



*Processes Are Needed to Identify Small
Businesses Erroneously Claiming the
Research Tax Credit Payroll Tax Offset*

December 19, 2018

Reference Number: 2019-40-014

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 = Law Enforcement Techniques/ Procedures and Guidelines for Law Enforcement Investigations or Prosecutions.

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HIGHLIGHTS

PROCESSES ARE NEEDED TO IDENTIFY SMALL BUSINESSES ERRONEOUSLY CLAIMING THE RESEARCH TAX CREDIT PAYROLL TAX OFFSET

Highlights

Final Report issued on December 19, 2018

Highlights of Reference Number: 2019-40-014 to the Commissioner of Internal Revenue.

IMPACT ON TAXPAYERS

Title 26 U.S. Code Section 41, *Credit for Increasing Research Activities*, was enacted in 1981 to stimulate research and development in the United States by helping businesses offset some of the costs associated with increasing their qualified research activities (the credit is hereafter referred to as the Research Credit). The Protecting Americans from Tax Hikes Act of 2015 made the Research Credit permanent after December 31, 2014, and now allows qualified small businesses to apply a portion of the Research Credit against their employer portion of the Social Security tax. Qualified small businesses could begin claiming this credit after December 31, 2015. In Tax Year 2017, over 2,200 Research Credit claims totaling over \$53.2 million were made.

WHY TIGTA DID THE AUDIT

This audit was initiated because qualified small businesses could begin claiming the Research Credit to offset their payroll tax liability beginning in Tax Year 2016. The objective of this review was to determine whether the IRS can ensure that taxpayers who claim the Research Credit against their payroll taxes are eligible to claim the credit and claim the correct amount.

WHAT TIGTA FOUND

The IRS does not have processes to identify small businesses that do not meet the eligibility requirements and dollar limitations for claiming the Research Credit. TIGTA's review of 1,467 businesses claiming over \$53.2 million in Research Credits on Tax Year 2017

employment tax returns identified 143 businesses that claimed or received about \$11.8 million in potentially erroneous Research Credits. For example, TIGTA identified 81 businesses with potentially erroneous Research Credit claims totaling almost \$2.8 million because they did not meet one or more of the eligibility requirements to claim the Research Credit. TIGTA also identified 55 businesses with potentially erroneous Research Credit claims totaling \$586,190 on a return prior to when the credit became available. The IRS agreed with 50 of the identified cases.

*****2*****
*****2*****
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*****2*****.

In response to our findings, IRS management stated that they are developing post-processing compliance initiatives to ensure that eligibility for the Research Credit has been met as well as to ensure the accuracy of the credit amounts claimed.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, Small Business/Self-Employed Division, review the potentially erroneous Research Credits claimed by the 81 businesses that did not meet eligibility requirements; review the ****2****
*****2*****
2; and timely implement post-processing initiatives. TIGTA also recommended that the Commissioner, Wage and Investment Division, implement procedures to identify returns that claim the credit prior to when the credit became available and also ensure that the tax accounts for the 50 businesses claiming the credit prior to when it became available are adjusted. IRS management agreed with all five of our recommendations and plans corrective actions.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

December 19, 2018

MEMORANDUM FOR COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Processes Are Needed to Identify Small
Businesses Erroneously Claiming the Research Tax Credit Payroll Tax
Offset (Audit # 201840018)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) can ensure that taxpayers claiming the *Credit for Increasing Research Activities*¹ (hereafter referred to as Research Credit) against their payroll taxes are eligible to claim the credit and claim the correct amount. This review is included in our Fiscal Year 2019 Annual Audit Plan and addresses the major management challenge of Reducing Fraudulent Claims and Improper Payments.

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

Copies of this report are also being sent to the IRS 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).

¹ Title 26 U.S. Code Section 41.



