Significant Actions Were Taken to Address Small Corporations Erroneously Paying the Alternative Minimum Tax, but Additional Actions Are Still Needed

May 2003

Reference Number: 2003-30-114

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INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 16, 2003

MEMORANDUM FOR ACTING COMMISSIONER, SMALL BUSINESS/
SELF-EMPLOYED DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Significant Actions Were Taken to Address Small Corporations Erroneously Paying the Alternative Minimum Tax, but Additional Actions Are Still Needed
(Audit # 200230042)

This report presents the results of our review to address the Internal Revenue Service's (IRS) corrective actions to: (1) better educate and inform taxpayers of provisions regarding the alternative minimum tax (AMT) exemption for qualifying small businesses and (2) identify and contact taxpayers who may have erroneously paid the AMT. This audit is a follow-up review to our letter report, *More Small Corporate Taxpayers Can Benefit from the Alternative Minimum Tax Exemption Provision.*[1] In that review, we found that small corporations appearing to qualify for an exemption from the AMT may have paid this tax erroneously.

The Congress enacted the corporate AMT to prevent companies from combining so many exclusions, deductions, and credits that they could avoid the corporate income tax altogether. Generally, corporations are required to go through AMT calculations each year to determine whether they owe taxes through the standard corporate income tax or the AMT.

The Taxpayer Relief Act of 1997[2] repealed the corporate AMT for small corporations meeting certain gross receipts tests. These small corporations are generally not liable

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[1] Reference Number 2001-30-019, dated November 2000.
[2] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).

for the AMT as long as they continue to meet these tests.[3] In our previous report, we discussed how some corporate taxpayers who appeared to meet the requirements for exemption from paying the corporate AMT might have paid this tax erroneously. The IRS agreed to take actions to address this issue.

In summary, we found that in many respects, the IRS took steps beyond those it normally takes to inform taxpayers of a tax law change. The IRS developed a notice that very clearly explained the exemption from the AMT and how the taxpayers may have erroneously paid the AMT, and sent close to 9,500 of these notices to taxpayers. A centralized processing unit was established to process amended tax returns received as a result of these notices. As of December 2002, IRS records indicated that small corporations had filed amended returns to claim refunds totaling over $12 million for overpaid AMT.[4] The IRS also updated applicable tax forms and publications to reflect the exemption from the AMT and implemented computer programming to automatically identify and send notices to small corporations that may pay the AMT erroneously in future years.

However, the IRS did not take all steps it had committed to taking. Specifically, the IRS did not fully complete two actions necessary to successfully address the issue of small corporations erroneously paying the AMT. Over 3,600 taxpayers who may have erroneously paid the AMT did not receive notices. These taxpayers paid over $37 million in AMT. Also, although the IRS formulated a communication strategy to educate taxpayers and tax practitioners about the exemption from the AMT for small corporations, it did not implement several of the actions in that strategy.

We recommended that the IRS identify and contact those taxpayers who may have overpaid the AMT but not received the prior notice. We also recommended that the IRS revise its communications strategy and ensure that relevant and appropriate educational information is provided for taxpayers and practitioners to help prevent the erroneous payment of the AMT in the future.

Management's Response: IRS management agreed with the recommendations presented in this report. The IRS will mail notices to all taxpayers that did not receive a prior notice but may have erroneously paid the AMT. In addition, IRS management stated that they have revised the communication plan to educate practitioners on the AMT exemption for small corporations; they also agreed to post AMT exemption information on the IRS web site. Management's complete response to the draft report is included as Appendix IV.

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[3] A corporation initially qualifies as a small corporation if it had average gross receipts of $5 million or less for the 3 tax years that ended with its first tax year beginning after December 31, 1993. A corporation can lose its status as a small corporation because it is aggregated with one or more corporations under Internal Revenue Code (I.R.C.) § 448(c)(2) or is treated as having a predecessor corporation under I.R.C. § 448(c)(3)(D). Once a corporation is recognized as a small corporation, it will continue to be exempt from the AMT as long as its average gross receipts for the prior 3-year period do not exceed $7.5 million.

