



*Processes Do Not Ensure That
Corporations Accurately Claim
Carryforward General Business Credits*

February 6, 2015

Reference Number: 2015-40-012

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:

2 = Risk Circumvention of Agency Regulation or Statute

Phone Number / 202-622-6500

E-mail Address / TIGTACommunications@tigta.treas.gov

Website / <http://www.treasury.gov/tigta>



HIGHLIGHTS

PROCESSES DO NOT ENSURE THAT CORPORATIONS ACCURATELY CLAIM CARRYFORWARD GENERAL BUSINESS CREDITS

Highlights

Final Report issued on February 6, 2015

Highlights of Reference Number: 2015-40-012 to the Internal Revenue Service Commissioners for the Small Business/Self-Employed Division and the Wage and Investment Division.

IMPACT ON TAXPAYERS

The general business credit (made up of several separate business-related credits) is offered as an incentive for a business to engage in certain kinds of activities considered beneficial to the economy or public at large, such as improving disability access for customers or providing child care for employees' children. During Processing Year 2013, the IRS received 87,674 corporate tax returns with general business credits that offset taxes owed by more than \$21 billion.

WHY TIGTA DID THE AUDIT

During Processing Year 2013, corporate filers claimed general business credits totaling more than \$93 billion. The objective of this review was to determine whether the IRS's controls are adequate to identify questionable general business credits claimed on business tax returns.

WHAT TIGTA FOUND

TIGTA identified 3,285 electronically filed Forms 1120, U.S. Corporation Income Tax Return, filed in Processing Year 2013 on which corporations claimed potentially erroneous carryforward credits totaling more than \$2.7 billion.

In addition, TIGTA's review of a statistically valid sample of 174 of 3,472 electronically filed

tax returns also found that 131 (75 percent) tax returns Based on this sample, TIGTA estimates

TIGTA also found that a programming error caused some corporations to not receive general business credits they claimed. TIGTA identified 717 Processing Year 2013 corporate tax returns for which taxpayers did not receive more than \$170 million in Empowerment Zone Employment Credits they claimed.

Finally, TIGTA identified 1,411 corporate tax returns filed in Processing Years 2012 and 2013 that erroneously claimed a current year general business credit as an Eligible Small Business subsequent to the expiration of the relevant tax provision. These businesses claimed almost \$35 million in general business credits as an Eligible Small Business.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS verify whether the 3,285 corporate filers TIGTA identified as having a questionable carryforward amount are entitled to claim the carryforward amount. In addition, send paper-filed returns to the Error Resolution function for correspondence with the filer. The IRS should also determine whether the programming error affects paper-filed business returns and verify whether taxes were affected for the 1,411 corporate filers TIGTA identified as having an incorrect Eligible Small Business designation.

The IRS agreed with three of TIGTA's five recommendations and disagreed with two. The IRS plans to review two samples of cases for audit potential and determine whether any further action is required. The IRS has requested corrections to programming for the 2016 Filing Season. The IRS did not agree to



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 6, 2015

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Processes Do Not Ensure That Corporations
Accurately Claim Carryforward General Business Credits
(Audit # 201340022)

This report presents the results of our review to determine whether the Internal Revenue Service's controls are adequate to identify questionable claims for general business credits claimed on business tax returns. This audit was included in our Fiscal Year 2014 Annual Audit Plan and addresses the major management challenge of Fraudulent Claims and Improper Payments.

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

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 or Russell P. Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services), at (978) 809-0296 if you have questions.



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Abbreviations

AMT	Alternative Minimum Tax
BRTF	Business Return Transaction File
CIC	Coordinated Industry Case
e-file(d), e-filing	Electronically file(d), electronic filing
IRS	Internal Revenue Service
PY	Processing Year
TY	Tax Year



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Background

The general business credit, which is made up of several separate business-related credits, is offered as an incentive for a business to engage in certain kinds of activities considered beneficial to the economy or public at large, such as improving disability access for customers or providing child care for employees' children. A corporation's regular tax liability is reduced dollar for dollar by allowable credits, and in some cases the credits can be used to offset a corporation's Alternative Minimum Tax (AMT).¹

During Processing Year 2013, the Internal Revenue Service (IRS) received 87,674 corporate tax returns with general business credit claims totaling more than \$93 billion.

To claim the credit, businesses must prepare and attach a Form 3800, *General Business Credit*,² to their Form 1120, *U.S. Corporation Income Tax Return*. Form 3800 is used to summarize business credits claimed and to calculate the total general business credit amount that can be claimed in the current tax year.³ In addition, businesses must generally complete and attach a required source credit form⁴ for each of the business credits claimed on Form 3800, *e.g.*, Form 8826, *Disabled Access Credit*.

The amount of the general business credit that can be claimed in a tax year consists of the carryforward⁵ amount of any unused credits from prior tax years plus the total of the current year business credits. The amount of the general business credit that can be actually used for the current year by the taxpayer to offset taxes owed is then reported on Form 1120. However, the total general business credit that can be claimed for the tax year is limited to a business' total tax liability amount. Any unused general business credits that are not applied to a business' current year taxes may be carried back one year or carried forward 20 years. Figure 1 shows that in Processing Year (PY)⁶ 2013, corporate taxpayers reported approximately \$93 billion on Form 3800 for general business credits. The amount of credits actually used to offset tax, *i.e.*, reported on Forms 1120, totaled more than \$21 billion, with nearly \$72 billion in general business credits remaining that can be carried back one tax year or carried forward 20 years.

¹ The AMT attempts to ensure that individuals and corporations that benefit from certain exclusions, deductions, or credits pay at least a minimum amount of tax.

² See Appendix V for an example of Form 3800.

³ A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due.

⁴ For Tax Year 2013, there are a total of 30 source credit forms. See Appendix VI for a list of these forms.

⁵ A carryforward is the amount of the general business credit that is unused because of the tax liability limit for claiming the credit.

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



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**Figure 1: Processing Year 2013 Corporation Tax Returns
Reporting a General Business Credit on Form 3800**

	Processing Year 2013 Returns		
	Electronically Filed	Paper-Filed	Total
Corporate Tax Returns Reporting General Business Credit	67,832	19,842	87,674
General Business Credit Amount Claimed	\$84,841,731,062	\$8,234,496,296	\$93,076,227,358
General Business Credit Amount Used to Offset Tax	\$20,606,065,665	\$473,191,868	\$21,079,257,533
Unused Credit Amount Available for Carryback or Carryforward	\$64,235,665,397	\$7,761,304,428	\$71,996,969,825

Source: Treasury Inspector General for Tax Administration analysis of the Business Return Transaction File⁷ for PY 2013 for filers of Form 1120.