*Processes Are Needed to Identify Small Businesses Erroneously
Claiming the Research Tax Credit Payroll Tax Offset*

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*Processes Are Needed to Identify Small Businesses Erroneously
Claiming the Research Tax Credit Payroll Tax Offset*

Abbreviations

IRS	Internal Revenue Service
TY	Tax Year



*Processes Are Needed to Identify Small Businesses Erroneously
Claiming the Research Tax Credit Payroll Tax Offset*

Background

Title 26 U.S. Code Section 41, *Credit for Increasing Research Activities*, was enacted in 1981 to stimulate research and development in the United States by helping businesses offset some of the costs associated with increasing their qualified research activities (the credit is hereafter referred to as the Research Credit).¹ The Protecting Americans from Tax Hikes Act of 2015² made the Research Credit permanent after December 31, 2014, and now allows qualified small businesses to apply a portion of the Research Credit against their employer portion of the Social Security tax. Qualified small businesses could begin claiming this credit after December 31, 2015 (*i.e.*, Tax Year³ (TY) 2016 returns).

For the purposes of claiming the Research Credit, the Internal Revenue Service (IRS) defines a qualified small business⁴ as a corporation (including an S corporation) or partnership that:

1. Filed a TY 2016 income tax return claiming gross receipts of less than \$5 million for the tax year.
2. Had no gross receipts for any tax year before the five tax year period ending with the tax year for which the claim was made.

Any other business may be considered a qualified small business if the business meets the requirements of (1) and (2), taking into account the aggregate gross receipts received in all the trades or businesses.

Processes for electing and claiming the credit

On an annual basis, a qualified small business specifies the amount of Research Credit it elects to claim against its employer portion of the Social Security tax liability. The maximum Research Credit allowed per year is \$250,000, for a total maximum limit of \$1,250,000 over five years. Generally, the election is calculated and made on Form 6765, *Credit for Increasing Research Activities*. The form is then included when the business files its income tax return using one of the following forms:

- Form 1040, *U.S. Individual Income Tax Return*.

¹ Qualified research must include discovering information that is technological in nature, and its application must be intended for use in developing a new or improved business component of the taxpayer. In addition, substantially all of the activities of the research must be elements of a process of experimentation relating to a new or improved function, performance, reliability, or quality.

² Consolidated Appropriations Act, 2016, Pub. L. 114-113, 129 Stat. 2242 (2015).

³ 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.

⁴ A qualified small business does not include a tax-exempt organization under Section 501.



Processes Are Needed to Identify Small Businesses Erroneously Claiming the Research Tax Credit Payroll Tax Offset

- Form 1065, *U.S. Return of Partnership Income*.
- Form 1120, *U.S. Corporation Income Tax Return*.
- Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*.
- Form 1120S, *U.S. Income Tax Return for an S Corporation*.

The business is also required to report the amount of the Research Credit claimed against the employer portion of the Social Security tax on Form 8974, *Qualified Small Business Payroll Tax Credit for Increasing Research Activities*.⁵ Form 8974 is included with the employment tax return filing⁶ (e.g., Form 941, *Employer's QUARTERLY Federal Tax Return*, or Form 944, *Employer's ANNUAL Federal Tax Return*). Figure 1 shows the number of TY 2017 Forms 941 and 944 and the Research Credit amount claimed against the employer portion of the Social Security tax.

Figure 1: Payroll Tax Credit Claimed on Forms 941 and 944 (Tax Year 2017)

	Totals
Form 941 Volume	2,200
Form 941 Credit Claimed Amount	\$53,238,379
Form 941 IRS Computed Amount	\$326,988,011 ⁷
Form 944 Volume (Annual Return)	3
Form 944 Claimed and Computed Amount	\$61,200

Source: TIGTA's analysis of Forms 941 and 944 data from the Business Return Transaction File, as of April 4, 2018.

This review was performed in the Wage and Investment Division's Submission Processing function in Ogden, Utah, and with information obtained from the Small Business/Self-Employed Division's Examination function during the period November 2017 through August 2018. 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.

⁵ See Appendix V.

⁶ Other employment tax returns that can claim the credit include: Form 941-SS, *Employer's QUARTERLY Federal Tax Return (American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands)*; Form 941-PR, *Planilla para la Declaración Federal TRIMESTRAL del Patrono*; or Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*.

