FYs 2002 through 2011.

   2. To review S corporation filing data for TYs 2006 through 2010, we obtained IRS Business Return Transaction File data for Processing Years 2006 through 2011. We then identified and grouped the data by tax year and validated the records by matching the tax year files to the IRS Business Master File to ensure we had data for returns that were processed to the IRS Master File.

   3. To review trends for no-change percentages in S corporation audits, we reviewed closed Audit Information Management System data for FYs 2009 through 2011. We validated the accuracy of this data with SB/SE Examination function management information reports. We sorted the data to identify audits involving tax shelters (Audit Information Management System Source Codes 17, 39, 40, and 44), audits selected or related to the DIF (Source Codes 02, 05, 10, and 12), and those from all other sources. For each type of audit, we identified the total returns audited, no-change closures, and closures with adjustments. We then computed the no-change percentage using those numbers.

F. Reviewed historical data for S corporation history and legislation and available documentation for the S corporation National Research Program study to determine the extent of testing done and if and when changes were made to audit selection formulas.

III. Reviewed the classification process to determine if the IRS was properly following guidelines and procedures for reviewing classified returns. For FY 2011, we reviewed a judgmental sample of Forms 5126, *Classification Quality Review Records*, for 42 classifiers in four PSP offices (California, Central, Gulf States, and Western) and reviewed the classification process used by the North Atlantic PSP office for 15 classifiers. We used judgmental sampling due to the availability of resources. We determined if procedures for quality reviews were adequate and effective by reviewing the volume of returns classified and the number of those returns selected for review by managers.

***Internal controls methodology***

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: IRS policies, procedures, and practices for classifying and examining S corporation returns. We evaluated these controls by reviewing source materials, interviewing management, reviewing examination case files, researching taxpayer accounts, and reviewing controls over the classification process.

**Appendix II**

# Major Contributors to This Report

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Frank Dunleavy, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Michelle Philpott, Acting Director
Alan Lund, Audit Manager
Kristi Larson, Lead Auditor
Carole Connolly, Senior Auditor
David Hartman, Senior Auditor
William Tran, Senior Auditor

**Appendix III**

# Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Director, Office of Research, Analysis and Statistics RAS
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Communications, Liaison and Disclosure, Small Business/Self-Employed Division SE:S:CLD
Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, Research, Small Business/Self-Employed Division SE:S:R
Director, Exam Planning and Delivery, Small Business/Self-Employed Division SE:S:E:EPD
Director, Exam Policy, Small Business/Self-Employed Division SE:S:E:EP
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:

- Commissioner, Small Business/Self-Employed Division SE:S
- Director, Office of Research, Analysis, and Statistics RAS

## Appendix IV

# Glossary of Terms

**Audit Information Management System –** A computer system used by the IRS Examination function to control returns, input assessments/adjustments to the Master File, and provide management reports.

**Business Master File –** The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

**Business Return Transaction File –** An IRS database that contains the transcribed line items on all business returns and their accompanying schedules or forms.

**Calendar Year –** The 12-consecutive month period ending on December 31.

**Disposal Code –** The IRS uses a two digit code to indicate the disposition of an examination.

**Fiscal Year –** A 12-consecutive-month period ending on the last day of any month, except December. The Federal Government's fiscal year begins on October 1 and ends on September 30.

**Master File –** The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

**Processing Year –** The calendar year in which the return or document is processed by the IRS.

**Source Code –** A numeric code that identifies the source of an audit.

**Subject Matter Expert –** An employee selected as an SB/SE Division point of contact for a specific tax topic.

**Tax Year –** A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

## Appendix V

# Management's Response to the Draft Report

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

RECEIVED
MAY 29 2012

MAY 29 2012

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 – TIGTA Draft Report - The Recommended Adjustments From S Corporation Audits Are Substantial, but the Number of No-Change Audits Is a Concern (Audit # 201030041)

Thank you for the opportunity to review your draft report titled: "The Recommended Adjustments From S Corporation Audits Are Substantial, but the Number of No-Change Audits Is a Concern." S corporation filings continue to grow and it is important to select returns with the greatest audit potential. We appreciate your recognition that our audit sources identified a significant number of non-compliant returns. We strive to select the best returns possible for examination.

Reducing the number of no-change audits will minimize taxpayer burden and enhance overall compliance. With this goal, we agree to initiate research of S corporation return data to help identify more productive returns for audit.

We recognize the importance of assuring the quality of returns selected for examination. Currently, our Internal Revenue Manual provides for a review of a representative sample of returns classified. We will strengthen our guidelines to reflect the need for a balanced review of the various types of returns classified by all classifiers.

Attached is a detailed response outlining our corrective actions.

If you have any questions, please contact me, or a member of your staff may contact, Shenita Hicks, Director, Examination, Small Business/Self-Employed Division at 859-669-5526.

Attachment

**Attachment**

**RECOMMENDATION 1:**
As resources become available, the Director, Research, SB/SE Division, should analyze S corporation data files to develop audit leads to help select additional productive returns for audit

**CORRECTIVE ACTION:**
The Director, SB/SE Research will work in collaboration with the Director, SB/SE Examination to analyze S corporation data files in order to better identify productive S corporation returns for audit.

**IMPLEMENTATION DATE:**
November 15, 2014

**RESPONSIBLE OFFICIAL(S):**
Director, SB/SE Research

**CORRECTIVE ACTION MONITORING PLAN:**
The IRS will monitor this corrective action as part of our internal management system of control.

**RECOMMENDATION 2:**
The Director, Exam Planning & Delivery, SB/SE Division should revise classification guidelines to clarify that quality reviews are needed for each type of return classified, including those classified by designated subject matter experts.

**CORRECTIVE ACTION:**
IRM 4.1.5 (Planning and Special Programs Handbook - Classification) provides guidance for the classification process and currently requires the review of a ten percent sample of classified returns. We will revise our guidance to reflect the need for a balanced review of various types of returns by all classifiers.

**IMPLEMENTATION DATE:**
March 15, 2013

**RESPONSIBLE OFFICIAL(S):**
Director, SB/SE Exam Planning & Delivery

**CORRECTIVE ACTION MONITORING PLAN:**
The IRS will monitor this corrective action as part of our internal management system of control.