TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Filing Characteristics and Examination Results for Small Business Corporate Returns

June 11, 2010

Reference Number: 2010-30-067

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HIGHLIGHTS

FILING CHARACTERISTICS AND EXAMINATION RESULTS FOR SMALL BUSINESS CORPORATE RETURNS

Highlights

Final Report Issued on June 11, 2010

Highlights of Reference Number: 2010-30-067 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

IMPACT ON TAXPAYERS

The Internal Revenue Service (IRS) examines income tax returns to determine whether corporations and other taxpayers have voluntarily complied with tax laws and reported the proper amount of tax. Despite continuing efforts to improve its examination process, Small Business/Self-Employed Division examiners closed almost 1 out of every 3 (32 percent) corporate return examinations in Fiscal Year 2009 without recommending any adjustments. Examinations that result in no change to the tax reported can result in an inefficient use of limited examination resources and place an unnecessary burden on compliant taxpayers.

WHY TIGTA DID THE AUDIT

The overall objectives of this review were to analyze IRS data for Fiscal Years 2005 through 2009 and to identify trends in the filings and audits of conventional small business corporate returns. This audit was part of our Fiscal Year 2010 Annual Audit Plan to highlight the important role a National Research Program study could have in understanding what the filings and audits of corporate returns mean for tax compliance. If approved and implemented, the National Research Program study would evaluate the extent to which corporations and their shareholders comply with the tax laws.

WHAT TIGTA FOUND

Between January 2005 and December 2009, the number of corporate returns processed annually by the IRS fell 7 percent, from almost 2.2 million to approximately 2 million. Despite the decrease in the number of filings, the amount of income taxes reported by corporate returns is significant. In Processing Year 2009, IRS records show that approximately $11 billion in corporate income taxes was reported from about 542,000 corporate returns.

One factor that may be contributing to the modest decline in corporate return filings is the popularity of organizing a business as a partnership or S corporation, which allows the partners and shareholders of these entities to avoid double taxation on business profits. According to the IRS, the number of partnership and S corporation filings is expected to increase by 49 percent and 39 percent, respectively, between 2006 and 2014.

IRS officials told us they are not permitted to set a target for the examination no-change rate. However, in 2003, the IRS reported to Congress that a high no-change rate means a significant amount of resources are being devoted to unproductive examinations, and compliant corporations are being unnecessarily burdened by examinations.

The results of the National Research Program study are expected to improve the IRS examination process by helping ensure the taxes on hundreds of billions of dollars of income earned by United States corporations are reported and paid properly. The statistical validity and comprehensiveness of the study is designed to provide the IRS with updated compliance data needed for deciding which corporate returns should be examined and how best to focus examination resources on the most significant areas of noncompliance.

WHAT TIGTA RECOMMENDED

Although TIGTA did not make any recommendations in this report, IRS officials were provided an opportunity to review the draft report. IRS management did not provide any comments on the draft report.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

June 11, 2010

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Filing Characteristics and Examination Results for Small Business Corporate Returns (Audit # 200930041)

This report presents the results of our review to analyze Internal Revenue Service (IRS) data for Fiscal Years 2005 through 2009 and to identify trends in the filings and audits of conventional[1] small business[2] corporate returns. This review was included in our Fiscal Year 2010 Annual Audit Plan to highlight the important role a National Research Program study could have in understanding what the filings and audits of corporate returns mean for tax compliance. This review addresses the major management challenge of Tax Compliance Initiatives.

Although we made no recommendations in this report, we did provide IRS officials an opportunity to review and provide comments on a draft of this report. IRS management did not provide us with any comments on the draft report.

Copies of this report are also being sent to the IRS managers affected by the report conclusions. Please contact me at (202) 622-6510 if you have questions or Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations), at (202) 622-8510.

[1] Corporations that file U.S. Corporation Income Tax Returns (Form 1120).
[2] Corporations with assets less than $10 million.

Table of Contents

Abbreviations

AIMS	Audit Information Management System
BRTF	Business Return Transaction File
DIF	Discriminant Index Function
FY	Fiscal Year
IRS	Internal Revenue Service
NRP	National Research Program
PY	Processing Year
SB/SE	Small Business/Self-Employed
U.S.	United States

Background

The corporate income tax is an important source of Federal income taxes. The common method used by United States (U.S.) corporations to report their income is the U.S. Corporation Income Tax Return (Form 1120). Due to special situations or because the Internal Revenue Service (IRS) needs specific information to administer the tax law, some corporations file unique versions of Form 1120. For example, the U.S. Income Tax Return for an S Corporation (Form 1120S)[1] is filed by qualifying small corporations that elect to be treated as flowthrough entities that pass their profits, credits, and other items through to their shareholders, who then pay the taxes on their individual returns. Another example is the Form 1120 consolidated[2] that is filed by affiliated corporations that want to combine their financial data in one return for tax purposes.

We conducted the review to highlight the important role a NRP study could have in understanding what the filings and audits of corporate returns mean for tax compliance.

This review was included in our Fiscal Year (FY) 2010 Annual Audit Plan to highlight the important role a National Research Program[3] (NRP) study could have in understanding what the filings and audits of corporate returns mean for tax compliance. If approved and implemented, the NRP study would evaluate the extent to which corporations and their shareholders comply with the tax laws. The IRS anticipates the study will involve the identification, selection, and examination of approximately 22,000 tax returns processed by the IRS for Tax Year 2009 filed by corporations with $50 million or less in total assets. Like NRP studies covering other types of tax returns, statistically valid sampling techniques will be used so the results from the examinations can reliably measure the level of compliance in the universe of corporations filing Form 1120 series tax returns reporting $50 million or less in total assets.

