



*Actions Can Be Taken to Better  
Identify Potentially Erroneous Domestic  
Production Activities Deductions*

**September 28, 2016**

**Reference Number: 2016-40-091**

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 = Risk Circumvention of Agency Regulation or Statute

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# HIGHLIGHTS

## ACTIONS CAN BE TAKEN TO BETTER IDENTIFY POTENTIALLY ERRONEOUS DOMESTIC PRODUCTION ACTIVITIES DEDUCTIONS

### Highlights

Final Report issued on September 28, 2016

Highlights of Reference Number: 2016-40-091 to the Internal Revenue Service Deputy Commissioner for Services and Enforcement.

#### IMPACT ON TAXPAYERS

Congress enacted the American Jobs Creation Act of 2004 to enhance the ability of domestic businesses and manufacturing firms to compete in the global marketplace and to enable small businesses to maintain their position as the primary source of new jobs in this country. Section 102 of this Act allows taxpayers to claim a Domestic Production Activities Deduction (DPAD) on their tax return. The DPAD gives businesses an incentive to participate in qualifying activities in the United States.

#### WHY TIGTA DID THE AUDIT

During Processing Years 2013 through 2015, taxpayers claimed more than \$131 billion in DPADs; nearly \$44 billion was claimed in Processing Year 2015 alone. TIGTA performed this review to determine whether the IRS has sufficient controls in place to ensure that the DPAD is properly claimed.

#### WHAT TIGTA FOUND

Processes have not been established to ensure that claims for the DPAD are

TIGTA's match of to the amount of DPAD claimed identified 2,829 taxpayers that filed returns for Tax Year 2013 that potentially overclaimed the DPAD by more than \$27 million.

IRS management explained that systemically identifying businesses and corporations overclaiming the deduction based on the

presents a challenge because many corporations file returns as part of a consolidated group, receive the DPAD from a pass-through entity, or use a Professional Employer Organization. TIGTA agrees there are challenges to the IRS systemically determining if a business has overclaimed the DPAD. However, actions can be taken by the IRS to address these challenges.

The IRS also has not established processes to ensure that businesses, i.e., individual taxpayers, are eligible to claim the DPAD. For example, individual taxpayers should only claim the DPAD if they have an. TIGTA identified 177 electronically filed Tax Year 2013 Forms 1040, U.S. Individual Income Tax Return, that claimed \$850,329 in the DPADs but did not have a.

#### WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS revise Form 8903, Domestic Production Activities Deduction, to include a line for providing the associated with a DPAD claim; develop processes to identify those taxpayers; develop processes and procedures to identify individuals claiming a DPAD and use its math error authority to disallow the deduction; and verify whether the 177 electronically filed returns that TIGTA identified as erroneously claiming the DPAD are entitled to the claim.

The IRS agreed with two of the four recommendations. The IRS disagreed that it should revise Form 8903 and verify the 177 returns that TIGTA identified as erroneously claiming the DPAD. TIGTA believes that requiring would ensure more accurate reporting and will provide the IRS the ability to systematically verify DPAD claims. TIGTA also believes the 177 returns potentially claimed a deduction to which they were not entitled.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

September 28, 2016

**MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND  
ENFORCEMENT**

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

**SUBJECT:** Final Audit Report – Actions Can Be Taken to Better Identify  
Potentially Erroneous Domestic Production Activities Deductions  
(Audit # 201540008)

This report presents the results of our review to determine whether the Internal Revenue Service has sufficient controls in place to ensure that the Domestic Production Activities Deduction is properly claimed. This audit is part of our Fiscal Year 2016 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 VI.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services).



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*Abbreviations*

DPAD	Domestic Production Activities Deduction
E-filed	Electronically Filed
EIN	Employer Identification Number
PEO	Professional Employer Organization
PY	Processing Year
QPAI	Qualified Production Activities Income
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year



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*Background*

Congress enacted the American Jobs Creation Act of 2004<sup>1</sup> to enhance the ability of domestic businesses and manufacturing firms to compete in the global marketplace and to enable small businesses to maintain their position as the primary source of new jobs in this country. Section 102 of this Act allows taxpayers to claim a Domestic Production Activities Deduction (DPAD) on their tax return. The DPAD gives businesses an incentive to participate in qualifying activities in the United States. Figure 1 shows the amount of the DPADs claimed in the last three processing years (PY).<sup>2</sup>

**Figure 1: The DPAD Claimed in Previous Three Processing Years**

	<b>Tax Returns</b>	<b>DPAD Claimed</b>
<b>Form 1040, U.S. Individual Income Tax Return</b>		
PY 2015	697,343	\$11.99 billion
PY 2014	691,021	\$10.96 billion
PY 2013	628,409	\$10.93 billion
<b>Form 1120, U.S. Corporation Income Tax Return</b>		
PY 2015	42,098	\$31.97 billion
PY 2014	47,166	\$33.82 billion
PY 2013	46,166	\$31.78 billion

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of Return Transaction Files,<sup>3</sup> as of May 5, 2016.

To be eligible for the DPAD, a taxpayer must participate in qualified production activities that are in whole or a significant part is produced in the United States. Qualified production activities include a broad range of activities such as manufacturing of goods, farming,<sup>4</sup> construction, film production, and engineering. Activities that do not qualify for the DPAD include the sale of food

<sup>1</sup> Pub. L. No. 108-357, 118 Stat. 1418.

<sup>2</sup> The calendar year in which the tax return or document is processed by the Internal Revenue Service.

<sup>3</sup> Files that contain data from initial input of the original individual and business tax returns during return processing.

<sup>4</sup> Taxpayers that are patrons of certain agricultural or horticultural cooperatives may be allocated a share of the cooperative's DPAD on Form 1099-PATR, *Taxable Distributions Received From Cooperatives*.



