

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately ***2*******

September 29, 2020

Reference Number: 2020-40-052

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HIGHLIGHTS: Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****



Final Audit Report issued on September 29, 2020
Reference Number 2020-40-052

Why TIGTA Did This Audit

In September 2004, TIGTA reported that the IRS did not develop procedures to calculate and *****2**** for taxpayers that filed unprocessable Forms 1120-S, *U.S. Income Tax Return for an S Corporation*, or provide the staffing needed to correct unprocessable Forms 1120-S compliance issues. Although IRS management took actions to address our prior recommendations, they have not provided the necessary resources to address the erroneous Forms 1120, *U.S. Corporation Income Tax Return*, and 1120-S filings using their Statutory Notice of Deficiency procedures and appropriately *****2***** *****2*****.

Impact on Taxpayers

Taxpayers that file an incorrect Form 1120 series tax return and do not reply to IRS correspondence are not taxed fairly and consistently.

What TIGTA Found

The IRS will remove Form 1120-S tax returns from processing if the taxpayer's account does not note a Form 1120-S filing requirement. The IRS will also remove Form 1120 tax returns from processing if a Form 1120-S filing requirement is present on the taxpayer's account. The IRS considers these types of filings as having an unpostable condition, *i.e.*, the return cannot be processed. Unpostable returns are sent to tax examiners for review and correspondence with the taxpayer to determine which Form 1120 should have been filed.

TIGTA identified that due to the lack of corrective action on previous findings, taxpayers can submit unprocessable Forms 1120/1120-S and *****2*****. For those taxpayers that do not respond to tax examiner correspondence, the taxpayer's Form 1120-S return will be converted to a Form 1120. However, when the IRS converts the return, no subsequent actions are being taken to address *****2***** *****2*****. TIGTA's analysis of Processing Year 2018 Forms 1120-S identified 48,044 return filings that were converted to a Form 1120, and TIGTA estimated that the IRS *****2***** almost \$156 million in corporate tax associated with an estimated \$447 million in net reported ***2***. Similarly, TIGTA identified 6,897 Form 1120 return filings that were converted to a Form 1120-S in which \$29 million in reported corporate *****2*****.

In addition, taxpayers did not always receive Letter 3853C, *Unpostable 310 - Forms 1120/1120-S Filing Requirement Mismatch*, notifying them to timely file or update their S Corporation Election. TIGTA's review of the tax accounts of 38,406 taxpayers that submitted an unprocessable Forms 1120 or 1120-S in Processing Year 2018 identified 2,290 taxpayers that did not receive Letter 3853C because tax examiners did not manually input the request into the IRS's computer system to send out the letter.

Finally, taxpayer filing requirements are not always updated. TIGTA identified 1,588 taxpayer accounts that were not correctly updated to remove the Form 1120-S filing requirement because internal guidelines were not added to instruct tax examiners to verify and manually update the taxpayer's account with the correct filing requirement where needed.

What TIGTA Recommended

TIGTA made five recommendations to improve the IRS's processes to ensure that taxpayers that elect S Corporation status file correct tax returns and are appropriately *****2*****. IRS management agreed with three recommendations. The IRS disagreed with TIGTA's methodology used to identify incorrectly filed Forms 1120-S and 1120 returns, and stated that it already had processes and procedures in place to address incorrect S Corporation tax returns. Due to the lack of sufficient corrective action, the IRS is not adequately addressing erroneously filed Forms 1120 and 1120-S and appropriately *****2*****.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 29, 2020

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Processes Do Not Ensure That Taxpayers
Filing an Incorrect Form 1120 Series Tax Return Are
Appropriately *****2***** (Audit # 201940016)

This report presents the results of our review to assess the Internal Revenue Service's processes to ensure correct tax return filings and payments based on corporate elections. This review is included in our Fiscal Year 2020 Annual Audit Plan and addresses the major management and performance challenge of *Improving Tax Reporting and Payment Compliance*.

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

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



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****

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Background

S Corporation elections are governed by Subchapter S of the Internal Revenue Code (I.R.C) Section (§) 1362. Where Subchapter S is silent, Subchapter C of the I.R.C. generally applies. An electing S Corporation is a domestic business entity that has made an election under §1362(a) to be treated as a corporation for Federal tax purposes. In actual form, such an entity may be a State-chartered corporation or an unincorporated entity, such as a limited liability company. The major advantage of filing as an S Corporation is that S Corporations generally pay no entity-level Federal taxes on their income. Instead, the income and deductions of the entity flow through to the shareholders who are responsible for their appropriate share of the entity's Federal income tax liability, similar to a partnership. Other than the specific limitations imposed by Subchapter S on, for example, the number and the type of owners as well as the number of classes of stock (see requirements in the next section), S Corporations share all of the attributes of any similar domestic business entity formed under the laws of its applicable jurisdiction.

S Corporation election eligibility requirements

A corporation can elect S Corporation status by completing Form 2553, *Election by a Small Business Corporation*.¹ An S Corporation election can be made at any time during the prior year or on or before the 15th day of the third month of the taxable year. To make an S Corporation Election, the Form 2553 must be signed by a corporate officer, accompanied by the written consent of all the corporation's shareholders, and meet the following general requirements:

- Be a domestic, for-profit corporation.
- Have only allowable shareholders.
 - Shareholders may be individuals, certain trusts,² estates, Employee Stock Ownership Plans, and I.R.C. § 501(c)(3) organizations, *i.e.*, charities.
 - Shareholders may not be partnerships, for-profit corporations, or nonresident aliens.
- Have no more than 100 shareholders.
- Have only one class of stock, *e.g.*, no preferred stock or special profit/loss allocations.
- Cannot be an ineligible corporation, *i.e.*, certain financial institutions, insurance companies, or domestic international sales corporations.

Once the Form 2553 is approved, the corporation will file Form 1120-S, *U.S. Income Tax Return for an S Corporation*, whereas corporations that do not make an S Corporation Election generally file Form 1120, *U.S. Corporation Income Tax Return*. Figure 1 shows the volumes of Forms 1120 and 1120-S for Processing Year (PY)³ 2018.

¹ See Appendix IV for a copy of Form 2553.

² Five types of trusts are permitted as shareholders under I.R.C. § 1361(c)(2)(A).

³ The calendar year in which the IRS processes the tax return or document.



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****

Figure 1: Forms 1120/1120-S Processed in PY 2018

Forms 1120	Forms 1120-S
1,791,753	5,134,888

Source: Treasury Inspector General for Tax Administration analysis of the Business Master File (BMF)⁴ as of December 31, 2018.