From a compliance perspective, this effort and other NRP studies are critically important for several reasons. One of the most important reasons is that the study results are expected to improve the IRS examination process by helping ensure the taxes on hundreds of billions of dollars of income earned by U.S. corporations are reported and paid properly. The statistical validity and comprehensiveness of the NRP study is designed to provide the IRS with updated compliance data needed for deciding which corporate returns should be examined and how best to focus examination resources on the most significant areas of noncompliance.

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[1] Eligible taxpayers must make an election to be a small corporation by filing Election by a Small Business Corporation (Form 2553).
[2] Taxpayers file Form 1120 consolidated by filing the regular Form 1120 by checking box 1a in section A.
[3] See Appendix V for a glossary of terms.

During the review, we relied on data from IRS databases. Although we did not audit the IRS databases, we did perform routine tests on the data and noted instances where data elements were duplicated from the databases. This situation occurred when a taxpayer filed multiple returns. Where information was missing or records were unable to be matched, we noted this by using the term “Unknown” in the figures presented throughout the report.

This review was performed at the IRS Small Business/Self-Employed (SB/SE) Division National Headquarters in New Carrollton, Maryland, during the period September 2009 through January 2010. Except for not auditing IRS databases to validate the accuracy and reliability of the information, we conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Results of Review

Organizing a business as a corporation has long provided a way of limiting owners' (shareholders) personal liability for business debts and court judgments because it is considered an independent entity, separate from the shareholders who own, control, and/or manage the business. As a separate entity, the corporation itself realizes a profit or loss, pays taxes to the IRS, and may distribute profits as dividends to its shareholders. Dividends that are distributed create a potential for double taxation since the dividends are taxed first as profits of the corporation and then at the shareholder level when received.

Between January 2005 and December 2009, the number of corporate returns processed annually by the IRS fell 7 percent, from almost 2.2 million to approximately 2 million. One factor that may be contributing to the modest decline in corporate return filings is the popularity of organizing a business as a partnership or S corporation, which allows these entities, as well as their partners and shareholders, to avoid double taxation on business profits. According to the IRS, the number of partnership and S corporation filings are expected to increase by 49 percent and 39 percent, respectively, between 2006 and 2014.

Corporate Return Filings Have Decreased Modestly but Remain a Substantial Source of Income Tax Revenue

While there was an overall decrease in corporate return filings between Processing Years (PY) 2005 and 2009, the decrease was not uniform across all segments of the corporate return filing population. In fact, corporations with assets of $5 million to less than $10 million filed 5 percent more returns in PY 2009 than they did in PY 2005. There was also significant growth (16 percent) from PYs 2005 to 2009 in the filings of corporate returns with no balance sheet. However, the increases in these two segments of corporate returns were not enough to offset the decrease in the filing of corporate returns in three other segments, as shown in Figure 1.

Figure 1: Corporate Return Filings for PYs 2005 and 2009, by Asset Class

	Corporate Return Filings		
Asset Class	**PY 2005**	**PY 2009**	**Percentage Change**
No Balance Sheet	385,637	448,992	16 %
Less than $250,000	1,227,169	1,026,452	-16 %
$250,000 to less than $1 million	373,487	348,261	-7 %
$1 million to less than $5 million	174,892	173,570	-1 %
$5 million to less than $10 million	28,187	29,630	5 %
Total	**2,189,372**	**2,026,905**	**-7 %**

Source: Our analysis of Business Return Transaction File (BRTF) data for PYs 2005 and 2009.

Despite the overall 7 percent decrease in filings, the amount of income taxes reported in corporate returns is significant when compared to individual income tax returns. In PY 2009, IRS records show that more than $1.1 trillion in taxes was reported from about 104 million individual income tax returns.[4] Comparatively, approximately $11 billion in corporate income taxes was reported from only about 542,000 corporate returns.[5] On a tax return basis, this equates to individuals reporting and paying an average of $10,602 in income taxes while corporations reported and paid an average of $19,813.

In PY 2009, among the top 5 industries with the highest percentage of corporate return filers were the professional services (12 percent), real estate industry (12 percent), retail trade (11 percent), construction (11 percent), and wholesale trade (7 percent). That same year, the professional services and real estate industry sectors reported holding $173 billion in assets and distributing $96 billion of income in the form of salaries and wages ($63 billion) and other compensation ($33 billion) to officers.

While seemingly a large amount, the $173 billion in assets held by corporations in the professional services and real estate industries represented only 21 percent of the total assets reported on all small corporate returns[6] processed in 2009. Moreover, total income fell 2 percent from amounts reported on corporate returns processed in PY 2005. In addition, the corporate returns processed in 2009 showed that shareholders borrowed 139 percent more from corporations than they did in 2006. The increase in borrowing and decrease in total income may be reflective of the recent economic downturn.

[4] Number of returns does not include those reporting losses or tax credits that eliminate tax liability.
[5] Number of returns does not include those reporting losses or tax credits that eliminate tax liability.
[6] Corporations with assets less than $10 million.

With businesses continuing to expand operations across international boundaries and engaging in cross-border transactions, it is not surprising that there was a 12 percent growth in the number of corporate returns with an attached Form 5471[7] and/or Form 5472[8] from PYs 2005 to 2008. In general, these forms are information documents that corporations, as well as other businesses, attach to their income tax returns to report results of foreign operations and amounts from certain transactions with foreign-related parties.

With U.S. businesses expanding to overseas markets and more foreign entities doing business in the U.S., the IRS increasingly needs and uses the information provided on these forms as a road map to assist in identifying international transactions for examination and for combating tax avoidance schemes that are developing in the international arena. The forms, among other things, disclose international inter-company transactions. This information can be used as a starting point for determining whether these related-party transactions for goods, services, and other property were fairly priced. Both the IRS and Congress are concerned with the loss of taxes due to questionable transfer pricing arrangements between related parties.