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prepared by the taxpayer at a retail establishment and the transmission or distribution of electricity, natural gas, and potable water. Due to the complexity of determining which activities qualify for the DPAD, the regulations contain safe harbors.<sup>5</sup>

The DPAD currently provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is generally equal to 9 percent<sup>6</sup> of its Qualified Production Activities Income (QPAI).<sup>7</sup> This currently equates to approximately a 3 percent reduction in the tax rate for a high-income individual taxpayer or corporation with a 35 percent tax rate.<sup>8</sup> The DPAD has two specific limitations, as follows:

- The applicable DPAD percentage is applied to the *lesser* of the taxpayer's QPAI or adjusted gross income (or taxable income for a corporation). For example, if a taxpayer has a QPAI of \$5,000 and an adjusted gross income of \$1,000, the DPAD would be calculated by multiplying \$1,000 (the lesser of QPAI and adjusted gross income) by 9 percent.
- The deduction cannot exceed 50 percent of Form W-2, *Wage and Tax Statement*, wages paid by the taxpayer during the taxable year.

### **Claiming the DPAD**

Taxpayers use Form 8903, *Domestic Production Activities Deduction*, to calculate and claim the allowable DPAD.<sup>9</sup> To claim the DPAD, the taxpayer must have income attributable to the actual conduct of a trade or business. An activity qualifies as a trade or business if the taxpayer's primary purpose for engaging in the activity is for income or profit and is conducted continually and regularly. Individual taxpayers claim the DPAD as an adjustment to income on line 35 of Form 1040. Corporations claim the deduction on line 25 of Form 1120.

Partnerships and S Corporations that conduct a trade or business that is a qualified activity do not claim the DPAD on their returns. Instead, the DPAD is allocated to the shareholder or partner to claim on their individual or corporate return. Information needed to compute the DPAD is reported by pass-through entities to the individual via Schedule K-1.<sup>10</sup>

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<sup>5</sup> A provision of a regulation that specifies that certain conduct will be deemed not to violate a given rule.

<sup>6</sup> Oil-related activities are limited to 6 percent.

<sup>7</sup> Income from the taxpayer's domestic production gross receipts, reduced by the cost of goods sold and related expenses including the cost of production and portion of indirect expenses, is known as the QPAI.

<sup>8</sup> Nine percent, *i.e.*, DPAD percentage, multiplied by 35 percent tax rate equals 3.15 percent reduction in the tax rate.

<sup>9</sup> See Appendix V for a copy of Form 8903.

<sup>10</sup> This includes Form 1041 (Schedule K-1), *Beneficiary's Share of Income, Deductions, Credits, etc.*; Form 1065 (Schedule K-1), *Partner's Share of Income, Deductions, Credits, etc.*; Form 1065-B (Schedule K-1), *Partner's Share of Income (Loss) From an Electing Large Partnership*; and Form 1120-S (Schedule K-1), *Shareholder's Share of Income, Deductions, Credits, etc.*



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### **Potential regulation changes**

On August 26, 2015, the Internal Revenue Service (IRS) issued proposed amendments, suggesting changes to the current regulations for the DPAD. Some of these proposed changes address:

- The allocation of Form W-2 wages in a short year<sup>11</sup> and in the acquisition or disposition of a trade or business.
- Guidance on the definition of oil-related QPAI.
- Definition of a qualified film.
- Treatment of activities in Puerto Rico.

Comments were due to the IRS by November 25, 2015, and a public hearing was held on December 16, 2015, to discuss the proposed changes and comments to the changes prior to finalizing these regulations. As of the report date, revisions to the regulations have not been finalized.

This review was performed with information obtained from the Large Business and International Division office in Washington, D.C.; the Small Business/Self-Employed Division office in Lanham, Maryland; and the Wage and Investment Division office in Atlanta, Georgia, during the period September 2015 through June 2016. 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.

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<sup>11</sup> A short tax year is a tax year of less than 12 months.



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Results of Review

Processes Have Not Been Established to Ensure That Claims for the Domestic Production Activities Deduction Are

Our review identified that the IRS has not established processes to ensure that taxpayers' claims for the DPAD are... Our match of... to the amount of the DPAD claimed identified 2,829 taxpayers that filed returns for Tax Year (TY) 2013 that potentially overclaimed the DPAD by more than \$27 million. Figure 2 provides a breakdown of the number of tax returns and potential amounts overclaimed by taxpayer type.

Figure 2: Potential Overclaimed DPAD by Taxpayer Type

Table with 3 columns: Taxpayer Type, Tax Returns, Amount. Rows include Business (2,721, \$23.2 million), Corporation (108, \$4.5 million), and Total (2,829, \$27.7 million).

Source: TIGTA analysis of TY 2013 tax returns claiming the DPAD.

Subsequent to the processing of the tax return, the IRS may identify a potentially erroneous claim if the taxpayer's tax return is examined. However, when we requested that the IRS provide us statistics showing how many taxpayers had been audited to verify a DPAD claim, the IRS stated that it does not have a specific examination program that focuses on identifying and selecting tax returns with potentially questionable DPAD claims.

12 For this audit, the term business refers to an individual filing a...

13 For this analysis, we removed those business records with a Schedule E attached to the return.

14 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.

15 Taxpayers and dollar amounts limited to only those that potentially overclaimed the DPAD by \$3,000 or more.



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To be eligible to claim the DPAD on their tax return, taxpayers must have paid wages to employees during the tax year. As previously stated, the deduction they are allowed is  $9\%$  of the qualified production activities income (QPAI) during the taxable year. Figure 3 provides a hypothetical example that shows the effect of this DPAD limitation.