⁷ See page 5 of this report for an explanation of why the IRS computed amount differed significantly from the claimed amount.



Processes Are Needed to Identify Small Businesses Erroneously Claiming the Research Tax Credit Payroll Tax Offset

Results of Review

Processes Do Not Ensure That Small Businesses Are Meeting Research Credit Eligibility Requirements and Dollar Limitations

The IRS does not have processes to identify small businesses that do not meet the eligibility requirements and dollar limitations for claiming the Research Credit. Our review of 1,467 businesses claiming over \$53.2 million in Research Credits on TY 2017 Forms 941 and 944 identified 143 businesses that claimed or received about \$11.8 million in potentially erroneous Research Credits. These include:

- 81 businesses with potentially erroneous claims totaling almost \$2.8 million. Each of these 81 businesses did not meet one or more of the eligibility requirements to claim the Research Credit. We provided IRS management with the claims, and they agreed that all 81 businesses could have potential erroneous Research Credits. However, management did note that verifying eligibility and amounts of the credit claimed is difficult because it requires information from different sources. In other words, eligibility cannot be determined from information on a single return and associated schedules. As such, the IRS will have to develop processes and procedures to review claims subsequent to the processing of tax returns.
- 55 businesses with potentially erroneous claims totaling \$586,190. Each of these businesses claimed the credit on a return prior to when the credit became available. For example, the Research Credit could first be claimed by a qualified small business on its Form 941 for the quarter that begins after the filing date of the TY 2016 income tax return. Thus, the earliest a Research Credit can be claimed on Form 941 is generally the second quarter of TY 2017. The 55 businesses we identified erroneously claimed the credit on their first quarter TY 2017 returns.

When we discussed the results of our analysis with IRS management, they agreed that 50 Research Credit claims totaling \$536,577 were processed incorrectly. The IRS disagreed with the remaining five cases with Research Credit claims totaling \$49,612⁸ because these claims were made on a duplicate return, which was subsequently disallowed. In response, management stated that they updated their internal guidance with procedures for correcting the erroneous credits by adjusting the tax account to reflect the correct amount of tax that should have been assessed resulting in a balance due or a reduced credit available for carryforward or refund. In addition, management is

⁸ Calculated dollar amount is off by \$1 due to rounding.



Processes Are Needed to Identify Small Businesses Erroneously Claiming the Research Tax Credit Payroll Tax Offset

working on procedures that will identify any future electronically filed returns processed that improperly claim the credit prior to when it became available.⁹ The IRS noted that of the 50 businesses claiming \$536,577 in Research Credits, a total of \$477,881 actually posted to 50 businesses' tax accounts. In some instances, the amount of the Research Credit claimed by the business was incorrect and the IRS subsequently made an adjustment to correct the amount.

- *2* businesses with potentially erroneous claims totaling more than ****2****. Each of these *2* businesses claimed Research Credits *****2*****. When we discussed the results of our analysis with IRS management, they noted that a systemic check was implemented in April 2018 for electronically filed returns to verify that the amount input on Form 8974 does not exceed ***2***. If the limitation is exceeded on Form 8974, the return will be rejected and the taxpayer will receive a message that the claim has been denied.

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 *****2*****. The IRS believes that six of the
 2 businesses with potentially erroneous claims totaling more *****2*****
 *****2*****.¹⁰ We agree that this is a possibility because further Internet
 research found that these businesses provide human resources or *****2*****.
 However, as management noted, the only way to verify the accuracy of these claims is by
 conducting an examination.

In discussing these results with IRS management, they stated that they are developing post-processing compliance initiatives to ensure that eligibility for the Research Credit has been met as well as to ensure the accuracy of the credit amounts claimed. For example, the IRS has drafted a compliance plan that includes programming of the systems to account for the payroll tax credit offset and how returns reporting the credit offset will be classified and selected for examination. Management noted that the plan is currently being reviewed by affected stakeholders prior to its approval.