The IRS significantly redesigned Form 3800 for Tax Year (TY) 2011. The form is divided into three parts. Part I summarizes the credit amounts that may be limited and can only be applied against regular tax. Part II is used to calculate the net credit amounts and contains detailed credit limitation calculations. Part III is used to list the various credits being taken and separates them into specified⁸ and nonspecified⁹ credit categories.

This review was performed with information obtained from the Small Business/Self-Employed Division office in Lanham, Maryland; the Wage and Investment Division office in Atlanta, Georgia; and the IRS Submission Processing Sites in Covington, Kentucky, and Ogden, Utah, during the period July 2013 through June 2014. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

⁷ The IRS database that contains transcribed line items from business tax returns and accompanying schedules or forms.

⁸ For purposes of this report, specified credits are defined as those general business credits that can be used to offset the AMT. Some of these credits include the Work Opportunity, Low-Income Housing, and Small Employer Health Insurance Premiums Credits.

⁹ Nonspecified credits are those general business credits that cannot be used to offset the AMT. Some of these credits include Increasing Research Activities, Disabled Access, and Orphan Drug Credits.



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Results of Review

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Our review *****2*****
*****2*****. We identified
3,177 electronically filed (e-filed)¹⁰ Form 1120 returns filed in PY 2013 on which corporations
claimed potentially erroneous¹¹ carryforward credits totaling more than \$1.5 billion.¹² For each
of the claims we identified, the corporation *****2*****
*****2*****.
*****2*****.

*****2*****
*****2*****. Subsequent to the processing of the
tax return, the IRS may identify the potentially erroneous claim if the corporation tax return is
examined. However, the IRS **2** conducted **2** examinations of corporations related to
general business credit claims in Fiscal Year 2013.¹³ *****2*****
*****2*****. In 96 percent of the **2** examinations
conducted, the IRS adjusted the amount of the general business credits claimed.

In addition, we identified another 108 corporate e-filed tax returns with potentially erroneous
carryforward credit claims totaling almost \$1.2 billion. However, it is likely the IRS will

¹⁰ We also included paper-filed Forms 1120 in our analysis. However, our review of the tax returns we identified
with discrepancies relating to carryforward claims found that a high percentage of potentially erroneous claims
resulted from transcription errors on the part of the IRS. Based on this, we removed paper-filed returns from our
quantification of potentially erroneous claims.

¹¹ The actual amount of potentially erroneous carryforward credits claimed is contingent upon *****2*****
*****2*****.
*****2*****.

¹² Although we identified 3,177 e-filed returns claiming potentially erroneous carryforward claims, we reduced this
by 127 returns in our outcome measure to account for those cases for which the examination of the general business
credit would not result in a change to the amount claimed (*i.e.*, the credit was correct). This resulted in a net figure
of 3,050 potentially erroneous carryforward claims amounting to more than \$1.4 billion. See Appendix IV for a
more detailed explanation.

¹³ The **2** corporations were selected for audit based solely on the General Business Credit they claimed. The
IRS can also include a review of General Business Credits during an audit of a tax return that was selected based on
another audit issue.



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identify these potentially questionable claims since these corporations are part of its Coordinated Industry Case (CIC) program.¹⁴ Corporations in this program are audited each year.

IRS management reviewed our exception cases and agreed with the methodology we used to identify the corporations claiming potentially erroneous carryforward credits. IRS management indicated that *****2*****. However, the IRS was unable to provide us with any documentation supporting its assertions related to cost and programming changes it *****2*****.

IRS management also stated *****2***** until they complete an in-depth analysis of the returns we identified to confirm that the changes would be warranted. *****2*****.

*****2*****

In September 2013,¹⁵ we reported that taxpayers claimed potentially erroneous carryforward credits on 3,998 Forms 1040, U.S. Individual Income Tax Return, and totaling \$41 million. In response, IRS management agreed that procedures should be reviewed to identify improvements in the detection of questionable general business credit claims. IRS management noted that success in correcting any deficiencies would be dependent upon developing a compliance strategy prior to taking specific actions.

On August 20, 2014, IRS management noted that, although they agreed with each of the recommendations in our September 2013 report, if the examination of the questionable returns we identified did not result in a high percentage of change cases, they would not proceed with implementing the remaining corrective actions in the prior report. As of October 17, 2014, the IRS completed correspondence examinations on 965 of the tax returns we identified as having a questionable carryforward credit. The IRS told us that 64 (6.6 percent) of the completed exams resulted in a change in the amount of the general business credit claimed. However, our review of the IRS’s examination methodology and some of the returns examined by the IRS identified

¹⁴ The CIC program involves tax returns that have more intricate and diversified business practices and transactions. These returns are worked in IRS Examination field offices.

¹⁵ 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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instances*****2*****. For example (hypothetically):

*Taxpayer A had an unused amount of general business credit (\$100,000) resulting from its inability to use the entire amount available to offset the tax liability on its Tax Year 2010 return. Taxpayer A files the Tax Year 2011 return reporting a tax liability of \$5,000 and a carryforward amount of \$150,000. In the IRS examination,****2*****

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We are concerned that the IRS is *****2*****
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The IRS did note that, for the tax returns we identified in our prior review as claiming general business credits that *****2*****and those on which taxpayers claimed the Energy Efficient Home Credit, examinations of a sample of these cases resulted in a high percentage of agreed adjusted audit changes. As a result, the IRS is including similar types of cases in its Fiscal Year 2015 examination work plan. IRS management indicated that they would take the same approach when addressing the recommendations we make in this current report.

Recommendations

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

Recommendation 1: Verify whether the 3,285 corporate filers we identified as having a questionable carryforward amount are entitled to claim the carryforward amount.

Management's Response: The IRS agreed with this recommendation. The IRS will review a sample of 30 cases, selected by the Small Business/Self-Employed Research function, for audit potential. Based on those reviews, the IRS will determine whether any further action is required to evaluate the remaining corporate filers.

Recommendation 2: *****2*****
*****2*****.

Management's Response: The IRS disagreed with this recommendation. Due to the lack of Information Technology organization resources and competing priorities, the IRS is unable to consider the process we recommended. This recommendation would require additional submission processing resources for transcription during return processing as well as significant cost to programming resources, which are not available. In addition,



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the IRS would also have to consider the risk of placing these returns in the audit stream, potentially bypassing other returns with higher audit potential. The benefits of this process do not outweigh the significant cost and the potential of lost revenue from other audit work. In addition, the IRS disagreed with our outcome measure, stating that it is not realistic to conclude that the tax effect of these claims is equal to the gross \$1.4 billion carryforward amount we reported because these taxpayers may never have adequate tax to absorb the remaining business credits.