**Figure 3: Example of DPAD Calculation**

	Taxpayer Y	Taxpayer Z
QPAI	\$10,000	\$10,000
Multiplied by DPAD Percentage	9%	9%
Potential DPAD	\$900	\$900
*****2*****	*****2*****	*****2*****
*****2*****	*****2*****	*****2*****
<b>DPAD</b>	<b>\$900</b>	<b>\$500</b>

Source: TIGTA analysis of Form 990.

When we brought our concern about DPAD overclaims to IRS management’s attention, they explained that systemically identifying businesses and corporations overclaiming the deduction  $9\%$  of QPAI. The IRS explained that corporations can receive the DPAD from pass-through entities,<sup>16</sup> as well as file returns as part of a consolidated group. Therefore,  $9\%$  of QPAI by the filing corporation may have actually been paid by another member of the consolidated group. Further, many businesses use a Professional Employer Organization (PEO).<sup>17</sup> In those situations, the PEO files the employment tax information under its own Employer Identification Number (EIN).<sup>18</sup>

<sup>16</sup> A pass-through entity is an entity that passes income, credits, deductions, etc., through to individuals or businesses that are partners, shareholders, or beneficiaries.

<sup>17</sup> A PEO, sometimes referred to as an employee leasing organization, enters into an agreement with an employer to perform some or all of the employment tax withholding, reporting, and payment activities related to workers performing services for the employer.

<sup>18</sup> A unique nine-digit number used to identify a taxpayer’s business account.



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We agree there are challenges to the IRS systemically determining if a business has overclaimed the DPAD \*\*\*\*\*2\*\*\*\*\*. However, actions can be taken by the IRS to address these challenges. In March 2015, we reported that the IRS had not established processes to link employers with their PEOs.<sup>19</sup> We also raised this same concern in prior reports.<sup>20</sup> We recommended that the IRS establish a program by which employers can inform the IRS of the PEOs they authorize to file and pay employment taxes and, once in place, ensure that tax account records are updated to reflect this information (establishing a link between the two entities). The IRS partially agreed with our recommendation and is currently implementing a voluntary PEO certification process in July 2016 to help address this concern.

We believe that the dollars at risk associated with these potential overclaims for the DPAD warrant the IRS's attention to better identify noncompliant taxpayers. While Form 8903 has a line item for entering wages for calculating the DPAD, it does not have a separate line item allowing for entry of the \*\*\*\*\*2\*\*\*\*\*. Creating a new line on the form to require the \*\*\*\*\*2\*\*\*\*\* would allow the IRS to ensure that businesses are not overclaiming the deduction \*\*\*\*\*2\*\*\*\*\*. Figure 4 shows a hypothetical example of how a line can be added next to lines 16 and 17 of Form 8903 to \*\*\*\*\*2\*\*\*\*\*.

**Figure 4: Example of DPAD Calculation With \*\*\*\*\*2\*\*\*\*\***

13	Enter 9% of line 12		13		
14a	Enter the smaller of line 10a or line 12	14a			
	<b>b</b> Reduction for oil-related qualified production activities income. Multiply line 14a by 3%		14b		
15	Subtract line 15b from line 13		15		
16	Form W-2 wages (see instructions) *****2*****		16		
17	Form W-2 wages from estates, trusts, and certain partnerships and S corporations (see instructions)..... *****2*****		17		
18	Add lines 16 and 17. Estates and trusts, go to line 19, all others, skip line 19 and go to line 20		18		
19	Amount allocated to beneficiaries of the estate or trust (see instructions)		19		

Source: TIGTA hypothetical example of Form 8903.

When we discussed our concerns with IRS management again on July 19, 2016, the IRS stated that it could not use math error authority<sup>21</sup> to address the potential overclaims. As such, taxpayers identified as not meeting the wage limitation requirement would need to have their returns examined, and IRS management stated that using its limited resources on these claims

<sup>19</sup> TIGTA, Ref. No. 2015-40-023, *Processes Are Needed to Link Third-Party Payers and Employers to Reduce Risks Related to Employment Tax Fraud* (Mar. 2015).

<sup>20</sup> TIGTA, Ref. No. 2007-30-169, *Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations, but More Can Be Done* (Sept. 2007); and TIGTA, Ref. No. 2011-40-103, *Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed* (Sept. 2011).

<sup>21</sup> Math error authority refers to an automated process in which the IRS identifies math or other statistical irregularities and automatically prepares an adjusted return for a taxpayer filing on paper and generally rejects electronic returns.



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with a potential average adjustment per return of less than \*\*2\*\* would not be prudent. However, further analysis of the 2,829 taxpayers identified that the top 50 had total potential overclaims of more than \$6.2 million, with those overclaims ranging from \$44,344 to more than \$1 million. Furthermore, IRS management stated that the burden on taxpayers and the IRS would exceed any potential enforcement benefit. We do not agree with the IRS's view on this. Rather, requiring an EIN would ensure more accurate reporting and provide the IRS with the ability to identify taxpayers that are not properly limiting their DPAD by \*\*\*\*\*2\*\*\*\*\*. \*\*\*\*\*2\*\*\*\*\*.

### Recommendations

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

**Recommendation 1:** Revise Form 8903 to include a line for providing \*\*\*\*\*2\*\*\*\*\* associated with the DPAD claim.

**Management's Response:** The IRS disagreed with this recommendation. The IRS believes implementing this recommendation would be premature. The IRS also does not agree that the \*\*\*\*\*2\*\*\*\*\* currently can be used to effectively identify appropriate DPAD examination cases. Unless these criteria can effectively be used for examination case selection, the minimal potential benefit that might be derived from the information obtained through a revision of Form 8903 does not outweigh the resources required to revise the form and to annually transcribe the data.

**Office of Audit Comment:** Revising the form to include \*\*2\*\* directly addresses a challenge the IRS raised during our review and in its disagreement with our outcome measure regarding the inability to identify who paid the wages in situations involving pass-through entities. In addition, not taking this action is contradictory to management's agreement and corrective action for Recommendation 2. In fact, requiring \*\*2\*\* would ensure more accurate reporting and provide the IRS with the ability to identify taxpayers that are not properly \*\*\*\*\*2\*\*\*\*\*.

