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United States Senate

COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP

WASHINGTON, DC 20510-6350

October 15, 2002

BY FACSIMILE
ORIGINAL BY U.S. MAIL

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Mr. Joseph Kehoe
Commissioner
Small Business/Self-Employed Division
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Dear Commissioners Rossotti and Kehoe:

The Treasury Inspector General for Tax Administration (TIGTA) recently completed a review of the Internal Revenue Service's (IRS) filing requirements and processing procedures for small business corporate returns (Form 1120S). As the Ranking Member of the Senate Committee on Small Business and Entrepreneurship, I am very concerned by TIGTA's findings that inefficiencies in the IRS' systems are hindering many small corporations from utilizing Subchapter S of the Internal Revenue Code.

As noted in TIGTA's audit report, "The Internal Revenue Service Needs to Simplify Filing Requirements and Clarify Processing Procedures for Small Business Corporate Returns," (Reference Number 2002-30-186), small corporations qualifying under Subchapter S of the Internal Revenue Code (S corporations) represent more than one-half of all corporate entities in this country. The tax benefits of qualifying as an S corporation are enormous -- the corporate level of taxation is eliminated and the profits or losses of the corporation are passed through to the shareholders in whose hands that income is taxed (or the loss is deducted) at the individual income tax rates. As a result, S corporations have additional capital to reinvest in their businesses, which is critically important today to small firms struggling to survive the current economic conditions.

The TIGTA report indicates that many small corporations are unable to access these benefits because of the IRS' burdensome application process and resulting inconsistent treatment of returns filed by such corporations. According to the report, over the 3-year period reviewed,

“the IRS had a recurring problem with thousands of first-time filers who filed Forms 1120S, while the IRS did not have valid elections on file to allow their returns to be processed.” Apparently this situation resulted in part because the IRS failed to notify taxpayers that their S-corporation election had been denied and also because the IRS’ recordkeeping system is inadequate to verify when the agency has granted an election. Both of these issues deserve prompt attention.

As a result of this inability to verify S-corporation elections, TIGTA estimates that each year more than 46,000 S corporations are unsuccessful in filing their corporate tax return (Form 1120S). TIGTA also estimates that taxpayers spend 3.2 million hours each year to prepare, copy, assemble, and send these unprocessed returns – at a modest \$50 per hour, that amounts to \$160 million in lost revenues to these small firms. And the wasted resources do not stop there. The IRS is estimated to spend \$264,000 just to handle these unprocessable forms, excluding the costs of attempts to resolve each of the 46,000 cases.

When faced with an unprocessable return, the IRS converts it into a regular corporate return (Form 1120), triggering corporate-level taxation of the small corporation. Unfortunately, TIGTA found that even when the taxpayer verified that it had received an S-corporation election (which the IRS should be able to verify on its own since the agency granted it), many of the returns were not switched back to an S-corporation return (Form 1120S). Based on its sample, TIGTA estimates that “each year, there is a potential for taxes on profits of \$41.0 million to be erroneously assessed to taxpayers who actually have valid elections on file. There is also the potential for losses of \$100.3 million to be erroneously reflected on Forms 1120 and for shareholders to not be allowed to claim these losses.”

In addition, in those cases in which an S-corporation election could not be verified, TIGTA found that many small corporations never received a notice of deficiency as required by law. Accordingly, TIGTA concludes that “[t]he inconsistent handling of the profits and losses from Forms 1120S leads to violations of taxpayer rights, creates the potential for lost revenue, hampers the IRS’ compliance efforts and creates unnecessary taxpayer burden”

The TIGTA report sets out a number of recommendations for correcting the election-processing and return-filing problems facing S corporations and the IRS. I urge you and your staff to give these recommendations serious consideration.

In particular, I concur with TIGTA’s recommendation that steps should be taken as quickly as possible to ensure that small corporations filing S-corporation elections are notified promptly that their application has been approved or denied. It is simply unacceptable that TIGTA could not find any evidence in calendar years 1998 through 2000 that 295,300 taxpayers received notification that their S-corporation election was either accepted or denied.

In addition, the IRS must improve its internal processes for verifying that such elections have been granted as annual tax returns (Form 1120S) are filed. The absence of such information

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opens the door for small corporations to file incorrect returns and the agency to process them incorrectly, all of which can snowball out of control if allowed to continue.

Given the serious consequences of these problems for small corporations, please advise me of the steps you will take to address the issues raised in the TIGTA report as well as the recommendations offered. I would appreciate receiving your response by October 31, 2002.

Thank you for addressing this important matter. If you have any questions or would like to discuss this matter in greater detail, please do not hesitate to contact me or have your staff contact Mark Warren, my Tax Counsel on the Committee, at 202/224-4086.

Sincerely,

A handwritten signature in black ink, appearing to read "Chris Bond", written in a cursive style.

Christopher S. Bond
Ranking Member