[4] The IRS' records reflect only those amended returns processed in the centralized processing unit. However, our computer analyses indicated that amended returns for refunds of overpaid AMT were processed by employees outside of the centralized processing unit but did not show up in the IRS' statistics.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Richard Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (631) 654-6028.

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Background

The Congress enacted the corporate alternative minimum tax (AMT) to prevent companies from combining so many exclusions, deductions, and credits that they could avoid the corporate income tax altogether. The corporate AMT *operates as a parallel or alternative tax structure to the* corporate income tax. Generally, corporations are required to go through the AMT calculations each year to determine whether they owe taxes through the standard corporate income tax or the AMT.

The Taxpayer Relief Act of 1997[1] repealed the corporate AMT for small corporations meeting certain gross receipts tests. These small corporations are generally not liable for the AMT as long as they continue to meet these tests.[2]

In a previous report,[3] we discussed how some corporate taxpayers who appeared to meet the requirements for exemption from paying the corporate AMT may have erroneously paid this tax. In that report, we recommended that the IRS enhance its efforts to educate taxpayers and tax professionals about the exemption from the AMT for small corporations. As a result of that report, Senator Christopher Bond issued a letter to the IRS expressing concern that taxpayers who overpaid the AMT would receive refunds only if they realized their own mistakes, and expressing the opinion that, unless the taxpayers' errors were brought to their attention, they were likely to repeat the same mistakes in the future. Senator Bond requested the IRS provide him

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[1] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 5 U.S.C., 19 U.S.C., 26 U.S.C., 29 U.S.C., 31 U.S.C., 42 U.S.C., and 46 U.S.C. app.).

[2] A corporation initially qualifies as a small corporation if it had average gross receipts of $5 million or less for the 3 tax years that ended with its first tax year beginning after December 31, 1993. A corporation can lose its status as a small corporation because it is aggregated with one or more corporations under Internal Revenue Code (I.R.C.) § 448(c)(2) or is treated as having a predecessor corporation under I.R.C. § 448(c)(3)(D). Once a corporation is recognized as a small corporation, it will continue to be exempt from the AMT as long as its average gross receipts for the prior 3-year period do not exceed $7.5 million.

[3] Letter Report: *More Small Corporate Taxpayers Can Benefit from the Alternative Minimum Tax Exemption Provision* (Reference Number 2001-30-019, dated November 2000).

with details of the corrective actions it was taking to address the recommendations in the Treasury Inspector General for Tax Administration report. He also requested the IRS give prompt attention to steps that could be taken to assist small corporations that have overpaid their taxes and to help all small corporate taxpayers avoid such overpayments as a result of the AMT in the future.

This audit of the IRS' corrective actions was conducted in accordance with *Government Auditing Standards* from July 2002 to January 2003 at the IRS' Ogden Campus[4] and the National Headquarters of the IRS' Small Business/ Self-Employed (SB/SE) Division. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The Internal Revenue Service Implemented, at Least in Part, Many of the Corrective Actions to Which It Committed

In response to our prior report and to Senator Bond's letter, the IRS agreed to take steps to issue refunds to businesses erroneously paying the AMT and to prevent such errors from occurring in the future. To accomplish this, the IRS committed to:

- Identify all small corporations that may have already erroneously paid the AMT and those making this error in subsequent years.
- Contact these taxpayers to explain the problem and ask them to follow up with the IRS to see if they have overpaid.
- Create a centralized processing unit to handle taxpayer inquiries related to the AMT.
- Issue an alert to all of its customer service representatives in its telephone operation, highlighting the AMT issue and providing instruction to direct telephone calls regarding this issue to representatives with AMT expertise.

[4] The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

- Alert tax practitioners about what they need to do on their clients' behalf with regard to this issue.

The IRS completed most of these actions. The SB/SE Division developed a notice that very clearly explained the exemption from the AMT and how the taxpayers may have paid the AMT erroneously. The notice also explained the process for filing amended returns for the tax periods in question and any subsequent years for which the taxpayers had made the same error. Close to 9,500 of these notices were sent to 8,849 taxpayers.[5] A centralized processing unit was established in the IRS' Ogden Campus to process amended tax returns received as a result of the notices. As of December 2002, IRS records indicated that 1,540 of these taxpayers had filed amended returns to claim refunds totaling over $12 million for erroneously paid AMT.[6]

The SB/SE Division also established a centralized unit in the Philadelphia Campus to receive telephone calls related to the AMT issue. The telephone assistors were given detailed instructions to help taxpayers determine whether they qualified for the exemption from the AMT.