**Recommendation 2:** Develop processes to identify those taxpayers not \*\*\*\*\*2\*\*\*\*\* that can be addressed during post-processing compliance activities.

**Management's Response:** The IRS agreed with this recommendation. The IRS will review its prior DPAD Compliance Initiative Projects, as well as the filters used by TIGTA and available filing information, to determine whether it can develop a new, more productive Compliance Initiative Project. However, management disagreed with our outcome measure because a taxpayer might actually \*\*2\*\* as a consolidated group, flow-through entity, or PEO sufficient to support the DPAD even if those \*\*\*\*\*2\*\*\*\*\* on the taxpayer's return.



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**Office of Audit Comment:** Our outcome measure only included those corporations we could identify as \*\*\*\*\*2\*\*\*\*\*. As we previously stated, without the addition of an \*\*\*\*\*2\*\*\*\*\*, as management indicates, there is no ability to identify (in certain situations) the corporation that \*\*\*\*\*2\*\*\*\*\**i.e.*, pass-through entities. As such, we did not include these corporations in our outcome measure.

**Processes Have Not Been Established to Identify Ineligible Individuals Claiming the Domestic Production Activities Deduction**

Our review identified that the IRS has not established processes to ensure that businesses, *i.e.*, individual taxpayers, are eligible to claim the DPAD. For example, individual taxpayers should only claim the DPAD if they have an \*\*\*\*\*2\*\*\*\*\*  
 \*\*\*\*\*2\*\*\*\*\*  
 \*\*\*\*\*2\*\*\*\*\*. We identified 177 electronically filed (e-filed) Forms 1040 for TY 2013 that claimed \$850,329 in the DPAD \*\*\*\*\*2\*\*\*\*\*the operation of a business.<sup>22</sup> We provided these returns to the IRS for review, and IRS management agreed that the taxpayers in these cases did not file the \*\*\*\*\*2\*\*\*\*\*  
 \*\*\*\*\*2\*\*\*\*\* to support the DPAD.<sup>23</sup>

An activity qualifies as a trade or business if the taxpayer’s primary purpose for engaging in the activity is for income or profit and is conducted continually and regularly. The IRS provides taxpayers with \*\*\*2\*\*\* in which an individual \*\*\*\*\*2\*\*\*\*\*  
 \*\*\*\*\*2\*\*\*\*\*  
 \*\*\*\*\*2\*\*\*\*\*.

\*\*\*\*\*2\*\*\*\*\*

***2***	*****2*****
*****2*****	*****2*****
*****2*****	*****2*****
*****2*****	*****2*****

\*\*\*\*\*2\*\*\*\*\*  
 \*\*\*\*\*2\*\*\*\*\*.

<sup>22</sup> Taxpayers and dollar amount limited to only those that claimed a DPAD of \$500 or more.

<sup>23</sup> We also included paper-filed Forms 1040 in our analysis. However, the IRS’s review of the tax returns we identified as claiming the DPAD \*\*\*\*\*2\*\*\*\*\* found that a high percentage of these potentially erroneous claims resulted from either IRS processing or taxpayer errors. Based on this, we removed paper-filed returns from our quantification of potentially erroneous DPAD claims.



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If an individual taxpayer does not file \*\*\*\*\*2\*\*\*\*\* with his or her individual return, then there is no support to show that he or she \*\*\*\*\*2\*\*\*\*\* which is required to claim the DPAD. We continue to report the lack of action taken on the part of the IRS to address individuals' claims for credits that are contingent upon the individual \*\*\*\*\*2\*\*\*\*\*. For example, we previously reported that the IRS had not established effective processes to identify individuals who claim General Business Credits without evidence included with the tax return to support the \*\*\*\*\*2\*\*\*\*\*.<sup>24</sup> The review of TY 2011 e-filed returns identified 3,187 returns claiming approximately \$1.2 billion in General Business Credits. The returns filed by these individuals did not have a \*\*\*\*\*2\*\*\*\*\*. The IRS agreed to make enhancements to its compliance strategy to identify these returns with no apparent\*\*\*\*\*2\*\*\*\*\*.

IRS management reviewed the methodology we used to identify the individuals that claimed a DPAD without an \*\*\*\*\*2\*\*\*\*\*. IRS management indicated that these cases could be addressed using its math error authority allowed under Internal Revenue Code Section 6213(b). As such, a claim for a DPAD for which the taxpayer does not include a \*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*.

## ***Recommendations***

***Recommendation 3:*** The Commissioner, Wage and Investment Division, should develop processes and procedures to identify individuals claiming a DPAD \*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*, and use its math error authority to disallow the deduction.

***Management's Response:*** The IRS agreed with this recommendation. The IRS has procedures in place to detect income tax returns claiming the DPAD \*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*; however, the process is manual and can be prone to human error. As a secondary control, the IRS will determine if math error business rules can be developed using the information available during processing that will not result in unnecessary math error notices being issued when a DPAD is claimed. Due to the constraints of limited funding and resources, and the prioritization of competing information technology needs, the IRS cannot provide an implementation date for this action.

***Recommendation 4:*** The Commissioner, Small Business/Self-Employed Division, should verify whether the 177 e-filed tax returns that we identified as erroneously claiming the DPAD are entitled to the claim.

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<sup>24</sup> TIGTA, Ref. No. 2013-40-093, *Unsupported and Potentially Erroneous Claims for General Business Credits Are Not Always Identified When Tax Returns Are Processed* (Sept. 2013).