Processing of Forms 2553

Forms 2553 are received by fax, mail, or filed with a Form 1120-S, and are processed by the Internal Revenue Service (IRS) at sites in Kansas City, Missouri; Cincinnati, Ohio;⁵ and Ogden, Utah. For those taxpayers that submit their Forms 2553 with a filed Form 1120-S, the IRS separates and processes the Forms 2553 apart from the tax return.⁶ Once received by the IRS, the Forms 2553 are assigned to tax examiners in the IRS's Entity Department to be processed. Tax examiners review the Form 2553 to ensure that it contains a live signature of a corporate officer or an individual who is authorized to sign documents on behalf of the corporation. Tax examiners then use an automated tool to input information from the Form 2553 into the IRS's Integrated Data Retrieval System (IDRS).⁷ The IDRS is used to determine if the:

- Corporation's name, address, and Employer Identification Number⁸ are valid and match what the IRS has on file.
- Corporation is an ineligible corporation. This verification is completed by researching the taxpayer's name, *e.g.*, does the corporation's name contain the words "Insurance" or "Finance," Employer Identification Number, and other entity information such as the location of the corporation, *i.e.*, domestic or international, as well as State department data.
- Corporation has only allowable shareholders. This verification is completed by researching the taxpayer's name, Taxpayer Identification Numbers,⁹ and other entity information to determine if the shareholders are partnerships, for-profit corporations, or nonresident aliens, as well as State department data.

⁴ 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.

⁵ As of June 17, 2019, the IRS officially stopped accepting tax returns at the Cincinnati Tax Processing Center, including Forms 2553.

⁶ If the Form 2553 has not been processed by the time the Form 1120-S is processed, the Form 1120-S will be removed from processing, *i.e.*, the return will go unpostable, to allow time for the Form 2553 to process. IRS guidance allows the IRS to hold an unposted Form 1120-S return for 60 days to allow time for an attached Form 2553 to be processed or for a Form 2553 to be submitted by the taxpayer.

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

⁸ A unique nine-digit number used to identify a taxpayer's business account.

⁹ A nine-digit number assigned to taxpayers for identification purposes. Depending upon the nature of the taxpayer, the Taxpayer Identification Number is either an Employer Identification Number, a Social Security Number, or an Individual Taxpayer Identification Number.



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The IRS's internal guidelines state that if tax examiners cannot process a Form 2553, they must first try to contact that taxpayer via telephone. If they are unable to make contact with the taxpayer, then they will send either Letter 312C, *S Corporation Election (F2553), Revocation, or Termination Incomplete for Processing and/or Not Timely Filed*, or Letter 6800sce, *Request for Missing Information to Complete Your Form/Election*, along with Form 2553 to the taxpayer for completion. However, if tax examiners identify an unallowable shareholder, the Form 2553 is denied. For denied forms, the tax examiner updates the taxpayer's tax account notating that the Form 2553 was denied and the taxpayer is sent Letter 326C, *S Corporation Election (F8869)/(F2553) Rejected/Revoked*, to notify them that the Form 2553 was denied with an explanation for the denial. Forms 2553 are retained locally for one year and then sent to the Federal Records Center for storage.

For approved Forms 2553, tax examiners notate the taxpayer's account that an approved S Corporation Election is on file with the IRS, *i.e.*, hereafter referred to as an approved S Corporation Election. The taxpayer's account is also systemically updated to reflect the requirement to file a Form 1120-S annually. For PY 2018, the IRS approved 509,877 and denied 1,465 S Corporation Election requests.

Identification of Forms 1120-S and 1120 that are inconsistent with filing requirements

The IRS will remove Form 1120-S tax returns from processing if the taxpayer's account does not note a Form 1120-S filing requirement. The IRS will also remove Form 1120 tax returns from processing if a Form 1120-S filing requirement is present on the taxpayer's account. The IRS considers these types of filings as having an unpostable condition, *i.e.*, the return cannot be processed. Unpostable returns are sent to tax examiners on the IRS's Entity Unpostables team for review. One of the first steps taken by the tax examiner is to determine whether a Form 2553 was submitted and/or processed, or if a Form 2553 has been received and is still waiting to be processed. The tax examiner will also determine if some other action was taken to explain the type of return that was filed, such as the taxpayer has submitted a final return that would terminate the S Corporation Election. If no explanation can be identified and the Form 2553 is not on file, the tax examiner will correspond with the taxpayer in an attempt to correct the problem. For example, the tax examiner will send Letter 3853C, *Unpostable 310 – Forms 1120/1120-S Filing Requirement Mismatch*, to taxpayers that have a Form 1120 series filing requirement but do not file the correct tax return, *i.e.*, when the taxpayer files a Form 1120-S but has a Form 1120 filing requirement and vice versa,. In Calendar Year 2018, the IRS issued 81,418 Letters 3853C.

Results of Review

In September 2004,¹⁰ we reported that the IRS did not develop procedures to *****2***** for taxpayers that filed unprocessable Forms 1120-S. We also reported that the IRS did not provide the staffing needed to address compliance issues related to unprocessable Forms 1120-S. We recommended that IRS management:

¹⁰ Treasury Inspector General for Tax Administration, Ref. No. 2004-30-172, *Increased Attention Is Needed to Reduce Taxpayer Burden and Ensure Fair and Consistent Tax Treatment When Filing Small Business Corporate Tax Returns* (Sept. 2004).



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- Clarify its internal guidelines to assign responsibility for determining and assessing the correct taxes and issuing Statutory Notices of Deficiency¹¹ when Forms 1120-S are converted to Forms 1120 because there is no valid S Corporation Election on file.
- Clarify the requirement to use Statutory Notice of Deficiency procedures on Forms 1120-S that were converted to Forms 1120.

In response, IRS management took the following corrective actions:

- Developed processes and procedures to ensure clear and consistent guidelines for handling unprocessable Forms 1120-S. This included updating internal guidelines for requiring Tax Processing functions to use Statutory Notice of Deficiency procedures on Forms 1120-S converted to Forms 1120.
- Assigned responsibility to the IRS’s Small Business/Self-Employed Division’s Examination function for assessing correct taxes and issuing Statutory Notices of Deficiency for S Corporations and their shareholders when their returns are converted.
- Reviewed a random sample of returns involving invalid S Corporation Elections and their shareholders to determine strategies for committing the necessary resources to ensure that taxpayers are fairly and consistently taxed. Although IRS management planned to review 9,000 returns, a lower number of returns was ultimately reviewed. As a result of these reviews, the IRS granted some taxpayers valid S Corporation Elections or made adjustments to the associated shareholder tax returns. We asked management to provide us with information pertaining to results of the reviews they conducted; however, because these reviews were completed so long ago, management was unable to locate the results.

Although IRS management took actions to address our prior concerns, they have not provided the necessary resources to address the erroneous Forms 1120 and 1120-S using their Statutory Notice of Deficiency procedures and appropriately *****2*****. In addition, our review found that taxpayers did not always receive required Letters 3853C, and that some tax accounts were not updated to reflect the correct tax return filing requirement.

Due to the Lack of Corrective Action, Taxpayers Can Submit Unprocessable Forms 1120/1120-S and ***2*******

Our review of PY 2018 Forms 1120-S identified 48,044 return filings that were converted to a Form 1120 because there was no associated S Corporation election on file. When the IRS converts these returns, it *****2***** original information reported on the Form 1120-S to the Form 1120. Dollar amounts reported by the taxpayer on the tax return *2* *****2*****. We

¹¹ A notice of deficiency, also called a "statutory notice of deficiency" or "90 day letter," is a legal notice in which the IRS Commissioner determines the taxpayer's tax deficiency. I.R.C. § 6212 and § 6213 require that the IRS issue a notice of deficiency before assessing additional income tax, estate tax, gift tax, and certain excise taxes unless the taxpayer agrees to the additional assessment.