Office of Audit Comment: We requested documentation to support the IRS’s assertions above. However, the IRS did not provide us with any documentation. The dollars at risk associated with this one carryforward credit alone warrant the IRS taking action. Moreover, *****2***** **any credits** that are able to be carried forward. This should be considered by the IRS when evaluating the amount at risk because of its *****2*****
*****2*****.

As it relates to our outcome measure, the actual amount of the \$1.4 billion in potential revenue protected is contingent upon *****2*****
*****2*****
*****2***** Taxpayers can carry these credits forward for up to 20 years, and any unused credits **must be** offset against future tax on a first-in, first-out basis before any current year general business credits are used. Companies that remain in business can continue to erroneously carry forward credits to reduce or eliminate their future tax liabilities.

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Our review of a statistically valid sample¹⁶ of 174 of the 3,472¹⁷ e-filed tax returns we identified found that 131 (75 percent) *****2***** . Based on this sample, we estimate that 2,614 returns *****2*****¹⁸ Instructions for Form 3800 lines 4 and 34 (lines on which the filer includes amounts of carryforwards of unused credits) state that filers must attach a statement to their tax return for each credit for which they are reporting a carryforward credit amount. Instructions state:

¹⁶ We used attribute sampling to calculate a sample size of 174 business tax returns claiming a carryforward amount based on a confidence level of 95 percent, an expected rate of occurrence of 37 percent, and a precision rate of ± 7 percent. We used a contracted statistician who assisted us in developing our sampling plan and projections.

¹⁷ This includes the 3,177 tax returns we identified with a questionable carryforward claim as well as the 108 tax returns filed by corporations in the CIC program and the 187 tax returns we identified with an Empowerment Zone Employment Credit programming error detailed on page 8.

¹⁸ The projection is based on a two-sided 95 percent confidence interval. We are 95 percent confident that between 2,396 and 2,831 taxpayers *****2*****.



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For each credit, attach a statement with the following information – show the tax year the credit originated, the amount of the credit as reported on the original return, and the amount allowed for that year. Also, state whether the total carryforward amount was changed from the originally reported amount and identify the type of credit(s) involved. For each carryforward year, show the year and the amount of the credit carryforward allowed for that year.

The IRS indicated that the carryforward statement resulted from a need to collect additional information from taxpayers for general business credit claims. The volumes of filers reporting carryforward credits was not significant enough when the carryforward statement was developed to warrant the IRS changing the Form 3800 to include this information. It was concluded that revising the Form 3800 was a significant undertaking, likely adding another page to the form, and would result in little benefit to the IRS. As such, the IRS decided to request a statement from taxpayers to obtain the additional information needed.

*****2*****
*****2*****
*****2***** We reported that our review of a statistically valid sample of 284¹⁹
TY 2011 tax returns with general business credits identified *****2*****
*****2*****
*****2*****
*****2*****
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*****2***** The IRS agreed with both of these recommendations, *****2*****
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*****2***** However, as previously noted, IRS management indicated that
they would not make any procedural changes until they complete an in-depth analysis of our
previous exception cases and determine that the changes are justified.

When we presented the results from this current review, IRS management advised us that
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¹⁹ We used attribute sampling to calculate the minimum sample size of 142 (284 total) for both e-filed and paper-filed tax returns based on a confidence level of 90 percent, an expected rate of occurrence of 5 percent, and a precision rate of ± 3 percent.



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Recommendation

Recommendation 3: The Commissioner, Small Business/Self-Employed Division, should develop a process to reject e-filed tax returns *****2*****
*****2***** , the return should be identified and sent to the Error Resolution function *****2*****
*****2*****.

Management's Response: The IRS disagreed with this recommendation. The IRS *****2*****
*****2*****
*****2***** would not affect the processability of the return; however, it may raise questions as to the validity of the claim. When that occurs, the IRS has the authority under the Internal Revenue Code to examine the taxpayer's books and records to determine the veracity of deductions and credits claimed on the return. The IRS will follow up on returns with missing supporting schedules during the normal return selection process.

Office of Audit Comment: Based on the small number of corporations selected for examination due to problems with general business credit claims, it is unlikely the IRS's approach will have a significant impact on this problem. At a minimum, *****2*****
*****2*****.

A Programming Error Caused Some Corporations to Not Receive General Business Credits They Claimed

We identified 717 corporate filers that did not receive more than \$170 million in Empowerment Zone Employment Credits they claimed. This resulted from a programming error in which the IRS's calculation of allowed general business credits used an incorrect line from Form 3800 when calculating general business credits that included the Empowerment Zone Employment Credit. For example, for corporate filers that claimed the Empowerment Zone Employment Credit, the IRS's computer program used the amount on Line 3 Part III from the Form 3800 rather than the amount claimed on Line 22 Part II. Because of this, the IRS only included Empowerment Zone Employment Credits related to the current tax filing period rather than the amount that included the current tax filing period and the carryforward amount from the prior tax filing period.

When we brought this to IRS management's attention, they acknowledged that there was an error in the programming requirements submitted for e-filed returns. The IRS indicated that a request to correct the programming was submitted on April 4, 2014, and the program was corrected on May 19, 2014. In addition, because the IRS does not transcribe the lines from paper-filed tax returns relating to this issue, we were unable to determine if the computer programming error



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exists on paper-filed business tax returns. When we discussed this with IRS management, management indicated that they are continuing to research whether the programming error also affects paper-filed business tax returns.

Recommendation

The Commissioner, Wage and Investment Division, should:

Recommendation 4: Determine whether the programming error affects paper-filed business returns and, if so, take actions to correct the programming.

Management's Response: The IRS agreed with this recommendation. Although corrections have been requested for the 2016 Filing Season, the IRS cannot be assured they will be implemented due to other priorities competing for the same resources. The IRS has manual processes in place to identify affected returns when they are referred to the Error Resolution function and the tax examiners have been trained on the procedures to follow to ensure that the returns are processed correctly.

Businesses Erroneously Claimed Eligible Small Business Credits Subsequent to the Expiration of the Relevant Tax Provision

Our review identified 1,411 corporate tax returns filed in PYs 2012 and 2013 that claimed a general business credit as an Eligible Small Business on Form 3800 subsequent to the expiration of the relevant tax provision. These corporations claimed almost \$35 million in general business credits that may have resulted in their incorrectly offsetting all credits against the amount of AMT they may have owed and not just those allowed specified credits. In addition, these filers may have also incorrectly claimed unused credit amounts as carrybacks for five years rather than the normal one year.