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**Management's Response:** The IRS disagreed with this recommendation. After a return is filed, the IRS cannot verify whether a taxpayer is entitled to a DPAD claim without an audit. The IRS reviewed the available return information for the three exception cases with the largest deductions to determine whether information reflected a compliance risk that warranted examination. After review of these cases, the IRS determined that these returns did not warrant further examination. The remaining cases have even smaller potential adjustments. Given the limited compliance risk and small potential adjustments, especially in light of the short statute (less than one year), the IRS does not believe it is prudent to deploy examination resources from cases with higher compliance risk and larger potential adjustments to these cases that reflect lower compliance risk and minimal potential adjustments. IRS management also stated that many of the cases we identified showed no indication of an improper claim of the DPAD. Additionally, the IRS disagreed with our outcome measure of more than \$166,000 for these exception cases.

**Office of Audit Comment:** After receiving the IRS's response, we requested information to substantiate its disagreement with our recommendation. IRS management stated that they reviewed approximately 100 of the returns with the highest deductions and found that multiple returns had indications of \*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*. The IRS provided us with 11 returns (three discussed above plus eight others) as further support of its claim. We reviewed these returns and we disagree with management's conclusions. In fact, our review of the 11 returns that IRS management provided identified that each taxpayer claimed an erroneous DPAD without reporting income from a \*\*\*\*\*2\*\*\*\*\* that would qualify for the DPAD.





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we determined that the average marginal tax rate for all the individual exception cases in this report was 19.62 percent.

- II. Determined if the IRS has processes and procedures to properly limit individual and corporate taxpayers' DPAD claims to \*\*\*\*\*2\*\*\*\*\*.
- A. Interviewed IRS personnel to obtain an understanding of the current processing of DPAD claims and IRS efforts to properly \*\*\*\*\*2\*\*\*\*\*.
- B. Determined if current procedures properly limit individual taxpayer DPAD claims.
1. Using the population of 679,948 individual taxpayers from Step I.C.1., identified the EIN(s)<sup>3</sup> the taxpayers used to report \*\*\*\*2\*\*\*\*\*.
  2. Using the EINs found from Step II.B.1., identified the \*\*\*\*\*2\*\*\*\*\*. We compared this to the DPAD claimed and determined that 2,721 taxpayers did not properly \*\*\*\*\*2\*\*\*\*\*.
  3. For those 2,721 taxpayers that may have not properly \*\*\*\*\*2\*\*\*\*\*, determined they potentially overclaimed \$23,230,484 of the DPAD. We provided this information to the IRS for its review and feedback. Further, to determine the potential tax effect for our outcome measures, we determined that the average marginal tax rate for all the individual exception cases in this report was 19.62 percent.
- C. Determined if current procedures properly limit corporate taxpayers' DPADs.
1. Obtained PY 2014 and 2015 data and identified 46,623 TY 2013 Forms 1120, *U.S. Corporation Income Tax Return*, filed claiming the DPAD.
  2. Determined the \*\*\*\*\*2\*\*\*\*\* the taxpayer paid employees during the year. We compared this to the DPAD claimed and determined that 108 taxpayers did not properly \*\*\*\*\*2\*\*\*\*\*.
  3. For those 108 taxpayers that may have not properly \*\*\*\*\*2\*\*\*\*\*, determined they potentially overclaimed \$4,527,407 of the DPAD. We provided this information to the IRS for its review and feedback. Further, to determine the potential tax effect for our outcome measures, we determined that the average marginal tax rate for the corporate exception cases was 18.66 percent.

<sup>3</sup> A unique nine-digit number used to identify a taxpayer's business account.



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### **Data validation methodology**

During this review, we relied on data from the IRS's Information Returns Master File<sup>4</sup> database for TY 2013 that were provided by TIGTA's Office of Investigations' Strategic Data Services. We performed additional extracts from the Business Master File<sup>5</sup> and Individual Master File<sup>6</sup> located on TIGTA's Data Center Warehouse. Before relying on our data, we ensured that each file contained the specific data elements we requested. In addition, we selected random samples of each extract and verified that the data in the extracts were the same as the data captured in the IRS's Integrated Data Retrieval System.<sup>7</sup> As a result of our testing, we determined that the data used in our review were reliable.

### **Internal controls methodology**

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objective. 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 that the following internal controls were relevant to our audit objective: IRS processes, procedures, and controls used to ensure that taxpayers are correctly claiming the DPAD. We evaluated the controls by reviewing the IRS's Internal Revenue Manual, interviewing IRS management, reviewing relevant legislation and Internal Revenue Code sections applicable to the DPAD, conducting data analysis, and reviewing past TIGTA audit work on related subjects.

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<sup>4</sup> The IRS database of current tax year information returns. These include Forms 1099-PATR, *Taxable Distributions Received From Cooperatives*, and W-2.

<sup>5</sup> 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.

<sup>6</sup> The IRS database that maintains transactions or records of individual tax accounts.

<sup>7</sup> IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



*Actions Can Be Taken to Better Identify Potentially Erroneous  
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**Appendix II**

*Major Contributors to This Report*

Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services)

Diana M. Tengesdal, Director

Larry Madsen, Audit Manager

Johnathan D. Elder, Lead Auditor

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**Appendix III**

*Report Distribution List*

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff  
Commissioner, Large Business and International Division  
Commissioner, Small Business/Self-Employed Division  
Commissioner, Wage and Investment Division  
Director, Examination, Large Business and International Division  
Director, Examination, Small Business/Self-Employed Division  
Director, Submission Processing, Wage and Investment Division  
Director, Office of Audit Coordination



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**Appendix IV**

*Outcome Measures*

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

**Type and Value of Outcome Measure:**

- Increased Revenue – Potential; \$5,402,635 for 2,829 taxpayers overclaiming the DPADs. These taxpayers did not properly \*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\* (see page 4).