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****

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

The IRS is not using deficiency processes and procedures to address erroneous Forms 1120 and 1120-S filings

When we brought the previous concerns to management’s attention, management stated that their processes and procedures are consistent with an Office of Chief Counsel opinion dated May 20, 1999. In this opinion, the Office of Chief Counsel stated that when a taxpayer files a Form 1120-S without an approved S Corporation Election, “it constitutes a return notwithstanding that the form is unpostable.” The opinion further stated that tax examiners working these returns *****2*****, even when it appears there is taxable income, because the IRS is required to follow its deficiency procedures. However, management stated that they do not have the staffing to examine each of these returns and issue a Statutory Notice of Deficiency as recommended by Office of Chief Counsel.

Management also noted that prior examinations of taxpayers that filed a Form 1120-S without having an approved S Corporation Election were unproductive, and that the number of Forms 1120-S converted to a Form 1120 represents less than 1 percent of the total population of Form 1120-S tax returns filed in PY 2018. Furthermore, management stated that its Automated Underreporter process will identify individual shareholders who do not report items from their Schedule K-1 (Form 1120-S) on their Forms 1040. IRS guidance provides that when there is a mismatch between the Form 1040 and a third-party information return, e.g., Form W-2, *Wage and Tax Statement, etc.*, they may be selected for further review and contacted to resolve the discrepancy. When we asked management to provide information supporting their statements, management indicated that they did not have any formal reports/statistics that support their position.

Many of the taxpayers we identified *****2***** *****2***** Forms 1120-S, and the IRS *****2***** this noncompliance

Our analysis of the IRS’s PYs 2016 through 2018 data on converted returns identified:

- 17,729 taxpayers that submitted 38,914 Forms 1120-S converted by the IRS to Forms 1120 in two of the three processing years.
- 3,871 taxpayers that submitted 12,096 Forms 1120-S converted by the IRS to Forms 1120 in all three processing years.

IRS management reviewed a random sample of 17 of the 12,096 converted returns¹⁶ and found that in six cases, the corporation filed a Form 1120-S without an approved S Corporation Election, and the shareholders *****2***** least one of the three processing years reviewed. This means that the IRS is *****2***** the income that was originally reported by the S Corporation. For the remaining 11 cases, taxpayers reported as required.

¹⁶ The converted returns for PYs 2016, 2017, and 2018 were identified by personnel in the IRS’s Wage and Investment Division, and we identified the taxpayers whose tax returns were converted in two or three processing years.



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Management explained that the IRS revised its internal guidelines on April 11, 2019, to have IRS employees contact the taxpayer's paid return preparer, where applicable, to address incomplete Forms 2553 prior to sending the taxpayer a letter. In addition, management also stated that even though the IRS corresponds with the taxpayers to ensure that they provide the required Form 2553, about 80 percent of the time taxpayers do not respond. Management explained that they believe taxpayers are not responding to the letter because *****2***** filing Forms 1120-S without a valid S Corporation Election. However, the IRS cannot currently *****2*****. The lack of sufficient action to address these erroneous filings is problematic *****2*****.

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

Recommendation 1: Review the 48,044 incorrectly filed Forms 1120-S and the 6,897 Forms 1120 returns we identified and refer those with potential tax adjustments to the Examination function to be addressed using its deficiency procedures.

Management's Response: The IRS disagreed with this recommendation. IRS management concluded that TIGTA's results are an inaccurate representation of true compliance risk because the methodology used to identify the incorrect returns was flawed. Due to limited resources, the IRS does not plan to take any additional actions on these returns.

Office of Audit Comment: The methodology we used was shared, reviewed, and concurred to by IRS management, and included identifying all PY 2018 taxpayer accounts with an Audit Code 4 and in which either a Form 1120 or Form 1120-S posted. We disagree with management's assertion that our results provide an inaccurate representation of the "true compliance risk." As our report notes, the compliance risk is the fact that 54,941 filers submitted incorrect tax returns in PY 2018 with *****2***** on the part of the IRS to address the erroneous Forms 1120 and 1120-S and appropriately *****2*****. In fact, as our report details, 21,600 taxpayers *****2***** Form 1120-S return for the three processing years we analyzed. Each of these taxpayers received a notification of their incorrect filing and took no action to respond to the IRS. Moreover, these 21,600 filers *****2***** incorrect returns. The fact remains that *****2***** by the IRS to address this noncompliance even though the IRS previously agreed to develop strategies to ensure that corporations that submit unprocessable Forms 1120-S and their related shareholders are taxed fairly and consistently.

Recommendation 2: Develop processes and procedures to refer incorrectly filed Forms 1120-S or 1120 tax returns with tax implications and where the taxpayer does not timely respond to the Examination function to be addressed using deficiency procedures.

Management's Response: The IRS disagreed with this recommendation. IRS management stated that they already have processes and procedures in place to identify and address an incorrect filing related to a corporation's S-election via the "audit code 4" indicator. These returns are currently available for examination and, if selected, could be subject to deficiency procedures. Additionally, IRS records demonstrate that assessments for this issue have been made as part of examinations during the period we



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****

reviewed. During the years covered by our audit, the IRS assessed \$2.5 million in tax related to S corporations without a valid election during the course of examinations.

Office of Audit Comment: Once these types of returns are identified, the IRS does not have adequate processes and procedures to evaluate these returns to determine if a referral to examination is warranted. In addition, management implies that the \$2.5 million in assessments were the result of IRS examinations to address the incorrect filings. This figure actually results from an analysis we conducted after management informed us that they did not have any examination statistics to provide on audits performed to address incorrect return filings. We did not include the results of this analysis in our report because we could not determine whether the tax assessments were the result of an IRS examination addressing the conversion of a Form 1120-S to a Form 1120.

Legislative Recommendation 3: In coordination with the Department of Treasury's Office of Tax Policy, develop a legislative change request to grant the IRS the *****2***** taxpayers that do not respond to the IRS's correspondence regarding incorrect Forms 1120 or 1120-S.

Management's Response: The IRS agreed with this recommendation. IRS management plans to share our report and this specific recommendation with the Department of Treasury's Office of Tax Policy and stated its willingness to support the Department of the Treasury if it determines to proceed with a legislative proposal.