National Research Program Results Are Critical to Understanding How Well Corporations Are Complying With the Tax Laws

The IRS last collected data on how well corporations complied with the tax law in 1988 under its Taxpayer Compliance Measurement Program. As we reported in 2004,[9] these data are out of date and, accordingly, less reliable for identifying, selecting, and examining the corporate returns that pose the greatest compliance risk. As a result, the IRS increasingly selects corporate returns for audit under special projects to address specific types of noncompliance such as abusive tax schemes and transactions.

Due in part to the absence of current compliance data, IRS executives have additionally invested considerable effort in various initiatives aimed at better focusing examinations. Although we did not attempt to measure the impact of these various projects and initiatives on the examination process, IRS statistics show the number of corporate examinations are increasing and taking less time to complete while generating more recommended additional taxes. Despite these positive trends, the number of examinations closed with no adjustment remains high, but could be reduced if NRP data were available to assist in the return identification, selection, and examination processes.

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[7] Information Return of U.S. Persons With Respect To Certain Foreign Corporations.
[8] Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business.
[9] *Additional Efforts Could Further Improve the Execution of the National Research Program* (Reference Number 2004-30-044, dated January 29, 2004).

The number of corporate returns examined[10] in the SB/SE Division is not likely to decrease in the near term

The SB/SE Division closed 34 percent more corporate examinations in FY 2009 than it did in FY 2005. As Figure 2 shows, the increase occurred in every size of corporation the Division serves, and at least two factors suggest the number of small corporate returns examined will not likely decrease in the near term.

Figure 2: SB/SE Division's Examinations of Corporate Returns in FYs 2005 and 2009, by Asset Class

	Corporate Returns Examined		
Asset Class	**FY 2005**	**FY 2009**	**Percentage Change**
No Balance Sheet	1,073	1,571	46 %
Less than $250,000	4,757	5,348	12 %
$250,000 to less than $1 million	2,507	3,693	47 %
$1 million to less than $5 million	1,483	2,590	75 %
$5 million to less than $10 million	517	696	35 %
Total	**10,337**	**13,898**	**34 %**

Source: Our analysis of Audit Information Management System (AIMS) data for corporate return examinations completed in FYs 2005 and 2009.

The first factor is the IRS' strategic goal of enhancing enforcement of the tax laws, which involves maintaining examination coverage across all segments of the taxpayer population and in the areas presenting the greatest compliance risk. Despite the modest decrease expected in the number of small corporate return filings in the near term, there may not be a corresponding decrease in the number of small corporate returns examined if coverage is to be maintained over this segment of the taxpayer population.

In terms of areas presenting the greatest compliance risk, the IRS has identified abusive tax schemes as a priority area for increased examination activity. According to the *IRS Strategic Plan 2009 - 2013*,[11] the focus on abusive tax schemes and transactions will continue to be a priority and, accordingly, may contribute to increases in the number of corporate returns examined. For example, in Calendar Year 2000, the IRS published guidance on 10 transactions that could trigger an examination because they purportedly abuse the tax law, represent a significant loss of tax revenue, and undermine the public's confidence in the tax system. By

[10] All examination statistics in this report exclude training returns.
[11] Publication 3744 (4-2009).

Calendar Year 2010, there were 34 such transactions of which at least 17 (50 percent) directly involved corporations.

The second factor that will likely have an impact on the number of corporate return examinations is the hiring of new revenue agents. After receiving budget increases in FYs 2009 and 2010, the IRS is in the midst of its largest hiring initiative in recent years, resulting in the hiring of scores of new revenue agents, as well as other enforcement personnel. Once hired, in addition to receiving individual taxation training, revenue agents attend a multi-week training class devoted solely to corporate and flowthrough entity taxation and subsequently participate in approximately 3 months of on-the-job training where they examine corporate returns under the supervision of an on-the-job coach.

Corporate return examinations are taking less time, generating more recommended additional taxes, and resulting in more agreements

IRS executives continue to invest considerable effort in developing and implementing work process changes aimed at reducing the length of examinations and better focusing examinations on areas of high noncompliance. Although we did not attempt to measure the impact the efforts have had on examination results, IRS statistics show that the length of corporate return audits fell a modest 4 percent in FY 2009 when compared to FY 2005 (see Appendix IV, Figure 13). However, as shown in Figure 3, the additional taxes recommended by examiners on an hourly basis increased by 28 percent from FY 2005 to FY 2009 and increased by 59 percent on a per return basis during the same period.

Figure 3: Additional Recommended Taxes in SB/SE Division's Corporate Return Examinations on an Hourly and Return Basis in FYs 2005 and 2009, by Asset Class

	Hourly Basis			Return Basis		
Asset Class	**FY 2005**	**FY 2009**	**Percentage Change**	**FY 2005**	**FY 2009**	**Percentage Change**
No Balance Sheet	$1,189	$2,015	69 %	$37,660	$65,334	73 %
Less than $250,000	$338	$559	65 %	$7,579	$18,690	147 %
$250,000 to less than $1 million	$531	$548	3 %	$14,536	$20,377	40 %
$1 million to less than $5 million	$576	$607	5 %	$24,239	$24,580	1 %
$5 million to less than $10 million	$784	$810	3 %	$41,603	$34,246	-18 %
Overall Averages for Asset Classes	$569	$729	28 %	$16,481	$26,287	59 %

Source: Our analysis of AIMS data for corporate return examinations completed in FYs 2005 and 2009.