**Methodology Used to Measure the Reported Benefit:**

We conducted an analysis of TY 2013 tax returns with a DPAD claimed. We analyzed both individual and corporate tax returns. We found that 2,721 individual taxpayers potentially overclaimed the DPAD by \$3,000 or more. This resulted in \$23,230,484 of the DPADs potentially overclaimed by individual taxpayers. To find the tax effect of the potentially overclaimed deductions, we determined that the average marginal tax rate of those individuals who potentially overclaimed the DPADs in this report is 19.62 percent. We multiplied the \$23,230,484 by the marginal tax rate of 19.62 percent and determined the tax effect for individuals to be \$4,557,821. We also found that 108 corporations potentially overclaimed the DPADs by \$3,000 or more. This resulted in \$4,527,407 of the DPADs potentially overclaimed by corporate taxpayers. To find the tax effect of the potentially overclaimed deductions, we determined that the average marginal tax rate of those corporations that potentially overclaimed the DPADs is 18.66 percent. We then multiplied this amount by the average marginal tax rate of 18.66 percent and determined the tax effect for corporations to be \$844,814. The IRS could potentially increase revenue by more than \$5.4 million if TIGTA’s recommendations are implemented.

**Type and Value of Outcome Measure:**

- Revenue Protection – Potential; \$166,835 for 177 taxpayers claiming the \*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\* (see page 8).

**Methodology Used to Measure the Reported Benefit:**

We conducted an analysis of PY 2014 individual tax returns with the DPADs claimed and found that there were 1,464 taxpayers who claimed \$2,708,037 of the DPADs and \*\*\*\*\*2\*\*\*\*\*  
\*\*\*\*\*2\*\*\*\*\*. Of these returns, we found that



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714 were e-filed and 750 were paper-filed. The paper-filed returns require the IRS to transcribe information from the tax returns onto its computer systems. This is performed by employees manually typing the applicable information. Because of this manual process, errors are sometimes made when transcribing the information. The IRS reviewed a sample of the paper-filed returns and found a high rate of IRS processing and taxpayer errors. As a result, we are not including the 750 paper-filed returns claiming \$1,774,784 of the DPADs in our outcome.

The remaining 714 e-filed returns claimed \$933,253 of the DPADs without proper support, 177 of which had DPAD amounts of \$500 or more with claims totaling \$850,329. To determine the tax effect of these deductions, we determined the average marginal tax rate on those individuals who potentially overclaimed the deduction in this report to be 19.62 percent. We multiplied the \$850,329 by the average marginal tax rate of 19.62 percent to obtain the tax effect of \$166,835. The IRS could potentially protect more than \$166,000 if TIGTA's Recommendation 3 is implemented.



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**Appendix V**

*Form 8903, Domestic  
Production Activities Deduction*

<b>Form 8903</b> <small>(Rev. December 2010)          Department of the Treasury          Internal Revenue Service</small>	<b>Domestic Production Activities Deduction</b> <small>► Attach to your tax return. ► See separate instructions.</small>	<small>OMB No. 1545-1964</small>  <small>Attachment Sequence No. <b>143</b></small>
<small>Name(s) as shown on return</small>		<small>Identifying number</small>
<p><b>Note. Do not</b> complete column (a), unless you have oil-related production activities. Enter amounts for all activities in column (b), including oil-related production activities.</p>		
	<b>(a)</b> <small>Oil-related production activities</small>	<b>(b)</b> <small>All activities</small>
<b>1</b> Domestic production gross receipts (DPGR) . . . . .	<b>1</b>	
<b>2</b> Allocable cost of goods sold. If you are using the small business simplified overall method, skip lines 2 and 3 . . . . .	<b>2</b>	
<b>3</b> Enter deductions and losses allocable to DPGR (see instructions) . . . . .	<b>3</b>	
<b>4</b> If you are using the small business simplified overall method, enter the amount of cost of goods sold and other deductions or losses you ratably apportion to DPGR. All others, skip line 4 . . . . .	<b>4</b>	
<b>5</b> Add lines 2 through 4 . . . . .	<b>5</b>	
<b>6</b> Subtract line 5 from line 1 . . . . .	<b>6</b>	
<b>7</b> Qualified production activities income from estates, trusts, and certain partnerships and S corporations (see instructions) . . . . .	<b>7</b>	
<b>8</b> Add lines 6 and 7. Estates and trusts, go to line 9, all others, skip line 9 and go to line 10 . . . . .	<b>8</b>	
<b>9</b> Amount allocated to beneficiaries of the estate or trust (see instructions) . . . . .	<b>9</b>	
<b>10a Oil-related qualified production activities income.</b> Estates and trusts, subtract line 9, column (a), from line 8, column (a), all others, enter amount from line 8, column (a). If zero or less, enter -0- here . . . . .	<b>10a</b>	
<b>b Qualified production activities income.</b> Estates and trusts, subtract line 9, column (b), from line 8, column (b), all others, enter amount from line 8, column (b). If zero or less, enter -0- here, skip lines 11 through 21, and enter -0- on line 22 . . . . .	<b>10b</b>	
<b>11</b> Income limitation (see instructions): <ul style="list-style-type: none"> <li>• Individuals, estates, and trusts. Enter your adjusted gross income figured without the domestic production activities deduction . . . . .</li> <li>• All others. Enter your taxable income figured without the domestic production activities deduction (tax-exempt organizations, see instructions) . . . . .</li> </ul>	<b>11</b>	
<b>12</b> Enter the smaller of line 10b or line 11. If zero or less, enter -0- here, skip lines 13 through 21, and enter -0- on line 22 . . . . .	<b>12</b>	
<b>13</b> Enter 9% of line 12 . . . . .	<b>13</b>	
<b>14a</b> Enter the smaller of line 10a or line 12 . . . . .	<b>14a</b>	
<b>b</b> Reduction for oil-related qualified production activities income. Multiply line 14a by 3% . . . . .	<b>14b</b>	
<b>15</b> Subtract line 14b from line 13 . . . . .	<b>15</b>	
<b>16</b> Form W-2 wages (see instructions) . . . . .	<b>16</b>	
<b>17</b> Form W-2 wages from estates, trusts, and certain partnerships and S corporations (see instructions) . . . . .	<b>17</b>	
<b>18</b> Add lines 16 and 17. Estates and trusts, go to line 19, all others, skip line 19 and go to line 20 . . . . .	<b>18</b>	
<b>19</b> Amount allocated to beneficiaries of the estate or trust (see instructions) . . . . .	<b>19</b>	
<b>20</b> Estates and trusts, subtract line 19 from line 18, all others, enter amount from line 18 . . . . .	<b>20</b>	
<b>21</b> Form W-2 wage limitation. Enter 50% of line 20 . . . . .	<b>21</b>	
<b>22</b> Enter the smaller of line 15 or line 21 . . . . .	<b>22</b>	
<b>23</b> Domestic production activities deduction from cooperatives. Enter deduction from Form 1099-PATR, box 6 . . . . .	<b>23</b>	
<b>24</b> Expanded affiliated group allocation (see instructions) . . . . .	<b>24</b>	
<b>25</b> <b>Domestic production activities deduction.</b> Combine lines 22 through 24 and enter the result here and on Form 1040, line 35; Form 1120, line 25; or the applicable line of your return . . . . .	<b>25</b>	
<small>For Paperwork Reduction Act Notice, see separate instructions.</small>		<small>Cat. No. 37712F</small>
		<small>Form <b>8903</b> (Rev. 12-2010)</small>