⁹ It should be noted that some of the erroneous credits resulted in a refund that was either intercepted by the IRS or returned by the taxpayer.

¹⁰ *****1*****



Processes Are Needed to Identify Small Businesses Erroneously Claiming the Research Tax Credit Payroll Tax Offset

A computer programming error resulted in the incorrect computation of the Research Credit amount

Our analysis of 1,467 businesses claiming Research Credits on TY 2017 Forms 941 and 944 identified 29 claims for which the IRS erroneously computed the Research Credit. These claims totaled almost \$274.8 million¹¹ and resulted from an error in the computer program used to calculate allowable Research Credit amounts. When we discussed the results of our analysis with IRS management, they agreed that the cases we identified were errors. The IRS acknowledged that its computer programming was not allowing for instances of the taxpayer claiming a lesser Research Credit than was calculated by the computer. For example, if the taxpayer claimed \$50,000 in Research Credit and the IRS computed that \$200,000 was the upper limit the taxpayer could claim, then the IRS erroneously allowed the larger amount.

In August 2017, management issued interim guidance alerting employees of the computer programming error. The guidance also included steps to either intercept the erroneous refund or adjust the tax and credit on the taxpayer's account. The IRS corrected the computer programming error in October 2017. The IRS has also taken actions to correct the erroneous Research Credit amounts that we identified.

Recommendations

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

Recommendation 1: Review the 81 businesses we identified that did not meet the eligibility requirements for claiming the Research Credit and recover any erroneously claimed Research Credits.

Management's Response: The IRS agreed with this recommendation and will review the 81 returns to determine if compliance activity, such as examinations or referrals, is warranted and take appropriate action.

Recommendation 2: Review the **2** businesses we identified that *****2***** and recover any erroneously claimed Research Credits.

Management's Response: The IRS agreed with this recommendation and will review the **2** returns to determine if any compliance activity, such as examinations or referrals, is warranted and take appropriate action.

Recommendation 3: Ensure timely implementation and use of post-processing initiatives to identify businesses that do not meet eligibility or threshold requirements and erroneously claim the Research Credit.

¹¹ This total does not include those cases where the business attempted to claim a higher Research Credit amount and the IRS calculated and allowed only the correct amount to post.



Processes Are Needed to Identify Small Businesses Erroneously Claiming the Research Tax Credit Payroll Tax Offset

Management's Response: The IRS agreed with this recommendation and will engage the Small Business/Self-Employed Research office to determine the size and scope of the noncompliance. Based on those results, IRS management will finalize a compliance strategy to identify businesses that do not meet the eligibility requirements for Research Credits.

The Commissioner, Wage and Investment Division, should:

Recommendation 4: Ensure that the tax accounts have been adjusted for the 50 businesses that claimed the Research Credit on a return prior to when the credit became available.

Management's Response: The IRS agreed with the recommendation and will ensure that the cases stated in the recommendation are adjusted as needed.

Recommendation 5: Ensure that procedures are implemented to identify any future electronically filed returns that improperly claim the credit prior to when it became available.

Management's Response: The IRS agreed with this recommendation and noted that it submitted computer programming requirements on July 5, 2018, that will identify electronically filed returns claiming the credit prior to its effective date. IRS management expects the programming to be implemented during January 2019; however, due to limited Information Technology resources and competing priorities that could affect completion of the work, they cannot provide an implementation date.

Although the IRS agreed with our recommendations, it disagreed with the outcome measures associated with Recommendations 1, 2, and 4. In their response, management noted that they agree that some of the taxpayers we identified may have claimed the credit erroneously. However, the actual amount will not be known until, as agreed to in response to our recommendations, the returns we identified are reviewed and the appropriate compliance activity is initiated to address the erroneous claim. We acknowledge in the methodology for our outcome measures that these measures are estimates and that the actual amount of the discrepancy will not be known until the IRS examines the returns of the businesses we identified.