Taxpayer Filing Requirements Are Not Always Updated

Our review identified 1,588 taxpayer accounts that were not correctly updated to remove the Form 1120-S filing requirement. When filing requirements are not correctly updated, taxpayers that file correctly can have their electronically filed (e-filed) returns needlessly rejected or their paper returns not able to be processed. Taxpayers will then need to either correspond with the IRS or refile their tax return, creating taxpayer burden. In addition, this also results in the IRS expending resources needlessly to resolve these cases. The 1,588 taxpayer tax accounts included:

- 1,390 taxpayer accounts that incorrectly reflected a Form 1120-S filing requirement when they did not have an approved S Corporation Election. We provided IRS management with our exceptions, and they reviewed a sample of 57 taxpayer accounts. Management found that the filing requirements associated with the tax accounts we identified were not correctly updated because internal guidelines were not added to instruct tax examiners to verify and manually update the taxpayer's account with the correct filing requirement where needed.
- 198 taxpayer accounts that incorrectly had a Form 1120-S filing requirement even though the S Corporation Election was denied. IRS management agreed with our results and stated that these taxpayer accounts were subsequently merged with another account. However, tax examiners did not accurately update the filing requirement when the S Corporation Election was denied or reversed. For these 198 accounts, we determined that 82 taxpayers incorrectly filed 89 Forms 1120-S in PY 2018 that were not identified by the IRS as unpostable for review.



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****

On February 13, 2020, IRS management updated their internal guidelines providing instructions to tax examiners to verify and update filing requirements, as needed, when an S Corporation Election is denied or reversed.

The Commissioner, Wage and Investment Division, should:

Recommendation 4: Remove the Form 1120-S filing requirement from the 1,588 accounts we identified.

Management's Response: The IRS agreed with this recommendation. IRS management is reviewing the 1,588 accounts and plans to remove the Form 1120-S filing requirement or correct the account, as applicable.

Taxpayers Did Not Always Receive Letter 3853C Notifying Them to Timely File or Update Their S Corporation Election

Our review of the tax accounts of 38,406 taxpayers that submitted a Form 1120 or 1120-S in PY 2018 that was unprocessable identified 2,290 taxpayers that did not receive Letter 3853C as required. We provided the results of our analysis to IRS management who reviewed a sample of 45 taxpayer accounts and identified five (11 percent) accounts for which Letter 3853C should have been sent but was not. They stated that tax examiners likely did not manually input the request into the IRS's computer system to send out the letter when resolving the unprocessable condition.

When taxpayers submit unprocessable Forms 1120 or 1120-S, Letter 3853C is sent notifying them to timely file or update their S Corporation Election within 30 days. Taxpayers who do not receive this letter will not know that they must respond within 60 days or their returns will be converted. In addition, these taxpayers will continue to submit unprocessable forms until they are otherwise notified that the IRS requires taxpayer action to resolve S Corporation Election issues.

The Commissioner, Wage and Investment Division, should:

Recommendation 5: Develop processes and procedures to ensure that all taxpayers that submit an unprocessable Form 1120 or 1120-S that becomes unprocessable because of an incorrect filing requirement receive Letter 3853C, as required.

Management's Response: The IRS agreed with this recommendation and has updated its guidelines, clarifying what letters are to be used.



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****

Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to assess the IRS's processes to ensure correct tax return filings and payments based on corporate elections. To accomplish our objective, we:

- Evaluated the IRS's processes and procedures for updating filing requirements based on changes to S Corporation Elections by identifying IRS processes for placing and updating filing requirements on taxpayer accounts, and determining if taxpayers had a Form 1120-S filing requirement although the S Corporation Election had been denied, reversed, or terminated and quantified the results.
- Quantified the impact of any programming changes on taxpayers when submitting returns for which the filing requirement had not been updated.
- Evaluated the IRS's processes and procedures for ensuring that correct taxes are assessed for S Corporations, C Corporations, and their shareholders when Forms 1120 or 1120-S are converted, and for ensuring that related entities are fairly and consistently taxed.
- Reviewed the IRS's procedures for converting Forms 1120 and 1120-S tax returns with incorrect filing requirements and met with IRS management to further our understanding.
- For those Forms 1120 and 1120-S tax returns that were converted in PY 2018, identified the taxpayers, obtained the originally submitted electronic returns, took a random sample¹ of paper returns, and determined whether tax was due or a loss was claimed. We used this information to quantify the amount of lost tax revenue.
- With the assistance of the Treasury Inspector General for Tax Administration's contracted statistician, developed all sampling plans and projections.
- Quantified the number of taxpayers in PY 2018 that did not respond to Letter 3853C.
- Quantified the number of taxpayers that did not receive Letter 3853C in PY 2018 as required.

Performance of This Review

This review was performed in the IRS Wage and Investment Division's Submission Processing offices in Kansas City, Missouri, and Ogden, Utah; the Small Business/Self-Employed Division's Examination office in Cincinnati, Ohio; and the Office of Chief Counsel in Washington, D.C., during the period of October 2018 through March 2020. 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.

¹ See Appendix III which provides our sampling criteria.



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****

Major contributors to the report were Russell P. Martin, Assistant Inspector General for Audit (Returns Processing and Account Services); Diana M. Tengesdal, Director; Nikole L. Smith, Audit Manager; Doug Barneck, Lead Auditor; and Ken Carlson, Senior Auditor.

Validity and Reliability of Data From Computer-Based Systems

During this review, we relied on data from the Modernized Tax Return Database (MTRDB)² to identify the original dollar amounts submitted on Forms 1120-S and 1120. We also relied on data from the IRS's BMF and Business Return Transaction File³ to identify taxpayers with Form 1120-S and 1120 filing requirements and valid S Corporation Elections to determine if the taxpayer's account reflected the correct filing requirement, and to identify taxpayers whose Forms 1120-S or 1120 were converted in PY 2018 and also had a subsequent tax assessment. Further, we relied on data from a list of those taxpayers that received Letter 3853C during PY 2018 and the Generalized Unpostable Framework⁴ file for Unpostable Code 310 with Reason Codes 3 and 4. We validated the results of the MTRDB data by matching a sample of Forms 1120-S and 1120 that were converted in PY 2018 to the Employee User Portal (EUP).⁵ We confirmed the validity of the BMF and Business Return Transaction File data by matching samples of returns to the IDRS and the EUP. We validated the Letter 3853C file by electronically testing the data for outliers and, where available, confirming notations in the IDRS that a letter was sent. We validated the Generalized Unpostable Framework file by matching a sample of tax accounts with Unpostable Code 310 and Reason Codes 3 or 4 to the IDRS and the EUP. 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: IRS policies and procedures for approving S Corporation Election requests and updating taxpayers' accounts with the correct filing requirement, and IRS policies and procedures for notifying taxpayers and, where applicable, converting Forms 1120-S and 1120 when the form filed does not match the filing requirement the IRS has on record and the taxpayers do not respond to Letter 3853C. We accomplished this by interviewing IRS management, and reviewing the Internal Revenue Manual, relevant I.R.C. sections, and Letters 3853C.

² The MTRDB is the legal repository for original e-filed returns received by the IRS through the Modernized e-File system.

³ The Business Return Transaction File contains transcribed tax return data from corporations, partnerships, trusts, exempt organizations, and other business entities. The data represent the tax return as originally processed by the IRS and reflect any math error corrections but not all adjustments.

⁴ The Generalized Unpostable Framework application consists of a group of batch programs and real-time command codes used to correct transactions that do not meet Master File posting criteria. It controls, validates, and corrects transactions through the Generalized Mainline Framework system.