Besides the favorable patterns in the length of and additional taxes from corporate return examinations, more corporations are agreeing to the additional taxes recommended during examinations. This acknowledgement is important from a revenue collection perspective because, as we have previously reported,[12] the additional taxes owed from agreed examinations are more likely to be collected than those that are either assessed by default or disputed and appealed through the IRS administrative processes or the courts.

The number of corporate audits that result in no adjustment is a concern

Despite continuing efforts to improve its examination process, SB/SE Division examiners closed almost 1 out of every 3 (32 percent) corporate return examinations in FY 2009 without recommending an adjustment (no change). The no-change rate was substantially higher among the larger corporate returns examined and remained about the same as in FY 2005. As Figure 4 shows, examiners no changed 44 percent and 42 percent of their examinations in FYs 2005 and 2009, respectively, when assets of $5 million to less than $10 million were reported on a corporate return. When assets of $1 million to less than $5 million were reported, 44 percent and 36 percent of examinations resulted in no change in FYs 2005 and 2009, respectively.

Figure 4: FYs 2005 and 2009 Corporate Return No-Change Rates, by Asset Class

	Corporate Returns No-Change Rates		
Asset Class	**FY 2005**	**FY 2009**	**Percentage Change**
No Balance Sheet	25 %	19 %	-24 %
Less than $250,000	36 %	31 %	-14 %
$250,000 to less than $1 million	45 %	34 %	-24 %
$1 million to less than $5 million	44 %	36 %	-18 %
$5 million to less than $10 million	44 %	42 %	-5 %
Overall No-Change Rates for Asset Classes	39 %	32 %	-18 %

Source: Our analysis of AIMS data for corporate return examinations completed in FYs 2005 and 2009.

Although IRS officials told us they are not permitted to set a target for the no-change rate, they were not satisfied with the current results. Officials also noted that the additional recommended taxes from corporate return examinations may be higher than reflected in IRS statistics because the IRS reports examination results as no change when the adjustments do not affect the

[12] *Potential Opportunities Exist to Enhance the Favorable Productivity Trends for Audits Initiated by the Updated Return Selection Formulas* (Reference Number 2009-30-105, dated August 5, 2009).

corporate return, even though the adjustments may change a shareholder's tax return. Nevertheless, in 2003 the IRS reported to Congress that a high no-change rate means a significant amount of resources are being devoted to unproductive examinations, and compliant corporations are being unnecessarily burdened by examinations.

We do not know what the no-change rate should be in examinations of corporate returns. However, no change to almost 1 out of every 3 corporate returns examined suggests there may be improvement opportunities in deciding which returns to examine and/or in how well returns are examined once selected. If implemented, the NRP study for corporate returns that is under consideration should provide the IRS with the current compliance data needed to better identify and select problem returns for examination. Consequently, we plan to focus the next phase of our work in this area on evaluating how well returns are examined.

Besides providing updated data for deciding which corporate returns should be examined, the NRP study data are expected to be used for other important tax administration activities such as identifying areas in which filing instructions could be improved, suggesting legislative changes, and refining estimates of the tax gap. Because of its benefits, numerous stakeholders support the NRP. In addition to the Treasury Inspector General for Tax Administration, the Government Accountability Office has discussed and reiterated the need for such compliance data in several reports and Congressional testimony. The previous IRS Commissioner has indicated the NRP is critical for measuring the level and sources of noncompliance. In its FY 2005 annual report, the IRS Oversight Board also expressed support for a NRP assessment of corporate taxpayers.

Appendix I

Detailed Objectives, Scope, and Methodology

The overall objectives of this review were to analyze IRS data for FYs 2005 through 2009 and to identify trends in the filings and audits of conventional[1] small business[2] corporate returns. During the review, we relied on databases provided to us by the IRS. We did not conduct audit tests to determine the accuracy and reliability of the information in any of the databases. However, we did assess the completeness and reliability of the data as described below and concluded the data were complete, reliable, and adequate to conduct our work. To accomplish our objectives, we:

I. Reviewed the types of business entities and the reasons taxpayers chose to file using the Form 1120 series of tax returns and analyzed the SB/SE Division Strategic Assessment for FYs 2009-2010, published by the SB/SE Division Research organization.

II. Analyzed the IRS' Individual Return Transaction File[3] data for PY 2009 to determine the number of returns filed and amount of taxes reported.

III. Analyzed the IRS' BRTF data for small corporate returns for PYs 2005 through 2009 to determine the:

   A. Number of small corporate returns filed by total assets.

   B. Number of small corporate returns filed by industries.

   C. Amount of taxes reported.

   D. Amount of salaries, wages, and other compensation to officers reported in PY 2005 and PY 2009.

   E. Amount of loans to shareholders reported in PY 2006 and PY 2009.

IV. Analyzed the IRS' AIMS data for small corporate returns for FYs 2005 through 2009 to determine the:

   A. Number of small corporate returns examined.[4]

   B. Amount of additional taxes recommended for the small corporate returns examined.

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[1] Corporations that file U.S. Corporation Income Tax Returns (Form 1120).
[2] Corporations with assets less than $10 million.
[3] See Appendix V for a glossary to terms.
[4] All examination statistics in this report exclude training returns.

C. Length of examinations for the small corporate returns examined.

D. No-change rates for the small corporate returns examined.

E. No-change rates by types of examinations for the small corporate returns examined.

F. Number of training returns examined by total assets.

V. Analyzed revenue agent hiring for FYs 2005 through 2009.

VI. Analyzed revenue agent training agenda.

VII. Discussed and obtained IRS management's input on filing and examination trends.

VIII. Assessed the completeness and reliability of Individual Return Transaction File, BRTF, and AIMS data to complete the above objectives.