The IRS also updated applicable tax forms and publications to reflect the exemption from the AMT, and instituted computer programming to automatically identify and send notices to small corporations that may pay the AMT erroneously in future years.

Two Actions Key to Addressing the Erroneously Paid Alternative Minimum Tax Issue Were Not Completely Implemented

The General Accounting Office's *Standards for Internal Control in the Federal Government* recommend that managers take prompt action to correct problems identified by auditors. Specifically, Federal Government managers are to: (1) evaluate findings and recommendations reported by auditors, (2) determine the actions to take in response to the findings and recommendations, and (3) complete actions

[5] Some taxpayers received more than one notice because they had potential errors on more than one tax return.

[6] The IRS' records reflect only those amended returns processed in the centralized processing unit at the Ogden Campus. However, our computer analyses indicated that as many as 1,185 more taxpayers may have filed amended returns for refunds of erroneously paid AMT, which were processed by employees outside of the centralized processing unit.

that correct the problems brought to their attention. Although the IRS did take steps which are beyond those it normally takes to inform taxpayers of a tax law change, it did not completely implement two actions necessary to successfully address the issue of small corporations erroneously paying the AMT.

Not all small businesses that may have erroneously paid the AMT were contacted by the IRS

In response to our report and to Senator Bond's letter, the IRS committed to identify and contact the complete universe of small corporations that may have erroneously overpaid the AMT. The IRS stated it would include all filers for 1998 and subsequent tax years. To accomplish this, the IRS needed to complete both of the following actions:

- Make programming changes to enable IRS computers to identify and send notices to taxpayers who may have erroneously paid the AMT when they file their tax returns.
- Use computer programs to identify taxpayers whose tax returns had already posted to the IRS' Business Master File,[7] with potentially erroneous AMT, before the on-line programming took effect.

In January 2003, the IRS began identifying and sending notices to taxpayers who may have erroneously paid the AMT, as their tax returns were processed. However, it did not identify all taxpayers whose returns had already posted to the Business Master File before this programming took effect.

IRS management committed to identify the complete universe of potentially affected taxpayers but did not ensure that this was fully accomplished. Prior to implementation of its on-line program to identify taxpayers that may be erroneously paying the AMT, the IRS identified only those taxpayers filing returns for tax periods through

[7] The Business Master File is 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.

November 2000. Taxpayers who may have erroneously paid the AMT for tax periods after November 2000, but prior to implementation of the on-line program, were not identified. As a result, over 3,600 taxpayers who may have erroneously paid over $37 million in AMT did not receive notices. We discussed this issue with IRS officials responsible for issuing these notices, and they agreed to initiate the issuance of the remaining notices.

The IRS did not inform and educate tax practitioners on what they need to do on their clients' behalf

The IRS had agreed to help taxpayers by alerting tax practitioners and informing and educating them on the AMT for small corporations. To accomplish this, the IRS developed a communication strategy intended to inform and educate tax practitioners by placing messages and information on the SB/SE Division page of the IRS web site, in practitioner news articles, in small business workshops, in a web broadcast on *taxtalktoday*, and in a news release to the tax trade. The IRS provided evidence that draft articles, releases, messages, etc., were prepared but could provide no documentation that many of the specific actions mentioned in the communication strategy were implemented. In fact, we found evidence that some of the actions for which the IRS provided us drafts had actually been cancelled.

The IRS gave several reasons why the communications strategy was not completed as designed. It determined a news release and the *taxtalktoday* broadcast were not the most appropriate and effective methods to inform taxpayers and practitioners of the AMT exemption for qualifying small corporations. Technology changes and conversions occurred which caused information on the IRS web page to appear for only a very short time. After the conversion, the information was never placed back on the SB/SE Division web page.