⁵ The EUP allows IRS employees to access business applications and data, *e.g.*, e-Services and Modernized e-file, via an intranet portal.



Appendix II

Outcome Measures

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

Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$156 million of corporate tax on \$447 million in net reported income on 48,044 Form 1120-S tax returns that were converted to Forms 1120 in PY 2018 (see Recommendation 1).

Methodology Used to Measure the Reported Benefit:

Our review of Forms 1120-S converted to a Form 1120 in PY 2018 identified 48,044 tax returns with an Audit Code 4 and for which a Form 1120 had posted to the IRS's Business Return Transaction File. In order to calculate the net reported income and potential corporate tax, we took the following steps:

- Identified 15,234 Forms 1120-S that, based on the document locator number,¹ were paper-filed in PY 2018. We reviewed a random stratified sample² of 94 of the 15,234 paper Forms 1120-S and captured the original tax return information from the paper Form 1120-S and Schedule K, *Shareholders' Pro Rata Share Items*. We used a random stratified sample because time constraints prohibited us from reviewing all 15,234 paper Forms 1120-S received in PY 2018.
- Totaled the net income for the 94 sampled paper-filed Forms 1120-S to arrive at net income of \$1,450,082. We used this information to calculate the potential corporate tax based on the net reported ordinary and separately stated items of income and loss that *****2***** if the taxpayer had submitted a Form 1120. Tax for the 94 sampled returns totaled \$472,606.
- Sent the results of our sample to our contracted statistician to project on the reported ordinary and separately stated items of income and loss reported on Form 1120-S and our calculation of corporate tax. We estimate 15,234 Forms 1120-S with \$73,623,612³ in

¹ A unique number assigned to every tax return to assist in controlling, identifying, and locating the return.

² Our sample was selected using a 95 percent confidence interval, 5 percent error rate, and ± 5 percent precision factor.

³ When projecting the results of our statistical sample, we are 95 percent confident that the actual total amount of \$73,623,612 corporate *****2***** for paper Form 1120-S returns converted to Forms 1120 in PY 2018 is between \$29,854,619 and \$117,392,605 (where \$29,854,619 and \$117,392,605 represent the lower and upper range, respectively).



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately ***2*******

corporate *****2***** the entity level for these taxpayers on \$237,774,349⁴ of income.

- Identified 12,313 returns that had location codes of 87, 85, or 43 meaning the return was originally paper. We did not separately review returns with these location codes as we reviewed 15,234 paper Forms 1120-S.
- Matched the remaining 18,186 Forms 1120-S to the MTRDB and determined that these e-filed returns should have reported \$81,938,415 of corporate tax on reported net ordinary and separately stated income and losses of \$209,260,289 million.
- Identified 2,311 electronic Forms 1120-S that did not match to the MTRDB.
- Totaled the results from the 15,234 paper-filed returns, 18,186 e-filed returns that matched to the MTRDB, 12,313 paper-to-paper conversions, and 2,311 e-filed returns not matching to the MTRDB to arrive at 48,044 returns with potential corporate tax of \$155,562,027 million.

We estimate that 11,800 returns of the 48,044 Forms 1120-S returns reported losses. We found that 6,963 were e-filed returns and an estimated 4,837 were paper-filed returns.⁵

Management’s Response: The IRS disagreed with this outcome measure stating that it fails to account for S corporation shareholders who *****2***** when their corporation files a Form 1120-S, even when the corporation does not have a valid S Corporation Election. The potential increase in “Corporate tax” of \$156 million fails to account for the *****2***** on the associated individual income tax returns. Also, the outcome measure fails to account for the opportunity cost of diverting examination resources away from areas of more significant noncompliance and from more productive cases.

Office of Audit Comment: The outcome measure is the amount of corporate tax owed by filers that the IRS identifies as filing an incorrect return. For each of the returns we identified, the IRS converted the return from a Form 1120-S to a Form 1120 and *****2*****. The IRS’s disagreement is based on a review of 17 randomly selected cases from the 3,871 taxpayers that *****2***** Forms 1120-S that were then converted to a Form 1120. For 11 of these cases, the IRS found that shareholders *****2***** For the remaining six cases, *****2***** by the associated shareholders for at least one of the three years reviewed. Furthermore, no *****2***** these 17 cases. The true amount of increased revenue can only be ultimately determined by having a process in place to address these types of incorrect

⁴ The \$237,774,349 is based on ordinary income and losses plus separately stated items of income and loss reported on Form 1120-S, Schedule K, which would be includable in taxable income for a C Corporation. When projecting the results of our statistical sample, we are 95 percent confident that the actual total amount is between \$56,005,259 and \$419,543,439 (where \$56,005,259 and \$419,543,439 represent the lower and upper range, respectively).

⁵ We based our review on a statistically valid sample of 94 of 15,234 paper Forms 1120-S converted to Forms 1120 in PY 2018. Our sample was selected using a 95 percent confidence interval, 5 percent error rate, and ± 5 percent precision factor.



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****

Management's Response: The IRS disagreed with this outcome measure, stating that it is not useful to assess the compliance risk. IRS management believes a sample of 31 paper-filed Forms 1120 is too small to provide a precise estimate for a dollar value with a wide range of outcomes. As a result, the confidence interval around the potential corporate tax is very wide and cannot aid in compliance decision-making.

Office of Audit Comment: This information could assist the IRS in its decision-making process. The intent of the sample and estimate is to provide the IRS the potential scope of the problem. As noted in our report, our contract statistician assisted with developing our sampling plans and providing the projected total tax reported *****2***** from paper-filed Forms 1120.

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential, 1,588 taxpayer accounts with Form 1120-S filing requirements that either did not have a valid S Corporation Election or the election had been reversed or denied (see Recommendation 4).

Methodology Used to Measure the Reported Benefit:

To identify the 1,588 taxpayer accounts, we queried the IRS's BMF for all taxpayer accounts with a Form 1120-S annual filing requirement. We then queried the BMF for taxpayer accounts with any S Corporation transaction code. We filtered out accounts without an active S Corporation Election or an approved S Corporation Election that was not the last transaction on the taxpayer's account, *i.e.*, no S Corporation Election was present on the account or it had been reversed or denied. We matched our results of taxpayer accounts with the Form 1120-S filing requirements to those without an active S Corporation Election and identified 1,588 taxpayer accounts with a Form 1120-S filing requirement but for which an S Corporation Election was either not present on the account, had been reversed, or had been denied.

Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Potential, 2,290 taxpayers that did not receive Letter 3853C stating that their Form 1120-S would be converted if they did not timely file or update their S Corporation Election (see Recommendation 5).