The Small Business Jobs Act of 2010²⁰ included a provision that provided Eligible Small Businesses²¹ with a special tax treatment when claiming general business credits. For these businesses, all general business credits, not just specified credits, could be used to offset any AMT. An Eligible Small Business could also carry any unused credit back five years as opposed to the normal one-year period for a business not designated as an Eligible Small Business. However, these special tax treatments only applied for claiming general business credits after December 31, 2009, and were applicable to only the TY 2010 tax return filing.

²⁰ Pub. L. No. 111-240, secs. 2012-2013, 134 Stat. 2504, 2554-2556.

²¹ An Eligible Small Business is defined as a corporation (whose stock is not publicly traded), a partnership, or a sole proprietorship, whose average annual gross receipts for the three tax years preceding TY 2010 do not exceed \$50 million.



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We provided the 1,411 exception cases we identified to the IRS. The IRS reviewed 30 of these cases and confirmed for all 30 tax returns that the filer incorrectly used the designation of an Eligible Small Business to claim the current year general business credit. IRS management indicated that an examination would need to be performed to determine a tax effect.

The erroneous claims resulted from the IRS not timely updating Form 3800 to remove the ability of a corporation to claim Eligible Small Business Credits subsequent to the expiration of this tax provision. IRS management indicated that it thought the Eligible Small Business tax provision would be extended. However, the provision was not extended, and the IRS subsequently revised Form 3800 for TY 2013 to remove the option of being able to designate current year general business credits as being claimed by an Eligible Small Business. Figures 2 and 3 show a comparison of the incorrect form to the revised form.

Figure 2: Selected Section of IRS Form 3800, Part III (2012 Version)

Form 3800 (2012)		Page 3
Name(s) shown on return		Identifying number
Part III General Business Credits or Eligible Small Business Credits (see instructions)		
Complete a separate Part III for each box checked below. (see instructions)		
A <input type="checkbox"/> General Business Credit From a Non-Passive Activity	E <input type="checkbox"/> Eligible Small Business Credit From a Non-Passive Activity	
B <input type="checkbox"/> General Business Credit From a Passive Activity	F <input type="checkbox"/> Eligible Small Business Credit From a Passive Activity	
C <input type="checkbox"/> General Business Credit Carryforwards	G <input type="checkbox"/> Eligible Small Business Credit Carryforwards	
D <input type="checkbox"/> General Business Credit Carrybacks	H <input type="checkbox"/> Eligible Small Business Credit Carrybacks	
I If you are filing more than one Part III with box A, B, E, or F checked, complete and attach first an additional Part III combining amounts from all Parts III with box A, B, E, or F checked. Check here if this is the consolidated Part III <input type="checkbox"/>		
(a) Description of credit	(b) If claiming the credit from a pass-through entity, enter the EIN	(c) Enter the appropriate amount
Note. On any line where the credit is from more than one source, a separate Part III is needed for each pass-through entity.		
1a Investment (Form 3468, Part II only) (attach Form 3468)	1a	
b Reserved	1b	
c Increasing research activities (Form 6765)	1c	
d Low-income housing (Form 8586, Part I only)	1d	

Source: IRS Form 3800, Part III (2012).



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Figure 3: Selected Section of IRS Form 3800, Part III (2013 Version)

Form 3800 (2013)		Page 3
Name(s) shown on return		Identifying number
Part III General Business Credits or Eligible Small Business Credits (see instructions)		
Complete a separate Part III for each box checked below. (see instructions)		
A <input type="checkbox"/> General Business Credit From a Non-Passive Activity	E <input type="checkbox"/> Reserved	
B <input type="checkbox"/> General Business Credit From a Passive Activity	F <input type="checkbox"/> Reserved	
C <input type="checkbox"/> General Business Credit Carryforwards	G <input type="checkbox"/> Eligible Small Business Credit Carryforwards	
D <input type="checkbox"/> General Business Credit Carrybacks	H <input type="checkbox"/> Reserved	
I If you are filing more than one Part III with box A or B checked, complete and attach first an additional Part III combining amounts from all Parts III with box A or B checked. Check here if this is the consolidated Part III <input type="checkbox"/>		
(a) Description of credit	(b) If claiming the credit from a pass-through entity, enter the EIN	(c) Enter the appropriate amount
Note. On any line where the credit is from more than one source, a separate Part III is needed for each pass-through entity.		
1a Investment (Form 3468, Part II only) (attach Form 3468)	1a	
b Reserved	1b	
c Increasing research activities (Form 6765)	1c	
d Low-income housing (Form 8586, Part I only)	1d	

Source: IRS Form 3800, Part III (2013).

Recommendation

Recommendation 5: The Commissioner, Small Business/Self-Employed Division, should verify whether taxes were affected for the 1,411 corporate filers we identified as having an incorrect Eligible Small Business designation.

Management’s Response: The IRS agreed with this recommendation. The IRS will review a sample of 30 cases, selected by the Small Business/Self-Employed Research function, for audit potential. Based on those reviews, the IRS will determine whether any further action is required to evaluate the remaining corporate filers.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the IRS's controls are adequate to identify questionable claims for general business credits claimed on business tax returns. To accomplish this objective, we:

- I. Determined whether the IRS's computer system accurately computes general business credits.
 - A. Identified what data fields are captured for e-filed and paper tax returns and evaluated if they were sufficient to allow for verification and computation of general business credits.
 - B. Discussed with Code and Edit and Error Resolution functions the steps taken to ensure the accuracy of general business credit claims.
 - C. Reviewed and evaluated IRS's documentation of computer programming used to compute general business credits on Form 3800, *General Business Credit*, during processing of Form 1120, *U.S. Corporation Income Tax Return*.
 - D. Using the Business Return Transaction File (BRTF)¹ from the Treasury Inspector General for Tax Administration's Data Center Warehouse,² identified 87,674 PY³ 2013 Form 1120, *U.S. Corporation Income Tax Return*, returns claiming \$93,076,227,358 in general business credits on Form 3800, *General Business Credit*.⁴ Also, we identified from the BRTF returns filing Form 3800 that appeared to claim only Empowerment Zone Employment Credits.
 - E. Requested a computer extract from IRS's Modernized Tax Return Database⁵ of corporate tax returns e-filed during PY 2013 claiming the Empowerment Zone Employment Credit by programmers from the Treasury Inspector General for Tax Administration's Data Center Warehouse.

¹ An IRS database of transcribed line items on all business returns and their accompanying forms and schedules.

² A collection of IRS databases containing various types of taxpayer account information that is maintained by the Treasury Inspector General for Tax Administration for the purpose of analyzing data for ongoing audits.

³ The calendar year in which the tax return or document is processed by the IRS.

⁴ Form 3800 also includes Empowerment Zone Employment Credit amounts on Part II, line 22. We did not include these additional amounts because Part II, line 22, is not transcribed.

⁵ A legal repository for e-filed returns received and accepted by the IRS during processing.