Processes Are Needed to Identify Small Businesses Erroneously Claiming the Research Tax Credit Payroll Tax Offset

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS can ensure that taxpayers claiming the *Credit for Increasing Research Activities*¹ (hereafter referred to as Research Credit) against their payroll taxes are eligible to claim the credit and claim the correct amount. To accomplish our objective, we:

- I. Determined whether the IRS has controls in place to verify the accuracy and eligibility of Research Credit claims against payroll taxes.
 - A. Reviewed processes and procedures to identify controls over the processing of Research Credit claims against payroll taxes.
 - B. Determined whether IRS controls ensure that taxpayers can claim only the payroll tax credit for the correct periods by analyzing Forms 941, *Employer's QUARTERLY Federal Tax Return*, filed prior to the second quarter of TY² 2017 and Forms 944, *Employer's ANNUAL Federal Tax Return*, filed prior to TY 2017 claiming the Research Credit as an offset to payroll taxes and determined whether the IRS has controls to ensure that taxpayers cannot claim the credit for periods prior to those allowed by the law. We reviewed and quantified any returns processed for the prior ineligible periods.
 - C. Matched TY 2017 Forms 941 and 944 claiming the Research Credit to the applicable income tax forms (Forms 1040, *U.S. Individual Income Tax Return*, Schedule C, *Profit or Loss From Business*; Forms 1065, *U.S. Return of Partnership Income*; Forms 1120, *U.S. Corporation Income Tax Return*; Forms 1120S, *U.S. Income Tax Return for an S Corporation*; and Forms 1120-F, *U.S. Income Tax Return of a Foreign Corporation*) to determine if the taxpayer:
 1. Filed a TY 2016 income tax form.
 2. Claimed a Research Credit on the TY 2016 income tax form.
 3. Had gross receipts of less than \$5 million on the TY 2016 income tax form.
 - D. For those taxpayers that claimed the Research Credit on their TY 2016 income tax return, we compared the taxpayer's income tax returns submitted for five tax years prior to the

¹ Title 26 U.S Code Section 41.

² 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.



Processes Are Needed to Identify Small Businesses Erroneously Claiming the Research Tax Credit Payroll Tax Offset

qualifying five-year period (TY 2011 and prior) to determine if the taxpayer had gross receipts in any of those prior years.

- E. Interviewed IRS personnel to determine what controls are in place for limiting credit claims per period and determining if there are controls to limit the amount of Research Credit offsets claimed to the yearly \$250,000 allowed per law.

Data validation methodology

During this review, we relied on IRS's Business Master File³ and Business Returns Transaction File⁴ data for TYs 2016 and 2017 stored on the Treasury Inspector General for Tax Administration's Data Center Warehouse⁵ and an analysis of data extracted from the Treasury Inspector General for Tax Administration's Strategic Data Services of Business Returns Transaction File data for Calendar Years⁶ 2010 through 2012. To assess the reliability of computer-processed data, Treasury Inspector General for Tax Administration programmers validated the data files we extracted, and we ensured that each data extract contained the specific data elements we requested and that the data elements were accurate. In addition, we performed extensive validation by reviewing random samples of each file and verified that the data in the files were the same as the data captured in the IRS's Integrated Data Retrieval System⁷ and/or the Employee User Portal.⁸ As a result of our testing, we determined that the data were sufficiently reliable for the purposes of this report.

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 that the following internal controls were relevant to our audit objective: 1) the processes and procedures used to verify the accuracy and eligibility of Research Credit claims against payroll taxes and 2) the processes and procedures used to ensure that taxpayers cannot claim more credit than they are eligible to receive. We evaluated these controls by reviewing policies and procedures, interviewing employees and management, and analyzing data.

³ 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.

⁴ A computer file of transcribed line items on all business returns and their accompanying forms and schedules.

⁵ A Treasury Inspector General for Tax Administration repository of IRS data.

⁶ A calendar year in which the return or document is processed by the IRS.

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

⁸ A web-hosting infrastructure located on the IRS intranet which allows IRS employees to access business applications and data such as e-Services.