Methodology Used to Measure the Reported Benefit

To determine if a taxpayer did not receive Letter 3853C, we queried a data extract of the Generalized Unpostable File provided by the IRS for taxpayer accounts notated with Unpostable Code 310 with Reason Code 4 in PY 2018, indicating that a Form 1120-S was sent to the Entity Unpostables team for resolution. We matched our results to the BMF to identify accounts with Transaction Code 971 and Action Code 375 in PY 2018, meaning the Entity Unpostables team notated that the taxpayer would receive Letter 3853C. We then matched these records to the list of taxpayers that received Letter 3853C in Calendar Year 2018 and identified 2,290 taxpayers whose accounts notated that they would receive Letter 3853C but were not on the Calendar Year 2018 Letter 3853C file for the same time period.



Appendix III

Random Sampling Criteria and Projection Details

In our report, we identified 48,044 Forms 1120-S return filings that were converted to a Form 1120 in PY 2018. For these 48,044 Forms 1120-S, the IRS *****2***** almost \$156 million in corporate tax associated with an estimated \$447 million in reported income. The following are additional details with respect to these figures, including random sampling criteria, point estimates, and upper/lower ranges for projections:

- Of the 48,044 returns, we estimate that 11,800 returns reported losses and were determined to have a \$0 effect on the total corporate income tax calculation.
 - The 11,800 returns include an estimate of 4,837 paper Forms 1120-S. We based our review on a statistically valid sample of 94 of 15,234 paper Forms 1120-S converted to Forms 1120 in PY 2018. Our sample was selected using a 95 percent confidence interval, 5 percent error rate, and ± 5 percent precision factor. When projecting the results of our statistical sample, we are 95 percent confident that the actual total amount is between 3,260 and 6,414 (where 3,260 and 6,414 represent the lower and upper range, respectively).
- The \$156 million includes an estimate of \$73,623,612 in corporate tax based on our review of a statistically valid sample of 94 of 15,234 paper Forms 1120-S converted to Forms 1120 in PY 2018. When projecting the results of our statistical sample, we are 95 percent confident that the actual total amount is between \$29,854,619 and \$117,392,605 (where \$29,854,619 and \$117,392,605 represent the lower and upper range, respectively).
- The \$447 million includes an estimate of \$237,774,349 in ordinary income and losses plus separately stated items of income and loss reported on paper Forms 1120-S, Schedule K, which would be includable in taxable income for a C Corporation. Separately stated items include, for example, capital gains/losses, interest income/losses, investment income/losses, rental income/losses, and other separately reportable gains and losses. Our estimate is based on our review of a statistically valid sample of 94 of 15,234 paper Forms 1120-S converted to Forms 1120 in PY 2018. When projecting the results of our statistical sample, we are 95 percent confident that the actual total amount is between \$56,005,259 and \$419,543,439 (where \$56,005,259 and \$419,543,439 represent the lower and upper range, respectively).

Our reports also identified 6,897 Forms 1120 converted to a Form 1120-S in PY 2018. For these 6,897 Forms 1120, we identified more than \$29 million in reported corporate income tax *****2***** from the Forms 1120. The following are additional details with respect to these figures, including random sampling criteria, point estimates, and upper/lower ranges for projections:

- Of the 6,897 returns, we estimate that 2,376 reported losses and were determined to have a \$0 effect on the total corporate income tax.
 - The 2,376 returns includes an estimate of 2,250 paper Forms 1120. We based our review on a statistically valid sample of 31 of 3,699 paper Forms 1120 converted to



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****

Forms 1120-S in PY 2018. Our sample was selected using a 95 percent confidence interval, 5 percent error rate, and ± 5 percent precision factor. When projecting the results of our statistical sample, we are 95 percent confident that the actual total amount is between 1,499 and 3,001 (where 1,499 and 3,001 represent the lower and upper range, respectively).

- The \$29 million includes an estimate of \$28,245,503 in total corporate tax reported on Forms 1120 from our review of a statistically valid sample of 31 of 3,699 paper Forms 1120 converted to Forms 1120-S in PY 2018. Our sample was selected using a 95 percent confidence interval, 5 percent error rate, and ± 5 percent precision factor. When projecting the results of our statistical sample based on an Empirical Likelihood Confidence Interval, we are 95 percent confident that the actual total amount is between \$1,876,780 and \$113,942,537 (where \$1,876,780 and \$113,942,537 represent the lower and upper range, respectively).



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****

Appendix IV

Form 2553, Election by a Small Business Corporation

Form 2553 Election by a Small Business Corporation (Under section 1362 of the Internal Revenue Code) (Including a late election filed pursuant to Rev. Proc. 2013-30) OMB No. 1545-0123

Note: This election to be an S corporation can be accepted only if all the tests are met under Who May Elect in the instructions, all shareholders have signed the consent statement, an officer has signed below, and the exact name and address of the corporation (entity) and other required form information have been provided.

Part I Election Information Table with columns: Name (see instructions), A Employer identification number, Type or Print, Number, street, and room or suite no. if a P.O. box, see instructions, B Date incorporated, City or town, state or province, country, and ZIP or foreign postal code, C State of incorporation

D Check the applicable box(es) if the corporation (entity), after applying for the EIN shown in A above, changed its [] name or [] address

E Election is to be effective for tax year beginning (month, day, year) (see instructions) ▶ _____

Caution: A corporation (entity) making the election for its first tax year in existence will usually enter the beginning date of a short tax year that begins on a date other than January 1.

F Selected tax year: (1) [] Calendar year (2) [] Fiscal year ending (month and day) ▶ _____ (3) [] 52-53-week year ending with reference to the month of December (4) [] 52-53-week year ending with reference to the month of ▶ _____ If box (2) or (4) is checked, complete Part II.

G If more than 100 shareholders are listed for item J (see page 2), check this box if treating members of a family as one shareholder results in no more than 100 shareholders (see test 2 under Who May Elect in the instructions) ▶ []

H Name and title of officer or legal representative whom the IRS may call for more information Telephone number of officer or legal representative

I If this S corporation election is being filed late, I declare I had reasonable cause for not filing Form 2553 timely. If this late election is being made by an entity eligible to elect to be treated as a corporation, I declare I also had reasonable cause for not filing an entity classification election timely and the representations listed in Part IV are true. See below for my explanation of the reasons the election or elections were not made on time and a description of my diligent actions to correct the mistake upon its discovery. See instructions.

Blank lines for providing explanation of late filing.

Sign Here Under penalties of perjury, I declare that I have examined this election, including accompanying documents, and, to the best of my knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete. Signature of officer Title Date



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****

Form 2553 (Rev. 12-2017)

Page **3**

Name

Employer identification number

Part II Selection of Fiscal Tax Year (see instructions)

Note: All corporations using this part must complete item O and item P, Q, or R.

O Check the applicable box to indicate whether the corporation is:

- A new corporation **adopting** the tax year entered in item F, Part I.
- An existing corporation **retaining** the tax year entered in item F, Part I.
- An existing corporation **changing** to the tax year entered in item F, Part I.

P Complete item P if the corporation is using the automatic approval provisions of Rev. Proc. 2006-46, 2006-45 I.R.B. 859, to request (1) a natural business year (as defined in section 5.07 of Rev. Proc. 2006-46) or (2) a year that satisfies the ownership tax year test (as defined in section 5.08 of Rev. Proc. 2006-46). Check the applicable box below to indicate the representation statement the corporation is making.