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- F. Matched returns from the BRTF computer extracts in I.D to returns from the Modernized Tax Return Database extract in I.E. to determine taxpayers that claimed Empowerment Zone Employment Credits. We identified 717 corporate filers that did not receive more than \$170 million in Empowerment Zone Employment Credits they claimed due to the IRS's computer programming error.
- II. Evaluated the effectiveness of IRS controls to verify the accuracy of the carryforward portion of the general business credit claimed by taxpayers on their business tax returns.
 - A. Using the BRTF, identified 49,011 PY 2013 business tax returns (Form 1120) that claimed a general business credit carryforward.
 - B. Using the BRTF, *****2*****
*****2*****
*****2*****.
 - C. Analyzed the BRTF computer extracts and identified 5,483 PY 2013 Form 1120 returns claiming \$4,375,132,723 as a carryforward general business credit **2****
*****2*****
*****2*****. The IRS reviewed a sample of 60 of the 5,483 tax returns and agreed with the methodology we used to identify from the BRTF the corporations claiming potentially erroneous carryforward credits.
 - D. Identified that the 5,483 (\$4,375,132,723) exceptions cases above included 2,011 (\$1,350,357,899) filed on paper, 108 (\$1,190,771,405) CICs, and 187 (\$332,384,459) claiming Empowerment Zone Employment Credits potentially affected by the programming error.
- III. Determined whether taxpayers met the eligibility requirement to claim the Eligible Small Business Credit.
 - A. Using the BRTF, identified 1,066 PY 2012 business tax returns and 578 PY 2013 business tax returns processed that claimed an Eligible Small Business Credit on Form 3800.
 - B. Determined from the BRTF computer extract whether those taxpayers that claimed the credit as an Eligible Small Business did so within the proper time limits of the tax provision. We identified 1,411 corporate tax returns that claimed a current year general business credit as an Eligible Small Business subsequent to the expiration of the tax provision. These businesses claimed general business credits totaling \$34,961,387.
 - C. For any taxpayers identified in audit step III.B as not qualifying as an Eligible Small Business, we provided the exception cases to the IRS for its review of the returns.



Processes Do Not Ensure That Corporations Accurately Claim Carryforward General Business Credits

The IRS reviewed 30 of the 1,411 business tax returns and confirmed that all 30 tax returns incorrectly used the designation of an Eligible Small Business to claim the current year general business credit.

IV. Assessed the effectiveness of procedures for *****2*****

A. Reviewed the Internal Revenue Manual⁶ and form instructions to identify requirements for attaching supporting schedules and forms to substantiate entitlement to the credit. We also reviewed IRS procedures for processing business tax returns claiming general business credits.

B. Selected a statistically valid random sample of 174 of 3,472 e-filed business returns from the BRTF exceptions identified in objective II.D for which the carryforward credit appeared to be erroneous. We used attribute sampling to calculate the sample size based on a confidence level of 95 percent, an expected rate of occurrence of 37 percent, and a precision rate of ±7 percent. We used a contracted statistician who assisted us in developing our sampling plan and projections. For each sampled tax return, we:

1. *****2*****

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

C. *****2*****

Data validation methodology

During this review, we relied on data stored at the Treasury Inspector General for Tax Administration’s Data Center Warehouse and performed analysis of data extracted from the BRTF. We also relied on data extracts from the IRS’s Modernized Tax Return Database that were provided by programmers from the Treasury Inspector General for Tax Administration’s Data Center Warehouse. To assess the reliability of computer-processed data, programmers within the Treasury Inspector General for Tax Administration’s Data Center Warehouse validated the data files we extracted and were provided, while we ensured that each data extract contained the specific data elements we requested and that the data elements were accurate. For example, we reviewed judgmental samples of the data extracted and verified that the data were

⁶ The Internal Revenue Manual is the IRS’s primary official source of instructions to staff relating to the administration and operations of the IRS. It contains the directions employees need to carry out their operational responsibilities.



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the same as the data captured in the IRS's Integrated Data Retrieval System.⁷ In addition we compared data to the e-filed returns as appropriate to verify that the amounts were supported. As a result of our testing, we determined that the BRTF data used in our review were reliable except for taxpayers that claimed the Empowerment Zone Employment Credit and were potentially affected by the IRS programming error referenced in this report. In addition, we determined that the Modernized Tax Return Database 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 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: policies and procedures followed when processing these returns and the systems/programming used. We evaluated the controls by reviewing the IRS's Internal Revenue Manual sections used by various business operating divisions, interviewing IRS management, reviewing Internal Revenue Code sections, and evaluating applicable documentation and management information reports.

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



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Appendix II

Major Contributors to This Report

Russell P. Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services)
Diana M. Tengesdal, Acting Director
Larry Madsen, Audit Manager
Kyle Bambrough, Lead Auditor
Levi Dickson, Senior Auditor
Denise Gladson, Auditor
Joe Butler, Information Technology Specialist



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Operations, Wage and Investment Division SE:W
Deputy Commissioner, Support, Wage and Investment Division SE:W
Director, Compliance, Wage and Investment Division SE:W:CP
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM
Director, Exam Policy, Small Business/Self-Employed Division SE:S:E:EP
Director, Reporting Compliance, Wage and Investment Division SE:W:CP:RC
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:
 Commissioner, Small Business/Self-Employed Division SE:S
 Chief, Program Evaluation and Improvement, Wage and Investment Division SE:W:S:PEI



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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:

- Revenue Protection – Potential; \$1,441,554,202 in potentially erroneous general business credit carryforward claims for 3,050 taxpayers (see page 3).¹

Methodology Used to Measure the Reported Benefit:

We identified 5,483 Forms 1120, *U.S. Corporation Income Tax Return*, business returns filed in PY² 2013 *****2*****
 *****2*****
 *****2*****. Of these returns, 3,472 were e-filed and claimed potentially erroneous carryforward amounts totaling \$3,024,774,824, and 2,011 were paper-filed tax returns and claimed potentially erroneous carryforward credit amounts totaling \$1,350,357,899. The returns filed on paper 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. We reviewed 19 of the paper-filed returns with the largest carryforward discrepancy amounts. Of the 19, we found 14 (74 percent) contained IRS transcription errors that caused the discrepancy amounts we identified on the returns. These transcription errors accounted for just more than \$467 million of the \$1.3 billion in overstated carryforward amounts from the paper-filed returns. Because of the high transcription error rates from the paper returns and because we could not identify exactly how many of the 2,011 paper returns contained an error without reviewing each return, we did not include the overstated carryforward amounts from the paper-filed returns in our outcome measure.