A. Reconciled BRTF data to IRS Data Books for PYs 2005 through 2009.

B. Reconciled BRTF data to Business Master File data.

C. Reconciled Individual Return Transaction File data to the IRS' Statistics of Income Bulletin - Winter 2010.

D. Reconciled Individual Return Transaction File data to Individual Master File data.

E. Reconciled closed AIMS data for FYs 2005 to 2009 with appropriate sections of Table 37, Examination Program Monitoring report.

F. Reconciled closed AIMS data with Business Master File data.

<u>Internal controls methodology</u>

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 did not assess internal controls because they were not significant to the review.

Appendix II

Major Contributors to This Report

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)
Frank Dunleavy, Director
Robert Jenness, Audit Manager
William Tran, Lead Auditor
Julia Tai, Senior Auditor

Appendix III

Report Distribution List

Commissioner C
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Appendix IV

Detailed Figures of Statistical Information

Figure 1 – Corporate Return Filings by Asset Class

Between January 2005 and December 2009, the number of small corporate returns[1] processed annually by the IRS fell 7 percent, from almost 2.2 million to approximately 2 million. The decrease was not uniform across all segments of the corporate return filing population. In fact, the number of larger corporations in this filing population, those with assets of $5 million to less than $10 million, filed 5 percent more returns in PY 2009 than they did in PY 2005. There was also significant growth (16 percent) from PY 2005 to PY 2009 in the filings of corporate returns with no balance sheet. However, the increases in these two segments of corporate returns were not enough to offset the decrease in the filings of the three other segments of corporate returns.

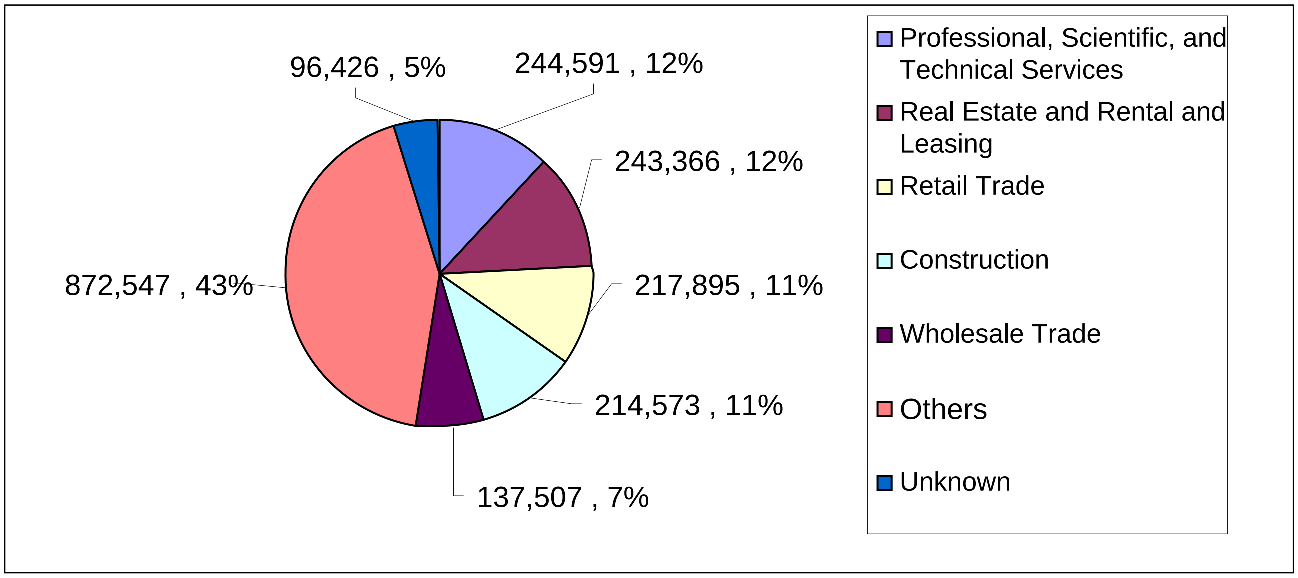
	Processing Years					Percentage Change
Asset Class	**2005**	**2006**	**2007**	**2008**	**2009**	**2005-2009**
No Balance Sheet	385,637	403,009	440,043	464,040	448,992	16 %
Less than $250,000	1,227,169	1,184,892	1,119,672	1,104,608	1,026,452	-16 %
$250,000 to less than $1 million	373,487	371,996	359,374	364,361	348,261	-7 %
$1 million to less than $5 million	174,892	179,203	177,273	181,652	173,570	-1 %
$5 million to less than $10 million	28,187	29,482	29,905	30,653	29,630	5 %
Total	**2,189,372**	**2,168,582**	**2,126,267**	**2,145,314**	**2,026,905**	**-7 %**

Source: Our analysis of BRTF[2] data for PYs 2005 – 2009.

[1] Corporations with assets less than $10 million.
[2] See Appendix V for a glossary of terms.

Figure 2 – Industry Composition of Corporate Return Filings

The top 5 industry classifications accounted for 52 percent of all small corporate filings in PY 2009. "Professional, Scientific, and Technical Services" and "Real Estate and Rental and Leasing" made up 24 percent of these corporate filings in PY 2009.[3]



Source: Our analysis of BRTF data for PY 2009.

[3] Total may not add up to 100% due to rounding.

Figure 3 – Corporate Return Filings by Industry Classification

Corporate returns processed in PYs 2005 - 2009 were concentrated in the real estate and professional, scientific, and technical services sectors. The filings for the top 5 industry categories of corporate returns decreased by 7 percent during this period.