- Natural Business Year** ► I represent that the corporation is adopting, retaining, or changing to a tax year that qualifies as its natural business year (as defined in section 5.07 of Rev. Proc. 2006-46) and has attached a statement showing separately for each month the gross receipts for the most recent 47 months. See instructions. I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2006-46 from obtaining automatic approval of such adoption, retention, or change in tax year.
- Ownership Tax Year** ► I represent that shareholders (as described in section 5.08 of Rev. Proc. 2006-46) holding more than half of the shares of the stock (as of the first day of the tax year to which the request relates) of the corporation have the same tax year or are concurrently changing to the tax year that the corporation adopts, retains, or changes to per item F, Part I, and that such tax year satisfies the requirement of section 4.01(3) of Rev. Proc. 2006-46. I also represent that the corporation is not precluded by section 4.02 of Rev. Proc. 2006-46 from obtaining automatic approval of such adoption, retention, or change in tax year.

Note: If you do not use item P and the corporation wants a fiscal tax year, complete either item Q or R below. Item Q is used to request a fiscal tax year based on a business purpose and to make a back-up section 444 election. Item R is used to make a regular section 444 election.

Q Business Purpose—To request a fiscal tax year based on a business purpose, check box Q1. See instructions for details including payment of a user fee. You may also check box Q2 and/or box Q3.

1. Check here ► if the fiscal year entered in item F, Part I, is requested under the prior approval provisions of Rev. Proc. 2002-39, 2002-22 I.R.B. 1046. Attach to Form 2553 a statement describing the relevant facts and circumstances and, if applicable, the gross receipts from sales and services necessary to establish a business purpose. See the instructions for details regarding the gross receipts from sales and services. If the IRS proposes to disapprove the requested fiscal year, do you want a conference with the IRS National Office?

Yes No

2. Check here ► to show that the corporation intends to make a back-up section 444 election in the event the corporation's business purpose request is not approved by the IRS. See instructions for more information.

3. Check here ► to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event (1) the corporation's business purpose request is not approved and the corporation makes a back-up section 444 election, but is ultimately not qualified to make a section 444 election, or (2) the corporation's business purpose request is not approved and the corporation did not make a back-up section 444 election.

R Section 444 Election—To make a section 444 election, check box R1. You may also check box R2.

1. Check here ► to show that the corporation will make, if qualified, a section 444 election to have the fiscal tax year shown in item F, Part I. To make the election, you must complete **Form 8716, Election To Have a Tax Year Other Than a Required Tax Year**, and either attach it to Form 2553 or file it separately.

2. Check here ► to show that the corporation agrees to adopt or change to a tax year ending December 31 if necessary for the IRS to accept this election for S corporation status in the event the corporation is ultimately not qualified to make a section 444 election.

Form **2553** (Rev. 12-2017)



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****

Form 2553 (Rev. 12-2017) Page **4**
Name Employer identification number

Part III Qualified Subchapter S Trust (QSST) Election Under Section 1361(d)(2)* **Note:** If you are making more than one QSST election, use additional copies of page 4.

Income beneficiary's name and address Social security number

Trust's name and address Employer identification number

Date on which stock of the corporation was transferred to the trust (month, day, year) ▶

In order for the trust named above to be a QSST and thus a qualifying shareholder of the S corporation for which this Form 2553 is filed, I hereby make the election under section 1361(d)(2). Under penalties of perjury, I certify that the trust meets the definitional requirements of section 1361(d)(3) and that all other information provided in Part III is true, correct, and complete.

Signature of income beneficiary or signature and title of legal representative or other qualified person making the election Date

*Use Part III to make the QSST election only if stock of the corporation has been transferred to the trust on or before the date on which the corporation makes its election to be an S corporation. The QSST election must be made and filed separately if stock of the corporation is transferred to the trust **after** the date on which the corporation makes the S election.

Part IV Late Corporate Classification Election Representations (see instructions)

If a late entity classification election was intended to be effective on the same date that the S corporation election was intended to be effective, relief for a late S corporation election must also include the following representations.

- 1 The requesting entity is an eligible entity as defined in Regulations section 301.7701-3(a);
- 2 The requesting entity intended to be classified as a corporation as of the effective date of the S corporation status;
- 3 The requesting entity fails to qualify as a corporation solely because Form 8832, Entity Classification Election, was not timely filed under Regulations section 301.7701-3(c)(1)(i), or Form 8832 was not deemed to have been filed under Regulations section 301.7701-3(c)(1)(v)(C);
- 4 The requesting entity fails to qualify as an S corporation on the effective date of the S corporation status solely because the S corporation election was not timely filed pursuant to section 1362(b); **and**
- 5a The requesting entity timely filed all required federal tax returns and information returns consistent with its requested classification as an S corporation for all of the years the entity intended to be an S corporation and no inconsistent tax or information returns have been filed by or with respect to the entity during any of the tax years, **or**
- b The requesting entity has not filed a federal tax or information return for the first year in which the election was intended to be effective because the due date has not passed for that year's federal tax or information return.



**Processes Do Not Ensure That Taxpayers Filing an Incorrect
Form 1120 Series Tax Return Are Appropriately *****2*******

Appendix V

Management's Response to the Draft Report

**DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224**

**COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION**

July 23, 2020

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Eric C. Hylton /s/ Eric C. Hylton
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Report – Processes Do Not Ensure Taxpayers Filing an
Incorrect Form 1120 Series Tax Return Are Appropriately
*****2***** (Audit # 201940016)

Thank you for the opportunity to review and comment on the above subject draft audit report. As you noted, we have taken actions in response to your prior report to address concerns around corporate tax returns (Forms 1120 and 1120-S) that are not filed consistently with the S corporation election status on file with the IRS. We have developed processes and procedures to ensure clear and consistent guidelines for handling unprocessable Forms 1120-S. In addition, Internal Revenue Code § 1362(f) allows the IRS to provide administrative relief to taxpayers who do not have a valid S election, and we have issued revenue procedures that provide relief to taxpayers seeking to make a late S election. This relief is very broad and favorable to taxpayers.

We are pleased to note your estimates confirm over 99% of S corporation filers are filing consistent with their S-election status. Unfortunately, TIGTA's analysis of the remaining returns filed is incomplete and unsound and does not allow a conclusion of the risk to be drawn. Of the less-than-one percent of filers who TIGTA identified as filing inconsistently with their S-election status, many reported losses, and we cannot issue notices of deficiency in those situations. Specifically, TIGTA estimates 25% of the S corporation filings and 35% of the C corporation filings they identified reported a loss.

Moreover, where the taxpayer did not report a loss, in many instances, its shareholders *****2***** on their individual tax returns. Our review of a random sampling of unpostable Forms 1120-S found that in 65% of cases the shareholder *****2***** from the Form 1120-S. If we examine a corporation that is converted from a Form 1120-S to a Form 1120 and propose an assessment, we must abate the tax on the individual shareholders' Forms 1040. Generally, then, examination of these types of unpostable Forms 1120-S do not result in any net tax collected. It follows that undertaking actions to address all of the returns identified by TIGTA, as TIGTA recommends, may burden taxpayers by merely



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately ***2*******

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*****2***** and would not be a prudent use of limited IRS compliance resources.