In addition, we asked the IRS to review two of the e-filed tax returns with the highest discrepancy amounts. The discrepancy amounts for these two returns amounted to more than \$550 million. The taxpayer with the largest discrepancy amount is part of an IRS program called

¹ The actual amount of revenue protected is contingent upon *****2*****
 *****2*****
 2.

² The calendar year in which the tax return or document is processed by the IRS.



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the CIC program. Companies under this classification are audited each year by the IRS. Because this company’s tax returns are examined each year and because this company is more likely to have the IRS review its general business credit claims as part of this yearly audit, we made the decision to exclude the overstated amounts from this company. The IRS also provided us with a list of 107 other companies also under the CIC classification that were part of our 3,472 exception cases. We excluded the overstated carryforward amounts attributable to these companies from our outcome measure. The total overstated amount from these 108 CIC companies was \$1,190,771,405.

We also determined the number of returns that could have shown an overstated carryforward amount due to an IRS programming error. We identified 187 tax returns which contained an Empowerment Zone Employment Credit that could have potentially been all or part of the reason for the overstated carryforward amount. These potential programming error returns amounted to \$332,384,459 in overstated carryforward claims. Finally, because 96 percent of the general business credit examinations the IRS completed resulted in an adjustment to the amount of the credit claimed, we further reduced our overall outcome by 4 percent (127 returns) and \$60,064,758.³ Our final outcome measure consists of the following:

Figure 1: Net Outcome Measure Totals

	Returns	Overstated Amount
Potential Erroneous Claims (E-filed & Paper Returns)	5,483	\$4,375,132,723
Potential Erroneous Claims (Paper Returns)	(2,011)	(\$1,350,357,899)
CIC Program Corporations	(108)	(\$1,190,771,405)
Potential Programming Error	(187)	(\$332,384,459)
Returns That Would Not Be Adjusted if Examined	(127)	(\$60,064,758)
Potential Erroneous Claims	3,050	\$1,441,554,202

Source: Treasury Inspector General for Tax Administration analysis.

³ Although we are unsure if the IRS’s examinations of general business credit claims involved the carryforward credit, we reduced our outcome to account for the percentage of the cases for which the IRS’s examination of the general business credit would not result in a change to the amount claimed (*i.e.*, the credit was correct).



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Type and Value of Outcome Measure:

- Reliability of Information – Actual; 717 tax returns that claimed \$170,077,737 in Empowerment Zone Employment Credits and were not used to compute the general business credit on the tax returns (see page 8).

Methodology Used to Measure the Reported Benefit:

During our review, we identified an error in the way IRS computer programs compute the general business credit amount when the Empowerment Zone Employment Credit is present. Our review identified 717 tax returns filed in PY 2013 that were potentially affected. These tax returns claimed \$170,077,737 for the Empowerment Zone Employment Credit that IRS did not use to systemically compute the total general business credit amount.



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Appendix V

Form 3800, General Business Credit

<p>Form 3800</p> <p>Department of the Treasury Internal Revenue Service (99)</p> <p>Name(s) shown on return</p>	<p>General Business Credit</p> <p>► Information about Form 3800 and its separate instructions is at www.irs.gov/form3800. ► You must attach all pages of Form 3800, pages 1, 2, and 3, to your tax return.</p>	<p>OMB No. 1545-0895</p> <p style="font-size: 2em; font-weight: bold;">2013</p> <p>Attachment Sequence No. 22</p>
		Identifying number
Part I Current Year Credit for Credits Not Allowed Against Tentative Minimum Tax (TMT) (See instructions and complete Part(s) III before Parts I and II)		
1 General business credit from line 2 of all Parts III with box A checked	1	
2 Passive activity credits from line 2 of all Parts III with box B checked <input type="checkbox"/> 2	2	
3 Enter the applicable passive activity credits allowed for 2013 (see instructions)	3	
4 Carryforward of general business credit to 2013. Enter the amount from line 2 of Part III with box C checked. See instructions for statement to attach	4	
5 Carryback of general business credit from 2014. Enter the amount from line 2 of Part III with box D checked (see instructions)	5	
6 Add lines 1, 3, 4, and 5	6	
Part II Allowable Credit		
7 Regular tax before credits: <ul style="list-style-type: none"> • Individuals. Enter the amount from Form 1040, line 44, or Form 1040NR, line 42 • Corporations. Enter the amount from Form 1120, Schedule J, Part I, line 2; or the applicable line of your return • Estates and trusts. Enter the sum of the amounts from Form 1041, Schedule G, lines 1a and 1b; or the amount from the applicable line of your return 	7	
8 Alternative minimum tax: <ul style="list-style-type: none"> • Individuals. Enter the amount from Form 6251, line 35 • Corporations. Enter the amount from Form 4626, line 14 • Estates and trusts. Enter the amount from Schedule I (Form 1041), line 56 	8	
9 Add lines 7 and 8	9	
10a Foreign tax credit	10a	
b Certain allowable credits (see instructions)	10b	
c Add lines 10a and 10b	10c	
11 Net income tax. Subtract line 10c from line 9. If zero, skip lines 12 through 15 and enter -0- on line 16	11	
12 Net regular tax. Subtract line 10c from line 7. If zero or less, enter -0-	12	
13 Enter 25% (.25) of the excess, if any, of line 12 over \$25,000 (see instructions)	13	
14 Tentative minimum tax: <ul style="list-style-type: none"> • Individuals. Enter the amount from Form 6251, line 33 • Corporations. Enter the amount from Form 4626, line 12 • Estates and trusts. Enter the amount from Schedule I (Form 1041), line 54 	14	
15 Enter the greater of line 13 or line 14	15	
16 Subtract line 15 from line 11. If zero or less, enter -0-	16	
17 Enter the smaller of line 6 or line 16	17	
C corporations: See the line 17 instructions if there has been an ownership change, acquisition, or reorganization.		
For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12392F Form 3800 (2013)		



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Form 3800 (2013)

Page **3**

Name(s) shown on return

Identifying number

Part III General Business Credits or Eligible Small Business Credits (see instructions)

Complete a separate Part III for each box checked below. (see instructions)

- | | |
|--|---|
| <p>A <input type="checkbox"/> General Business Credit From a Non-Passive Activity</p> <p>B <input type="checkbox"/> General Business Credit From a Passive Activity</p> <p>C <input type="checkbox"/> General Business Credit Carryforwards</p> <p>D <input type="checkbox"/> General Business Credit Carrybacks</p> | <p>E <input type="checkbox"/> Reserved</p> <p>F <input type="checkbox"/> Reserved</p> <p>G <input type="checkbox"/> Eligible Small Business Credit Carryforwards</p> <p>H <input type="checkbox"/> Reserved</p> |
|--|---|