*Actions Can Be Taken to Better Identify Potentially Erroneous Domestic Production Activities Deductions*

**Appendix VI**

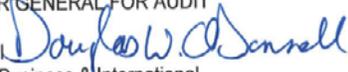
*Management's Response to the Draft Report*



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, DC 20224

September 12, 2016

MEMORANDUM FOR MICHAEL E. MCKENNEY  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Douglas W. O'Donnell   
Commissioner Large Business & International

SUBJECT: Draft Audit Report – Actions Can Be Taken to Better Identify Potentially Erroneous Domestic Production Activities Deductions (Audit # 2015-40-008)

Thank you for the opportunity to review your draft report titled "Actions Can Be Taken to Better Identify Potentially Erroneous Domestic Production Activities Deductions."

In 2004, the American Jobs Creation Act of 2004 (AJCA) was enacted. Section 102 of the AJCA phased in a new tax deduction, for a broad range of domestic manufacturing and production businesses, as well as for many companies engaged in activities not traditionally viewed as manufacturing (e.g., film production, agriculture, electricity generation, and building construction), but which nevertheless create jobs in the United States. The deduction is available to corporations, partnerships, other pass-through entities, and individuals. The deduction, which was fully phased in beginning in 2010, effectively reduces the tax rate on corporate manufacturers that engage in "domestic production" from 35% to 32%. To claim the deduction, a taxpayer submits a Form 8903, Domestic Production Activities Deduction (DPAD).

DPAD is a complex issue and in most cases requires an audit to determine whether the activities qualify for the deduction and to calculate the domestic production gross receipts (DPGR) and expenses properly allocable to DPGR in addition to other issues. We appreciate your acknowledgement of the challenges for the IRS due to the scope, size, and complexity of the DPADs. These challenges are further compounded by cuts to the IRS's budget. Your report includes potential increased revenue and revenue protection of less than \$6 million, which is a small fraction of the nearly \$43 billion in DPAD claimed in Processing Year 2013. Given constraints on resources, we have to make strategic and risk-based decisions to ensure our limited resources are allocated to areas with the highest levels of potential noncompliance.



Actions Can Be Taken to Better Identify Potentially Erroneous Domestic Production Activities Deductions

We do not agree with the report's premise that the IRS can ensure that DPAD is properly claimed through simple mathematical review of returns. Therefore, we respectfully disagree with your recommendation to revise Form 8903 to include a line for providing the information associated with the DPAD claim. This requirement would be difficult to apply where through multi-tiered partnerships and where wages comes from various entities. The burden on taxpayers and the IRS would exceed any potential enforcement benefit.

TIGTA concedes that cases identified using the cannot be resolved using math error authority and must be resolved through examination. However, currently do not identify productive examination work. Our SBSE Division previously initiated two compliance initiative projects (CIP) involving DPAD; one CIP specifically used a. Both CIPs were terminated because the exam results did not justify additional time and resources. In particular, the results of the CIP appear to support our contention that there are legitimate reasons why a return with a valid DPAD may appear to exceed the. However, because we continually strive to improve the identification of returns with the highest risk of noncompliance, we will analyze these past CIPs as well as the filters used by TIGTA and available filing information to determine whether we can develop a new, more productive CIP.

We agree with the recommendation that the Commissioner, Wage and Investment Division, should develop processes and procedures to identify individuals claiming a DPAD without evidence of a and use math error authority to correct the return. The IRS has procedures in place to detect income tax returns claiming DPADs without; however, the process is manual and can be prone to human error. As a secondary control, we will request programming that will validate is present on the return when a DPAD is claimed and flag the return for the appropriate corrective.

We respectfully disagree that we should verify whether the 177 e-filed tax returns identified by TIGTA are entitled to the DPAD. We cannot "verify" whether a taxpayer is "entitled" to a DPAD claim without an audit. We reviewed the available return information for these cases to determine whether there exists a compliance risk that warrants examination. Our review found that many cases show no indication of an improper claim. We do not believe it is prudent to deploy examination resources from cases with higher compliance risk and larger potential adjustments to these cases that reflect lower compliance risk and minimal potential adjustments.