Because it fails to account for those instances where there is no net tax, TIGTA's estimate of a potential increase in "Corporate tax" of \$156 million in TY 2018 is significantly overstated. Moreover, TIGTA's methodology and small sample size resulted in a range of over \$300 million for possible corporate income, so it is difficult to determine the actual scope of the compliance risk.

The IRS can, and does, examine S election noncompliance when appropriate and in the government's interest. During the years covered by the TIGTA audit, the IRS assessed \$2,521,239 in tax related to S corporations without a valid election during the course of examinations.

Lastly, many taxpayers who fall within the scope of this TIGTA audit would qualify for late election relief under Rev. Proc. 2013-30 if they timely responded to the Letter 3853C (*Unpostable 310, Forms 1120/1120-S Filing Requirement Mismatch*). As noted in the report, the IRS issued 81,418 letters in calendar year 2018. This indicates the compliance risk associated with invalid S elections may be de minimis.

Attached is a detailed response to address your recommendations. If you have any questions, please contact me or Scott Irick, Director, Examination Operations, Small Business/Self-Employed Division.

Attachment



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****

Attachment

RECOMMENDATION 1:

The Commissioner, Small Business/Self-Employed Division, should review the 48,044 incorrectly filed Forms 1120-S and the 6,897 Forms 1120 returns we identified and refer those with potential tax adjustments to the Examination function to be addressed using its deficiency procedures.

PLANNED CORRECTIVE ACTION:

Based on the reasons cited in the narrative of our letter, the methodology used to identify these returns is flawed, which leads us to conclude the results are an inaccurate representation of true compliance risk. Due to our limited resources and the need to focus those resources on the most productive work, we will not take any additional actions on these returns.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL:

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 2: The Commissioner, Small Business/Self-Employed Division, should develop processes and procedures to refer incorrectly filed Forms 1120-S or 1120 tax returns with tax implications and where the taxpayer does not timely respond to the Examination function to be addressed using its deficiency procedures.

PLANNED CORRECTIVE ACTION:

The IRS already has processes and procedures in place to identify and address an incorrect filing related to a corporation's S-election via the "audit code 4" indicator. These returns are currently available for examination and, if selected, could be subject to deficiency procedures. IRS records demonstrate that assessments for this issue have been made as part of examinations during the period TIGTA reviewed. During the years covered by the TIGTA audit, the IRS assessed \$2,521,239 in tax related to S corporations without a valid election during the course of examinations.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL:

N/A



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****

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CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 3:

In coordination with the Department of Treasury's Office of Tax Policy, develop a legislative change request to grant the IRS the ability *****2***** taxpayers who do not respond to the IRS's correspondence regarding incorrect Forms 1120 or 1120-S.

PLANNED CORRECTIVE ACTION:

The IRS does not formally propose legislation. We will share TIGTA's report and this specific recommendation with the Department of Treasury's Office of Tax Policy and state our willingness to support Treasury if it determines to proceed with a legislative proposal.

IMPLEMENTATION DATE:

January 15, 2021

RESPONSIBLE OFFICIAL:

Director, Exam Quality and Technical Support, 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 remove the Form 1120-S filing requirement from the 1,588 accounts we identified.

PLANNED CORRECTIVE ACTION:

The 1,588 accounts are being reviewed and the Form 1120-S filing requirements will be removed, or the account will be corrected, as applicable.

IMPLEMENTATION DATE:

December 15, 2020

RESPONSIBLE OFFICIAL:

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



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately ***2*******

CORRECTIVE ACTION MONITORING PLAN:

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

RECOMMENDATION 5:

The Commissioner, Wage and Investment Division, should develop processes and procedures to ensure that all taxpayers that submit an unprocessable Form 1120 or 1120-S that become unpostable because of an incorrect filing requirement receive Letter 3853C, as required.

PLANNED CORRECTIVE ACTION:

Internal Revenue Manual (IRM) 3.13.222, *BMF Entity Unpostable Correction Procedures*, was updated on May 6, 2020, clarifying what letters are to be used. IRM 3.13.222 was updated with IRM Procedural Update 20U0586.

IMPLEMENTATION DATE:

Implemented

RESPONSIBLE OFFICIAL:

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

CORRECTIVE ACTION MONITORING PLAN:

N/A

OUTCOME MEASURE 1:

Increased Revenue – Potential; \$156 million of corporate tax on \$447 million in net reported income on 48,044 Form 1120-S tax returns that were converted to Forms 1120 in Processing Year (PY) 2018.

IRS RESPONSE:

TIGTA's analysis significantly overstates the measurable benefits on tax administration, because it fails to account for S corporation shareholders who *****2***** when their corporation files a Form 1120-S even when the corporation does not have a valid S election. The potential increase in "Corporate tax" of \$156 million fails to account for the necessary *****2***** on the associated individual income tax returns. Our review of a random sampling of unpostable Forms 1120-S found that in 65% of cases the shareholder *****2***** from the Form 1120-S. As a result, the net potential increase of revenue would be significantly smaller than \$156 million. TIGTA's methodology and small sample size resulted in a range of over \$300



Processes Do Not Ensure That Taxpayers Filing an Incorrect Form 1120 Series Tax Return Are Appropriately *****2*****

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million for possible corporate income, so it is difficult to determine the actual scope of the compliance risk. Also, the outcome measure fails to account for the opportunity cost of diverting examination resources away from areas of more significant non-compliance and from more productive cases.

OUTCOME MEASURE 2:

Increased Revenue – Potential; \$29 million of corporate tax *****2***** from 6,897 Forms 1120 converted to a Form 1120-S in PY 2018.

IRS RESPONSE:

This outcome measure is not useful to assess the compliance risk. A sample of 31 paper-filed Forms 1120 is too small to provide a precise estimate for a dollar value with a wide range of outcomes. As a result, the confidence interval around the potential corporate tax is very wide and cannot aid in compliance decision making.

OUTCOME MEASURE 3:

Taxpayer Burden – Potential, 1,588 taxpayer accounts with Form 1120-S filing requirements that either did not have a valid S Corporation Election or the election had been reversed or denied.

IRS RESPONSE:

We agree with this outcome measure.

OUTCOME MEASURE 4:

Taxpayer Rights and Entitlements – Potential, 2,290 taxpayers that did not receive Letter 3853C stating that their Form 1120-S would be converted if they did not timely file or update their S Corporation Election.

IRS RESPONSE:

We agree with this outcome measure.



**Processes Do Not Ensure That Taxpayers Filing an Incorrect
Form 1120 Series Tax Return Are Appropriately *****2*******

Appendix VI

Abbreviations

BMF	Business Master File
e-file(d)	Electronically filed
EUP	Employee User Portal
IDRS	Integrated Data Retrieval System
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
MTRDB	Modernized Tax Return Database
PY	Processing Year