	Processing Years					Percentage Change
Industry Classification	**2005**	**2006**	**2007**	**2008**	**2009**	**2005-2009**
Professional, Scientific, and Technical Services	259,371	255,148	251,412	253,944	244,591	-6 %
Real Estate and Rental and Leasing	248,776	255,019	255,139	258,884	243,366	-2 %
Retail Trade	243,152	240,127	230,752	231,354	217,895	-10 %
Construction	233,136	236,303	232,928	232,674	214,573	-8 %
Wholesale Trade	148,006	147,234	142,538	145,965	137,507	-7 %
Totals for Top Five Industries	**1,132,441**	**1,133,831**	**1,112,769**	**1,122,821**	**1,057,932**	**-7 %**
Health Care and Social Assistance	146,037	142,303	139,712	137,892	133,199	-9 %
Other Services (except Public Administration)	133,507	134,788	134,136	137,264	132,510	-1 %
Manufacturing	118,642	115,784	111,637	112,073	104,855	-12 %
Finance and Insurance	89,652	89,167	88,202	89,028	84,208	-6 %
Accommodation and Food Services	88,898	90,324	88,901	90,254	86,719	-2 %
Transportation and Warehousing	73,264	74,629	75,528	77,341	73,573	0 %
Agriculture, Forestry, Fishing, and Hunting	68,148	67,818	65,018	67,158	64,687	-5 %
Administrative and Support and Waste Management and Remediation Services	64,349	64,694	65,380	67,422	65,638	2 %
Information	42,711	42,457	42,407	43,466	41,505	-3 %
Arts, Entertainment, and Recreation	39,941	39,479	39,387	40,765	38,754	-3 %
Mining, Quarrying, and Oil and Gas Extraction	15,404	15,343	15,040	15,722	15,385	0 %
Management of Companies and Enterprises	14,658	14,945	14,890	15,436	15,020	2 %
Educational Services	12,014	12,040	12,092	12,595	12,307	2 %
Utilities	4,290	4,082	4,186	4,161	4,127	-4 %
Public Administration	119	90	76	92	60	-50 %
Unknown	145,297	126,808	116,906	111,824	96,426	-34 %
Totals	**2,189,372**	**2,168,582**	**2,126,267**	**2,145,314**	**2,026,905**	**-7 %**

Source: Our analysis of BRTF data for PYs 2005 – 2009.

Figure 4 – Corporate Return Examinations by Asset Class

Small corporate return examinations[4] increased 34 percent between FYs 2005 and 2009 with the largest increase, 75 percent, taking place in corporate returns with assets of $1 million to less than $5 million.

	Fiscal Years					Percentage Change
Asset Class	**2005**	**2006**	**2007**	**2008**	**2009**	**2005-2009**
No Balance Sheet	1,073	987	1,268	1,518	1,571	46 %
Less than $250,000	4,757	3,743	5,315	4,846	5,348	12 %
$250,000 to less than $1 million	2,507	2,201	3,213	3,296	3,693	47 %
$1 million to less than $5 million	1,483	1,797	2,109	2,522	2,590	75 %
$5 million to less than $10 million	517	764	725	735	696	35 %
Total	**10,337**	**9,492**	**12,630**	**12,917**	**13,898**	**34 %**

Source: Our analysis of AIMS data for corporate examinations completed in FYs 2005 – 2009.

[4] All examination results in this report exclude training returns.

Figure 5 – Top Six Industry Classifications of Corporate Return Examinations

Examinations of small corporate returns in the construction and the wholesale trade industry classifications increased 166 percent and 149 percent, respectively, between FY 2005 and FY 2009.

	Fiscal Years					Percentage Change
Industry Classification	**2005**	**2006**	**2007**	**2008**	**2009**	**2005-2009**
Professional, Scientific, and Technical Services	2,678	1,269	1,986	1,762	2,093	-22 %
Health Care and Social Assistance	2,388	1,030	1,850	1,232	1,147	-52 %
Construction	879	1,398	1,720	1,929	2,336	166 %
Retail Trade	699	940	1,273	1,236	1,333	91 %
Manufacturing	564	699	724	941	1,016	80 %
Wholesale Trade	451	683	882	1,060	1,124	149 %
Totals for Top Six Industries	**7,659**	**6,019**	**8,435**	**8,160**	**9,049**	**18 %**

Source: Our analysis of AIMS data for corporate examinations completed in FYs 2005 – 2009.

Figure 6 – Corporate Return Audit No-Change Rates by Asset Class

The overall corporate return no-change rate decreased 18 percent from 39 percent to 32 percent between FYs 2005 and 2009. The largest decreases were in returns with no balance sheet and returns with assets between $250,000 to less than $1 million, which decreased 24 percent from a 25 percent no-change rate to a 19 percent no-change rate, and a 45 percent no-change rate to a 34 percent no-change rate between FYs 2005 and 2009, respectively.

	Fiscal Years					Percentage Change
Asset Class	**2005**	**2006**	**2007**	**2008**	**2009**	**2005-2009**
No Balance Sheet	25 %	23 %	26 %	21 %	19 %	-24 %
Less than $250,000	36 %	35 %	40 %	27 %	31 %	-14 %
$250,000 to less than $1 million	45 %	39 %	37 %	30 %	34 %	-24 %
$1 million to less than $5 million	44 %	39 %	39 %	32 %	36 %	-18 %
$5 million to less than $10 million	44 %	49 %	46 %	37 %	42 %	-5 %
Overall No-Change Rates for Asset Classes	39 %	37 %	38 %	28 %	32 %	-18 %

Source: Our analysis of AIMS data for corporate return examinations completed in FYs 2005 – 2009.

Figure 7 – Discriminant Index Function (DIF) and DIF-Related Corporate Return No-Change Rates

The overall DIF and DIF-related no-change rate decreased by 5 percent in FY 2009 when compared to FY 2005. The largest decrease of 15 percent occurred in returns with assets between $1 million to less than $5 million.