The IRS mission of helping taxpayers understand and meet their tax responsibilities includes preventing errors by educating taxpayers and telling them about recurring problems. Without appropriate education material on the AMT, taxpayers will continue to pay this tax erroneously.

Recommendations

The Director, Taxpayer Education and Communication, along with the Directors, Customer Account Services and Compliance, SB/SE Division, should:

1. Identify and contact those taxpayers who may have erroneously paid the AMT but did not receive a notice during prior mailouts.

Management's Response: The SB/SE Division's Customer Account Services, Accounts Management, will send notices to all remaining taxpayers who did not receive any prior notices.

2. Revise the communications strategy developed in response to our prior audit report and issue relevant and appropriate information to help taxpayers and practitioners understand the exemption from the AMT and to help prevent the erroneous payment of the AMT in the future.

Management's Response: The communication plan to educate practitioners on the AMT exemption for small corporations was revised, and the AMT exemption information will be posted to the IRS web site to allow affected small business taxpayers and practitioners sufficient time to review the information.

Appendix I

Detailed Objective, Scope, and Methodology

The objective of this review was to determine if the Internal Revenue Service (IRS) implemented corrective actions, based on recommendations made in our previous report,[1] to better educate and inform taxpayers of provisions regarding the alternative minimum tax (AMT) exemption for qualifying small businesses and identify and contact taxpayers who may have erroneously paid the AMT. To accomplish our objective, we:

I. Determined if the IRS properly implemented corrective actions to better educate and inform taxpayers of the Internal Revenue Code provisions regarding the AMT exemption for qualifying small businesses.

   A. Reviewed the IRS' response and the Treasury's Inventory Tracking and Closure System (ITCS)[2] to identify the corrective actions and planned implementation dates for the recommendations made in the prior report related to education of taxpayers.

   B. Reviewed instructions and other supporting documentation given to IRS employees to determine if planned corrective actions were implemented.

   C. Reviewed taxpayer educational materials and other supporting documentation to determine if planned corrective actions were implemented.

II. Determined if the IRS properly implemented corrective actions to identify and contact taxpayers who may have erroneously paid the AMT.

   A. Reviewed the IRS' response and the ITCS to determine the corrective actions and planned implementation dates for the recommendations made in the prior report related to the identification of and contact with taxpayers.

   B. Reviewed supporting documentation to determine if planned corrective actions were implemented. Used a computer program to identify 4,429 corporate returns for all tax years ending December 31, 2000, and thereafter filed through the 45th week of Calendar Year 2002, that had claimed the AMT and had gross receipts that qualified for treatment as small corporations. Identified and eliminated the number of taxpayers the IRS had previously contacted by notice as potentially qualifying for the exemption from the AMT.

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[1] Letter Report: *More Small Corporate Taxpayers Can Benefit from the Alternative Minimum Tax Exemption Provision* (Reference Number 2001-30-019, dated November 2000).

[2] Once an audit has been completed, the Treasury Inspector General for Tax Administration issues a report of its findings and recommendations. These findings and recommendations, and the related IRS corrective actions, were controlled through the IRS' Office of Management Controls on the ITCS. That system has now been replaced by the Joint Audit Management Enterprise System.

C. Performed interviews and a walk-through of the centralized processing unit for AMT recovery at the IRS' Ogden Campus[3] to determine what procedures and controls were implemented to provide AMT exemptions for qualifying small businesses.

D. Reviewed a judgmental sample[4] of 40 returns, from a total of 2,725 identified accounts from the IRS' Business Master File,[5] with an abatement of prior tax assessment matched to accounts the IRS had identified as potentially qualifying for the corporation exemption from the AMT and had contacted by notice.

   1. Selected 30 cases at random from a report prepared by the IRS listing abatements of the AMT.

   2. Performed our own computer analyses to identify taxpayers who may have filed amended returns for abatement of the AMT as a result of notices issued by the IRS. From the results of these analyses, randomly selected 10 cases that did not appear to be present on the IRS listing discussed in step II.D.1. above.

   3. Reviewed these returns to determine if the abatement was related to the AMT and whether the abatement amounts were captured on the IRS' Alternative Minimum Tax Report.