*Processes Are Needed to Identify Small Businesses Erroneously
Claiming the Research Tax Credit Payroll Tax Offset*

Appendix II

Major Contributors to This Report

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

Diana M. Tengesdal, Director

Roy E. Thompson, Audit Manager

Stephen A. Elix, Acting Audit Manager

Douglas C. Barneck, Senior Auditor



*Processes Are Needed to Identify Small Businesses Erroneously
Claiming the Research Tax Credit Payroll Tax Offset*

Appendix III

Report Distribution List

Deputy Commissioner for Services and Enforcement
Commissioner, Small Business/Self-Employed Division
Commissioner, Wage and Investment Division
Director, Customer Account Services, Wage and Investment Division
Director, Examination Quality and Technical Support, Small Business/Self-Employed Division
Director, Headquarters Examination, Small Business/Self-Employed Division
Director, Specialty Examination Policy and Quality, Small Business/Self-Employed Division
Director, Office of Audit Coordination



Processes Are Needed to Identify Small Businesses Erroneously Claiming the Research Tax Credit Payroll Tax Offset

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:

- Revenue Protection – Potential; \$2,781,274 (see page 3).

Methodology Used to Measure the Reported Benefit:

Our review of 1,467 businesses claiming over \$53.2 million in *Credit for Increasing Research Activities*¹ (hereafter referred to as Research Credits) on TY 2017 Forms 941, *Employer's QUARTERLY Federal Tax Return*, and Forms 944, *Employer's ANNUAL Federal Tax Return*, identified 81 businesses that claimed \$2,781,274 in potentially erroneous Research Credits. These 81 cases are comprised of taxpayers that claimed a Research Credit against their payroll taxes and appear to not meet one or more of the following requirements: 1) filed a TY 2016 income tax return at the time of claiming the credit with reported gross receipts of less than \$5 million and 2) reported no gross receipts for any tax year before the five-tax-year period ending with the tax year for which the claim was made. According to IRS management, the true dollar amount of the discrepancy will not be known until an examination has been performed.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$477,881 (see page 3).

Methodology Used to Measure the Reported Benefit:

Our review of 1,467 businesses claiming over \$53.2 million in Research Credits on TY 2017 Forms 941 and 944 identified 55 businesses that erroneously claimed \$586,190 because they claimed the credit on a return prior to when the credit became available. The Research Credit could first be claimed by a qualified business on its Form 941 for the quarter that begins after filing the income tax return beginning in TY 2016. Thus, the earliest a Research Credit can be claimed on Form 941 is generally the second quarter of TY 2017. When we discussed the results of our analysis with IRS management, they agreed that 50 Research Credit claims totaling \$536,577 were processed incorrectly. The IRS noted that of the 50 businesses claiming \$536,577 in Research Credits, a total of \$477,881 actually posted to the business' tax accounts.

¹ Title 26 U.S. Code Section 41.



Processes Are Needed to Identify Small Businesses Erroneously Claiming the Research Tax Credit Payroll Tax Offset

In some instances, the amount of the Research Credit claimed by the business was incorrect and the IRS subsequently made an adjustment to correct the amount. The amount that posted to the business' tax accounts represents the amount of the benefit that the business actually received.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$8,418,221 (see page 3).

Methodology Used to Measure the Reported Benefit:

Our review of 1,467 businesses claiming over \$53.2 million in Research Credits on TY 2017 Forms 941 and 944 identified **2** businesses that potentially received *****2*****
*****2*****
*****2*****. According to IRS management, the true dollar amount of the discrepancy will not be known until an examination has been performed.



Processes Are Needed to Identify Small Businesses Erroneously Claiming the Research Tax Credit Payroll Tax Offset

Appendix V

Form 8974, Qualified Small Business Payroll Tax Credit for Increasing Research Activities

Form **8974: Qualified Small Business Payroll Tax Credit for Increasing Research Activities** 950817
 (Rev. December 2017) Department of the Treasury — Internal Revenue Service OMB No. 1545-0029

Employer identification number (EIN) -

Name (not your trade name)

The credit from Part 2, line 12, will be reported on (check only one box):
 Form 941, 941-PR, or 941-SS
 Form 943 or 943-PR
 Form 944 or 944(SP)

Calendar year You must select a quarter if you file Form 941, 941-PR, or 941-SS.