	Fiscal Years					Percentage Change
Asset Class	**2005**	**2006**	**2007**	**2008**	**2009**	**2005-2009**
No Balance Sheet	26 %	37 %	36 %	23 %	27 %	4 %
Less than $250,000	35 %	40 %	36 %	29 %	40 %	14 %
$250,000 to less than $1 million	41 %	39 %	35 %	31 %	37 %	-10 %
$1 million to less than $5 million	48 %	41 %	38 %	34 %	41 %	-15 %
$5 million to less than $10 million	50 %	52 %	49 %	36 %	49 %	-2 %
Overall No-Change Rates for Asset Classes	41 %	41 %	37 %	30 %	39 %	-5 %

Source: Our analysis of AIMS data for corporate return examinations completed in FYs 2005 – 2009.

Figure 8 – Non-DIF Corporate Return No-Change Rates

The overall non-DIF corporate return no-change rate decreased by 37 percent in FY 2009 when compared to FY 2005. The largest decrease of 40 percent occurred in returns with no balance sheet.

	Fiscal Years					Percentage Change
Asset Class	**2005**	**2006**	**2007**	**2008**	**2009**	**2005-2009**
No Balance Sheet	25 %	18 %	22 %	19 %	15 %	-40 %
Less than $250,000	36 %	33 %	43 %	25 %	23 %	-36 %
$250,000 to less than $1 million	45 %	38 %	39 %	28 %	29 %	-36 %
$1 million to less than $5 million	43 %	38 %	41 %	30 %	29 %	-33 %
$5 million to less than $10 million	41 %	46 %	43 %	39 %	34 %	-17 %
Overall No-Change Rates for Asset Classes	38 %	34 %	39 %	27 %	24 %	-37 %

Source: Our analysis of AIMS data for corporate return examinations completed in FYs 2005 – 2009.

Figure 9 – Corporate Return No-Change Rate by Industry

The overall corporate return no-change rate decreased by 16 percent between FYs 2005 and 2009. The largest decrease of 37 percent occurred in Educational Services.

	Fiscal Years					Percentage Change
Industry Classification	**2005**	**2006**	**2007**	**2008**	**2009**	**2005-2009**
Professional, Scientific, and Technical Services	48 %	38 %	43 %	34%	35%	-27 %
Health Care and Social Assistance	34 %	39 %	51 %	27%	27%	-21 %
Construction	34 %	32 %	34 %	26 %	30 %	-12 %
Manufacturing	42 %	39 %	41 %	28 %	38 %	-10 %
Retail Trade	33 %	36 %	32 %	27 %	31 %	-6 %
Wholesale Trade	47 %	45 %	38 %	35 %	36 %	-23 %
Real Estate and Rental and Leasing	38 %	39 %	32 %	26 %	31 %	-18 %
Arts, Entertainment, and Recreation	53 %	40 %	41 %	28 %	36 %	-32 %
Finance and Insurance	33 %	34 %	36 %	27 %	31 %	-6 %
Administrative and Support and Waste Management and Remediation Services	41 %	36 %	32 %	29 %	33 %	-20 %
Other Services (except Public Administration)	33 %	31 %	27 %	25 %	28 %	-15 %
Transportation and Warehousing	32 %	38 %	36 %	26 %	31 %	-3 %
Agriculture, Forestry, Fishing, and Hunting	38 %	36 %	37 %	24 %	28 %	-26 %
Accommodation and Food Services	34 %	39 %	35 %	26 %	25 %	-26 %
Information	42 %	40 %	36 %	27 %	43 %	2 %
Management of Companies and Enterprises	40 %	35 %	61 %	44 %	51 %	28 %
Mining, Quarrying, and Oil and Gas Extraction	40 %	40 %	38 %	31 %	36 %	-10 %
Educational Services	41 %	27 %	49 %	21 %	26 %	-37 %
Utilities	31 %	17 %	43 %	14 %	20 %	-35 %
Overall No-Change Rates for Industry Classifications	38 %	36 %	38 %	28 %	32 %	-16 %

Source: Our analysis of AIMS data for corporate return examinations completed in FYs 2005 – 2009.

Figure 10 – Additional Recommended Taxes in Corporate Return Audits

The additional taxes recommended by examiners increased 114 percent in FY 2009 when compared to FY 2005. The largest increase of 177 percent occurred in returns with assets less than $250,000.

	Fiscal Years					Percentage Change
Asset Class	**2005**	**2006**	**2007**	**2008**	**2009**	**2005-2009**
No Balance Sheet	$40,408,903	$25,377,020	$26,773,559	$27,812,723	$102,639,335	154 %
Less than $250,000	$36,053,482	$40,712,723	$62,259,449	$76,523,042	$99,956,174	177 %
$250,000 to less than $1 million	$36,442,550	$36,726,414	$62,888,003	$69,878,140	$75,251,914	106 %
$1 million to less than $5 million	$35,947,022	$41,510,827	$64,393,321	$70,056,347	$63,660,999	77 %
$5 million to less than $10 million	$21,508,505	$13,007,802	$38,562,962	$24,195,102	$23,835,021	11 %
Total	**$170,360,462**	**$157,334,786**	**$254,877,294**	**$268,465,354**	**$365,343,443**	**114 %**

Source: Our analysis of AIMS data for corporate return examinations completed in FYs 2005 – 2009.

Figure 11 – Additional Recommended Taxes in Corporate Return Audits on an Hourly Basis

The additional taxes recommended by examiners on an hourly basis increased 28 percent in FY 2009 when compared to FY 2005. The largest increase of 69 percent occurred in returns with no balance sheet.