We respectfully disagree with the measurable benefits. Since we do not agree with the premise that your reliably identify invalid



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claims, we cannot agree with the basis of your computation. In addition, the outcome measures do not account for the opportunity costs associated with redeploying resources away from cases with higher compliance risks and larger potential adjustments to the cases with lower compliance risk and minimal potential adjustments. Specifically:

- Revenue Protection Potential of more than \$5.4 million: As stated above, a mathematical \*\*\*\*\*2\*\*\*\* on the face of the return or \*\*\*\*\*2\*\*\*\*\* under that taxpayer's EIN does not necessarily mean that the taxpayer erroneously claimed a DPAD. TIGTA acknowledges that \*\*\*\*\*2\*\*\*\*\* by corporations that file returns as part of a consolidated group, from a flow-through entity or by Professional Employer Organizations (PEO) that would file employment tax return information under their own EIN. In other words, a taxpayer may actually \*\*\*2\*\*\* sufficient to support the DPAD claimed even if \*\*\*\*\*2\*\*\*\*\* \*\*\*\*\*2\*\*\*\*\* on the taxpayer's return. The outcome measures do not account for these valid claims. Moreover, even assuming all of the claims are invalid, using the marginal tax rates assumed by TIGTA (19.62%), the average potential tax revenue per case is \$1,908.
- Revenue Protection Potential of more than \$166,000: As we explained above, of the identified 177 taxpayers, a review of the three returns with the highest reported DPAD show minimal or no potential adjustments. In fact, 121 of the 177 cases (more than 68%) claimed deductions of \*\*\*2\*\*\* or less (i.e. potential adjustment of less than \*\*\*2\*\*\*).

Attached is a detailed response outlining our corrective actions to address your recommendations.

If you have any questions, please contact me or a member of your staff may contact Holly O. Paz, Director, Corporate Issues and Credits, at (202) 317-8559.

Attachment



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*Actions Can Be Taken to Better Identify Potentially Erroneous Domestic Production Activities Deductions*

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**Attachment 1**

TIGTA Audit Draft Report 2015-40-008- Actions Can Be Taken to Better Identify Potentially Erroneous Domestic Production Activities Deductions

**RECOMMENDATION 1:**

The Commissioner, Small Business/Self-Employed Division, should revise Form 8903 to include .a line for providing the \*\*\*\*\*2\*\*\*\*\* associated with the DPAD claim.

**CORRECTIVE ACTION(S):**

We believe implementing this recommendation would be premature. We do not agree that the \*\*\*\*\*2\*\*\*\*\* currently can be used to effectively identify appropriate DPAD examination cases. Unless these criteria can effectively be used for examination case selection, the minimal potential benefit that might be derived from the information obtained through a revision of Form 8903 does not outweigh the resources required to revise the form and to annually transcribe the data.

**IMPLEMENTATION DATE:**

N/A

**RESPONSIBLE OFFICIAL(S):**

N/A

**CORRECTIVE ACTION(S) MONITORING PLAN:**

N/A



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**RECOMMENDATION 2:**

The Commissioner, Small Business/Self-Employed Division, should develop processes to identify those taxpayers not \*\*\*\*\*2\*\*\*\*\* that can be addressed during post-processing compliance activities.

**CORRECTIVE ACTION(S):**

We will review our prior DPAD Compliance Initiative Projects (CIP) as well as the filters used by TIGTA and available filing information to determine whether we can develop a new, more productive CIP.

**IMPLEMENTATION DATE:**

March 15, 2017

**RESPONSIBLE OFFICIAL(S):**

Director, Exam Case Selection, SB/SE Examination

**CORRECTIVE ACTION(S) MONITORING PLAN:**

IRS will monitor this corrective action as part of our internal management system of controls.

**RECOMMENDATION 3:**

The Commissioner, Wage and Investment Division, should develop processes and procedures to identify individuals claiming a DPAD \*\*\*\*\*2\*\*\*\*\* and use its math error authority to disallow the deduction

**CORRECTIVE ACTION(S):**



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The IRS has procedures in place to detect income tax returns claiming DPADs without \*\*\*\*\*2\*\*\*\*\*; however, the process is manual and can be prone to human error. As a secondary control, we will determine if math error business rules can be developed using the information available during processing that will not result in unnecessary math error notices being issued when a DPAD is claimed. Due to the constraints of limited funding and resources, and the prioritization of competing information technology needs, we cannot provide an implementation date for this action.

**IMPLEMENTATION DATE:**

N/A

**RESPONSIBLE OFFICIAL(S):**

Director, Submission Processing, Customer Account Services, Wage and Investment Division

**CORRECTIVE ACTION(S) MONITORING PLAN:**

We will monitor this corrective action as part of our internal management control system.

**RECOMMENDATION 4:**

The Commissioner, Small Business/Self-Employed Division, should verify whether the 177 e-filed tax returns that we identified as erroneously claiming the DPAD are entitled to the claim.

**CORRECTIVE ACTION(S):**

After a return is filed (as is the case for the 177 exception cases identified), we cannot "verify" whether a taxpayer is "entitled" to a DPAD claim without an audit. We reviewed the available return information for the three exception cases with the largest deductions to determine whether information reflected a compliance risk that warranted examination. After review of these cases, we determined that these returns did not



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warrant further examination. \*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\* . Even if it is not valid, the potential adjustment is not cost-effective for examination. The remaining cases have even smaller potential adjustments. Given the limited compliance risk and small potential adjustments, especially in light of the short statute (less than 1 year), we do not believe it is prudent to deploy examination resources from cases with higher compliance risk and larger potential adjustments to these cases that reflect lower compliance risk and minimal potential adjustments.

**IMPLEMENTATION DATE:**

N/A

**RESPONSIBLE OFFICIAL(S):**

N/A

**CORRECTIVE ACTION(S) MONITORING PLAN:**

N/A