Report for this quarter . . .

Check only one box.

1: January, February, March

2: April, May, June

3: July, August, September

4: October, November, December

Part 1: Tell us about your income tax return.

	(a) Ending date of income tax period	(b) Income tax return filed that included Form 6765	(c) Date income tax return was filed	(d) EIN used on Form 6765	(e) Amount from Form 6765, line 44, or if applicable, the amount that was allocated to your EIN	(f) Amount of credit from column (e) taken on a previous period(s)	(g) Remaining credit (subtract column (f) from column (e))	
1	/ /		/ /		-	-	-	
2	/ /		/ /		-	-	-	
3	/ /		/ /		-	-	-	
4	/ /		/ /		-	-	-	
5	/ /		/ /		-	-	-	
6	Add lines 1(g) through 5(g) and enter the total here						-	-

Part 2: Determine the credit that you can use this period.

7 Enter the amount from Part 1, line 6(g) 7

8 Enter the amount from Form 941 (941-PR or 941-SS), line 5a, Column 2; Form 943 (943-PR), line 3; or Form 944 (944(SP)), line 4a, Column 2 8

9 Enter the amount from Form 941 (941-PR or 941-SS), line 5b, Column 2; or Form 944 (944(SP)), line 4b, Column 2 9

10 Add lines 8 and 9 10

11 Multiply line 10 by 50% (0.50). Check this box if you're a third-party payer of sick pay or check this box if you received a Section 3121(c) Notice and Demand. See the instructions before completing line 11 11

12 **Credit.** Enter the smaller of line 7 or line 11. Also enter this amount on Form 941 (941-PR or 941-SS), line 11; Form 943 (943-PR), line 12; or Form 944 (944(SP)), line 8 12

For Paperwork Reduction Act Notice, see the separate instructions. www.irs.gov/Form8974 Cat. No. 37707C Form 8974 (Rev. 12-2017)

Source: IRS.gov



*Processes Are Needed to Identify Small Businesses Erroneously
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Appendix VI

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

November 15, 2018

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Mary Beth Murphy *Mary Beth Murphy*
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report –Processes Are Needed to Identify Small
Businesses Erroneously Claiming the Research Tax Credit
Payroll Tax Offset (Audit # 201840018)

Thank you for the opportunity to review and comment on the subject draft report. The Protecting Americans from Tax Hikes Act of 2015 made the research credit permanent. The act allows qualified small businesses to apply part or all their research credit against the employer portion of their Social Security tax liability, instead of their income tax liability, after December 31, 2015.

Verifying the eligibility and the amount of credit that may be claimed against the employer portion of Social Security is challenging. It cannot be determined from information on a single return and associated schedules. As your report notes, we have already implemented certain systemic checks to verify certain limitations and are evaluating whether additional checks are feasible. We are also preparing a compliance plan which will include post-processing compliance checks.

Your report includes several recommendations and outcome measures. While we agree that some taxpayers may have claimed erroneous amounts and plan to take corrective actions in response to your recommendations, we disagree with the stated outcome measures for revenue protection.

Attached is a document detailing our responses and planned corrective actions to address your recommendations and outcome measures. If you have any questions, please contact me or Brenda Dial, Director, Examination, Small Business/Self-Employed Division.

Attachment



Processes Are Needed to Identify Small Businesses Erroneously Claiming the Research Tax Credit Payroll Tax Offset

Attachment

RECOMMENDATION 1:

The Commissioner, Small Business/Self-Employed Division, should review the 81 businesses we identified that did not meet the eligibility requirements for claiming the Research Credit and recover any erroneously claimed Research Credits.

CORRECTIVE ACTION:

We agree with this recommendation and will review the 81 returns to determine if compliance activity, such as examinations or referrals, is warranted and will take appropriate action.