	Fiscal Years					Percentage Change
Asset Class	**2005**	**2006**	**2007**	**2008**	**2009**	**2005-2009**
No Balance Sheet	$1,189	$702	$623	$567	$2,015	69 %
Less than $250,000	$338	$266	$343	$443	$559	65 %
$250,000 to less than $1 million	$531	$377	$481	$525	$548	3 %
$1 million to less than $5 million	$576	$490	$670	$704	$607	5 %
$5 million to less than $10 million	$784	$337	$1,075	$753	$810	3 %
Overall Averages for Asset Classes	$569	$384	$523	$552	$729	28 %

Source: Our analysis of AIMS data for corporate return examinations completed in FYs 2005 – 2009.

Figure 12 – Additional Recommended Taxes in Corporate Return Audits by Return

The additional taxes recommended by examiners on a return basis increased 59 percent in FY 2009 when compared to FY 2005. The largest increase of 147 percent occurred in returns with assets less than $250,000.

	Fiscal Years					Percentage Change
Asset Class	**2005**	**2006**	**2007**	**2008**	**2009**	**2005-2009**
No Balance Sheet	$37,660	$25,711	$21,115	$18,322	$65,334	73 %
Less than $250,000	$7,579	$10,877	$11,714	$15,791	$18,690	147 %
$250,000 to less than $1 million	$14,536	$16,686	$19,573	$21,201	$20,377	40 %
$1 million to less than $5 million	$24,239	$23,100	$30,533	$27,778	$24,580	1 %
$5 million to less than $10 million	$41,603	$17,026	$53,190	$32,919	$34,246	-18 %
Overall Averages for Asset Classes	$16,481	$16,576	$20,180	$20,784	$26,287	59 %

Source: Our analysis of AIMS data for corporate return examinations completed in FYs 2005 – 2009.

Figure 13 – Average Length of Corporate Return Audits by Asset Class

The length of examinations as measured by average cycle time declined a modest 4 percent, from 24 months to 23 months between FYs 2005 and 2009. The largest decrease of 32 percent occurred in returns with assets of $5 million to less than $10 million.

	Fiscal Years					Percentage Change
Asset Class	**2005**	**2006**	**2007**	**2008**	**2009**	**2005-2009**
No Balance Sheet	22 mo.	23 mo.	23 mo.	23 mo.	23 mo.	5 %
Less than $250,000	23 mo.	25 mo.	26 mo.	24 mo.	24 mo.	4 %
$250,000 to less than $1 million	23 mo.	25 mo.	24 mo.	22 mo.	22 mo.	-4 %
$1 million to less than $5 million	29 mo.	26 mo.	26 mo.	20 mo.	22 mo.	-24 %
$5 million to less than $10 million	31 mo.	27 mo.	25 mo.	21 mo.	21 mo.	-32 %
Average Exam Length for Asset Classes	24 mo.	25 mo.	25 mo.	22 mo.	23 mo.	-4 %

Source: Our analysis of AIMS data for corporate return examinations completed in FYs 2005 – 2009.

Figure 14 – Training Return Examinations by Asset Class

The number of training returns increased 9 percent in FY 2009 as compared to FY 2005. The largest increase of 2,015 percent was in returns with assets of $1 million to less than $5 million.

	Fiscal Years					Percentage Change
Asset Class	**2005**	**2006**	**2007**	**2008**	**2009**	**2005-2009**
No Balance Sheet	241	568	326	221	138	-43 %
Less than $250,000	2,031	2,035	2,655	2,648	1,571	-23 %
$250,000 to less than $1 million	793	903	1,385	1,532	1,076	36 %
$1 million to less than $5 million	27	61	640	845	571	2,015 %
$5 million to less than $10 million	6	2	8	29	14	133 %
Total	**3,098**	**3,569**	**5,014**	**5,275**	**3,370**	**9 %**

Source: Our analysis of AIMS data for FYs 2005 – 2009.

Appendix V

Glossary of Terms

Audit Information Management System – A computer system used by the SB/SE Division and others to control returns, input assessments/adjustments to the Master File, and provide management reports.

Balance Sheet – An accounting tool used to show the financial condition of a business at a particular date.

Business Master File – 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.

Business Return Transaction File – A computer file of transcribed line items on all business returns and their accompanying forms and schedules.

Discriminant Index Function – Mathematical formulas used by the IRS to calculate and assign a score for all individual returns based on their examination potential.

Flowthrough Entities – Certain entities, such as partnerships and S corporations, that generally distribute their income, losses, credits, and other tax items to their owners untaxed.

Individual Master File – The IRS database that maintains transactions or records of individual tax accounts.

Individual Return Transaction File – A computer file containing data transcribed from initial input of the original individual tax returns during return processing. Subsequent or amended return data are not contained in the file.

IRS Oversight Board – A nine-member independent body charged to oversee the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws and to provide experience, independence, and stability to the IRS so it may move forward in a cogent, focused direction.

National Research Program – Research conducted by the IRS to determine filing, payment, and reporting compliance by taxpayers for different types of taxes. The IRS established the program in Calendar Year 2000 to resume measuring taxpayers' voluntary compliance.

Processing Year – The calendar year in which tax returns and other tax data are processed by the IRS.

Revenue Agents – Employees in the Examination function who conduct face-to-face examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes (e.g., excise tax returns).

S Corporation – A small business corporation with a limited number of shareholders that elects to be a flowthrough entity for income tax purposes.

Tax Gap - The difference between what taxpayers should have paid and what they actually paid timely.

Tax Year – Annual accounting period taxpayers use to keep records and report income and expenses on their tax returns.

Taxpayer Compliance Measurement Program – The IRS' method of data collection that audits every line on tax returns for a random sample of taxpayers.