I If you are filing more than one Part III with box A or B checked, complete and attach first an additional Part III combining amounts from all Parts III with box A or B checked. Check here if this is the consolidated Part III

(a) Description of credit	(b) If claiming the credit from a pass-through entity, enter the EIN	(c) Enter the appropriate amount
1a Investment (Form 3468, Part II only) (attach Form 3468)	1a	
b Reserved	1b	
c Increasing research activities (Form 6765)	1c	
d Low-income housing (Form 8586, Part I only)	1d	
e Disabled access (Form 8826) (see instructions for limitation)	1e	
f Renewable electricity, refined coal, and Indian coal production (Form 8835)	1f	
g Indian employment (Form 8845)	1g	
h Orphan drug (Form 8820)	1h	
i New markets (Form 8874)	1i	
j Small employer pension plan startup costs (Form 8881) (see instructions for limitation)	1j	
k Employer-provided child care facilities and services (Form 8882) (see instructions for limitation)	1k	
l Biodiesel and renewable diesel fuels (attach Form 8864)	1l	
m Low sulfur diesel fuel production (Form 8896)	1m	
n Distilled spirits (Form 8906)	1n	
o Nonconventional source fuel (Form 8907)	1o	
p Energy efficient home (Form 8908)	1p	
q Energy efficient appliance (Form 8909)	1q	
r Alternative motor vehicle (Form 8910)	1r	
s Alternative fuel vehicle refueling property (Form 8911)	1s	
t Reserved	1t	
u Mine rescue team training (Form 8923)	1u	
v Agricultural chemicals security (Form 8931) (see instructions for limitation)	1v	
w Employer differential wage payments (Form 8932)	1w	
x Carbon dioxide sequestration (Form 8933)	1x	
y Qualified plug-in electric drive motor vehicle (Form 8936)	1y	
z Qualified plug-in electric vehicle (carryforward only)	1z	
aa New hire retention (carryforward only)	1aa	
bb General credits from an electing large partnership (Schedule K-1 (Form 1065-B))	1bb	
zz Other	1zz	
2 Add lines 1a through 1zz and enter here and on the applicable line of Part I	2	
3 Enter the amount from Form 8844 here and on the applicable line of Part II	3	
4a Investment (Form 3468, Part III) (attach Form 3468)	4a	
b Work opportunity (Form 5884)	4b	
c Biofuel producer (Form 6478)	4c	
d Low-income housing (Form 8586, Part II)	4d	
e Renewable electricity, refined coal, and Indian coal production (Form 8835)	4e	
f Employer social security and Medicare taxes paid on certain employee tips (Form 8846)	4f	
g Qualified railroad track maintenance (Form 8900)	4g	
h Small employer health insurance premiums (Form 8941)	4h	
i Reserved	4i	
j Reserved	4j	
z Other	4z	
5 Add lines 4a through 4z and enter here and on the applicable line of Part II	5	
6 Add lines 2, 3, and 5 and enter here and on the applicable line of Part II	6	

Form **3800** (2013)



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Appendix VI

Source Credit Forms for General Business Credits

1. Schedule K-1 (Form 1065-B), Partner's Share of Income (Loss) From an Electing Large Partnership – Credit applies to those credits that are taken by the partnership but not separately reported to partners.
2. Form 3468, Investment Credit – Credit consists of the total of the following credits: rehabilitation credit, energy credit, qualifying advanced coal project credit, qualifying gasification project credit, qualifying advanced energy project credit, and qualifying therapeutic discovery project credit.
3. Form 5884, Work Opportunity Credit – Credit applies to businesses that hire individuals from targeted groups that have a particularly high unemployment rate or other special employment needs.
1. Form 6478, Alcohol and Cellulosic Biofuel Fuels Credit – Credit consists of the alcohol mixture credit, alcohol credit, small ethanol producer credit, and cellulosic biofuel producer credit.¹
2. Form 6765, Credit for Increasing Research Activities – Credit is designed to encourage businesses to increase the amounts they spend on research and experimental activities, including energy research.
3. Form 8586, Low-Income Housing Credit – Credit generally applies to each new qualified low-income building placed in service after 1986 and is used by owners of qualified residential rental buildings in low-income housing projects.
4. Form 8820, Orphan Drug Credit – Credit applies to qualified clinical testing expenses paid or incurred during the tax year.
5. Form 8826, Disabled Access Credit – Credit applies to amounts paid or incurred by the Eligible Small Businesses to comply with applicable requirements under the Americans With Disabilities Act of 1990 (Public Law 101-336) as in effect on November 5, 1990.
6. Form 8835, Renewable Electricity, Refined Coal, and Indian Coal Production Credit – Credit is allowed for the sale of electricity, refined coal, or Indian coal produced in the United States or U.S. possessions from qualified energy resources at a qualified facility.

¹ For TY 2013, this form was renamed and is now Form 6478, *Biofuel Producer Credit*.



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7. Form 8844, Empowerment Zone and Renewal Community Employment Credit – Credit is available to employers for wages paid to qualified employees residing in an empowerment zone for which the credit is available.
8. Form 8845, Indian Employment Credit – Credit applies to qualified wages and health insurance costs paid or incurred for American Indians who are qualified employees.
9. Form 8846, Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips – Credit is generally equal to the employer’s portion of Social Security and Medicare taxes paid on tips received by employees of a food and beverage establishment in which tipping is customary.
10. Form 8864, Biodiesel and Renewable Diesel Fuels Credit – Credit applies to certain fuel sold or used in business and consists of the following: biodiesel credit, renewable diesel credit, biodiesel mixture credit, renewable diesel mixture credit, and small agri-biodiesel producer credit.
11. Form 8874, New Markets Credit – Credit is for qualified equity investments made in qualified community development entities.
12. Form 8881, Credit for Small Employer Pension Plan Startup Costs – Credit applies to pension plan startup costs of a new qualified defined benefit or defined contribution plan.
13. Form 8882, Credit for Employer-Provided Childcare Facilities and Services – Credit applies to the qualified expenses paid for employee childcare and qualified expenses paid for childcare resource and referral services.
14. Form 8896, Low Sulfur Diesel Fuel Production Credit – Credit is for the production of low sulfur diesel fuel by a qualified small business.
15. Form 8900, Qualified Railroad Track Maintenance Credit – Credit applies to qualified railroad track maintenance expenditures paid or incurred during the tax year.
16. Form 8906, Distilled Spirits Credit – Credit is available to eligible wholesalers of distilled spirits.
17. Form 8907, Nonconventional Source Fuel Credit – Credit is allowed for qualified coke or coke gas produced and sold to an unrelated person during the tax year.
18. Form 8908, Energy Efficient Home Credit – Credit is available for eligible contractors for each qualified energy efficient home sold or leased to another person during the tax year for use as a residence.
19. Form 8909, Energy Efficient Appliance Credit – Credit is available to manufacturers of qualified energy efficient appliances, e.g., eligible dishwashers, clothes washers, and refrigerators.