IMPLEMENTATION DATE:

November 15, 2020

RESPONSIBLE OFFICIAL:

Director, Exam Case Selection, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 2:

The Commissioner, Small Business/Self-Employed Division, should review the **2** businesses we identified that *****2***** and recover any erroneously claimed Research Credits.

CORRECTIVE ACTION:

We agree with this recommendation and will review the **2** returns to determine if any compliance activity, such as examinations or referrals, is warranted and will take appropriate action.

IMPLEMENTATION DATE:

November 15, 2020

RESPONSIBLE OFFICIAL:

Director, Exam Case Selection, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

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



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RECOMMENDATION 3:

The Commissioner, Small Business/Self-Employed Division, should ensure timely implementation and use of post-processing initiatives to identify businesses that do not meet eligibility or threshold requirements and erroneously claim the Research Credit.

CORRECTIVE ACTION:

We agree with this recommendation. We will engage SB/SE Research to determine the size and scope of the non-compliance. Based on those results, we will finalize a compliance strategy to identify businesses that do not meet the eligibility requirements for Research Credits.

IMPLEMENTATION DATE:

February 15, 2020

RESPONSIBLE OFFICIAL:

Director, Exam Case Selection, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 4:

The Commissioner, Wage and Investment Division, should ensure that the tax accounts for the 50 businesses that claimed the Research Credit on a return prior to when the credit became available have been adjusted.

CORRECTIVE ACTION:

We agree with the recommendation and will ensure the cases stated in the recommendation are adjusted as needed.

IMPLEMENTATION DATE:

February 15, 2019

RESPONSIBLE OFFICIAL:

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

CORRECTIVE ACTION MONITORING PLAN:

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



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RECOMMENDATION 5:

The Commissioner, Wage and Investment Division, should ensure that procedures are implemented to identify any future electronically filed returns that improperly claim the credit prior to when it became available.

CORRECTIVE ACTION:

We agree with this recommendation. Unified Work Request 211901 was submitted on July 5, 2018, establishing the programming requirements that will identify electronically filed returns claiming the credit prior to its effective date. We expect the programming to be implemented during January 2019; however, due to limited Information Technology resources and competing priorities that could affect completion of the work, we cannot provide an implementation date.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL:

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

CORRECTIVE ACTION MONITORING PLAN:

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

OUTCOME MEASURE 1:

Revenue Protection – Potential; \$2,781,274 (taxpayers did not appear to meet requirements)

IRS RESPONSE:

We disagree with this figure. Several of these cases have smaller potential erroneous claims that could not be cost-effectively examined. The extent of non-compliance for the remaining claims cannot be determined unless an audit is completed. The opportunity costs to examine these cases is not included in the revenue protection estimate. However, as part of our corrective action for Recommendation 1, we will review the returns and take compliance actions where appropriate.

OUTCOME MEASURE 2:

Revenue Protection – Potential; \$477,881 (credits claimed for a period when not yet available)

IRS RESPONSE:

We do not agree with this outcome measure. Our initial research of a sample of cases showed that the amounts allowed during processing of the identified returns was less



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Claiming the Research Tax Credit Payroll Tax Offset*

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than the amounts claimed on the Forms 6765 *Credit for Increasing Research Activities* and 8974 *Qualified Small Business Payroll Tax Credit for Increasing Research Activities*. Until we complete additional research to determine the necessary account adjustments, the actual amount of revenue protection is unknown. We plan to ensure cases are adjusted as needed as part of our corrective action for Recommendation 4.

OUTCOME MEASURE 3:

Revenue Protection - Potential; \$8,418,221 (taxpayers appeared to exceed gross receipts threshold)

IRS RESPONSE:

We disagree with this figure. The **2** largest businesses appear to be *****2*****
*****2***** and the underlying businesses for which they are filing
may be *****2*****. The amount of non-compliance, if any, associated with
those businesses cannot be determined without an audit. As part of our corrective action
for Recommendation 2, we will review the *****2***** and take
compliance actions where appropriate.