E. Determined if the IRS' corrective actions will enable future identification of taxpayer errors related to the AMT.

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[3] The campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the computing centers for analysis and posting to taxpayer accounts.

[4] We chose a judgmental sample because of the significant time and resource commitments involved in obtaining a statistically valid sample of these amended tax returns.

[5] The Business Master File is 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.

Appendix II

Major Contributors to This Report

Richard J. Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)
Kyle R. Andersen, Acting Director
Bill R. Russell, Acting Audit Manager
Kyle D. Bambrough, Senior Auditor
Greg A. Schmidt, Senior Auditor
Layne Powell, Computer Specialist

Appendix III

Report Distribution List

Commissioner N:C
Deputy Commissioner N:DC
Acting Deputy Commissioner, Small Business/Self-Employed Division S
Director, Compliance, Small Business/Self-Employed Division S:C
Director, Customer Account Services, Small Business/Self-Employed Division S:CAS
Director, Taxpayer Education and Communication, Small Business/Self-Employed Division S:T
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:AR:M
Audit Liaison: Commissioner, Small Business/Self-Employed Division S

Appendix IV

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

MAY 2 2003

RECEIVED
MAY 0 6 2003

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Dale F. Hart
Acting Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Significant Steps Were Taken To Address Small Corporations Erroneously Paying the Alternative Minimum Tax, But Additional Actions Are Still Needed (Audit # 200230042)

We agree with your findings that some small corporations are still erroneously paying the Alternative Minimum Tax (AMT).

TIGTA recommended that the IRS identify and contact those taxpayers who may have overpaid the AMT but have not received prior notice. As a result of IRS actions during 2002, 8,849 taxpayers received a special notice, which clearly explained the AMT exemption and outlined the process for filing amended returns for affected years. A centralized processing site adjusted 1,540 amended returns and issued $12 million in refunds to affected taxpayers. A centralized call unit provided detailed instructions to taxpayers and practitioners calling about the AMT exemption. We have made computer programming changes to identify and notify small corporations that erroneously pay the AMT. We have also enhanced procedures to prevent erroneous AMT refunds.

TIGTA also recommended that IRS revise its communications strategy and ensure that relevant and appropriate educational information is available for taxpayers and practitioners to help prevent erroneously paid AMT in the future. Although problems experienced in implementing the original communication plan are unlikely to recur, we have revised the attached communication plan and will closely monitor its implementation. Tax year 1999 and subsequent forms and publications correctly reflected the AMT exemption.

Our comments on your recommendations follow:

RECOMMENDATION 1

Identify and contact those taxpayers who may have erroneously paid the AMT but did not receive a notice during prior mailouts.

CORRECTIVE ACTION

SB/SE Customer Account Services, Accounts Management will perform an additional mailout to all remaining taxpayers identified by TIGTA's extract.

IMPLEMENTATION DATE

May 31, 2003

RESPONSIBLE OFFICIAL

Chief, Accounts Management Policies, Procedures, and Guidance.

CORRECTIVE ACTION MONITORING PLAN

As with prior mailouts, we will track the number and amounts of the tax decreases for Forms 1120X that taxpayers send to the centralized unit in Ogden.

RECOMMENDATION 2

Revise the communications strategy developed in response to our prior audit report. Issue relevant and appropriate information to help taxpayers and practitioners understand the exemption from the AMT and to help prevent erroneously paid AMT in the future.

CORRECTIVE ACTION

We have revised the communication plan to educate practitioners on the AMT exemption for small corporations. The AMT exemption information will be posted to the IRS website to allow affected small business taxpayers and practitioners sufficient time to review the information.

IMPLEMENTATION DATE

May 31, 2003

RESPONSIBLE OFFICIAL

Director, Taxpayer Education and Communication.

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CORRECTIVE ACTION MONITORING PLAN

The Director, Taxpayer Education and Communication, Small Business/Self-Employed Division will monitor the implementation of the communication plan.

If you have any questions please contact me at (202) 622-0600, or Bobby Hunt, Director, Office of Taxpayer Education and Communication, Small Business/Self-Employed Division at (202) 283-2627.

Attachment