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20. Form 8910, *Alternative Motor Vehicle Credit* – Credit is for the following vehicles placed in service: qualified fuel cell motor vehicle, advanced lean-burn technology motor vehicle, qualified hybrid motor vehicle, qualified alternative fuel motor vehicle, and qualified plug-in electric drive motor vehicle conversion.
21. Form 8911, *Alternative Fuel Vehicle Refueling Property Credit* – Credit applies to the cost of any qualified alternative fuel vehicle refueling property placed in service.
22. Form 8923, *Mine Rescue Team Training Credit* – Credit applies to training program costs paid or incurred for certain mine rescue team employees.
23. Form 8931, *Agricultural Chemicals Security Credit* – Credit applies to qualified agricultural chemicals security costs paid or incurred by eligible agricultural businesses.
24. Form 8932, *Credit for Employer Differential Wage Payments* – Credit provides certain small businesses with an incentive to continue to pay wages to an employee performing services on active duty in the uniformed services of the United States for more than 30 days.
25. Form 8933, *Carbon Dioxide Sequestration Credit* – Credit is allowed for qualified carbon dioxide that is captured and disposed of or captured, used, and disposed of by the taxpayer in secure geological storage.
26. Form 8936, *Qualified Plug-in Electric Drive Motor Vehicle Credit* – Credit is for new qualified plug-in electric drive motor vehicles placed in service during the tax year.
27. Form 8941, *Credit for Small Employer Health Insurance Premiums* – Credit applies to the cost of certain health insurance coverage provided to certain employees.



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Appendix VII

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

DEC 22 2014

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Karen Schiller
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Processes Do Not Ensure Corporations
Accurately Claim Carryforward General Business Credits
(Audit #201340022)

Thank you for the opportunity to review your draft report titled: "Processes Do Not Ensure Corporations Accurately Claim Carryforward General Business Credits." We appreciate your acknowledgment that business credits present unique challenges for the IRS. These challenges are only further compounded by the deep cuts to the IRS's budget, cuts which will unequivocally hurt tax collection and threaten the nation's revenue collection.

Given these constrained resources, the IRS has to make strategic and risk-based decisions in devising our examination plan. Our examination program aims to ensure that our limited resources are allocated to focus on areas with the highest levels of noncompliance. This allows us to maximize audit coverage in the most egregious tax filing issues while achieving balanced overall coverage. The IRS continues to work on improving the detection of returns with the highest risk of error. We cannot simply prioritize the discrete universe of corporate returns you identified as potentially questionable in your report because we have to consider the risk of placing these returns in the audit stream, and thereby potentially bypassing other returns with higher audit potential.

Your report includes potential revenue protection of \$1,441,554,202 in potentially erroneous general business credit carryforward claims for 3,050 taxpayers. While we agree that some taxpayers may have claimed erroneous amounts of general business credit carryforward, it is not realistic to conclude that the tax effect is equal to the gross carryforward amount because the taxpayer may never have adequate tax to absorb the remaining business credits. Therefore, we disagree with the stated revenue protection amount. We agree with the Reliability of Information Outcome Measure of 717 tax returns claiming \$170,077,737 in Empowerment Zone Employment Credits that were not used to compute the general business credit on the tax returns.



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We have attached a response outlining our planned corrective actions. Due to our limited staffing and Information Technology resources, we are unable to implement all of your recommendations at this time. If you have any questions, please contact me, or a member of your staff may contact Shenita Hicks, Director, Examination, Small Business/Self Employed Division at 240-613-2849.

Attachment



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Attachment

RECOMMENDATION 1:

The Commissioner, Small Business/Self-Employed Division should verify whether the 3,285 corporate filers we identified as having a questionable carryforward amount are entitled to claim the carry forward amount.

CORRECTIVE ACTION:

The IRS will review a sample of 30 cases, selected by SB/SE Research, that were pulled from the 3,285 identified by TIGTA for audit potential. Based on those reviews, we will determine whether any further action is required to evaluate the remaining corporate filers.

IMPLEMENTATION DATE:

June 15, 2016

RESPONSIBLE OFFICIAL:

Director, SB/SE Examination Case Selection
Director, LB&I Pre-Filing and Technical Guidance

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 2:

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

CORRECTIVE ACTION:

Due to our lack of Information Technology (IT) resources and competing priorities, we are unable to consider the process you recommend. This recommendation would require additional submission processing resources for transcription during return processing as well as significant cost to our IT programming resources, which are not available. In addition, we would also have to consider the risk of placing these returns in the audit stream potentially bypassing other returns with higher audit potential. The benefits of this process do not outweigh the significant cost and the potential of lost revenue from other audit work.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIALS:

N/A



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CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 3:

The Commissioner, Small Business/Self-Employed Division should develop a process to reject e-filed tax returns *****2*****
*****2*****
*****2*****, the return should be identified and sent to the Error Resolution function
*****2*****.

CORRECTIVE ACTION:

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

** would not affect the processability of the return; however, it may raise questions as to the validity of the claim. When that occurs, the IRS has the authority under the Internal Revenue Code to examine the taxpayer's books and records to determine the veracity of deductions and credits claimed on the return. We will follow up on returns with missing supporting schedules during the normal return selection process.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIALS:

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 4:

The Commissioner, Wage and Investment Division should determine whether the programming error affects paper-filed business returns, and if so, take actions to correct the programming.

CORRECTIVE ACTION:

Although corrections have been requested for the 2016 filing season, we cannot be assured they will be implemented due to other priorities competing for the same resources. We have manual processes in place to identify affected returns when they are referred to the Error Resolution System and our tax examiners have been trained on the procedures to follow to ensure the returns are processed correctly.

IMPLEMENTATION DATE:

Implemented



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3

RESPONSIBLE OFFICIAL

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

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 5:

The Commissioner, Small Business/Self-Employed Division, should verify whether taxes were affected for the 1,411 corporate filers we identified as having an incorrect Eligible Small Business designation.

CORRECTIVE ACTION:

The IRS will review a sample of 30 cases, selected by SB/SE Research, pulled from the 1,411 identified by TIGTA to determine the audit potential. Based on those reviews we will determine whether any further action is required to evaluate the remaining corporate filers.

IMPLEMENTATION DATE:

June 15, 2016

RESPONSIBLE OFFICIAL(S):

Director, SB/SE Examination Case Selection.
Director, LB&I, Pre-Filing and Technical Guidance

CORRECTIVE ACTION MONITORING PLAN:

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